FSB FINANCIAL STABILITY BOARD

THE CHAIR

10 November 2022

To G20 Leaders

Developments since the Rome Summit have been a stark reminder that global financial stability should not be taken for granted. The return of inflation to levels not seen in decades has resulted in a strong interest rate response and significantly tighter financial conditions. The growth outlook has weakened, a development which is exacerbated by heightened geopolitical tensions and pronounced uncertainty. All this is occurring amidst record-high levels of debt of non-financial corporates, households and governments globally. This challenging confluence of factors threatens to expose vulnerabilities within the financial system.

Under the leadership of the Indonesian G20 Presidency the FSB has intensified its monitoring of current vulnerabilities and taken forward work to reinforce the resilience of the financial system. At the same time, we have continued our work to enable the financial system to adjust to fundamental structural global shifts – digitalisation, climate change – in a way that delivers tangible gains for society.

A resilient global financial system is essential for strong, sustainable, balanced and inclusive growth. Financial resilience also preserves room for manoeuvre for monetary and fiscal policy. In the remainder of this letter, I will elaborate on key areas of the FSB's work to promote global financial resilience, and on the importance of international cooperation for the success of these efforts.

Promoting financial resilience amidst current challenges

The past year has seen the sharpest tightening of financial conditions since the global financial crisis. This tightening importantly reflects higher interest rates across the board, but also rising risk premia and market volatility. Moreover, the appreciation of the US dollar has added to a higher cost of financing especially for many emerging market and developing economies (EMDEs).

So far, the global system has remained resilient. Global financial markets have largely coped with evolving economic conditions and high volatility in an orderly manner, with limited and temporary support when necessary, and systemic financial institutions have shown resilience to market strains – in large part due to the post-crisis financial reforms introduced by the G20.

However, there is no room for complacency. Current conditions are unprecedented in a number of respects, and we need to be attentive to existing and potential new financial vulnerabilities. The record-high debt levels have made markets sensitive to the impact of policy actions on debt servicing costs and debt sustainability. Moreover, financial institutions and market participants have not experienced sharply rising interest rates for a long time. Very low interest rates may have become embedded in business models and risk management, making the adjustment to a world of higher rates challenging.

More fundamentally, the current tightening is occurring in a global financial system where the provision of finance through non-banks has become as important as bank credit. This rapidly evolving part of the financial system, which we call somewhat technically non-bank financial intermediation, or NBFI, is very diverse – including, for example, money market and investment funds, broker-dealers, hedge funds, insurance firms and pension funds – and provides a broad array of financial services. A flip side of this dynamism and diversity is that some parts are not very transparent and are subject to vulnerabilities which can be triggered during periods of market stress. So-called hidden leverage is one example, the difference between the redemption terms offered by investment funds and the ease with which these funds' assets can be liquidated is another. Indeed, recent market stresses, including strains in both interest rate and commodities markets, underscore the need to address vulnerabilities in NBFI.

Over the past two years, the FSB has taken forward an ambitious work programme to strengthen the resilience of NBFI. To this Summit, the FSB is delivering a set of policy proposals to address systemic risk in NBFI. These proposals involve largely repurposing existing NBFI policy tools rather than creating new ones, given the extensive policy toolkit already available. The FSB will assess in due course whether repurposing such tools is sufficient to address systemic risk in NBFI, including the need to develop additional tools for use by authorities. In 2023, the FSB will deepen its analysis and horizon scanning of vulnerabilities in NBFI, with a particular focus on hidden leverage, and will then work to address identified issues. We will also take steps to tackle liquidity mismatches in investment funds and ensure better preparedness of market participants for sudden spikes in demand for liquidity. Taken together, all these initiatives hold the promise of making large, destabilising liquidity imbalances much less likely. To achieve this goal, continued support from the G20 is vital.

Making the financial system fit for structural changes

While having to cope with a challenging conjuncture, the financial system is also confronted with two secular trends – digitalisation and climate change. Each of these trends brings its own opportunities and risks. These include the prospect of digitalisation fundamentally changing the way finance works and the financial industry is organised, and climate change having a pervasive effect on the global economy and the nature of financial risks. Harnessing the opportunities of these trends while containing associated risks is critical for financial stability and prosperity.

One area where innovation can be expected to bring substantial benefits to peoples is cross-border payments. Recognising the importance of making cross-border payments faster, cheaper, more transparent and more inclusive, the G20 endorsed the Roadmap for Enhancing Cross-Border Payments two years ago. Since then, the foundations for material improvements have been laid, by carefully taking stock and analysing the status quo, and by setting ambitious targets for enhancements. Now it is time to move to the second phase, where the focus will be on actual change in a few key priority areas. To achieve tangible progress, the FSB will be cooperating closely with the private sector. Here too, continued political support from the G20 will be necessary.

Public dissatisfaction with existing cross-border payments has been one argument used by the proponents of crypto-assets. However, developments in 2022 have served as a reminder that existing crypto-assets, including so-called stablecoins, suffer from important structural vulnerabilities. The crypto-market turmoil also underlines that crypto-assets activities and markets must be subject to effective regulation and oversight commensurate to the risks they pose, both at the domestic and international levels. To this end, the FSB in October proposed a comprehensive framework for the effective regulation of crypto assets activities, including stablecoins. This framework embeds the principle of ‘same activity, same risk, same regulation’, while taking account of novel features of crypto-assets and harnessing potential benefits of the technology behind them. Finalising these recommendations and monitoring their effective implementation will be a priority for FSB work.

The events of the past year have also reinforced the importance of addressing financial risks from climate change, including the need to manage climate transition risk. While work has been progressing in all four areas of the FSB’s Roadmap for addressing financial risks from climate change – disclosures, data, vulnerabilities assessment, and regulatory and supervisory policy – the importance of being able to assess such risks on a global scale has become even clearer. To make such assessments, we need consistent climate disclosures by companies. The new standard-setter in this area, the ISSB, will be providing the global baseline standard but, to be effective, national and regional rules will need to be interoperable with each other and with the new baseline. We also need to further develop our ability to carry out scenario analyses to better understand the financial risks that different transition paths pose. We have delivered for this meeting, together with the Network for Greening the Financial System, a report on early lessons from these analyses.

Global cooperation on financial stability remains key

The importance of global financial stability is back on the mind of market participants and policymakers around the world. This is welcome, because a recognition of the challenges that lie ahead is a precondition for their effective management.

These challenges make global cooperation on financial stability matters as important now as it was after the global financial crisis. First, to develop a shared understanding of risks and vulnerabilities that can inform policy decisions at the domestic level. Second, and related, to account for cross-border considerations and spill-overs when setting domestic policy. And third, to make the financial system more resilient through appropriate regulation at the global level.

In the aftermath of the global financial crisis, the decisions of G20 Leaders triggered reforms that, coordinated through the FSB, have made the global financial system more resilient and growth-enhancing. At this critical juncture, I ask for the G20's continued and reinforced support for the work of the FSB, to strengthen the resilience of the financial system as a whole. The objective is not only to address key vulnerabilities; but to ensure that finance can support our economies in harnessing the benefits of digitalisation and the climate transition while managing the associated risks.

I look forward to a close and cooperative relationship with the Indian G20 Presidency as we take forward our work in 2023.

Yours sincerely,

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