FSB FINANCIAL STABILITY BOARD

THE CHAIR

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To G20 Leaders

The New Delhi Summit is taking place at a pivotal time for global financial stability. Relatively strong and persistent inflation has seen financial conditions tighten and interest rates rise strongly in many jurisdictions over the past year. This, alongside a slowing growth outlook, could impair the capacity of borrowers to service the historically high stock of outstanding global debt and create challenges for both bank and non-bank lenders.

Earlier this year amid shifting financial conditions, we witnessed the first failure of a global systemically important bank since the 2008 global financial crisis (GFC), as well as a few medium sized bank failures. Contagion from these individual bank failures was limited, thanks to the swift and concerted actions of authorities on both sides of the Atlantic and amid confidence in the resilience of the broader financial system. This resilience is underpinned by the G20 reforms introduced following the GFC. Still, further strains in financial markets cannot be ruled out in the months ahead as higher debt servicing costs continue to permeate the economy. At the same time, the financial system is in the midst of deep structural change, including the need to respond to accelerating digitalisation and to climate change risks.

A resilient and stable financial system is indispensable to sustaining economic growth, particularly in the current environment. Under the leadership of the Indian G20 Presidency, the FSB has advanced work to promote global financial stability in two key ways. First, by addressing existing vulnerabilities in the financial system. Second, through analytical and policy work to further enhance the resilience of the financial system to structural changes. The Synthesis Paper on Policies for Crypto-Assets that we and the IMF have delivered to this Summit is an important example of the latter.

Addressing existing vulnerabilities in the financial system

The global economic recovery is losing momentum, and the effects of the rise in interest rates in major economies are increasingly being felt. So far, the global financial system has remained resilient overall, not least thanks to the strong bank capital buffers introduced by the post-crisis G20 reforms. Going forward, it will be important for authorities to closely monitor asset quality in those sectors most sensitive to interest rate increases – such as real estate – and to ensure that financing providers to those sectors manage their risks properly and remain resilient.

The March banking sector turmoil constituted a test of the financial reforms put in place following the 2008 GFC. Among other issues, it exposed vulnerabilities in individual institutions relating to poor liquidity and interest rate risk management and governance, and it reinforced the need for strong and effective supervision by authorities. It also highlighted the importance

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of fully and consistently implementing the Basel III framework, thereby further enhancing banking sector resilience as soon as possible. The turmoil has challenged long-held views about the stickiness of deposits and the speed of bank runs, and it has raised questions about the role of social media in those runs. The FSB and the Basel Committee on Banking Supervision (BCBS), as well as our member authorities, are examining the implications of these issues to identify lessons and adjust policy frameworks where needed. We remain convinced that the international resolution framework developed by the FSB in the aftermath of the 2008 GFC is fit for purpose, but we have identified a number of implementation challenges that need to be addressed. To this end, the FSB will soon publish a report on preliminary lessons learned for resolution and policy priorities going forward.

A key trend in recent years has been the increased importance of non-bank finance, which has diversified borrowing sources but has also contributed to the build-up of leverage in non-bank financial intermediation (NBFI). If not properly managed, leverage can amplify stress in the event of a shock and lead to systemic disruption, as demonstrated by recent strains in commodities and bond markets. NBFI leverage can take different forms and is often difficult to identify or measure, which complicates the assessment of associated vulnerabilities. Our report to the Summit on this topic describes recent trends in NBFI leverage and identifies possible actions to fill key data gaps and address associated vulnerabilities.

Over the past three years, the FSB has worked to assess and address systemic risk in NBFI. This year the FSB delivered to the G20 a consultation report on policies to address liquidity mismatch in open-ended funds. The recommendations in this report aim to significantly strengthen liquidity management by open-ended fund managers. Policy work to reduce the procyclicality of margining practices and to enhance liquidity preparedness for margin and collateral calls is well underway. These two sets of policies aim to reduce excessive and potentially destabilising spikes in liquidity demand during times of stress. As a complement to these policies, a major focus of our NBFI policy work next year will be to address financial stability risks associated with non-bank leverage.

Going forward it is critical that G20 countries implement the agreed reforms to enhance NBFI resilience. The FSB will work with the standard-setting bodies (SSBs) to assess, in due course, whether implemented reforms have sufficiently addressed systemic risk in NBFI, including whether to develop additional tools for use by authorities.

