FSB FINANCIAL STABILITY BOARD

THE CHAIR

14 April 2022

To G20 Finance Ministers and Central Bank Governors

Russia's invasion of Ukraine has profoundly changed the global economic and financial market backdrop. Uncertainty around the outlook for a sustained and broad-based recovery from the COVID-19 pandemic has grown, and inflationary pressures have risen. So far, global financial markets have been functioning in an orderly manner and no major financial institution has shown signs of distress, notwithstanding bouts of high market volatility and large commodity price swings.

Yet global financial stability cannot be taken for granted going forward. Close monitoring of current developments and timely and thorough assessment of their financial stability impacts remains key. By the same token, the unpredictable nature of shocks underlines the importance of the FSB's ongoing work to support the resilience of the global financial system.

In this letter, I will discuss the outlook for financial stability and set out what the FSB plans to do in the coming months to assess and address emerging vulnerabilities.

Current outlook for financial stability

The Russian invasion of Ukraine triggered large price fluctuations in global financial markets. The epicentre has been commodity markets, reflecting expected or actual tightening of physical supply of a range of energy products and other commodities. Prices have swung wildly, with liquidity temporarily evaporating in some commodity derivatives market segments and a number of traders coming under strain, including from large margin calls. Global financial markets have also been volatile, but have functioned in an orderly manner, despite heavier than normal trading volumes. Liquidity in core funding markets has broadly remained adequate.

Thus far, the direct global financial stability impact of the war in Ukraine appears limited compared to the COVID-19-induced turmoil in March 2020. To some extent, this may reflect the different nature of the two shocks. And the experience with COVID-19 – including the determined and bold international policy response to it and the demonstrated greater resilience of the core of the global financial system, not least thanks to the G20's post-2008 crisis reforms – may have supported market confidence.

However, there is no room for complacency. Uncertainty about the potential future economic and financial market impacts of the war in Ukraine remains high. Inflation is back, and with it (the prospect of) tighter financing conditions. Markets might react to unfolding events in

Phone: +41 61 280 80 80 E-mail: fsb@fsb.org CH-4002 BASEL, SWITZERLAND

unexpected ways, and sharp moves in prices and liquidity needs have the potential to crystallise vulnerabilities that have been building for some time, such as high debt levels in the non-financial sector and stretched valuations.

The past few weeks have surfaced a number of issues that warrant particular attention. A first issue concerns linkages between commodity markets and the rest of the financial system. These markets may impact financial stability through various channels including lending to commodity market participants. A second, related issue is that commodity market volatility has led to large margin calls for commodities derivatives, that seem to have placed strains on a number of market participants. Third, it is important to gain a more comprehensive picture of leverage in the financial system and possible amplifiers in the event of market stress, including through banks' prime brokerage businesses. Finally, cyber attacks remain a key risk that calls for heightened vigilance and strong cyber response and recovery capabilities.

For many emerging market and developing economies heightened geopolitical tensions and rising energy and food prices are adding to the economic strain from COVID-19, reduced policy space and tightening global financial conditions. This backdrop reinforces the need to address vulnerabilities related to external financing. The report on *US dollar funding and emerging market economy vulnerabilities*, which the FSB submitted to this G20 meeting, draws policy implications to tackle the build-up of foreign exchange mismatches, to address liquidity mismatches in investment funds, to enhance crisis management tools, and to deal with data gaps to facilitate risk monitoring and the timely adoption of policies.

The FSB is responding to the current financial stability challenges in two main ways. One is intensified monitoring of current market developments and emerging vulnerabilities, with a focus on the resilience of critical nodes in the global financial system. The other is in-depth analysis and assessment of specific potential vulnerabilities, with a particular focus on commodity markets, margining and leverage. The FSB's ongoing work for the G20 on exit strategies from COVID-19 and measures to avoid scarring effects will also consider the possible implications of current developments for financial policies.

Current developments and ongoing policy work

The current financial stability challenges reinforce the importance, and increase the urgency, of the FSB's ongoing policy work in a number of areas, including: the financial risks from climate change; strengthening the resilience of non-bank financial intermediation; as well as crypto-assets and cyber risks.

The intense debate about current and future energy policies in many jurisdictions highlights that financial risks related to climate change, including transition risks, are not just a long-term issue or tail event. It confirms the importance of taking forward the *FSB Roadmap for Addressing Climate-related Financial Risks*. Work is progressing in all four areas of the Roadmap: disclosures, data, vulnerabilities analysis, and regulatory and supervisory practices and tools. Later this month, the FSB will publish for consultation an interim report on supervisory and regulatory approaches to addressing climate-related financial risks. A milestone has been the recent publication by the International Sustainability Standards Board (ISSB), under the IFRS Foundation, of its exposure draft for consultation on climate-related reporting standards. We welcome this release as a major step towards the establishment of a global baseline standard for corporate climate disclosures.

Discussions about the role of non-bank participants in commodity markets, margins and leverage underline the need to properly understand the interconnections between non-banks and banks to facilitate a more holistic approach to enhancing financial sector resilience. Complementing the focused work on margins and leverage mentioned before, as part of its work programme to strengthen non-bank financial intermediation (NBFI), the FSB is developing a systemic approach to NBFI and policy proposals that are effective from a system-wide perspective. In October, the FSB will deliver a comprehensive progress report on the various initiatives under the NBFI work programme to the G20 Summit, including on the main findings of relevant FSB and standard-setting body initiatives and on policy proposals to address systemic risk in NBFI.

The Russia-Ukraine war has reinforced pre-existing concerns about the growth and potential illicit use of crypto-assets. Crypto-asset markets are fast evolving and could reach a point where they represent a threat to global financial stability due to their scale, structural vulnerabilities and increasing interconnectedness with the traditional financial system. The FSB is taking forward, in collaboration with standard-setting bodies, including FATF, work on the regulation and supervision of ‘unbacked’ crypto-assets and ‘stablecoins’. It is also analysing the financial stability impacts of rapidly evolving Decentralised Finance (DeFi), in order to help to create the necessary conditions for safe innovation. We will keep the G20 updated on the FSB’s work on crypto-assets, reflecting the ambitions set out in the February G20 communique.

Recognising that information on cyber incidents is crucial for effective action, the FSB will build on its earlier work in this area by promoting greater convergence in cyber incident reporting and deliver a consultative report on its proposals to the G20 in October.

The FSB is continuing to coordinate the work to advance the G20 cross-border payments roadmap. This work will provide the platform for the action and investment needed, by both the private and public sector, to meet the targets for improving cross-border payments that G20 members committed to last October.

The FSB’s *work programme for 2022*, published a few weeks ago, sets out the other main areas of work and deliverables .

Conclusion

Current challenges underscore the importance of the FSB’s system-wide perspective and its work to bolster the resilience of the financial system as a whole. Russia’s invasion of Ukraine is creating headwinds for the global economic recovery, through highly volatile commodity prices as well as indirectly, through added upward pressure on inflation and interest rates. The uncertain economic outlook, alongside rapid structural shifts in the financial system related to digital innovation and climate change, may result in new vulnerabilities that call for coherent policy responses across sectors and jurisdictions.

The current situation also exemplifies the need for continued close international cooperation on financial stability matters. The provision of finance for an equitable recovery and a transition to sustainable growth is contingent upon financial stability. Maintaining global financial stability requires an early identification of vulnerabilities and their potential international implications; a common understanding of measures needed to address vulnerabilities; and the ability to take swift action across jurisdictions as needed.

Yours sincerely,

Klaas Knot