THE CHAIR

14 July 2020

To G20 Finance Ministers and Central Bank Governors

The outbreak of COVID-19 and the containment measures that governments have adopted in response (the "COVID Event") have taken an unprecedented economic toll. But the shuttering of economic activity has also sparked unprecedented fiscal and monetary interventions, and as a result we have seen some hopeful signs. From these events, we can draw two productive initial conclusions. First, we have seen that financial reform can improve economic resilience, including resilience to a shock that originated outside the financial sector. As a direct result of the international reforms undertaken both by authorities and by the banking sector itself after the Global Financial Crisis of 2008-09, banks were able to absorb rather than amplify the shock of the COVID Event. Second, we have seen that markets are responsive to quick and decisive policy actions. In the immediate term, the swift intervention of FSB members helped to stabilize markets. But the COVID Event is not over, and the path of recovery is still uncertain, with a high likelihood of starts and sputters along the way.

Against this backdrop, the FSB is playing a critical role in coordinating the response: ensuring that members stay agile, learn from one another, and anticipate coming challenges. Since the beginning of the COVID Event, FSB members have been meeting by video link and telephone almost continuously to discuss market developments, assess financial vulnerabilities, review policy actions taken, and coordinate regulatory responses based on the FSB Principles that the G20 endorsed in April. FSB member views have also been informed by outreach with the private sector during this time. This work is summarized in the report on the COVID Event that we submitted to the G20 today.

Looking ahead, we see some challenges to come. The corporate sector entered the crisis with high levels of debt and necessarily borrowed more to navigate the crisis, raising solvency concerns for some borrowers. Stresses in key funding markets triggered emergency central bank intervention, which stabilized markets and eased strains in non-bank financial intermediation, including in money market mutual funds (MMFs). Notwithstanding actions on this unprecedented scale, further liquidity stresses remain a risk. Volatility in markets has decreased but may well return. We may be seeing significant pricing disconnects between the market and economic fundamentals, which could result in sudden and sharp repricing. The impacts of these economic strains may be amplified in emerging markets, given the risks to their currency and debt markets from capital outflows.

We *cannot* be complacent. The crisis is far from over and we must not lose sight of the hard work we must do together to support global recovery. We also must not close our eyes to the lessons of this crisis. As in the past, the FSB will play a critical role in using our collective learning to improve resilience in the global financial system.

Maintaining financial stability during the COVID Event and beyond: existing and future work

In the update report on the financial stability implications of the COVID Event submitted to the G20 for this meeting, we draw on significant work undertaken to assess vulnerabilities, consider policy responses under different recovery scenarios, and note where additional work may be necessary. This report also consolidates the extraordinary policy measures taken across our national membership and standard-setting bodies (SSBs) to address the financial fallout of the pandemic.

Assessing vulnerabilities during the current crisis. The FSB has identified a number of priority areas that require further analysis during the current crisis, including, among others, risks related to liquidity stress; the debt burden of non-financial corporates; and effects of credit rating downgrades. The FSB, working closely with IOSCO's Financial Stability Engagement Group, has also put in place a monitoring exercise to regularly report on the resilience of four critical nodes in the global financial system to COVID Event stresses, namely the ability of i) the financial system to finance the real economy; ii) market participants to obtain U.S. dollar funding, particularly in emerging markets; iii) financial intermediaries to meet liquidity demands without forced asset sales; and iv) market participants to effectively manage counterparty risks. This work provides essential and near real-time input for policymakers to anticipate and address developing risks in the financial system.

Reinforcing resilient non-bank financial intermediation (NBFI). The impact of the COVID Event on credit markets has highlighted vulnerabilities in the NBFI sector related to liquidity mismatches, leverage and interconnectedness, and investor behavior related to certain funds that they may treat as cash equivalents during economic calm but not during crisis. While extraordinary central bank interventions calmed capital markets, which remained open and enabled firms to raise new and longer-term financing, such measures should not be required. Understanding risk, risk transmission, and policy implications for the NBFI sector is more important than ever.

Authorities across the financial sector must develop a shared understanding of our financial system as a whole and build consensus where policy responses may be needed. The FSB has formed a group on non-bank financial intermediation, composed of senior leaders from market regulators, macroprudential authorities, and international organizations, which will build a holistic view of resilience in the NBFI sector. By the G20 Summit this November, the group will carry out a holistic review of the market turmoil that occurred in March by leveraging the various workstreams underway in the FSB and SSBs. In addition, the FSB has begun a mapping exercise of the critical connections between traditional banking and non-bank sectors in a cross-border setting. This combined work will clarify the various points of vulnerabilities and risk amplification and transmission in the financial system, and will inform future steps of the FSB in 2021 under the Italian G20 Presidency to improve the resiliency of the NBFI sector while preserving its benefits.

