

To G20 Leaders

2018 has been a year of transition:

- from robust, broad-based global growth to a more uneven global expansion with emerging downside risks;
- from accommodative to tightening financial conditions; and
- from strong capital inflows to emerging market economies to capital outflows from many of them, in some cases significantly so.

These transitions are taking place against a backdrop of important structural changes in the financial system, with fast-growing sectors such as fintech and non-bank finance bringing welcome diversity while also creating potential vulnerabilities.

The FSB has also transitioned. After a decade delivering the G20's ambitious reforms to address the fault lines that caused the global financial crisis, the FSB is pivoting to focus on implementing those reforms, evaluating their effectiveness, and adjusting them where necessary. In parallel, new policies are being developed to address new risks to financial stability.

A world in transition will not only test the resilience of the global financial system; it will also present a major strategic opportunity for the G20. Your leadership has created the platform for a more integrated global financial system. Advances in non-bank finance and fintech can build a more inclusive system. Seizing these advantages would ensure that the global financial system serves households and businesses in good times and bad, delivering strong, sustainable and balanced growth across the G20.

The balance of this letter reports on the progress made during 2018 and highlights the main issues which require the attention of G20 Leaders. It follows the priorities of the Argentine Presidency, specifically:

1. Addressing emerging vulnerabilities while harnessing the benefits of innovation;
2. Disciplined completion and implementation of the G20 reform programme;
3. Pivoting from new policy development to ensuring that reforms are operating as effectively and efficiently as possible; and
4. Optimising how the FSB works.

1. Addressing emerging vulnerabilities while harnessing the benefits of innovation

As crisis memories fade, there is a risk that complacency sets in. That's why the FSB undertakes regular, disciplined analysis of financial vulnerabilities and opportunities. We focus equally on what could go wrong and how the system can be strengthened to withstand future shocks, irrespective of source. At present, three developments merit particular attention.

Continued vigilance to contain the risks of non-bank finance

The FSB's latest risk assessment reinforces the importance of implementing its recommendations endorsed by G20 Leaders at the 2017 Hamburg Summit to address the structural vulnerabilities associated with asset management.

Asset management has grown from US\$50 trillion to nearly US\$80 trillion over the past decade, bringing new forms of investment and promoting capital flows from advanced to emerging market economies. Recent developments have, however, also highlighted the risks associated with the US\$30 trillion in open-ended funds that promise their investors daily liquidity while, in some cases, investing in potentially highly illiquid assets.¹ The FSB recommendations address the risk that the liquidity management tools, including redemption terms, and the leverage measures for these funds are inadequate. If unaddressed, these deficiencies could increase the volatility and reduce the sustainable level of capital flows to emerging market economies.

In response, the International Organization of Securities Commissions (IOSCO) issued recommendations in February on the measures to improve funds' liquidity management, and has just launched a consultation on a framework which should deliver consistent, decision-useful measures of leverage in funds. Once the recommendations are implemented, the FSB will report to the G20 on the assessment by IOSCO and FSB of whether this implementation has been effective or if more action is required.

The continued support of G20 Leaders in this area is important, particularly given the stakes for sustainable capital flows to emerging market economies.

Making the core of the system as robust to operational risks as to financial ones

While past crises had their roots in financial losses, in our digital era systemic shocks can also come from non-financial sources, including cyber incidents. Building on the 2017 stocktake of regulatory and supervisory cyber security practices, the FSB is delivering to this Summit a cyber lexicon to support the work of both the public and private sectors in addressing this threat. The FSB's focus will now turn to developing effective practices for financial institutions' responses to, and recovery from, major cyber incidents.

Harnessing the benefits of new financial technologies while containing the risks

The FSB is working to ensure that the G20 can harness the benefits of new financial technologies, while containing associated risks to financial stability. Where risks are material,

¹ As identified in the FSB's 4th Annual Report on Implementation and Effects of G20 Financial Regulatory Reforms delivered to G20 Leaders.

they are treated proportionately to, and consistently with, those already present in the financial system. This ensures that regulation does not choke off dynamism and innovation.

In response to the G20's request earlier in the year, the FSB undertook an initial assessment of crypto-assets and concluded that they did not currently pose significant risks to global financial stability. The FSB recognised that risks could increase if crypto-assets became more widely used or if their linkages to the rest of the financial system grew. It also highlighted the serious issues crypto-assets pose around consumer and investor protection, money laundering, and terrorist financing. Work to address these issues is now being undertaken by national authorities and standard-setting bodies, including the Financial Action Task Force. The FSB will continue to monitor the situation and report to the G20 as required.

More generally, the FSB and standard-setting bodies are exploring how a broad range of innovations—including distributed ledger technology, the global legal entity identifier (LEI), artificial intelligence and various payments technologies—could promote financial stability while bringing wider benefits to consumers and businesses. In these efforts, we will work closely with the IMF and World Bank to support the Bali Fintech Agenda.

2. Disciplined completion and implementation of the G20's reform priorities

After a decade of concerted effort, policies are now in place to address most of the G20's financial reform priorities.

