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Good morning.

Let me start by saying that it is a real pleasure to be here in Lisbon among so many good friends. I would like to thank the Associação Portuguesa de Bancos and its President, António de Sousa, for their kind invitation to participate in this important event.

In this talk, I will focus on the role of financial regulation and supervision in addressing systemic risks. And, for a start, I would like to use a botanical metaphor—the forest and the trees. One of the important factors in the genesis of the recent financial crisis was that, before the crisis, many regulators and supervisors did not see the forest, the financial system as a whole. And they did not even see the trees in many places. In fact, authorities in many countries did not know enough of what was going on within specific financial institutions, some of which were very large and systemically important. Since then, significant policy efforts have been made to ensure that authorities will focus as much as possible on both the forest and the trees.

The process of global financial regulatory reform was launched at the G20 summit in Washington in November 2008, and the Financial Stability Board (FSB) stepped up its efforts to help change the global regulatory landscape and create a safer financial system. I will expand on the areas where most progress has been made. But I will also highlight areas where a lot of work still needs to be done.

Significant progress has been made in trying to see the trees, and in trying to ensure that individual trees are healthier. This has been driven by the Basel III process, under which banks need to bolster their capital buffers in terms of quantity and quality of capital. This agreement also means that more supervisory attention will be paid to financial leverage, through a leverage ratio, and to liquidity. The Basel III measures will be implemented over time, as part of a process that will end on January 1st, 2019. Meanwhile, there has been progress in addressing too-important-to-fail institutions. I am using this term—rather than too-big-to-fail—because size is only one aspect of the problem. Big financial institutions can be perfectly healthy if they are well diversified. By contrast, smaller highly complex firms could prove to be very toxic for the system. There has been an agreement on the methodology to identify systemically important banks, which has led to the creation of a list of 29 banks. These global systemically important banks are facing higher capital surcharges, more intense supervision, and an obligation to submit recovery and resolution plans in 2012.

This is the good news, but a lot more work remains to be done. For a start, increased efforts are needed to implement what has already been agreed; the timetables for implementation are particularly demanding in the next few years. Moreover, there are three important areas that

require significant work. One is the derivatives market. Lehman Brothers proved to be systemically important because of its derivatives exposures. AIG was not allowed to fail because its demise could have wrought havoc in the global financial markets through its derivatives positions. The risk of a domino-effect should not be underestimated, because many derivatives—such as the so-called over-the-counter (OTC) derivatives—are based on undisclosed bilateral contracts. The demise of one counterparty in such deals can lead to further counterparty failures that may have system-wide effects. While there has been some progress, this problem has yet to be fixed. Increased efforts are needed to make OTC derivatives markets safer and more transparent, including through centralized clearing of trades and reporting of relevant information to trade repositories.

Second, more work is needed on cross-border resolution mechanisms for systemically important financial institutions, including banks and non-banks. This is a fundamental issue: not only are some firms too important to fail, but they may also be too complex to be resolved. Even mid-sized groups, such as Dexia and Fortis, often have operations in several different jurisdictions. This is perhaps the toughest nut to crack in the global regulatory process, because it requires legal changes in many countries to ensure international cooperation in the case of cross-border resolution. The too-important-to-fail problem is now even bigger than it was at the beginning of the crisis because there have been quite a few mergers and acquisitions. It is, therefore, more important than ever to avoid a situation where profits are privatized in good times and losses are socialized in bad times, which is the essence of the moral hazard problem.

The third area in which more work is needed is shadow banking. If we only tried to make the banking system safer, we might create problems elsewhere. Risks would simply migrate to areas that are less transparent. It would be akin to squeezing a balloon. To ensure the safety of the financial system as a whole, we need to come to grips with systemically important non-banks, including money market funds. Efforts to enhance the transparency of the shadow banking system and expand the regulatory perimeter are being made, but have not yet matured.

