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A Medium Term (5-10 Year) Vision for the Financial Stability Board

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Thank you for inviting me to speak to you today. I feel I am participating in a meeting of great importance to the future of the global financial system—to put the Financial Stability Board on an enduring organizational footing.

I am speaking in my capacity as the Co-Chairman of the Council on Global Financial Regulation. The Council was formed in 2010 with the objective of providing government officials and regulators with independent recommendations, analysis and commentary on issues relating to international financial regulatory coordination. The Council is composed of fifteen individuals, representing eleven different nationalities, who are experienced in financial regulatory matters and who have committed to act independently of any institutions with which they are or have been affiliated. None of the Council's members presently hold any position in any governmental or financial regulatory body.

As you may know, this Council a year ago this month – in April 2011 – issued a report titled "Practical Measures for Strengthening International Financial Regulatory Coordination." That Report focused in large part on the mandate, capacity and governance of the Financial Stability Board. We took that as our focus because of a belief that effective international coordination in the financial field is essential to healthy financial markets and global growth. Moreover, the Council in its Report took the view that the FSB should be a central and enduring part of the global financial institutional architecture. We offered what we believed were practical measures for strengthening the coordinating function of the FSB. Our thinking today remains in line with our April Report, but the Council has gone beyond it and in the spirit of offering constructive ideas for discussion is pleased to present today some additional thoughts with respect to development and implementation of standards. Our goal is less to be definitive, than to contribute ideas to a creative process of thinking as to the future of the Financial Stability Board.

The 2008 financial crisis made us painfully aware of the vulnerability of the global financial system. While the subprime crisis was centered in countries that experienced housing bubbles, the collapse of the bubble affected financial institutions globally that were exposed to declines in housing assets or that had financial exposures to institutions that did have housing asset exposure. While Asian and Latin American financial institutions were relatively unscathed, their economies were affected by the recessionary conditions that beset their Western trading partners. The G20 was relatively quick to realize that the financial crisis required not just a national but a coordinated

global response. This was not only because of the widespread effects of the crisis and the interdependence of global financial institutions, but also to avoid regulatory inconsistencies, protectionist responses, gaps and arbitrage. The need for a coordinated global response was important background for the conversion of the Financial Stability Forum to the Financial Stability Board (FSB) in April 2009. As 2008 and its aftermath recede from memory and economic conditions stabilize, there is an unfortunate but understandable tendency for such coordination to yield to the more immediate interests of national policy makers and regulators, and local politics. This tendency needs to be resisted by further strengthening the role of the FSB.

I will discuss this morning my view that the FSB's activities over the next five to ten years should have two main areas of focus. First, the FSB should monitor, identify and address national regulations that are in conflict with each other or with international standards set by international standard setting bodies, where such conflicts pose a significant risk to the financial system. At the moment, the regulation of derivatives and of proprietary trading by banks require particular attention in this regard.

Second, the FSB should identify high-risk regulatory gaps at the national and international level, for example, as they have done with shadow banking. The FSB must identify the relevant international organization that should address these regulatory gaps, or, where no existing organization can fill this role, itself coordinate the necessary national action. I will then turn to capacity issues of the FSB regarding organization, governance and funding.

Regulatory Inconsistency

Let me begin with the role of the FSB in dealing with regulatory inconsistency where the inconsistency creates a problem for the stability of the global financial system. The FSB must identify potential and existing regulatory divergences of this kind. This will require the FSB to institute a regular process to monitor G20 members' regulations, as well as the standards set forth by international standard setting bodies. As the CGFR suggested in its April 2011 report, the FSB should encourage G20 member governments routinely to provide the FSB with proposed national financial regulatory measures that have cross-border implications, so that the FSB may coordinate a period of consultation among other G20 members prior to implementation. That process is intended to identify potential regulatory divergences before they come into effect and will facilitate collaboration between national authorities.