G20 post-crisis reforms have delivered a safer, simpler and fairer financial system

Reforms have strengthened the core of the financial system so that it would likely absorb, rather than amplify, most shocks. Large banks are considerably stronger, more liquid, and more focused. They are now subject to greater market discipline as a consequence of globally-agreed standards to end too-big-to-fail. A series of measures have eliminated toxic forms of shadow banking at the heart of the crisis, while reinforcing resilient non-bank financial intermediation. Reforms to over-the-counter (OTC) derivative markets are replacing a complex and dangerous web of exposures with a more transparent and robust system that better serves the real economy.

To reinforce this progress, the FSB is working with standard-setters to complete work on a few final policy areas and focus on the full, timely and consistent implementation of the agreed reforms.

Finalising and implementing Basel III

The finalisation of the remaining elements of Basel III a year ago marks completion of one of the most significant areas of post-crisis reform design. Emphasis will now be on full, timely and consistent implementation in order to secure the benefits of a resilient international banking system.

Finalising policy to deliver resilient, recoverable and resolvable central counterparties

Greater use of central counterparties (CCPs) will reduce systemic risks in derivative markets, provided CCPs meet the highest standards of resilience, recoverability and resolvability. To that end, G20 reforms have significantly increased margin and liquidity standards and improved the operational and cyber resilience of CCPs.

The FSB issued for this Summit for public consultation a framework to evaluate whether CCPs have adequate financial resources to support resolution, and whether equity holders are treated appropriately. The FSB will finalise its guidance in this area by 2020 and later report to G20 Leaders on whether, when taken together, policies on resilience, recovery and resolution are adequate given the critical role of CCPs in our financial systems.

Bolstering measures to address the underlying causes of misconduct

This year, the FSB completed a toolkit of measures which supervisors and firms can use to strengthen the governance frameworks of financial institutions, including by increasing the accountability of senior management for misconduct within their firms. The toolkit complements other elements of the FSB's Misconduct Action Plan, including compensation recommendations that better align risk and reward and reforms to strengthen major financial benchmarks, as part of broader measures to restore public trust in the financial system.

Delivering a new framework for addressing systemic risks in insurance

During 2018, the FSB has monitored progress by the International Association of Insurance Supervisors (IAIS) to develop a holistic framework for the assessment and mitigation of systemic risk in the insurance sector. Ahead of this Summit, the IAIS has issued a consultation on such a framework, setting out an activities-based approach for sector-wide risk monitoring and management, as a key component, and tools for dealing with the build-up of risk within individual insurers. The FSB notes that a new holistic framework, appropriately implemented, would provide an enhanced basis for mitigating systemic risk in the insurance sector.

Maintaining an open and inclusive financial system through the Correspondent Banking Action Plan

'De-risking' in correspondent banking relationships has threatened the ability of a range of affected countries to access the international financial system, with consequences for financial inclusion and financial stability in these countries.

The FSB is delivering for this Summit all policy development elements of its Correspondent Banking Action Plan, including regular production of data on trends; clarification of regulatory expectations; support for domestic capacity-building through technical assistance; and stronger tools for due diligence by banks. In response to a related G20 request, the FSB made in March strategic recommendations for the actions national authorities, banks and remittance firms can take to improve remittance firms' access to banking services.

Going forward, standard-setting and international bodies, under the coordination of the FSB, will pick up the mantle of monitoring implementation of the Action Plan, including the remittance elements, to maintain the momentum needed to improve the situation. Should the situation deteriorate further, additional actions to address the issue may need to be considered. This work will be vital both to addressing anti-money laundering and counter-terrorist financing imperatives and to ensuring a wide range of countries beyond the G20 stay connected to the global financial system.

Mitigating the financial stability risks from climate change through the Taskforce on Climate-related Financial Disclosures (TCFD)

There has been encouraging progress since the voluntary, private-sector-led TCFD recommendations were finalised for the Hamburg Summit. Demand for climate-related financial disclosures is becoming mainstream, with support for the TCFD from financial institutions responsible for managing US\$100 trillion of assets, including three-quarters of globally systemically important banks, 8 of the top 10 global asset managers, the world's leading pension funds and insurers, and the two dominant shareholder advisory service companies. Companies are responding to this surge in demand, with the TCFD's September report finding that a majority of companies reviewed are already reporting against some of its recommendations. Adoption can be expected to widen and improve as the private sector refines emerging good practice in efficient, decision-useful material climate-related financial disclosure. The TCFD will provide a full implementation report to the Japanese G20 Presidency.

3. Pivoting to policy evaluation to ensure reforms are delivering resilience efficiently

As its work to fix the fault lines that caused the financial crisis draws to a close, the FSB is pivoting from design of new policy initiatives towards dynamic implementation and rigorous evaluation of the effects of the agreed G20 reforms. Our objectives are to assess whether reforms are operating as intended, and to identify and deliver adjustments where appropriate, without compromising on the agreed level of resilience. This dynamic implementation will ensure that the G20 reforms remain fit for purpose amidst changing circumstances. The new policy evaluation framework delivered to the previous G20 Summit was applied for the first time during the Argentine Presidency, with the FSB reporting on two evaluations and deciding on future evaluation topics.

