FSB FINANCIAL STABILITY BOARD

THE CHAIR

14 February 2022

To G20 Finance Ministers and Central Bank Governors

Two years after its onset, the COVID-19 pandemic continues to weigh on the global economy. New waves of infections have led to further rounds of containment measures, and have contributed to an uneven recovery across regions, higher inflation and record-high debt levels globally. The global financial system has been able to support the recovery to date, thanks to the greater resilience of banks and market infrastructures – supported by the G20's post-2008 crisis reforms – and a determined policy response to the pandemic. A resilient, well-functioning global financial system remains key for leaving the pandemic behind us and for achieving strong, inclusive and sustainable growth over the long term.

However, promoting global financial resilience during the transition to a post-pandemic world poses its own challenges. Heightened economic uncertainty and potentially lasting changes in the global economy may significantly affect interest rates and asset prices. The financial system also needs to harness the benefits of digital innovation while managing the risks, not least in the form of rapidly developing crypto-assets, and play its part in the transition to reduced, and eventually, net zero carbon emissions. The move into a post-pandemic world brings with it a demand for more sustainable and innovative forms of finance, which promise to deliver tangible benefits to citizens and societies. But it may also give rise to vulnerabilities, which must be addressed if their benefits are to be fully realised.

The FSB and G20 will play key roles in ensuring that these transitions happen smoothly. This letter lays out how I see the FSB's policy work to promote global financial resilience during the coming year. An annex provides a complete list of FSB deliverables to the G20 in 2022.

Supporting financial market adjustment to a post-COVID world

The transition path to a post-pandemic economy remains highly uncertain. Accommodative financial conditions have kept debt servicing costs low and supported asset prices, amid a continued search for yield. But, in the current environment, embedded leverage in some parts of the financial system as well as rising real estate and other asset valuations across a number of jurisdictions have become vulnerabilities. A rapid or disorderly tightening of financial conditions and a greater divergence of these conditions between advanced and emerging market economies could pose risks to financial stability, including through volatile capital flows. *The FSB will continue to monitor and analyse these risks closely and update the G20 on relevant issues.*

Increasing divergences in growth across regions mean that an asynchronous unwinding of pandemic support measures is becoming more likely, with the potential for cross-border spillovers. In many jurisdictions, limited remaining policy space constrains the ability to counter

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such spillovers. Supporting an even, sustainable and inclusive recovery requires careful consideration of both these potential spillovers as well as the residual policy space.

As part of the exit and recovery process, it is also important to guard against the risk of longer-term scarring of the real economy. Financial sector policies should address factors that could impair the ability of the financial system to provide financing to the economy over the medium term, including on a cross-border basis. These factors include corporate debt overhang in the aftermath of the pandemic. *The FSB will report to the G20 on policy considerations to support a more even, sustainable and inclusive global recovery, and on effective financial sector practices for national authorities to consider for addressing the effects of COVID-19 scarring. This will comprise an interim report in July and a final report in October.*

Reinforcing financial system resilience in light of the COVID experience

The COVID experience, and the March 2020 turmoil in particular, provided important lessons for the resilience of the global financial system. Some parts of the financial system, particularly banks and financial market infrastructures, were able to absorb rather than amplify the macroeconomic shock, supported by the G20's post-crisis reforms. However, key funding markets experienced acute stress and public authorities needed to take a wide range of measures to improve liquidity conditions in those markets and support the supply of credit to the real economy. This experience underscored the need to strengthen resilience in the non-bank financial intermediation (NBFI) sector, which continues to evolve rapidly.

Enhancing NBFI resilience offers significant benefits, not least during the transition to a post-COVID world. First and foremost, it will ensure a more stable provision of financing to the economy. The NBFI sector now represents almost half of global financial assets. Second, having a variety of resilient channels for financial intermediation can enhance the ability of the financial system to absorb different types of shocks. An important corollary is that a resilient NBFI sector reduces the need for extraordinary central bank interventions.

