FSB FINANCIAL STABILITY BOARD

THE CHAIRMAN

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To G20 Finance Ministers and Central Bank Governors

Thus far this year, the global economy and financial system have weathered two spikes in uncertainty and risk aversion. The first reflected downward revisions to the expected medium-term growth prospects of the world economy as a result of renewed appreciation of the structural challenges facing a number of G20 economies. In the financial sector, the volatility also reflected concerns that many banks have more to do to adjust their long-term business models to a lower growth and nominal interest rate environment and strengthened international regulatory framework. The second episode, occurring in recent weeks, reflects uncertainty over the potential implications of the UK's vote to leave the European Union. It may take time for the ramifications of the vote to be fully understood.

In both cases, the global financial system continued to function effectively, and the financial system dampened aftershocks from these events rather than amplifying them. This resilience in the face of stress demonstrates the enduring benefits of G20 reforms. Large financial institutions are now significantly better capitalised, and stronger liquidity requirements mean banks have the funding to continue lending in stressed conditions. Financial markets have been made more robust to shocks, and credible stress tests have proven a valuable part of the post-crisis toolkit.

Although welcome, we cannot allow this resilience to foster complacency. Recent events reinforce the importance of finishing the job of implementing the post-crisis reforms. Both episodes highlight the importance of the ongoing work of the FSB to address potential structural vulnerabilities in some aspects of market-based finance.

Going forward, our collective goal should be to build an open, global financial system which supports sustainable cross-border investment. Such a financial system will reinforce other elements of the G20 agenda by supporting the long-term and infrastructure investments that will benefit all.

To this end, the FSB's priorities for 2016 continue to be:

1. Promoting a coordinated programme of reforms to deliver resilient sources of market-based finance, including addressing structural vulnerabilities associated with asset management activities;
2. Developing robust financial market infrastructure, including assessing policies on central counterparty (CCP) resilience, recovery and resolvability, and recommending any necessary improvements; and
3. Supporting effective macroprudential arrangements, by drawing lessons from national experiences of the practical application of macroprudential policy frameworks and tools working in partnership with the IMF and BIS.

Alongside these current priorities, the FSB is also:

4. Pursuing the full and consistent implementation of post-crisis reforms, while addressing material unintended consequences;
5. Addressing new and emerging vulnerabilities in the financial system, including those associated with conduct, correspondent banking and climate change; and
6. Monitoring the potentially systemic implications of financial technology innovations, and the systemic risks arising from operational disruptions.

This letter outlines the progress the FSB is making in advancing these and other goals ahead of the Hangzhou Summit of the Chinese G20 Presidency.

BUILDING AN OPEN AND RESILIENT GLOBAL FINANCIAL SYSTEM

1. Promoting resilient sources of market-based finance

A top priority for the FSB in 2016 has been to tackle the structural vulnerabilities of asset management activities.

This focus reflects the fact that the financial system has changed markedly since the crisis. Market-based finance has grown significantly, creating new sources of credit and investment, promoting financial openness and international flows of capital, adding welcome diversity and reducing reliance on bank-based finance.

Indeed since the crisis, a growing share of credit has been extended via market-based debt finance. This is particularly true for emerging market economies, which have tripled their net annual issuance of international bonds compared to the five years before the crisis to an annual average of almost $300 billion over the past five years. Asset managers are now major intermediaries for international capital flows and the diversity and reduced reliance on bank-based finance they bring is helping to create a more resilient financial system that can support long-term goals such as infrastructure and green investment.

If these capital flows are to be sustained without the risks of ‘sudden stops’ in investment, then structural vulnerabilities presented by asset management activities must be addressed. This is all the more important as greater capital flow volatility and divergent monetary policy paths can lead to reversals of capital flows to emerging market economies.

In June 2016, the FSB published 14 proposed policy recommendations to address the financial stability risks posed by funds’ liquidity mismatch; leverage within funds; operational challenges associated with transferring investment mandates in stressed situations; and the securities lending activities of asset managers and funds. The FSB also encouraged authorities to consider the use of stress testing to assess the individual and collective ability of funds to meet their redemptions under stressed market conditions.

Support from G20 Finance Ministers and Governors will help maintain momentum to see this work through and to ensure market-based finance remains a resilient source of finance for strong, sustainable and balanced growth.