But the FSB must also play a role in identifying important inconsistent policies and regulations that are adopted, particularly if they create conflicts, and formulate plans for resolving them. The so-called regulatory dialogues, which perform this function bilaterally, need to be systematized and in many subject areas become multilateral. The FSB should maintain a thorough detailed database comparing key regulations and make this database open to the public. The FSB has taken steps in this direction, for example, by publishing on its website national and regional responses to a survey conducted by the FSB Implementation Monitoring Network regarding progress of these nations and regions toward implementing G20 recommendations. This information should be kept current, and should be presented in a manner that allows for easy comparison of regulations across jurisdictions.

Completeness of Implementation

Although not the main focus of my remarks, I should also mention that beyond monitoring inconsistent policy and regulation among countries, the FSB should also monitor the completeness of implementation of policies in areas where it has formulated an action program. This is necessary to make sure we can detect problems that go beyond looking only at "law on the books." The CGFR has made two recommendations to make this process effective: the FSB should conduct or oversee a review of domestic laws which limit information-sharing across jurisdictions, and the FSB together with the International Monetary Fund (IMF) should develop a standardized framework for the G20 peer review process. The FSB's Standing Committee on Standards Implementation has already developed such a framework for monitoring the implementation of international standards, which includes mechanisms for information gathering, evaluation and assessment and publication of results. Going forward the FSB and the IMF must clarify and formalize their respective responsibilities on multilateral surveillance.

The FSB should also strengthen and formalize the basis on which international standard setting bodies collaborate among themselves. Because these entities have distinct areas of technical competence, they are generally well-positioned to identify divergent cross-border regulations in a particular area. The FSB must work with these entities to coordinate their standards across sectors. These issues will be the topic of Olin Wethington's address in the next panel.

Derivatives

The need to deal with significant inconsistencies is especially evident in the area of derivatives reform, which the G20 has identified as an area of priority. At the initiative of the FSB, a working group led by representatives of the Committee on Payment and Settlement Systems (CPSS), the International Organization of Securities Commissions (IOSCO) and the European Commission was formed in April 2010 to make recommendations on the implementation of the G20 derivatives reform. In October 2010, the FSB issued a report on "Implementing OTC Derivatives Market Reforms" which contained 21 recommendations regarding practical issues authorities might encounter in implementing the goals of the G20. The FSB issued its first implementation progress report in April 2011, where it expressed concern over whether many jurisdictions would meet the G20's end-2012 deadline. The FSB issued a second report in October 2011, with an even more detailed assessment of progress. The FSB's OTC Derivatives Working Group will continue to monitor implementation of derivatives reform as the end-2012 deadline approaches.

Unfortunately, divergence in derivatives regulation has begun to emerge, for example, in U.S. and E.U. regulation of clearinghouses. Both the U.S. and proposed E.U. regimes will permit their home-country institutions to participate in a foreign clearinghouse only if the regulation of that foreign clearinghouse is equivalent to that of the regulation of clearinghouses in the home country. These equivalence determinations are primarily designed to avoid regulatory arbitrage but the cure could be worse than the bite. It would be highly inefficient and risky, and perhaps even unworkable, to split central clearing of derivatives geographically. Where a trade has a U.S. and E.U. counterparty, where would the trade be cleared if equivalence were deemed lacking by both the U.S. and E.U.? Note that if one party found equivalence and the other did not, all trading would migrate to the location that did not find equivalence (since this venue would be acceptable to the

party that found this location was equivalent). Such trading migration would likely not be acceptable, thus further underscoring the necessity of coordinated action.

The solution, of course, is to make sure each side finds equivalence, but this requires that there be minimum divergence in regulatory approach. Ensuring this outcome is complicated by different timetables for implementation of regulation, the U.S. being ahead of the E.U. This underscores the need for the FSB to encourage compatible timetables in implementation of regulation. And as for the substance, the FSB, or the OTC Derivatives Working Group as coordinated by the FSB, must be involved in the areas where the risk of divergence is highest, for example regarding margin requirements and other measures of protection for the clearinghouse, including capital requirements for members, ownership and governance restrictions, and clearinghouse access to a central bank discount window.