Enhancing the resilience of the NBFI sector, while preserving its benefits, therefore continues to be a top priority for the FSB. The FSB's NBFI work programme to date, carried out in close coordination with standard-setting bodies (SSBs), has focused on assessing and addressing vulnerabilities in specific areas that may contribute to the build-up of liquidity imbalances. The areas being examined include money market funds, open-ended funds, margining practices, bond market liquidity, and the interaction of US dollar cross-border funding with vulnerabilities in emerging market economies. *The FSB, together with the IMF, will deliver a report on cross-border US dollar funding and vulnerabilities in emerging market economies in April*.

The FSB in 2022 will take forward its NBFI work programme. This includes assessing the effectiveness of the FSB's 2017 asset management recommendations on liquidity mismatch in open-ended funds and considering what additional steps may be needed to address any identified shortcomings. These efforts will be complemented by the FSB developing a systemic approach to NBFI and a policy toolkit that is effective from a system-wide perspective, informed by a public conference in June. *In October, the FSB will deliver a comprehensive progress report on the various initiatives under the NBFI work programme to the G20 Summit, including on the main findings of relevant FSB and SSB initiatives and on policy proposals to address systemic risk in NBFI.*

Harnessing the benefits of digitalisation while containing its risks

The pandemic has brought into even sharper focus the central role of digital innovation, in terms of the opportunities that it offers for more efficient and inclusive finance, but also in terms of potential new risks to financial stability. Given its importance and pervasiveness in the financial system, digital innovation will continue to be a priority area of FSB work.

The use of new technology is one important element of the ongoing work to enhance cross-border payments. The aim of this initiative is to bring about cheaper, faster and more transparent and inclusive cross-border payment services, including remittances, for the benefit of citizens and businesses worldwide. Following a year of foundational work under the G20 Roadmap for Enhancing Cross-Border Payments and the establishment of quantitative targets, the next stage of work includes the development of specific proposals for material improvements to existing systems and arrangements, as well as the development of new systems. The practical work involved will require global coordination, strong involvement from the public and private sectors and sustained political support. It will also require investment in order to upgrade systems, processes and technologies. *In October, the FSB, in coordination with the Committee on Payments and Market Infrastructures and other SSBs, will deliver a progress report on the G20 Cross-Border Payments Roadmap, and will also report on the implementation approach for monitoring progress towards the Roadmap's targets.*

The FSB is also focused on addressing potential financial stability risks associated with digitalisation. An area that will receive considerable attention in 2022 is crypto-assets. Crypto-asset markets are fast evolving and could reach a point where they represent a threat to global financial stability due to their scale, structural vulnerabilities and increasing interconnectedness with the traditional financial system. Financial stability risks could rapidly escalate, underscoring the need for timely and pre-emptive evaluation of possible policy responses. *We have delivered to you for this meeting the FSB's updated assessment of the risks to financial stability posed by the major component parts of the crypto-asset ecosystem, including so-called Decentralised Finance (DeFi).*

It is critical to address emerging financial stability risks in crypto-asset markets holistically to avoid fragmented approaches that could give rise to regulatory gaps and arbitrage. The FSB plays a key role as the forum for cross-border and cross-sectoral coordination, and is stepping up its work in this area. We will continue to work with SSBs to address any gaps or overlaps in regulatory standards for so-called "global stablecoins". In parallel to this, the FSB is beginning work with SSBs to examine regulatory and supervisory issues and approaches in relation to "unbacked" crypto-assets. This additional work has become more urgent as crypto-asset markets have grown rapidly over the past year. *We will keep the G20 updated on the FSB's work on crypto-assets. Specifically, in October, the FSB will deliver a consultative report on its review of the high-level recommendations in the FSB's 2020 stablecoin report, and how any gaps identified could be addressed by existing frameworks.*

During the pandemic, financial institutions have made greater use of outsourcing to third-party service providers. While this may have provided additional resilience during the pandemic, it has also reinforced the importance of effective policies for the oversight of financial institutions' reliance on critical service providers. The FSB will continue its work on third-party risk management and outsourcing. A related issue that the pandemic has further highlighted is

cyber risk. Recognising that information on cyber incidents is crucial for effective action, *the FSB will build on its earlier work in this area by developing best practices for regulatory cyber incident reporting requirements and deliver a report on its proposals to the G20 in October*.

