FSB FINANCIAL STABILITY BOARD

THE CHAIR

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To G20 Finance Ministers and Central Bank Governors

The effects of COVID-19 on the global financial system and the unprecedented responses governments took (the "COVID Event") continue to hit economies significantly. Yet, in the second year of the COVID Event, there are also signs of an emerging inflection point. Vaccines are rolling out across countries and, even though progress is moving at different paces across jurisdictions and sectors, bring with them hope for a return of normal life. While it is sensible to keep measures that support financial system stability and financing of the real economy in place as long as needed, the factors to be considered in deciding whether to extend, amend and, eventually, end support measures are taking shape.

Reflecting this emerging shift in emphasis, the FSB's work this year brings much needed attention to the financial impacts of the policy response measures put in place at the onset of the COVID Event and the implications for policies going forward. A year ago, the G20 endorsed the FSB's COVID-19 principles, which focus on coordination both with respect to the use of the flexibility built into financial standards during the initial market stress going into the COVID Event and orderly transition out of these temporary measures. The report being submitted to this G20 meeting shows the strides being made with respect to policy measures and understanding their impacts, while still recognizing the current uncertainties we face. This joint analysis helps to support such coordination.

Looking beyond these near-term issues, we are working on drawing lessons from the COVID Event for financial stability in the longer term. For this G20 meeting, we are submitting the final report, following public consultation, on the effects of 'too big to fail' (TBTF) reforms for systemically important banks (SIBs), both globally and domestically. The real life test provided by the COVID Event has confirmed that the reforms have helped to reduce the risks previously posed by SIBs. Following up on our Holistic Review of the March 2020 market turmoil, a key priority for this year is our ongoing work to strengthen the resilience of non-bank financial intermediation (NBFI). We will report on this work to the G20 at subsequent meetings this year.

The FSB is also taking a lead role in coordinating work to better understand and address climate-related financial risk. While work in this area has gained considerable momentum in multiple forums, it has never been more important to speak with one voice on a forward direction. Given the FSB's mandate as a coordinating entity across financial authorities such as central banks, finance ministries, and securities regulators, as well as across other international organizations and standard-setting bodies the FSB has a natural role to play in helping to coordinate, shape, and seek agreement on a path forward in this space. To this end, the FSB will develop a roadmap that will identify where climate-related work on financial risk is underway, what work is needed, and how the different workstreams fit together.

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Managing the trade-offs of COVID-19 policy support measures going forward

A speedy, sizeable, and sweeping policy response has been key to limiting the economic fallout of the COVID Event. Globally, most of the COVID-19 support measures remain in place and in many cases their withdrawal is not imminent. Nonetheless, policymakers need to form views on whether, when, and how to extend, amend, or end their support measures, which the FSB's report to the G20 aims to assist with by summarizing relevant considerations. While the report recognizes that circumstances differ widely, it also highlights that policymakers around the globe are wrestling with similar trade-offs and that coordination can help to reduce the risks from spillovers.

One key message from the report is that authorities generally view the risks to financial stability associated with early withdrawal of support measures as currently greater than those associated with a late withdrawal. An early withdrawal of support measures could pose risks to financial stability in some cases, although, such risks may build for the future if support measures remain in place too long.

Being mindful of potential trade-offs between withdrawing too early and too late, a second message is that authorities have a number of options to manage these trade-offs. These include ensuring that measures are targeted, making the terms at which support is provided progressively less generous, and sequencing the withdrawal of support measures. Overall, a flexible, state-contingent approach – rather than a pre-announced timetable for withdrawal – can help to minimize long-term financial stability risks, conserve fiscal resources, and promote smooth economic adjustment. Communication about policy intentions can aid adjustment, by reducing the risk of surprises and abrupt adjustments in financial markets.

More work is yet to be done as the world transitions into recovery. Both banks and non-banks will be at the forefront of providing financing to the economy as public measures are phased out. Simulations and stress testing can help to assess fragilities, including better understanding harmful spillover effects across jurisdictions.

Hence, a third message concerns the importance of international coordination going forward. At the onset of the COVID Event, the G20 endorsed the FSB's COVID-19 principles, including to: coordinate through the FSB and standard setting bodies the future timely unwinding of temporary support measures; assist in returning financial conditions and firms' operations to normal in a smooth and consistent manner; and maintain long-term financial stability. The report to the G20 itself is a product of close cooperation and coordination, and FSB members will remain committed, as always, to coordinating closely and sharing insights and effective practices once countries and authorities begin to unwind and exit measures in place.