Finally, to complement these reforms, we need to put in place fully-fledged macroprudential policy frameworks designed to address systemic risk. The Bank of Portugal, for example, is making important changes aimed at enhancing its ability to take into account systemic risk. I think all countries should have fully-fledged policy frameworks for this purpose. We have detailed the key elements of these new macroprudential policy frameworks in a recent report, in collaboration with the FSB and the Bank for International Settlements (BIS). This report was presented at the G20 summit in Cannes in November 2011.

Macroprudential policy is still in its infancy, and there will be a lot of “learning by doing”. We recently saw the launch of the European Systemic Risk Board (ESRB), an independent European Union body responsible for macroprudential oversight. Its U.S. counterpart — the Financial Stability Oversight Council (FSOC)—held its first meeting in October 2010. And other countries, such as the United Kingdom, France, and Germany, are establishing

macroprudential policy frameworks.

Good macroprudential policy is based on several key factors. First, authorities need to have a good system for identifying and assessing systemic risks. Second, they need to have a set of tools to address systemic risk. This toolkit includes, for example, loan-to-value ratios that can be used in an anti-cyclical manner. It also includes tools such as dynamic provisioning and counter-cyclical capital charges. Third, policymakers need to create an institutional framework that oversees the selection and implementation of these policy tools. Should the central bank play a leading role? What about the Ministry of Finance? Should there be a new macroprudential agency? These issues are very important, and need to be resolved.

Paying attention to systemic risk is particularly important at this stage, given that the world remains deep in the "danger zone". Despite recent improvements in market sentiment, we continue to face elevated systemic uncertainties. The epicenter of these uncertainties lies in the euro area.

Four key policy actions are needed to contain the current systemic risks. They include two "R"s and two "S"s: regulate and supervise, repair and stabilize. First, it is essential to complete the regulatory reform agenda without delays. There is some discontent within the financial industry over the strength of the forthcoming regulations. However, let me make it clear that the international regulatory community is determined to complete the reform agenda, as this is essential to move towards a safer financial system.

Second, supervision needs to be stepped up. As you know, it is not enough to have good rules. Rules are only as good as the supervisors that enforce them. In the run-up to the latest financial crisis, many rules—both good and bad—were not properly enforced. Third, increased efforts are needed to repair the financial system. A number of banks, particularly in Europe, need to be recapitalized. Some will have to be restructured, and others need to be resolved. These two concepts—restructuring and resolution—have not been sufficiently applied during this crisis.

Fourth, the current situation in the euro area needs to be stabilized through a combination of good policies at the national level and good policies at the European level. At the national level—particularly in the three program countries, as well as in Italy and Spain—progress must continue to be made in the following areas: (i) fiscal consolidation, to restore confidence in the sovereign and reduce sovereign risk; (ii) financial sector reform, to strengthen banks, make them safer, and break the adverse feedback loop between weak banks and sovereigns; and (iii) structural reforms, to increase potential economic growth.

Moreover, good policies need to be implemented at the European Union level and within the euro area. The three key policies form what I would call a "confidence triangle". One side of this triangle involves "discipline". Based on the recent agreement by European leaders, fiscal discipline will be enshrined in a multi-lateral framework. The other side of the confidence triangle involves "solidarity", including through the European Stabilization Mechanism

(ESM). We believe that the size and flexibility of the ESM need to be enhanced. I also firmly believe that the ESM should have the capacity to take direct stakes in banks, so as to further reduce the adverse feedback loop between sovereign risk and banking risk. The third side of the confidence triangle involves “growth”. The European Union now has a fiscal compact as part of its discipline framework, but it also needs to have a growth compact, a growth strategy. Financial stability in Europe cannot be restored unless all three sides of the triangle are in place. And this has to be done swiftly. In addition, there is a need for greater global solidarity. The IMF is currently seeking to increase its lending capacity in order to further contribute to the stabilization of market confidence and deal with potential global spillovers.

Let me conclude with the old adage that, “if there is a will, there is a way”. I think that the way is clear, but we still need the political will to make it happen. Given that the financial system remains fragile, we need swift and decisive actions to fully stabilize it, so that it can support the economic recovery. Thank you.