Addressing financial risks from climate change

That climate change may create risks to global financial stability is by now generally recognised. To be effective, actions to address such risks need to take into account the particular nature of climate risk: it is global, in its causes and its implications, and it is pervasive, affecting all kinds of financial assets and contracts. Against this backdrop, the ultimate goal of the FSB's roadmap for addressing climate-related financial risks is to ensure that climate risks are properly reflected in all financial decisions. The roadmap supports international coordination by bringing together the work of international organisations and national authorities on the various initiatives in this area. In doing so, our roadmap – focusing on financial risks from climate change – complements the G20 Sustainable Finance Working Group's broader roadmap.

The FSB's own work this year will contribute to all four pillars of the FSB roadmap: disclosures, data, vulnerabilities analysis, and regulatory and supervisory approaches. More specifically, we are monitoring, and helping to support progress in, the achievement of consistent climate-related financial disclosures. This includes supporting the development and widespread adoption of the global baseline standard by the IFRS Foundation's new International Sustainability Standards Board (ISSB), as well as progress in the meantime by jurisdictions and firms in implementing and improving disclosures. We will build and strengthen the analytical basis for monitoring climate-related risks to financial stability, including by addressing data gaps, and work jointly with the Network for Greening the Financial System on the use of scenario analysis by jurisdictions and the financial metrics needed for this analysis. We are also complementing the work of sectoral SSBs by working on regulatory and supervisory approaches to address climate-related financial risks, with a focus on system-wide aspects and tools for macroprudential purposes. *The FSB will report to the G20 on these initiatives in October, following a report on the progress of the roadmap during its first year in July.*

Conclusion

I would like to take the opportunity in my first letter to you as FSB Chair to thank you for entrusting me with this role, and for the kind words of support and encouragement that I have received. I look forward to working with you and with my fellow FSB members to advance the important work of the FSB. I am grateful to my predecessor, Randal K. Quarles, for his leadership in a challenging period, during which he further strengthened the FSB in its role as the primary coordinating mechanism for authorities on financial stability matters.

The issues discussed in this letter underline the importance of a global and cross-sectoral approach to financial stability policy during the transition to a post-COVID world and beyond. Many key financial challenges that we face are global in nature and affect the system as a whole. Climate risk is perhaps the obvious example, but the same is true for digitalisation, and potentially also shifts in the macroeconomic and interest rate environment. The FSB, through

its global and cross-sectoral membership, brings to bear a holistic perspective on financial stability. It will continue to do so during my term as FSB Chair, so that the global financial system may even more effectively contribute to strong, sustainable, balanced and inclusive growth.

Yours sincerely,

Klaas Knot

Annex: FSB reports to the G20 during the 2022 Indonesian Presidency

Date	Report
February	Updated assessment of risks to financial stability from crypto-assets
April	Report on USD funding and emerging market economy vulnerabilities during the March 2020 turmoil
July	COVID-19 exit strategies to support equitable recovery for financial stability and scarring effects – Interim report
	Annual progress report on climate roadmap
October	Promoting Global Financial Stability: 2022 FSB Annual Report
	COVID-19 exit strategies to support equitable recovery for financial stability and scarring effects – Final report
	Report on policy proposals to address systemic risk in NBFI
	Best practices for reporting cyber incidents to financial authorities
	Annual report on implementation of the cross-border payments roadmap
	Key performance indicators to monitor progress towards the quantitative targets for the cross-border payments roadmap
	Regulatory and supervisory approaches to addressing climate-related financial risks – Final report
	Report, jointly with NGFS, on the outputs of climate risk scenario analysis by jurisdictions
	Report on progress in achieving consistent climate-related financial disclosures
	Progress report on the regulation, supervision and oversight of global stablecoins