



To G20 Finance Ministers and Central Bank Governors

The conflict in the Middle East has resulted in a substantial shock to the global economy. It has prompted significant financial market reactions, so far notably in energy prices and government bond yields. To date, the financial system has absorbed this shock, reflecting the resilience built into the system, including through post-crisis reforms.

Financial conditions have tightened. We have to be particularly alert to this volatility in financial markets and tightening in conditions interacting with other vulnerabilities, including: stretched asset valuations; the build-up in the non-bank sector of high and increasingly concentrated leverage; and liquidity mismatches, opacity and growing complexity in certain markets, notably private credit.

Put simply, there is an increased likelihood that multiple vulnerabilities could crystallise at the same time, thereby amplifying the threat to financial stability and the provision of critical financial services. I call this the risk of a double or triple “whammy”.

In terms of triggers, one that I would emphasise is financial markets moving to price a much larger impact on global economic growth. So far, more of the impact has been seen in rates markets, consistent with a greater emphasis on the inflation consequences. Were markets to switch their relative attention to risk assets, consistent with relatively more emphasis on growth consequences, abrupt re-pricing in equity prices could coincide with the already greater focus on valuations in private assets.

Outlook uncertain and unpredictable

The conflict has made the global financial environment more uncertain and unpredictable. The distinction is important: uncertainty is about the difficulty of assigning a probability to an expected outcome; unpredictability is whether the outcome can be predicted in the first place. This makes it much harder for financial markets to price economic fundamentals, thereby increasing asset price volatility.

The impact of these conditions on financial stability will depend on the duration, scale and consequences of the conflict. There is no doubt that the most effective way to tackle the situation is at the source of the shock, in other words to re-open energy supply routes. Even then, the physical damage to oil and gas infrastructures will continue to weigh on energy supply for some time.

Sovereign bond markets have continued to see historically large levels of issuance. Many of these markets have transformed in recent years, such that they feature a high use of leverage by a limited number of funds pursuing similar strategies across jurisdictions. As a consequence, there is a heightened risk of a disorderly unwinding of positions leading to illiquidity in core markets and cross-border spillovers. So far, the greater volatility and much higher trading volumes have been absorbed by markets. But this requires constant vigilance to prevent disorderly developments having a larger impact.

Valuations of some risky assets have declined in response to the conflict. But, in general, despite the outbreak and the impact on energy supplies, risk premia in global equity and debt markets remain compressed by historical standards. This has limited the fall-out from the conflict, but the risk remains of a sharp adjustment if economic conditions deteriorate.

Relevant here is the presence of some sectors where valuations were particularly stretched before the conflict broke out. In some – such as those that are AI-related – a natural part of the business model is to require the financing of very substantial investment, alongside understandably significant uncertainty around future returns. The conflict could exacerbate the inherent vulnerability of this situation.

Investor sentiment relating to some risky credit markets, notably private credit, had deteriorated before the conflict started. Increasing concerns around asset quality, valuations and liquidity have led to a larger scale of redemption requests in some funds, and in some cases to enforcements of existing structural redemption limits. There is a higher level of opacity involved in the structure of the private credit sector.

That is important because the economic consequences of the conflict could increase debt-servicing pressures for leveraged borrowers and could reduce asset quality, thereby raising the pressure on private credit funds. There is a heightened risk that the opacity of these markets could trigger a wider loss of confidence, even when the precise causes of problems are idiosyncratic to particular borrowers. The FSB's upcoming report on private credit examines potential vulnerabilities related to three areas: the interlinkages between banks and private credit, the creditworthiness of private credit borrowers, and the difficulties in valuing private credit assets. We will continue our monitoring and conduct further work in the months ahead.

Resilience of the financial system

Despite the uncertainty, banks have remained resilient, reflecting the strength and importance of our post-global financial crisis reforms. These reforms have materially enhanced the system's capacity to absorb shocks rather than transmit them. It remains essential that we continue progress in implementing agreed reforms, including Basel III standards, to ensure sustained resilience.

We have seen the growth of interlinkages between the private equity and credit markets and some areas of the life insurance sector. There are natural reasons for these linkages, particularly in view of the longer-term nature of the assets. However, in view of the importance of life insurance contracts for the long-term saving and retirement income of many people, it is vital that these arrangements are subject to robust risk management and oversight. The FSB

will work with the International Association of Insurance Supervisors to support its efforts in this area.

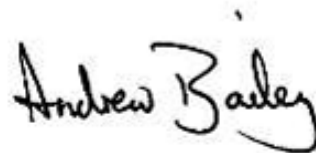
While wholesale funding markets have continued to function so far, they warrant close attention given the role they can play in propagating shocks. One channel could be via the repo markets, which, as our recent report shows, can face sharp demand and supply imbalances. We continue to monitor this closely. Another channel could be via the foreign exchange derivative markets, where the FSB is also advancing analytical work.

Conclusion

The FSB remains focused on identifying vulnerabilities early, strengthening the resilience of the financial system, and supporting members in navigating an increasingly uncertain global environment. If the size and economic impact of this shock continues to increase, the risk that it interacts with known vulnerabilities will also increase. We will monitor closely how this shock develops, including the potential of more than one vulnerability crystallising at the same time, leading to broader effects within the system, and a loss of confidence.

At this time of heightened risk, international cooperation on financial stability is even more important.

Yours sincerely,

A handwritten signature in black ink that reads "Andrew Bailey". The signature is written in a cursive, slightly slanted style.

Andrew Bailey