Klaas Knot: Financial stability risks and the FSB's work program

Speech by Mr Klaas Knot, Chair of the Financial Stability Board and President of De Nederlandsche Bank, at the CFA Institute Systemic Risk Council, Washington DC, 26 April 2024.

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Thank you for inviting me once again. It's truly a pleasure to address such a distinguished audience in this virtual gathering today. The similarities of goals between the Systemic Risk Council and the Financial Stability Board are evident, and I look forward to your insights and questions later.

What was on our minds when we last met in December 2022? At that time, we had just seen the sharpest tightening of financial conditions since the 2008 global financial crisis. We had concerns about elevated debt levels and interconnectedness between banks and non-bank financial intermediaries amid high inflation and a deteriorating growth outlook. In this context, I emphasized that financial stability could not be taken for granted.

So where are we today? Well, these concerns have not vanished; they continue to shape large parts of the FSB's work.

While inflation has somewhat eased, there is still some uncertainty about the persistence of inflation.

What's more, market valuations remain elevated. The tight spreads and low volatility in corporate bond markets are hard to square with rising defaults and upcoming higher refinancing costs. Similarly, equity valuations appear stretched.

So, why is the market so upbeat?

Investors prepare for a soft landing, hoping to evade serious challenges in refinancing a wall of maturing debt. Caution is warranted though. Delays in disinflation or negative surprises in the future path of monetary policy may cause sudden repricing.

Moreover, geopolitical tensions add to the already uncertain environment and do not seem to be properly reflected in asset prices. Perhaps because geopolitics is regarded as an 'unpriceable' risk; it is zero or one, with an unpredictable probability distribution.

But be it unpredictable or not, the world has been far from dull: surprises may occur. Market shocks could propagate. Volatility in the markets could trigger vulnerabilities in some non-bank investors that are highly leveraged and face liquidity mismatches.

We also remain concerned about indebtedness.

Households, companies and sovereigns too show high debt levels at a time of declining growth rates and high interest rates. Past interest rate hikes are still passing through to borrowers and debt service challenges could still arise. Meanwhile, property prices remain under pressure. For now, the vulnerability is mostly located in a subsector of commercial real estate: downtown office space. We must watch closely if spillovers to different subsectors emerge.

These debt servicing pressures could spill over to banks, leading to a worsening in asset quality. While aggregate banking sector capitalization has been steady for several years, low equity market valuations for some banks make it costly to raise capital. And we still are vividly reminded that the March 2023 market turmoil suggests that deposit runs can be faster than previously thought.

This is the backdrop that we are facing today. All in all, the outlook is improving but we clearly have no space for complacency.

Lessons from the March 2023 banking turmoil

Just after my last visit, we had a sharp reminder of this. Let us zoom in on the series of events of March 2023, as the lessons drawn continue to shape large parts of the FSB's work.

The banking turmoil was the most significant system-wide banking stress since the 2008 Global Financial Crisis. The bank failures had largely distinct causes but triggered a broader crisis of confidence in the resilience of banks, banking systems and financial markets across multiple jurisdictions. The turmoil exposed fundamental shortcomings in these banks' basic risk management of interest and liquidity risk. Unprecedented factors played an important role too: the speed of deposit outflows was striking.

The FSB's review of lessons learned from the 2023 bank failures confirmed the soundness of the international resolution framework. But areas deserving further attention in the implementation of that framework were highlighted too: we need to maintain momentum and advance the work on bank resolvability. We will focus on public-sector backstop funding mechanisms, on better operationalizing a range of resolution options, and on the impact of social media and digital innovation on resolution and depositor runs. We are also doing analytical work to examine interest rate and liquidity risk in the financial system.

Following the takeover of Credit Suisse by UBS, there remains just one G-SIB in Switzerland so it is more important than ever that relevant options can be implemented in a timely and credible manner. The Swiss government's recent steps to further strengthen their TBTF framework echo the recommendations in our recent Switzerland peer review, and if adopted would make the framework stronger. But additional steps can be taken to further strengthen the TBTF framework in Switzerland.

Non-bank financial intermediation

We are also maintaining momentum in our work to address other vulnerabilities in the financial system.

During my last visit we talked extensively about the NBFI sector. The growing importance of NBFI for the financing of the real economy – including for capital flows to emerging market and developing economies – underscores the need to effectively assess and address vulnerabilities in this sector.