The task of authorities is to ensure markets still function well under pressure and that financial systems are not undermined by market illiquidity or become fragmented. The FSB has studied the extent, drivers and likely persistence of shifts in market liquidity in fixed income markets. To date, there is little evidence of a decrease in the liquidity of these markets in normal times, but there is some evidence of less depth in specific sovereign and corporate debt markets. The implications of this for the resilience of market liquidity under stressed conditions will be further analysed. Specifically, the FSB will deliver:

- **Ahead of your July meeting,** the FSB has already published for public consultation its policy recommendations to address the structural vulnerabilities associated with asset management activities. The recommendations will be finalised by the end of 2016, and IOSCO will take forward the operationalisation of the recommendations on funds' liquidity mismatch by end-2017.
- **Also ahead of your July meeting**, the FSB has published a peer review on members' implementation of the Policy Framework for Oversight of Regulation of Shadow Banking. The peer review made recommendations for further operationalisation of the Framework, which remains at an early stage of implementation, including by facilitating the sharing of information among member authorities on policy tools and public disclosures.
- **By the early part of the German G20 Presidency**, we propose to report our further findings on market depth and funding liquidity, including the results of a cross-jurisdiction study by the Committee on the Global Financial System of developments in repo markets, given the importance of these markets for overall market liquidity.

2. Developing robust financial market infrastructure

Robust financial market infrastructure is also needed to underpin efficient, effective and resilient markets that are able to support investment and growth. The services provided by central counterparties (CCPs) support the continued growth of international market-based finance and facilitate more sustainable cross-border capital flows.

Greater reliance on CCPs to reduce systemic risks by making the links between banks less complex and systemic, as well as by making derivatives markets simpler and more robust, has been a central element of G20 reforms. However, since CCPs are themselves systemic, the FSB is now working with CPMI and IOSCO to ensure that CCPs do not become too-big-to-fail. This work is focused on strengthening CCP resilience, including in relation to their ability to recover after shocks, and to be resolved in the event that recovery efforts do not succeed.

To strengthen CCP resilience and recovery, CPMI-IOSCO will issue for consultation in the coming weeks recommendations regarding financial market infrastructure governance, credit and liquidity stress testing, coverage of financial resources, margin, and a CCP's contributions of its financial resources to losses. The consultation also provides guidance to facilitate a CCP's development of its recovery plan by building on and reiterating certain aspects of CPMI-IOSCO's *Recovery of financial market infrastructures.*

Toward developing policies for CCP resolution, the FSB's forthcoming consultation on high-level guidance covers the timing of entry into resolution, the adequacy of financial resources in resolution, the order for allocating losses in resolution, as well as cross-border cooperation in resolution.

While good progress is being made, encouragement from G20 Finance Ministers and Governors will provide important support to the efforts of public and private sector stakeholders to finalise the recommendations in late 2016 and early 2017.

- **By the Hangzhou Summit:**
  - CPMI-IOSCO will issue for public consultation additional granular guidance on CCP resilience and recovery;
  - the FSB will publish high-level guidance on resolution issues relating to CCPs.
- **In early 2017**, the FSB will issue for public consultation standards or guidance for CCP resolution planning, resolution strategies and resolution tools. These will be finalised by the time of the 2017 G20 Summit.

3. Supporting effective macroprudential frameworks and policies

Macroprudential policy is the use of primarily prudential tools to limit the systemic risks which could cause widespread disruption to the provision of financial services with serious consequences for the real economy. Such risks may build up over time or arise from the structural vulnerabilities associated with interconnectedness and the distribution of risk within the financial system.

Experience with macroprudential policy across advanced economies is growing, and some emerging markets have also been early adopters. To help draw lessons across the accumulated experience of FSB members, the FSB, working with the IMF and BIS, has taken stock of the experiences gained so far regarding elements and practices, across policy tools and frameworks. These experiences can help inform all G20 jurisdictions in the development of effective macroprudential policymaking.

Leaders may consider the potential to leverage this stocktake, including as experience with macroprudential frameworks grows. This will help to identify best practices which would equip jurisdictions seeking to improve domestic macroprudential management and to implement effective macroprudential policies with helpful references and inputs.

- **By the Hangzhou Summit,** the IMF, FSB and BIS will deliver to Leaders a review of international experience and lessons of macroprudential policy frameworks and tools.

OTHER FSB PRIORITIES

4. Full and consistent implementation of post-crisis reforms

Full, timely and consistent implementation of agreed reforms will deliver a more resilient financial system that better supports job creation and growth in the short, medium and long term.

The FSB's second Annual Report to G20 Leaders details our progress implementing agreed reforms and their effects. Steady progress in implementation is being made. We are deepening our framework for evaluating the effects and effectiveness of reforms, while remaining alert to unintended consequences and ready to adjust policies where this is merited.