The U.S. and E.U. have also diverged in the proposed treatment of non-financial derivatives counterparties. The proposed European Market Infrastructure Regulation offers a more generous end-user exemption than the end-user exemption in the Dodd-Frank Act. The end-user exemption in the Dodd-Frank Act exempts only derivatives activity by a non-financial end-user for hedging purposes, whereas the E.U. proposal exempts any derivatives activity by a non-financial end-user up to a certain unhedged threshold. This threshold has yet to be determined. Thus it is likely that for a substantively similar derivatives transaction, non-financial end-users in the E.U. would not have to clear the transaction with a clearinghouse or report the transaction to trade repositories, while the same transaction in the U.S. would require both clearing and reporting. The FSB should have an active role in resolving these problems and others like it.

Unilateral Regulation Outside the G20 Framework

While significant inconsistencies in regulation can arise in the implementation of the G20 reform agenda, they can also arise when countries pursue reforms outside the agenda that impact the interest of other countries. This suggests that the FSB may need to play a role in restraining such action, even when undertaken by prominent members. Here I have in mind the impact of the Volcker Rule and Vickers Commission recommendations on the rest of the world.

The Volcker Rule bans proprietary trading and certain investments in hedge or private equity funds by U.S. banking organizations; this is not part of the G20 agenda nor has it so far been proposed or adopted by any other G20 member, to my knowledge. The Volcker Rule will not only limit the activities of U.S. banking organizations, it will also limit the activities of foreign banks operating in the U.S. In addition, it may prevent foreign banks outside the U.S. from investing in funds that are sold to U.S. residents. And most notably, it grants U.S. banking organizations an exemption for trading U.S. government but not foreign government debt, a discrimination that will be hard to fix by regulation. The Vickers Commission proposes splitting insured deposit retail banking activities and wholesale banking activities of U.K. banks into separate ring-fenced affiliates with the intent that the U.K. public safety net would cover only the retail bank. Unlike the Volcker Rule, the Vickers Commission proposal does not apply to foreign banks operating in the U.K. through branches although it has urged foreign supervisors to encourage their banks to operate in the U.K. in subsidiary rather than branch form. Nonetheless, the Vickers Commission could have substantial international repercussions. Suppose the U.K. wholesale bank were to fail with

significant impact on foreign counterparties. Could or should the U.K., which was the home country supervisor of the failing wholesale bank, walk away from any financial responsibility just because the wholesale bank did not take insured deposits? The general point is that the FSB may have to police countries adopting policies outside the G20 consensus that significantly impact other countries.

Regulatory Gaps

In addition to resolving significant inconsistencies, a second main focus for the FSB in the coming five to ten year period should be in addressing gaps in financial regulation that create potential sources of systemic risk, across nations and regions. The FSF, pre-cursor to the FSB, was created in 1997 in part to serve an early warning function in future economic crises. An important part of identifying potential future crises will be to understand where the regulatory shortcomings lie. In many instances, these gaps exist outside the traditional banking industry, the principal focus of the FSB.

Shadow Banking

Regulation of the shadow banking system is an important gap, which *is* currently being addressed by the FSB. The shadow banking system, which the FSB has broadly defined as "credit intermediation outside the regular banking system," encompasses such diverse activities as money market funds, securitization, securities lending and repo transactions, among others. It introduces significant benefits to market participants as a source of funding and liquidity. At the same time though, it is subject to "runs" similar to traditional bank short-term funding, and can thus be a source of systemic risk—this was a major problem with respect to the money market funds during the crisis. In addition, as the G20 noted in its report last November, the relatively unregulated status of the shadow banking system can create opportunity for regulatory arbitrage. At the G20's request, the FSB created a Task Force on Shadow Banking to help identify the role and risks of the shadow banking system, and to set out approaches for effective monitoring and to prepare, where necessary, additional regulatory measures to address risks posed by the system. The FSB issued a report in October of 2011 that sets forth 11 specific recommendations for monitoring and enhancing regulation of shadow banking and the G20 has called on the Task Force to draft rules and regulations for the shadow banking industry by year-end.