Enhancing the resilience of the financial system to structural change

The global financial system continues to evolve in response to two secular trends – digitalisation and climate change. The FSB is coordinating the work to address the financial stability implications of both these trends.

A notable example of accelerated digitalisation has been the emergence of crypto-assets, including so-called stablecoins. A number of incidents over the past year have highlighted the vulnerabilities in the crypto-asset ecosystem, which warrant close monitoring given the growing linkages with the traditional financial system. In July, the FSB delivered to the G20 a set of recommendations that act as a baseline for the regulation, supervision, and oversight both of crypto-assets and markets and of global stablecoin arrangements. These recommendations represent a major step forward. They promote comprehensive and consistent global regulatory and supervisory approaches based on the principle of “same activity, same risk, same regulation,” to support a level playing field and ensure a technology-neutral approach. We are now working with SSBs and international organisations to ensure that these recommendations are implemented across both FSB and non-FSB member jurisdictions, and we will report on progress made.

The risks of crypto-assets are not confined to financial stability, but can also include macroeconomic risks relating to monetary sovereignty, capital flow volatility and fiscal policy. At the request of the Indian G20 Presidency, and recognising the need for a comprehensive policy response, the FSB and IMF are delivering to this Summit a Synthesis Paper that brings together the risks identified by each institution and how they interact. The paper highlights the amplified macro-financial risks from crypto-assets that emerging market and developing economies may face, which could raise the need for additional targeted measures. The paper also includes a roadmap for future work on the implementation of policy frameworks; building institutional capacity beyond G20 jurisdictions; global coordination, cooperation, and information sharing; and addressing data gaps.

More generally, accelerating digitalisation across all parts of the financial system has improved efficiencies but also raised operational resilience challenges and the risk of disruption to the business models of incumbent financial institutions stemming from new technologies and providers of financial services. For instance, the interconnectedness of the global financial system makes it possible that a cyber incident at one financial institution, or an incident at one of its third-party service providers, could have spill-over effects across borders and sectors. To address these risks, the FSB set out recommendations in April to achieve greater convergence in cyber incident reporting frameworks. The FSB has also consulted on a policy toolkit that financial institutions and financial authorities can use to enhance their third-party risk management and oversight.

New technology brings not only risks but also opportunities. The FSB is coordinating work to take forward the G20 Roadmap to make cross-border payments cheaper, faster, more inclusive, and more transparent. Good progress has been made already. I have written to you separately on the importance of your continued support for this work.

Global exposure to climate risks is becoming more evident, and recent weather events have shown the potential for non-linear effects. The FSB is coordinating closely with SSBs and international organisations to implement the four building blocks of its Roadmap on Climate-related Financial Risks: data, disclosures, vulnerabilities analysis and supervisory and regulatory approaches. An important milestone in the FSB’s Climate Roadmap has been the publication of the International Sustainability Standards Board (ISSB)’s disclosure standards, which have been endorsed by the International Organization of Securities Commissions (IOSCO). The ISSB standards serve as a global framework for sustainability disclosures and, when implemented, will strengthen the comparability, consistency, and decision-usefulness of climate-related financial disclosures around the world. These standards can be seen as a culmination of the work of the FSB’s Task Force on Climate-related Financial Disclosures (TCFD), which has made a major global contribution since its creation in 2015. The FSB will work with the ISSB and other relevant bodies to promote their timely and wide use.

Conclusion

The individual cases of banking sector stress earlier this year were a stark reminder of the speed with which vulnerabilities can be exposed in the current environment. The FSB is committed to learning lessons from this event. At the same time, it is encouraging – and a testament to the G20 reforms since the GFC – that the strains faced by individual banks did not cascade into a full-blown crisis.

One reason for this is the close ties among regulators and supervisors around the world, which facilitated prompt and effective decision making and information sharing. In short, the value of cross-border cooperation and improved regulation was demonstrated once again. These attributes, although difficult to measure, can at times mean the difference between a severe recession and continued economic growth.

There will certainly be further challenges and shocks facing the global financial system in the months and years to come. But it is possible, through concerted policy action by authorities, for the financial system to absorb rather than amplify these shocks. With the support of the G20, the FSB will remain focused on building resilience, so that the financial system can continue to play its part in strong, sustainable, inclusive, and balanced growth.

Yours sincerely,

Klaas Knot