CFA Institute
Systemic Risk Council

QUARTERLY SYSTEMIC REPORT

October 2022

INSIDE

CFA Institute Systemic Risk Council (SRC or the Council) is a private sector, nonpartisan body of former government officials and financial and legal experts committed to addressing regulatory and structural issues relating to global systemic risk, with a particular focus on the United States and Europe. It was formed to provide a strong, independent voice for reforms that are necessary to protect the public from financial instability. The goal is to help ensure a financial system in which we can all have confidence.

CONTACT:
Kurt N. Schacht, JD, CFA
Council Executive Director
CFA Institute Systemic Risk Council
systemicriskcouncil.org
kurt.schacht@cfainstitute.org

In this Fall edition of the *Quarterly Systemic Report* (*QSR*), we provide a quarterly recap of the activities of the CFA Institute Systemic Risk Council (SRC or the Council) and highlight the key systemic issues affecting global markets, industries, and regulators. As part of our mission, the Council presents an independent, expert perspective on matters of building and urgent systemic concern—and advocates for action where improvements in detecting, monitoring, and responsiveness are needed to meet systemic risk threats.

This quarter, the Council continued to monitor the developments around Ukraine, and the confluence of events around inflation, interest rate hikes, and commodity spikes. The Council will continue to assess whether markets, regulators, and prudential overseers are overlooking anything systemic in the face of recession and sticky inflation. Key considerations include confidence in whether bank capital and liquidity remain solid and Central Counterparties (CCPs) are sound as well as whether Council resiliency suggestions post–Great Financial Crisis (GFC) should remain in place or warrant further adjustment to meet new challenges in 2022–2023.

We welcome your comments on the *QSR* and any suggestions for future topics. — Kurt Schacht, Council Executive Director

SRC in Action

EC DG FOR FINANCIAL STABILITY WEIGHS IN ON GLOBAL RISK ISSUES

EC DG Berrigan

In September, John Berrigan, the director-general (DG) for Financial Stability, Financial Services, and Capital Markets Union, of the European Commission (EC), met with the SRC to offer his perspective on a range of important systemic risk topics, including crypto, climate change risks, and the Ukraine-related shocks to energy markets and inflation.

Inflation and interest rates: Given recent global market woes, Berrigan gave his perspective on the current environment, including how the combination of low interest rates, loose fiscal policy resulting from COVID-19, new rounds of fiscal action to stem effects of energy and inflationary developments, and slow-to-act monetary adjustments are now generating the conditions for a low-growth and high-inflation environment (stagflation) not seen in recent times. The EU financial sector is facing significant risks as this shift in equilibrium may persist. The good news, Berrigan reported, is that banks are more resilient and come into this phase with better liquidity and capitalization, courtesy of GFC reforms, but he warned there is no room for complacency. Concerns about asset quality deterioration in real estate, corporate debt, and the non-bank mortgage and lending sector are growing.

The war in Ukraine: On the Ukraine conflict's effects on the global market, Berrigan spoke about the already-significant impact of energy sanctions and, as this conflict persists, the extent of commodity market disruption potentially on the horizon this winter. On a positive note, the EU region has been working diligently to implement demand reduction programs and build gas and oil reserves. Planning and action are definitely progressing, and security efforts have ramped up, yet the region is destined to face further challenges, including vulnerabilities for energy pipeline, telecommunications, and internet sabotage.

Crypto-asset regulation: Regarding crypto markets and assets of all sorts, Berrigan relayed concerns in the EU region (similar to those of US regulators) about emerging technologies outpacing the regulator's ability to monitor and develop more efficient oversight. He observed that the EU is making strides with the creation of a major framework for crypto oversight and regulation, tracking many of the Financial Stability Board (FSB) principles. That said, there are concerns about the complexity and pace of crypto asset advancement given the unique "multijurisdictional" complications of overseeing virtual markets. Berrigan commented on the recent $18 billion Terra Luna stablecoin implosion. He noted these sizeable crypto problems and resulting downdraft in other crypto valuations (such as Bitcoin) have yet to be systemic. They have, however, demonstrated how prone crypto markets are to great volatility and velocity. Global regulators can quickly find themselves behind the curve on proper regulation, monitoring, and fraud detection.

