FSB FINANCIAL STABILITY BOARD

THE CHAIR

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To G20 Finance Ministers and Central Bank Governors

Current outlook for financial stability

The G20 is meeting at a time of growing financial stability challenges. The combination of lower growth, rising inflation and tighter global financial conditions may crystallise pre-existing vulnerabilities in the global financial system or give rise to new ones. So far, markets have coped with evolving economic conditions and high volatility in an orderly manner, even though liquidity has deteriorated in some key funding markets. No major financial institution has shown signs of distress. However, vigilance is required as an unexpected deterioration in economic conditions may test financial resilience.

The rise in indebtedness across sovereigns, non-financial corporates and households in response to COVID-19 exposes these sectors to rising debt service costs, especially as market interest rates have risen in many jurisdictions. Weaker growth could further weigh on debt servicing capacity. Moreover, potential vulnerabilities stemming from liquidity mismatches and hidden leverage in non-bank financial intermediation (NBFI) persist. Emerging market and developing economies (EMDEs) have been particularly affected by tightening financial conditions. This, together with a greater divergence of economic conditions across regions, could give rise to volatile capital flows and expose external vulnerabilities.

The volatility in commodity markets following Russia's invasion of Ukraine has highlighted the risk of financial strains in these markets – through large margin calls, undetected leverage and concentrated exposures. In addition, there may be knock-on effects on the broader financial system, for instance through unexpectedly procyclical margin dynamics. The centrality of key energy, metals and food commodities to the functioning of the global economy means that any disruptions to the financing of producers or traders in these markets could have an outsized impact. The FSB, working with standard setting bodies, is analysing financial issues in commodity markets and is closely monitoring the possible spillovers from these markets into the broader global financial system as part of its ongoing surveillance.

A resilient global financial system is essential for strong and sustainable global growth. The economic impact of the pandemic was contained through a timely and effective global policy response. This response involved the utilisation of financial buffers and an increase in non-financial sector debt. With the exit from COVID-19 now well underway, it is important to rebuild macroprudential policy space whenever national conditions allow.

The FSB is taking forward its work to bolster the resilience of the financial system. In this regard, I am pleased to update you on two specific areas of the FSB's work for which documents have been submitted to this meeting: exit strategies and addressing scarring effects from COVID-19 and the update on progress under the FSB's climate roadmap. I am also updating you on our work on crypto-assets, on which we issued a public statement this week.

COVID-19: exit strategies and addressing scarring effects

The recent economic and financial developments described above have made it more challenging for policy makers to support a strong, equitable and inclusive recovery from COVID-19. Policy space is limited and the financial buffers of firms and households have been reduced. The limited ability to provide additional policy support, in particular in the form of fiscal stimulus, has been a factor behind a relatively weaker recovery, notably in many EMDEs. Policies to contain economic scarring from the pandemic will therefore be an important contributor to financial resilience and sustainable economic growth going forward, particularly in EMDEs.

Targeted approaches and the phasing-out of COVID-19 measures may help to mitigate adverse effects of high debt and prevent scarring. To this end, jurisdictions should pay attention to coordination in the narrowing down and phasing out of support measures and in designing effective mechanisms to deal with the debt overhang resulting from such measures. At the same time it may be necessary to amend the support measures in light of recent events. Close cooperation and information exchange is critical for authorities in ensuring appropriately tailored policy responses and exit strategies.

The prospect of an uneven global economic recovery may increase the risk of negative spillovers and the importance of policies to contain them. Exit strategies need to reflect specific domestic economic conditions and avoid excessive financial market reactions, which may limit the scope to engineer a fully synchronised exit across jurisdictions. For instance, clear and consistent messaging on central bank actions may help market participants to appreciate the motivation for, and drivers of, differences in policy normalisation across jurisdictions. Additionally, addressing excessive procyclicality in capital flows can help mitigate cross-border spillovers.

The interim report on 'Exit strategies to support equitable recovery and address effects from COVID-19 scarring in the financial sector' submitted to this G20 meeting discusses these issues in more detail. When commissioned in late 2021, the report was intended to discuss policies in the aftermath of a past shock. Since then, the economic and financial market situation has evolved considerably, and the situation will no doubt evolve further in the months between this interim report and the final report, to be delivered to the G20 in November. The final report will consider relevant new economic developments and input from stakeholders.