In addition to shadow banking, there are other areas where the G20 has suggested the FSB should address gaps in regulation. For example, the G20 identified the need to integrate financial consumer protection policies into regulatory and supervisory frameworks, and endorsed the FSB's report on consumer finance protection and the high level principals the FSB developed along with the Organisation for Economic Co-operation and Development (OECD). The G20 has also called upon the FSB to undertake ongoing monitoring and reporting on compensation practices, to identify gaps in implementation of the FSB principals and standards on compensation. The FSB has also been tasked with developing principles on credit ratings and in coordinating the preparation of recommendations for a global legal entity identifier. Addressing gaps in regulation will be an important role of the FSB. In addressing these gaps, the FSB should set priorities, focusing on areas where the potential for systemic risk is the greatest.

Another serious area of concern is the supervision and resolution process for important financial organizations operating across borders. The FSB has been very active in stepping into the action gap in this area. Its "Key Attributes of Effective Resolution Regimes for Financial Institutions" sets forth the principal features that should be part of all national resolution regimes. The Key Attributes also include requirements for information sharing between national authorities, institution-specific cross-border crisis management groups and institution-specific cooperation agreements between home and host authorities. The Key Attributes were endorsed by the G20 in November 2011 and the 29 financial institutions designated as G-SIFIs by the FSB and the Basel Committee on Banking Supervision (BCBS) are required to meet the resolution planning requirements by the end of 2012.

Capacity of the FSB

I would now like to discuss some key issues relating to making the FSB a "fully enduring organization," as the G20 formulated the objective at the Cannes Summit. It goes without saying that its endurance will require that it be successful in fulfilling its mission, parts of which I have already discussed.

With this objective in mind, the work of the Council in recent months has concentrated on exploring and considering the various possible frameworks which have been used for different international organizations and which may also be appropriate for the FSB. When I say "framework," our attention and research has particularly focused on three features which are central to any organizational structure—(i) its legal identity and corporate capacity; (ii) its governance process; and (iii) the primary sources of funding for its operation and staffing.
I think it would be helpful to briefly summarize the Council's research in which we have examined these three features in 13 different international organizations.

Legal Identity and Capacity

On the topic of legal identity and capacity, let's begin with the FSB. The FSB is a unique body among the various international organizations which the Council has researched. At present, the FSB does not possess its own legal identity and its charter is essentially an informal memorandum of understanding for cooperation among its member signatories. In fact, Article 16 of the FSB Charter states that the document "is not intended to create any legal rights and obligations." The FSB effectively operates as an arm or extension of the BIS, and its actions or decisions evolve from political consensus rather than legal or statutory powers.

In contrast, most other international organizations today fall into one of three categories.

First are organizations which employ a traditional corporate structure under the laws of a particular jurisdiction, typically where their head office is located. This has been the preferred approach of the multilateral development banks such as the European Bank for Reconstruction and Development (EBRD), the Asian Development Bank (ADB) and the African Development Bank (AfDB) as well as the Bank for International Settlements (BIS). And, although the shareholders of these organizations include governments or national monetary institutions, these entities typically have customary corporate constitutional documents and share capital structures.

The second category would include organizations which are established by inter-governmental agreement or treaty. In these cases, the relevant constitutional document under which the organization is formed generally states that the organization is granted legal identity and capacity by the governments which are party to the inter-governmental agreement or treaty. Hence, for example, Article IX of the Articles of Agreement of the IMF states that the Fund "shall possess full juridical personality including the capacity to contract, acquire and dispose of immovable and movable property and institute legal proceedings." The IMF's Articles goes on to require that signatory states take the necessary action "within their territories" to give effect to the organization's legal identity. Other examples of these types of organizations include the World Bank, OECD, Association of Southeast Asian Nations (ASEAN), the International Labour Organization (ILO) and the World Trade Organization (WTO).