Identifying and assessing policy responses. The decisive immediate policy response has laid the ground for effectively containing the economic and financial fallout of the COVID Event. As the focus shifts to measures to address a growing need for real-economy financing amid deteriorating credit quality, the FSB has been sharing information on policy responses and their relationship to the potential paths of economic recovery. We are identifying indicators to help assess the efficacy of policy actions. This will provide policymakers with a better understanding of the consequences of their interventions and a mechanism to share lessons learned with policymakers from other jurisdictions. As this work continues and information sharing deepens, FSB members will be better prepared to act and to adjust according to the course of economic recovery.

Looking forward, the FSB will continue to consider how supervisors and regulators can successfully navigate through this crisis, and eventually emerge from it. The FSB will study policy responses, including evaluating aspects of importance for emerging market economies. The FSB will also help coordinate supervisory and regulatory actions, including to take account of cross-border spillovers and promote a level playing field.

Monitoring consistency with standards. Reflecting the FSB's commitment to agreed-upon financial reforms, it has compiled, in cooperation with SSBs, the COVID Event actions taken by FSB members. This work evaluates the consistency of the member actions with agreed-upon financial reforms and the extent to which the actions have used the flexibility within international standards. The review covered the FSB standards on resolution regimes and compensation practices, the BCBS Basel III framework, the CPMI-IOSCO principles for financial market infrastructures, and the IOSCO recommendations for investment funds and MMFs. The FSB will carry out a further review of policy measures ahead of the November G20 Leaders' Summit.

Using flexibility in standards and buffer use. Most measures taken by FSB members have used the flexibility built into international standards, including regarding the use of capital and liquidity buffers. The FSB supports the Basel Committee statement that a measured drawdown of buffers is both expected and appropriate during the current period of stress. Use of Basel III buffers in this time of crisis to both absorb losses and support lending is consistent with a well-functioning, prudently-managed banking system and with the design and intended functioning of the Basel III framework. Supervisors have agreed that banks will be given sufficient time to restore buffers, taking account of economic and market conditions and individual bank circumstances.

Maintaining a commitment to a more resilient financial system

The crisis has not weakened our resolve to continue work we already have begun to strengthen the global financial system. Systemic vulnerabilities must be addressed to improve access, resiliency, and efficiencies in the global financial system.

Evaluating financial reforms. The COVID Event has underscored the need to ensure that regulatory reforms are working as intended. Last month, we published a consultation report on the effects of our too-big-to-fail reforms, the most important yet in our series of evaluations of the reforms following the 2008-09 crisis. The evaluation has found that banks are now more resilient and resolvable, and that the benefits of the reforms significantly outweigh the costs. But there are still gaps that need to be addressed by implementing the agreed standards in order to remove remaining obstacles to resolvability. We look forward to public feedback on these findings.

Supporting a smooth transition away from LIBOR. LIBOR transition remains an essential task that will strengthen the global financial system. Our report on supervisory issues associated with transition away from LIBOR draws attention to the continued need to focus on ending reliance on LIBOR and provides recommendations to assist with this. The FSB remains committed to, and urges the official and private sector to prepare for, the transition from LIBOR by end-2021.

Enhancing cross-border payments. Improving arrangements for cross-border payments remains critical. Building on our earlier report that identified challenges posed by existing systems, we submit to you a second report, written by CPMI, that provides a comprehensive set of building blocks to address the identified challenges. The FSB will deliver in October, as planned, the overall roadmap to improve cross-border payments, in coordination with the CPMI and other bodies. This final stage will yield a plan so that the international community can take decisive action to improve payments arrangements and make the financial system more resilient and inclusive.

Conclusion

The FSB was created in time of crisis to navigate through uncertain and challenging times and to provide a new global coordination mechanism for the future. The COVID Event has demonstrated the importance of that mechanism for the current crisis – and also highlighted a path for future work. FSB members will study potential risks and consider the appropriate coordinated policy responses for the range of future paths to economic recovery. We also will continue the work that will make the global financial system more resilient to any future crises. Together with the resolve of the G20, the FSB has led in times of crisis and will continue to do so in the coming months.

Yours sincerely,

Randal K. Quarles