The regulation of crypto-assets

The recent turmoil in crypto-asset markets has crystallised some of the vulnerabilities that the FSB highlighted in February in its Assessment of risks to financial stability from crypto-assets. The sharp fall in market values has, once again, shown that crypto-assets are heavily exposed to swings in market confidence, which makes them an unreliable store of value. Recent events have also highlighted the potential fragility of so-called stablecoin arrangements and the central role these instruments currently play in the functioning of crypto-asset markets. The stress that different crypto-assets and participants have undergone underlines that crypto-asset markets are a complex and constantly evolving ecosystem that needs to be considered holistically when assessing related financial stability risks in order to create the necessary conditions for safe innovation.

Similarly, the turmoil highlights the importance of advancing the ongoing work to address the risks posed by crypto-assets. This turmoil brings into sharp focus their intrinsic volatility, structural vulnerabilities and the issue of their increasing interconnectedness with the traditional financial system. The failure of a market player may not just impose large losses on investors and threaten market confidence. It could also quickly transmit risks to other parts of the crypto-asset ecosystem and spill over to important parts of traditional finance, such as short-term funding markets. An effective regulatory framework must therefore ensure that crypto-asset activities posing risks similar to traditional financial activities are subject to the same regulatory outcomes ("same activity, same risk, same regulation"), while taking account of the novel features of crypto-assets, and harnessing potential benefits of the technology behind them.

The FSB issued a communication on crypto-assets at the beginning of this week. Its aim is to underscore the risks arising from crypto-assets, including so-called stablecoins, and to clarify that crypto-assets do not operate in a regulation-free space. The communication stresses that crypto-asset providers must not commence operations in any jurisdiction unless they meet all applicable regulatory, supervisory and oversight requirements. It also reiterates FSB members' commitment to using the enforcement powers within their jurisdiction to promote compliance with existing legal obligations and act against violations.

The FSB is working to ensure that crypto-assets are subject to robust regulation and supervision and will continue to coordinate regulatory initiatives in this area. We are taking forward, in close collaboration with standard-setting bodies, including FATF, work on the regulation and supervision of so-called stablecoins and other crypto-assets. We are also analysing the financial stability implications of decentralised finance. The FSB will submit to the G20 Finance Ministers and Central Bank Governors meeting in October a consultative report on its review of the FSB High-Level Recommendations for 'global stablecoins' and a consultative report with recommendations on regulatory and supervisory approaches to other crypto-assets.

Executing on the FSB's climate roadmap

The continued commitment of the FSB membership to take forward work to address the financial risks of climate change is encouraging. Testament to this is the progress that international bodies and authorities have made on our Roadmap for Addressing Climate-related Financial Risks during its first year in all four key areas: disclosures, data, vulnerabilities analysis, and regulatory and supervisory approaches. A recent milestone has been the International Sustainability Standards Board (ISSB)'s publication for comment of its exposure drafts of global baseline disclosure standards. An important further milestone will be IOSCO's decision on whether to endorse the final version of the standards as this would pave the way for wide adoption across jurisdictions.

We have to keep up momentum. Public authorities are still overcoming residual challenges of the pandemic, and are now faced with the issue of how to take forward policies to address climate change amid rising energy prices and inflation. The imperative to address the risks from climate change has not lessened. Current developments should reinforce, rather than detract from, international sustainability ambitions.

The FSB will continue to play its role in tackling financial risks stemming from climate change. Improving data quality and consistency is essential to the identification and assessment of vulnerabilities and the development of new policy tools. In this regard, the FSB will publish its joint work with the NGFS on climate scenarios in November. The FSB also plans to publish the final version of its report on supervisory and regulatory approaches to climate change in October. In addition, the FSB will publish in October a report on the progress by the ISSB in developing the global minimum baseline disclosures standards as well as by individual jurisdictions and firms in improving climate disclosures. All of these are deliverables to the G20.

Conclusion

The FSB's unwavering commitment to promote global financial stability through close international coordination has proved its worth in the face of recent shocks. I can assure you that the momentum for this work will continue. Detecting and addressing financial system vulnerabilities remains essential as policy makers face up to shifting economic conditions. A key focus will be to deliver on our ambitions in areas such as crypto-assets and climate through the development and consistent implementation of appropriate policies. This will not be easy. But, I am confident that we will deliver, as always, through the combined work of our diverse and cross-sectoral membership and with the valuable oversight of the G20. It is through this multilateral approach that the FSB will continue to develop global solutions to truly global challenges.

Yours sincerely,

Klaas Knot