FSB FINANCIAL STABILITY BOARD

THE CHAIR

30 June 2021

To G20 Finance Ministers and Central Bank Governors

For the last year, we at the Financial Stability Board (FSB) have focused our efforts on addressing the strains in the financial system resulting from the containment measures implemented in response to COVID-19 – the "COVID Event". Today, the mounting evidence of global recovery, even if uneven across regions, provides hope that we are moving forward towards the end of the tunnel. The promising signs in a number of jurisdictions of a return to normal life help to define a way forward even while others face less auspicious circumstances.

Yet, on the road to normality, some risks to financial stability still remain elevated. Economic uncertainty is still high and negative surprises could test the liquidity of financial markets. Moreover, while borrowing served as an important lifeline during the COVID Event, in some jurisdictions solvency risk remains an issue amid higher corporate debt levels, especially in the sectors most affected by the COVID Event. The FSB has already begun work to address the vulnerabilities posed by debt overhang in those jurisdictions, and we will continue to analyze and respond to events as they unfold.

While remaining vigilant to emerging vulnerabilities, the FSB is beginning to draw lessons from the turmoil of the COVID Event for financial stability. The global financial system has weathered the COVID Event thus far, thanks to greater resilience brought about by the G20 financial regulatory reforms, and the swift, bold and determined international policy response. But there are areas where we need to understand better whether the reforms have functioned as intended, and others where the COVID Event has surfaced vulnerabilities that need to be addressed with urgency, notably in non-bank financial intermediation (NBFI), including in money market funds (MMFs).

Much recent focus has understandably been on the immediate problems at hand. There are, however, financial stability risks beyond the COVID Event that demand our continued attention. In the near term, a smooth transition away from LIBOR is within striking distance. A much longer voyage will be necessary to understand and address potential climate-related financial stability risks, which is a high priority for the FSB and we need to make quick progress. The FSB roadmap for addressing climate-related financial risk, which we are submitting to this G20 meeting, provides a basis for coordinating international efforts in the coming years.

Learning lessons from the COVID Event for financial stability

The COVID Event tested the G20 reforms put in place after the 2008 global financial crisis and highlighted areas that require further attention from policymakers. While it is too early to draw definitive conclusions, the FSB is submitting to the G20 an interim report on lessons learned from COVID-19 from a financial stability perspective. The report will provide an opportunity to engage with stakeholders on these early lessons and help to inform the financial stability work of the FSB and standard-setting bodies (SSBs) going forward. A final report will be provided in October.

The global financial system withstood the real-life stress test presented by the COVID Event, with largely positive results. Extraordinary and bold policy actions played a key role in successfully maintaining confidence. While the test exposed frailties in certain sectors of NBFI and emphasized the need for further study of procyclicality and the use of capital and liquidity buffers, early conclusions point to areas of improved resilience. Thanks to the international reforms to strengthen the core of the system following the 2008 crisis, the banking sector was able to absorb rather than amplify the shock, central counterparties largely performed as intended, and, from an operational perspective, markets continued to function effectively in spite of the prolonged remote work. At the same time, the regulatory frameworks in place were sufficiently flexible to allow authorities to shape policy support in their jurisdictions. Reflecting jurisdiction-specific circumstances and needs, authorities broadly used the flexibility within international standards to support continued financing of the real economy. In a few cases, individual temporary measures have gone beyond the available flexibility. At the same time, monitoring and coordination, guided by the FSB COVID-19 Principles, has also discouraged actions that could distort the level playing field and lead to harmful market fragmentation.

The COVID-19 experience reinforces the importance of completing the remaining elements of the G20 reform agenda. Indeed, those parts of the global financial system where implementation of post-crisis reforms is most advanced displayed the greatest resilience. This underlines the financial stability benefits of the full, timely, and consistent implementation of agreed upon reforms.

Looking forward, COVID-19 has also reinforced the need to promote resilience amid rapid technological change. In particular, the boost that COVID-19 seems to have given to digital financial services has put the spotlight on operational resilience, including to cyber risks, in an environment of greater reliance on outsourcing and third-party service providers, including on a cross-border basis. It has also emphasized the importance of the ambitious roadmap to improve the efficiency of cross-border payments that is underway.

Enhancing resilience of MMFs

One area where the FSB is already taking action is on non-bank financial intermediation (NBFI). The COVID Event revealed vulnerabilities in parts of the NBFI sector that need to be addressed with urgency. Building on the November 2020 *Holistic Review of the March Market Turmoil,* the FSB is taking forward a comprehensive work program, in collaboration with the SSBs, to enhance the resilience of the NBFI sector while preserving its benefits.

As a first deliverable under the NBFI work program, the FSB is submitting to the July G20 meeting a consultation report with policy proposals to enhance MMF resilience. For the second time in just over a decade, strains in MMFs added to stress in short-term funding markets and the broader financial system, again requiring extraordinary interventions. These strains were eased only after massive official sector interventions. As the consultation report explains, MMFs face structural vulnerabilities – namely, the susceptibility of MMFs to sudden and disruptive redemptions and the challenges MMFs can face in selling assets to meet these redemptions. It is imperative that we enhance the resilience of MMFs by fully addressing these vulnerabilities.

