FSB FINANCIAL STABILITY BOARD

THE CHAIR

15 November 2020

To G20 Leaders

Although financial conditions have continued to ease in the second half of this year, the global economic outlook remains uncertain. A resilient and well-functioning global financial system that can effectively support recovery is, therefore, more important than ever.

This exceptional year has underlined the FSB's ability to provide a quick and coordinated response to meet financial stability challenges and to support the continued flow of financing to the real economy. FSB work to date has been expansive, covering: analysis of vulnerabilities exposed during the crisis; policy responses; assessments of the extent to which jurisdictions have responded in a flexible yet coordinated manner; and identification of areas of developing concern or where there have been lessons to learn – to name a few.

Since the outbreak of COVID-19 and the imposition of associated containment measures (the COVID Event), we have reported to the G20 on our work. These timely and comprehensive reports are a testament to the strong coordination and commitment of financial authorities in the G20 and beyond, which has proved invaluable during this period of volatility and uncertainty. Continued coordination, underpinned by the FSB principles agreed in April, will remain of critical importance in the coming months, in particular when jurisdictions start to move towards unwinding temporary policy measures.

The shocks related to the COVID Event offer lessons for financial stability policy going forward. Thanks to the reforms that G20 Leaders agreed to more than a decade ago and to other measures taken by market participants, core elements of the financial system, particularly banks and financial market infrastructures, were able to absorb rather than amplify the shock. At the same time, some stresses were intensified through impacts on non-bank financial intermediation (NBFI), which has come to play an increasingly important role in the financing of the real economy and managing the savings of households and companies. The FSB's Holistic Review of the March market turmoil analyses how the initial stages of the turmoil propagated and exposed vulnerabilities throughout the financial sector. The report highlights a number of areas where FSB members believe that additional investigation is warranted, including money market funds, liquidity risks in open-ended funds, margin dynamics, and bond market structure and liquidity. The accompanying NBFI work plan charts a course of action for strengthening financial resilience in these areas.

Coming to a shared diagnosis

The COVID Event represents an unprecedented simultaneous shock to aggregate supply and demand. This shock made it difficult for the financial sector to absorb the large increase in demand for liquidity, which in turn put strains on critical nodes of the financial system. However, the public sector acted quickly and decisively to halt further intensification of this shock to markets. These unprecedented interventions, which included fiscal, monetary, and prudential policy measures, helped to alleviate market strains, but could lead to moral hazard issues in the future.

The turmoil earlier this year manifested itself differently in countries around the world. Emerging market economies, for example, experienced severe strains in offshore U.S. dollar funding markets; whereas some advanced economies experienced significant outflows from certain types of investments, such as money market funds investing in non-government securities. However, the holistic review assesses the initial stages of the COVID Event as having exposed a number of common strengths and vulnerabilities across the global financial system.

The financial system entered the crisis more resilient and better able to sustain financing to the households and businesses that are the foundation of the real economy. In particular, major banks at the core of the financial system demonstrated increased resilience. Financial market infrastructures, particularly central counterparties (CCPs), also functioned well, despite challenging financial and operational conditions.

Conversely, some stresses were intensified through NBFI channels. Increased demand for cash, coupled with liquidity imbalances between asset maturities and redemptions in certain money market funds and other open-ended funds, may have exacerbated outflows from these instruments. While CCPs demonstrated resilience, in some instances margin calls may have been larger than expected, further boosting the need for cash and the financial stress created by the resultant demand for liquidity. Additionally, disruptions in bond markets have raised questions about the role of leveraged investors and the willingness and capacity of dealers to intermediate in these markets at times of stress.

The need for continued vigilance and policy support

While financial market conditions have continued to ease, in part as a result of the significant fiscal and monetary policy actions taken in the spring, persistent economic uncertainty and still elevated financial stability risks call for continued vigilance. The FSB continues to carefully monitor for signs of emerging vulnerabilities as the COVID Event continues.

Our update report, *COVID-19 pandemic: Financial stability impact and policy responses*, identifies several areas that are important to monitor for potential signs of stress, especially with the emergence of another wave of containment measures in a number of countries. Ongoing low levels of activity in certain industries and falling commodity prices continue to add to already high debt levels in parts of the non-financial corporate sector. These growing debt levels among non-financial corporates may adversely affect the banking sector. Additionally, further credit downgrades could stress bond markets, as some asset managers are contractually obligated to sell bonds downgraded below investment grade. Downgrades of sovereigns in emerging market economies could potentially trigger capital outflows as well.

The protracted nature of the COVID Event requires continued efforts to support financial resilience and ensure a sustained flow of financing to the real economy. It is critical to ensure that bank capital and liquidity buffers are used to absorb shocks and support lending. The use of analytical tools, such as stress testing, is important to assess potential solvency risks to financial stability and inform any necessary adjustments to policy responses. Authorities' communication of their support measures and policy approaches, at a time when conditions are changing quickly and the outlook is uncertain, is important to support confidence.

Enhancing financial sector resilience going forward

The COVID Event has provided us with an opportunity to further assess financial stability risks and to refine measures put in place after the 2008 Global Financial Crisis, where appropriate. These lessons can help us strengthen financial sector resilience to better prepare for future shocks. In particular, this past year has demonstrated the need for the FSB to further investigate how to enhance resilience and address systemic risks in the NBFI sector, which is so important for financing and saving. I look forward to the FSB and other global standard setting bodies undertaking important work in this area in 2021.

The FSB has publicly consulted on its evaluation of the effects of our too-big-to-fail reforms, the most important yet in our series of evaluations of the reforms following the 2008 crisis. The evaluation has found that banks are now more resilient and resolvable, although there are still gaps that need to be addressed.

While the pandemic is by no means over, it is also important that we keep an eye to ensuring economic growth and financial stability beyond COVID-19. In particular, the FSB must continue to press forward with priority initiatives to strengthen the financial system - to develop more efficient cross-border payment services, to address risks from stablecoins, to assess climate-related financial stability risks, to strengthen cyber resilience, and to facilitate a smooth transition away from LIBOR.

Conclusion

The challenges posed by the COVID Event have by no means dissipated yet and we are just starting to draw the necessary lessons. While continued efforts are required to preserve financial stability and ensure the flow of financing to support economic recovery, the positive effects of the G20 reforms on financial resilience show that financial reforms do bring important benefits for both the financial sector and the real economy.

Undertaking ambitious initiatives to strengthen financial resilience, while remaining vigilant for indications of emerging financial market stress, will certainly be no mean feat. Addressing the vulnerabilities exposed by the COVID Event, such as those in the NBFI sector, and making progress on other important topics ranging from cross-border payments to LIBOR will no doubt be a lengthy process requiring strong commitment and coordination at the international level. The FSB looks forward to advancing work on these topics in coordination with the incoming Italian G20 Presidency throughout 2021.

With the continued support of G20 Leaders, I am confident that the FSB will be able to further the resilience of the global financial system, enabling it to provide the financing that our economies need to return to a path of strong, sustainable, balanced, and inclusive growth.

Yours sincerely,

Randal K. Quarles