Supporting infrastructure finance through good times and bad

The first evaluation, on financial intermediation, supports the Argentine G20 Presidency's focus on *infrastructure investment*. The report delivered to this Summit assesses how financial reforms affect the availability and cost of infrastructure finance, and whether, whilst strengthening the financial system, reforms have had unintended consequences in this area.

The report notes that G20 financial reforms help ensure that the financial system can continue to support the real economy through the cycle, while reducing the macroeconomic impact of crises. This will support higher levels of infrastructure financing through time.

The evaluation finds that the more specific effects of G20 reforms on infrastructure financing have been of second order importance relative to other factors such as the supply of investable projects (which are being considered through the G20's initiative to develop infrastructure as an asset class). There is evidence that the G20 banking reforms have helped diversify the sources of infrastructure finance, which should provide greater stability of financing over time. The evaluation also reinforces the importance of international standard-setting bodies keeping under consideration the extent to which their standards – such as those for insurance – are adequately calibrated to the particular characteristics of infrastructure finance.

Making derivative markets safer, through better incentives to centrally clear

The second evaluation delivered to this Summit considers whether adequate incentives to centrally clear OTC derivatives are in place. The evaluation concludes that they are, with G20 reforms supporting marked increases in clearing rates and collateralisation of exposures. These changes have meaningfully reduced systemic risks in derivatives markets.

At the same time, a tension between other reforms designed to improve the resilience of banks and those to incentivise central clearing was confirmed. In response, the standard setter, the BCBS, has recently issued a consultation setting out options for adjusting the leverage ratio treatment of client cleared derivatives.

Taken together, these two evaluations show how the FSB can coordinate work to address issues spanning the broad set of G20 financial reform objectives and sectors. They also show the importance of a robust evidence-based approach that results in adjustments only where warranted. This enhances the effectiveness of reforms without compromising the resilience of the global financial system.

The FSB will now evaluate whether G20 reforms are supporting the flow of finance to small and medium enterprises, and how effectively G20 measures are ending too-big-to-fail.

4. Optimising how the FSB works to maximise its effectiveness and transparency

A decade ago, the G20 created the FSB to identify and address vulnerabilities that could threaten the stability of the global financial system. The G20 put the FSB on a firm institutional footing which has ensured its effectiveness in pursuing an ambitious set of cross-sectoral financial reforms to fix the fault lines that caused the crisis as well as to mitigate new and emerging risks.

The FSB's strength results from its multidisciplinary, consensus-based and member-driven approach. The FSB provides a unique forum for senior policy makers drawn from finance ministries, central banks and supervisors to promote financial stability. It has maintained a lean and efficient approach, with its work supported by a small secretariat of only 30 people. The transition from policy development has meant that the number of FSB working groups has fallen by one third from its 2016 peak.

To make sure the FSB is fit for the next phase, we have reviewed how we work and will take a number of steps to improve process and transparency, including an enhanced approach to prioritisation of work focused on promoting financial stability and outreach with external stakeholders.

Conclusion

The G20 reforms over the past decade have built a safer, simpler and fairer financial system.

The first challenge is to maintain these hard-won gains. 800 years of economic history teaches that as memories fade, complacency sets in, and backsliding begins. In financial stability, success is an orphan.

The G20 and FSB bear heavy responsibilities to safeguard recent progress, address new risks, and seize new opportunities presented by the major transitions underway in the global economy and financial system.

Safeguarding progress does not mean defending all aspects of reform at all costs. In assessing what is working as intended and addressing any inefficiencies or unintended consequences, the FSB is tailoring not tapering. It is critical that this process of evaluation and adjustment does not compromise overall system resilience.

Addressing new risks means having the foresight to anticipate new vulnerabilities from accountability to asset management, and from cyber to CCPs. We must have the discipline to build a system that is robust to the risks we do not anticipate.

Seizing new opportunities includes building a more open, integrated and resilient financial system on the strong platform you have created. Common standards that are rigorously implemented create a level playing field and provide the basis for the cross-border cooperation needed to preserve an integrated and open financial system. Further efforts to deepen coordination would deepen support for sustainable cross-border investment flows and more inclusive growth.

This year also marks a transition of the FSB's leadership as I hand over to Randal K. Quarles who will take on the role of FSB Chair immediately after the Summit concludes. Randy and the new Vice Chair, Klaas Knot, will provide strong leadership as the FSB moves forward with implementing the post-crisis reforms and addressing any emerging vulnerabilities in the global financial system.

It has been an honour to serve these last seven years. I would like to commend the dedication and professionalism of the FSB Secretariat, and the commitment and wisdom of my fellow policymakers. Finally, I would like to thank G20 Leaders for your unwavering determination to build a more resilient global financial system to support your ultimate objective of strong, sustainable and balanced growth for all.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'M. Carney', with a long horizontal flourish extending from the end of the signature.

Mark Carney