Significant progress made on 'too big to fail' reforms for banks

Drawing lessons from the COVID Event for financial stability is in many instances tantamount to considering whether the reforms put in place after the Global Financial Crisis are working as intended. The FSB, with its cross-sectoral, system-wide perspective, has been a leader in evaluating post-crisis financial sector reforms, and the evaluation of TBTF reforms for banks has been the largest evaluation carried out under our program thus far. The final report submitted to this G20 meeting reflects dedicated work over a two-year period.

The evaluation suggests that reforms have reduced systemic risks, enhanced the credibility of resolution and market discipline, and ultimately produced net benefits for society. At the same time, the report has identified areas in which TBTF reforms can be further developed. These gaps include, but are not limited to, remaining obstacles to resolvability such as total loss absorbing capacity (TLAC) implementation and transparency of resolution funding mechanisms. The gaps will be addressed by the FSB and its membership. Doing so will be particularly relevant in the current environment, as non-financial firms' debt levels have kept rising and a deterioration in the credit quality of these non-financial borrowers could increase the likelihood of loan defaults, causing losses for banks.

At a time when the global financial sector is still sifting through the effects of the COVID Event, it is clear that these TBTF reforms are essential components to staving off systemic risk from the largest, most complex banks. The progress made in establishing resolution regimes and enhancing the resolvability of banks gives authorities more options for dealing with banks in distress. But the past year has shown that the reforms have had other important, though perhaps less visible, benefits: resolution planning, together with enhanced supervision, have significantly improved the operational capabilities of banks and authorities, as well as the accuracy and detail of the information available to them – a key advantage during a period of rapidly evolving economic and financial conditions.

The TBTF evaluation confirms that assessments of the financial stability implications of regulatory reforms call for a system-wide perspective. As non-bank financial institutions have picked up market share, some risks have moved outside the banking system. This shift may enhance the stability of the financial system, not least because it may lead to a diversification of funding sources. But the March 2020 turmoil highlighted the increasingly important role of vulnerabilities in NBFI, a sector that has grown markedly since the 2008 financial crisis. The FSB examined these vulnerabilities in detail in its Holistic Review delivered in November 2020 and is working to address them through its NBFI work program. A first important deliverable will be policy proposals to enhance money market fund resilience, which we will submit to the G20 in July.

A roadmap for understanding and addressing climate-related financial risks

Addressing issues related to climate change is a key priority during this year's G20 Presidency and is essential to a sustainable recovery from the COVID Event and beyond. Currently, the FSB is building on last year's report on financial stability implications of climate change, with three climate-related workstreams underway covering data, disclosures, and regulatory and supervisory practices, and bringing together work being carried out by standard setting bodies and international organizations. These workstreams will provide important input to the two reports that the G20 has asked from the FSB in July, on ways to promote consistent, high-quality climate disclosures based on the recommendations of the Task Force for Climate-related Financial Disclosures, and on the data necessary for the assessment of financial stability risks and related data gaps. The FSB welcomes the steps being taken by the Trustees of the IFRS Foundation, supported by IOSCO, to accelerate convergence in global sustainability reporting standards with an initial focus on climate, through the further development of a prototype built on the TCFD recommendations.

Looking ahead, the increased sense of urgency has resulted in a proliferation of work by various bodies on climate change. While the greater momentum in climate work is welcome, it also increases the importance of strategic vision, good coordination, and clear communication to the G20 and the public. To this end, the FSB will present a coordinated, forward-looking roadmap to address climate related financial risk. This will leverage work being carried out by standard setting bodies and international organizations while simultaneously using our mechanisms to identify vulnerabilities and build consensus on ways forward. To assist with this coordination, the FSB has invited the Network for Greening the Financial System (NGFS) to participate in FSB climate-related work, and the FSB will apply for observer status in the NGFS. The work we can do to sharpen focus, amplify important messages, and identify areas where agreement on the way forward has been reached – or needs to be reached - will be key in promoting quick progress.

Given the magnitude of the task, I expect that the roadmap will cover actions needed over several years and seek to harness the respective strengths of, and progress made by, the international standard setting bodies and organizations engaged in this critical work. We will also coordinate closely with the G20 group on sustainable finance re-established by the Italian G20 Presidency as it develops its broader roadmap on sustainable finance, so that our work dovetails with theirs. The FSB roadmap, along with our work on climate-related disclosures and data, will be delivered to the G20 this summer.

Conclusion

The coordinated policy responses taken forward by FSB members have laid the foundation for the financial sector’s contribution to the recovery of the global economy. The reports that we deliver to this G20 meeting reflect the commitment of the FSB’s diverse membership to work together to assess global policy challenges and to coordinate where needed. These strengths continue to be very important to support global financial resilience and the financing of a strong, sustainable global recovery.

Yours sincerely,

Randal K. Quarles