With the agreements reached in recent years, including the Basel III framework and the global agreement on Total Loss-Absorbing Capacity, the overall international regulatory and resolution framework for banks is now largely settled. The FSB, the Basel Committee and national authorities will continue to work to provide maximum clarity about the details of the framework, to instil confidence about the stability of overall requirements, and to deliver transparency about the extent to which member countries and institutions meet them.

- **By end-2016**, the Basel Committee will address elements of the Basel III framework to ensure its coherence and maximise its effectiveness, and in doing so authorities are committed to not significantly increasing overall capital requirements across the banking sector.

Further steps have also been taken on reforms in other areas. In June the International Association of Insurance Supervisors (IAIS) published its Updated Assessment Methodology for global systemically important insurers (G-SIIs).

- **By end-2016**, the FSB will make its annual update to the lists of global systemically important financial institutions (G-SIFIs).

Trade reporting requirements for over-the-counter derivatives are in place in almost all FSB jurisdictions, thus improving transparency in this market. The FSB is coordinating work to address remaining issues with the quality and completeness of the data which limit authorities' ability to access, use and aggregate these data, including to assess vulnerabilities and concentrations of risk. Member jurisdictions have reported to the FSB their plans to meet their commitments to remove legal and regulatory barriers to the reporting of OTC derivatives to trade repositories and facilitate authorities' access to data by mid-2018.

- **By the Hangzhou Summit**, the FSB will publish members' plans to remove these barriers, together with a summary overview.

5. Addressing new and emerging vulnerabilities

Misconduct risks

The FSB, with other standard-setters, is pursuing a work programme to reduce financial misconduct, which has the potential to create systemic risks by undermining trust in financial institutions and markets. The work includes studying governance frameworks and potentially developing a supervisory toolkit or guidance; examining the effectiveness of disincentives to misconduct in compensation structures; addressing issues in fixed income, currency and commodity markets; and coordinating reforms to major financial benchmarks. The FSB is publishing this month a further monitoring report on implementation of its recommendations on interest rate benchmarks. In May the BIS released the first phase of a Global Code of Conduct for the Foreign Exchange Market.

- **By the Hangzhou Summit,** the FSB will report on progress in the overall work programme to reduce misconduct risk.

Correspondent banking

The Chinese G20 Presidency has rightly emphasised financial inclusion. The Hangzhou Summit can reinforce the FSB's coordinated action plan to address the decline in correspondent banking, which will support inclusion, trade and openness by addressing the risk of some countries or classes of customers becoming excluded from the financial system were current trends in withdrawal of correspondent banking relationships to continue unchecked.

- **By the Hangzhou Summit**, the FSB will deliver a progress report to the Summit on progress in the action plan.

Task Force on Climate-related Financial Disclosures

Access to better quality information on climate-related financial risks will allow market participants to better understand and manage these risks through time. Early understanding will promote a smooth, rather than an abrupt, market repricing of those risks. The FSB established in January a private-sector industry-led task force chaired by Michael Bloomberg to develop voluntary, consistent climate-related financial disclosures for use by companies. In April the task force issued its Phase 1 report, setting out fundamental principles of effective, relevant disclosure in this area and defining the scope and objectives of the next phase of the task force's work.

- **By end-2016**, the task force will publish for public consultation specific recommendations and leading practices for climate-related financial risk disclosures.

6. Financial stability implications of financial technology

A number of technological innovations have potentially transformative implications for the financial system. The regulatory framework must ensure that it is able to manage any systemic risks that may arise from technological change without stifling innovation.

The FSB and the various international standard-setting bodies have set work in train to analyse the financial system implications of financial technological innovations. The FSB has agreed a framework for categorising the innovations and their potential financial stability implications, and we are now analysing specific applications together with the standard-setting bodies.

- **By early 2017,** the FSB and the standard-setting bodies will report on the fintech case studies underway and surface issues that may merit policy attention.

CONCLUSION

Recent events have proven that our intensive work over the past seven years to fix the fault lines that led to the Global Financial Crisis is paying off and is now making a positive contribution towards strong, sustainable and balanced growth. Thanks to rigorous implementation of G20 reforms, the financial sector has been dampening aftershocks from recent events, rather than amplifying them. This shows the G20 is on the right track.

Our collective priority must be to continue the course to implement fully and consistently our past agreements, while swiftly addressing new risks and vulnerabilities, and continue to build an open global financial system that benefits all.

Yours sincerely

Mark Carney