Finally, the third category of organization would involve a type of international association." Two examples are the International Association of Insurance Supervisors (IAIS) and IOSCO. In both cases, the organizations have specific statutory authority for their existence in the jurisdiction in which they are located – in the case of the IAIS, under the Swiss Civil Code, and in the case of IOSCO under a Spanish law recognizing "public utility associations."

It is important to note an over-arching principle in all three of these categories and which is a feature shared by all the organizations we examined. Specifically, in each case (with the exception of the IMF and the World Bank which were created by intergovernmental agreements), there is a legal basis for the identity and capacity of the entity which arises from the legal jurisdiction in which it is physically located. In this way, an organization can expect to have certainty under the laws of the place where it is physically located so that it can engage in its business with the rights and privileges as well as responsibilities of the laws governing commercial or related types of activities. This covers a wide range of matters including, for example, engaging in real or personal property transactions, staffing and employment, intellectual property protection and, if necessary, judicial review for the enforcement of rights or redress of grievances arising in the place where the organization is operating.

This legal basis and the certainty it can afford may arise under existing corporate law or under express statutory authority. In the case of Swiss-based organizations, this can also be accomplished under what is referred to as a "headquarter agreement" through which the Swiss Federal government recognizes the legal identity of the organization and confers certain immunities and privileges under the Federal "Host State Act" (Federal Act on Privileges, Immunities and Facilities of 22 June 2007).

In terms of the future of the FSB, of these various options, the easiest path would be for the FSB to establish itself as a separate legal entity in Switzerland – a jurisdiction with the experience and precedent for hosting international organizations. The FSB Secretariat is already located in Switzerland and, as mentioned, Swiss law expressly offers a legal framework for giving an existing international organization a separate legal identity without the more difficult process of constituting a body through an international treaty or inter-governmental agreement. As mentioned, this can be accomplished under either existing statutory authority for associations as well as through "headquarter agreements" through which the legal identity of the FSB would be recognized. Both of these approaches should be explored with Swiss counsel and the staff of the

FSB, taking into account the continuation of links with the BIS while keeping in mind the goal of optimizing the independence of the FSB not only vis-a-vis the BIS but in more general terms. Separation from the BIS will serve to differentiate its role from that of traditional central banks and thereby be capable of speaking to a wider audience and coordinating with a broader range of participants in financial regulatory matters.

Governance

Turning now to the topic of governance, the FSB presently has a distinct and informal approach, albeit with structures which are drawn from more formal governance methods found in public and private bodies. Specifically, the FSB's present governance structure consists of the Plenary, a Steering Committee, a Chairperson and the FSB Secretariat. The Plenary, whose representatives are governors of central banks and other international institutions, is the decision-making body of the FSB and its decisions are taken informally by consensus. The Plenary, with the help of standing committees and working groups approves the work program of the FSB, decides its membership and adopts reports, standards and recommendations. The Steering Committee, whose composition is decided by the Plenary, meets at least four times each year and provides operational guidance between the Plenary meetings to carry forward the directions of the FSB. The Chairperson, the principal spokesperson of the FSB, is appointed by the Plenary from FSB members for a term of three years renewable once. Finally, the Secretariat is directed by the Secretary General who is appointed by the Plenary at the proposal of the Chairperson. The Secretariat supports the activities of the FSB, ensures the effective communication to Members and manages the financial, material and human resources allocated to the FSB.