The consultation report provides detailed analysis of the most significant vulnerabilities in MMFs and sets out policy options to address them. Recognizing that every jurisdiction's experience is different and market structures vary, the report provides a range of policies that could be used to enhance MMF resilience. Because a single policy option on its own may not address all the identified vulnerabilities, authorities should consider a full range of options that can be used together to address all MMF vulnerabilities prevalent in their jurisdiction. The appropriate combination of measures in jurisdictions should also take account of cross-border considerations and prevent international regulatory arbitrage that could arise from adopting divergent approaches across jurisdictions.

Given the need for global engagement on the critical issue of MMF reform, we request your feedback on the policy proposals set out in the report. The functions and roles of MMFs, their vulnerabilities, and the consideration of proposals to enhance their resilience, pose important questions that deserve our collective attention.

Finalizing preparations for LIBOR transition

We are now at the final chapter in the transition of the financial sector away from the use of LIBOR benchmarks. LIBOR will no longer be usable for new financial contracts by the end of this year. Completing the transition to robust alternative rates by end-2021 remains of utmost importance and the FSB strongly urges market participants to act now to complete the steps set out in its Global Transition Roadmap and June 2021 statement.

We are coordinating authorities to set globally consistent expectations that encourage firms to cease the new use of LIBOR and identify alternative benchmarks for use according to the relevant timelines for each currency, regardless of where those trades are booked, as delineated in the global transition roadmap. The progress report on LIBOR transition, delivered to the G20, shares solutions to benchmark transition issues common to many jurisdictions, and serves as a guide for authorities in determining appropriate alternative benchmark rates.

Mapping a path forward for climate work

A large, and growing, number of international initiatives are underway on addressing the various financial risks posed by climate change. This reflects the increasing attention paid to the topic as well as the global and cross-sectoral nature of climate-related financial risks. The interconnected nature of climate-related financial risks and the growing body of work to address them reinforce the need for coordinated action. With its diverse membership, the FSB is well placed to coordinate internationally, and give visibility to, the work to address climate-related financial risks.

To this end, the FSB is submitting to you, for your endorsement, a comprehensive roadmap for addressing climate-related financial risks. The roadmap outlines the work underway and still to be done by SSBs and international organizations over a multi-year period in four key policy areas: disclosures, data, vulnerabilities analysis, and regulatory and supervisory approaches. As a flexible document, the roadmap recognizes that actions to be taken in later years are dependent on the evolution of climate work across the various SSBs and across our membership. Thus, the roadmap includes annual reporting to the G20 to document progress, showcase work, and identify potential areas for further work. In addition to working closely with SSBs, the Network for Greening the Financial System, and other international organizations, we will also coordinate closely with the G20 Sustainable Finance Working Group (SFWG) to ensure that our Climate Roadmap dovetails with the SFWG's broader roadmap on sustainable finance.

Within the roadmap areas, the FSB's own work has recently focused on availability of climate-related data and promotion of globally comparable, high quality climate-related disclosures. We are submitting reports to this G20 meeting on both topics. The report on the availability of data on climate-related financial stability risks identifies the limitations of existing data and encourages authorities to work together to develop a concrete plan to rectify the limitations, while taking into account the specific circumstances of each country. Addressing such data gaps will enhance the assessment and monitoring of climate-related risks to financial stability and enable market participants to incorporate climate-related financial risks more effectively in their decisions, including the pricing of credit and allocation of capital.

The FSB's work to promote consistent, comparable, and high-quality disclosures builds on its role as sponsor of the Task Force on Climate-related Financial Disclosures (TCFD). Consistent and comparable disclosures are foundational for enabling appropriate investment decisions and risk assessment. The work being carried forward by the International Financial Reporting Standards (IFRS) Foundation and International Organization of Securities Commissions (IOSCO), in consultation with key global stakeholders and organizations, provides a promising path toward a needed global baseline standard for such disclosures. Such a global baseline would not preclude authorities from going further or at a faster pace in their jurisdictions.

The FSB is also helping to bring cohesion to climate-related disclosures. Its report calls for an acceleration of progress in the implementation of such disclosures, using a framework based on the TCFD Recommendations, and identifies member approaches to promoting such disclosures. The FSB will continue to provide guidance on steps jurisdictions can take towards achieving consistent outcomes, particularly in the period while the IFRS work proceeds.

Conclusion

One encouraging lesson from the COVID Event is our determination to act collectively to address global challenges, as demonstrated by the unprecedented actions taken by FSB members since the start of the pandemic. We are also seeing the benefits of our past collective efforts – the regulatory reforms agreed on in the aftermath of the 2008 global financial crisis – for financial stability. It will be important to carry this spirit of collaboration forward during the recovery from the COVID Event, and beyond, to address the longer-term challenges that lie ahead.

The FSB has fostered cooperation and coordination, by analyzing and responding to rapidly unfolding events, working to stabilize the financial system and the provision of finance amidst great uncertainty, and assessing the impact of our collective actions. These strengths will continue to guide us going forward. As we progress towards a post-COVID Event world, FSB members will continue to work together, leveraging our collective strengths to address current and evolving priorities and promote global financial stability in the face of new challenges.

Yours sincerely,

Randal K. Quarles