Enhancing NBFI resilience should ensure a more stable provision of financing to the economy and reduce the need for extraordinary central bank interventions.

To do so requires that we contain liquidity imbalances. That means we should address sources of elevated liquidity demand during stress, such as one-sided selling of assets by investment funds or unexpectedly large margin calls. We should further keep a close watch on excessive build-up of leverage, which may amplify adverse dynamics.

The FSB and standard setters have made progress in addressing these vulnerabilities. We published recommendations for addressing liquidity mismatch in open-ended funds in December; last week, we published a consultation report on liquidity preparedness for margin and collateral calls; and we are currently working on policies to address excessive leverage in NBFI. Furthermore, we work to identify NBFI data gaps and ways to fill them.

It is now time to move forward and implement the recommendations and tools that are needed.

Structural vulnerabilities

I do not want to take much more of your time before giving the floor back to you.

But before I do so, let me briefly discuss some other, more structural, vulnerabilities the FSB is addressing.

All of what I discussed before, is happening in a financial world that is increasingly interconnected through accelerating digitalisation. This increases the contagion potential of a cyber or operational incident at a financial institution. Timely and accurate information on cyber incidents is crucial for effective incident response and recovery and to mitigate adverse impacts on financial stability. Building on our work to promote convergence in cyber incident reporting, this year, the FSB is developing a common format for exchanging incident reports. The wide adoption of AI presents opportunities but is also associated with risks that need to be understood and managed appropriately. We will deliver a report on the financial stability implications of AI to the G20 later this year.

In 2023, the FSB reached a major milestone by publishing two reports with a revised set of recommendations for global stablecoins and a new set of recommendations for broader crypto-asset activities and markets. The recommendations are guided by the principle of 'same activity, same risk, same regulation'. That is, crypto activities that seek to perform equivalent economic functions to ones in traditional finance should be subject to equivalent regulation, commensurate to the financial risks, including financial stability risks, that they pose. Our recommendations set a global regulatory baseline that should be applied to crypto-assets in any jurisdiction. Our focus this year is on promoting their implementation. To ensure global consistency and minimise regulatory arbitrage, it is crucial that the work on implementation includes jurisdictions from beyond the FSB's membership that is based around the G20

Our work to address climate-related financial risks is also important. Not doing enough to limit global warming or leaving it too late could have destabilizing effects on the financial system, such as a spike in risk premia for assets exposed to climate risks and or gaps in the insurance to cover losses caused by natural disasters. According to the World Meteorological Organisation, 2023 was the warmest year on record that brought intense heatwaves, floods and droughts. So this is not just a long-term financial risk or tail event, but a current risk.

Our roadmap for addressing climate-related financial risks coordinates progress by financial authorities across four pillars: disclosures, data, vulnerabilities analysis, and regulatory and supervisory approaches. Last June saw a milestone with the finalisation of the ISSB sustainability and climate disclosure standards. The standards are based on the recommendations of the FSB's Task Force on Climate-related Financial Disclosures. We now face the practical challenges of making sure that such disclosures are comprehensive, reliable and are supported by proportionality and capacity-building to assist emerging markets and developing economies. We are supporting the efforts of the ISSBs and others on that.

Within the FSB, we are developing metrics to embed the analysis of climate-related vulnerabilities into the FSB's overall Surveillance Framework. There is growing attention on transition plans as a tool to provide a forward-looking view on business strategies to achieve net-zero. We are assessing the relevance of these plans for financial stability.

Finally, there is also increasing attention among financial authorities to whether biodiversity loss could also be a relevant financial risk and ways in which climate and nature risks may reinforce each other. Indeed, the Brazilian G20 Presidency has asked the FSB to conduct a stocktake of regulatory and supervisory initiatives on nature-related financial risks, which we will publish in July.

The FSB will continue work on these vulnerabilities and we will stay alert for new vulnerabilities that potentially emerge.

Wrapping up

Now, for the sake of time, let me wrap up. One and a half years have passed since my last visit. The outlook has changed greatly. What will be on our minds, one and a half year from now, end of 2025? We cannot predict what is coming, but we will enhance resilience in the financial system by addressing the vulnerabilities discussed today and those that may emerge. We continue to do so. Now, I hope to hear more about your views; I give back the floor to you.