The other international organizations we have examined share what are broadly similar governance structures which are similar to private corporations. In brief, member states or institutions are represented by a board of directors or governors or a council which meets and take decisions at annual or bi-annual meetings or conferences. A secretariat or executive board with permanent members oversees the day-to-day work of the organization and is often assisted by a number of committees and sub-committees. At the head of each organization is typically a managing director, director-general or president, often assisted by deputy managing directors or vice-presidents.

In terms of voting, there are three distinguishable voting procedures employed by the organizations we have reviewed: consensus; simple majority; and higher majority. The constitutional documents of the IMF, the BIS, the ILO, the IAIS, the EBRD, the ADB and the AfDB all include provisions for voting generally to be carried out on a simple majority basis, but prescribe higher levels of majority for certain matters, often relating to the constitution of the organization itself or for capital funding issues. For example, the statutes of the BIS require a two-thirds majority to authorize any increase or reduction of share capital, the cancellation of shares, the election of its Board of Governors or any amendments to the Statutes themselves.

Notwithstanding formal voting procedures, decision-making in international organizations is also often an informal and consultative process in which decisions are taken in a consensual fashion with recourse to formal voting only where no consensus can be reached. This approach is at the heart of the present governance method at the FSB. However, as it evolves towards a more enduring organization, the Council believes that the FSB should introduce greater formality,

regularity and transparency in it decision-making process. These features are hallmarks of well-run public and private organizations which enjoy the support of their members or shareholders, and their introduction in the context of a more enduring status for the FSB should enhance the credibility of the organization's decision-making process.

Funding

In completing my overview of other international organizations, I should also speak briefly about funding. The FSB, under its present structure, is an extension of the BIS and has funding arrangements which are dependent on budgetary allocations from the BIS. In considering the alternatives, the international organizations we investigated obtain their funding from essentially two sources.

The first method is through voluntary contributions of members. All of the organizations we researched obtain a portion of their funding in this way. This can be structured either through the issuance of share capital or through a dues-based system, and the amount of contributions may be equal across all members (e.g. ASEAN) or vary according to the size of a member's economy (e.g. OECD).

The second method is what can be loosely described as private or profit-based funding. This includes private capital raising methods such as bond issuances or borrowing facilities. And in the case of international organizations engaged in lending or other commercial activities, funding may be provided by the revenues generated by such activities.

Finally, the funding framework for the BIS also suggests a type of "endowment" method of funding as this institution has specific reserve funds which are funded by an annual percentage of the BIS's net profits and thereby provides a supplemental source of revenue for the institution.

In the Council's view, and as we have previously recommended, the FSB should develop a funding approach that transitions away from primary reliance on the BIS to a more independent and sustained approach – at the same time taking into consideration the benefits of a continued relationship with the BIS. The alternative approaches for funding an organization like the FSB with limited capacity for profit-making activity are narrow and, hence, most likely to depend on dues-based contributions from member organizations. The level of these contributions may also be set so as to provide for an "endowment" reserve fund, similar to the BIS, which could facilitate the independence and stability of the FSB's funding resources. A difficult question will also be the share allocation among member organizations – specifically, whether dues based funding should be equal across all members or vary according to certain criteria related to the size of the member's economy. As the initial budget of the FSB may be modest, a simpler equal-sharing approach among members may be most attractive at the outset.

Conclusion

As we have discussed, the FSB's key mission should be to coordinate financial regulatory policies of the G20 that have the greatest importance to the stability of the global financial system. This requires making the FSB a more enduring organization. We have also considered the options to

accomplish this, focusing on three central features of any organizational structure – legal identity and capacity, governance and funding. While each of these topics offers alternatives and complexities, I would like to conclude by noting that these three areas are inter-connected for our purposes today. Legal identity is the starting point. Effective governance requires a legal identity to be in place. Both are necessary for fund raising operations and professional staffing. In short, these three features will be at the heart of any enduring organization because, in our view, it is the prudent and effective combination of these features which will offer an organizational foundation to ensure the effectiveness, independence and objectivity of the FSB in its future work.

Thank you again for inviting me to speak to you today.