Climate change and systemic risk: Berrigan noted that the EU has assumed a leadership role in advancing the debate on climate change repercussions for financial system stability. The EU has long recognized the potential for causing major systemic disruptions, and the region's central banks, in particular, have taken steps to accelerate monitoring and improve scenario testing as part of regular prudential practice. The EC remains concerned about the speed and unpredictability of climate change and the challenges of accurately measuring zero-carbon goals, emerging mitigation techniques, and the highly subjective corporate disclosures around such matters. Meanwhile, the EU region is focused on both impact and financial materiality disclosures from companies and has gone farther than other jurisdictions in terms of climate change reporting standards. Berrigan acknowledged the current global fragmentation in approaches to sustainability reporting but remains hopeful that we will converge around a single global approach.

SRC in Action

US REGULATORS: URGENT NEED FOR CRYPTO REGULATORY ACTION

Wild west: In a recent article, Paul Andrews, managing director, Research, Advocacy, and Standards at CFA Institute and member of the SRC, outlined the painfully slow and disjointed response and reaction from the US regulatory and congressional bodies to the critical area of unregulated cryptocurrency market. The highly volatile and speculative crypto marketplace is complex and confusing with thousands of new e-tokens and digital "currencies" emerging, along with many crypto operational and infrastructure businesses, all in need of enhanced regulatory oversight.

SRC advocacy: The SRC has beat a steady drum on the need for congressional and regulatory action on unregulated crypto assets, including stablecoins. "We proposed a two-pronged strategy that included the Financial Stability Oversight Council (FSOC) moving quickly to designate stablecoins as systemically important payment, clearing, and settlement activities, while various FSOC member agencies, including the banking regulators, the Securities and Exchange Commission (SEC), and Commodity Futures Trading Commission (CFTC) would use their existing enforcement authorities to regulate stablecoins and other crypto assets where indicated," said Andrews.

Update: FSOC releases report
(7 October): Taking a step in the right direction, the FSOC's Report on Digital Asset Financial Stability Risks and Regulation sounded a warning that the significant increased scale of crypto-asset activities could pose risks to the stability of the US financial system and provided recommendations, including legislation and increased monitoring and regulation. Read more.

Slow regulatory response: Government authorities in the US — including Congress, the Biden administration, and the various members of the FSOC — are all eyeing the crypto space and have indicated the need for legislative authority and regulatory adjustments. Despite these various statements, little meaningful regulatory or legislative action has been advanced to oversee the ever-expanding crypto-asset market.

Next steps: The SRC has heard from a range of regulatory and policy experts and it is clear that sustained actions to address the growing risks to global financial stability posed by unregulated crypto assets are falling behind a rapidly evolving industry. In the view of Andrews, "There must be a sense of market integrity and regulatory certainty. All players must have confidence in how various assets are structured, documented, traded, cleared, and held in safe custody. To become mainstream, these markets and assets must bridge the current gap in transparency, accountability, and regulatory certainty."

SRC MEMBERS WEIGH IN ON SYSTEMIC RISK ISSUES

Independent, expert voices: The SRC is a nonpartisan body of former government officials and financial and legal experts committed to addressing regulatory and structural issues relating to global systemic risk. We are pleased to share some of our members' recent perspectives and publications.

- *Banking Crisis Breakthroughs Win Nobel Economics Prize for Bernanke, Diamond, Dybvig* by Simon Johnson and Johan Ahlander (Reuters, 10 October 2022): A trio of US economists, including former Federal Reserve Chair Ben Bernanke, won this year's Nobel Economics Prize for laying the foundation of how world powers now tackle global crises like the recent pandemic or the Great Recession of 2008.
- *America Comes Roaring Back* by Simon Johnson (*Project Syndicate*, 31 August 2022): A series of supply shocks over the past two years, along with the Federal Reserve's determination to raise interest rates to fight inflation, have been troublesome for the US economy. But an alternative view focusing on flexible work schedules and workplace arrangements, and next-generation high-tech hubs is pointing toward significant sustained US economic expansion.
- *Entering the Superbubble's Final Act* by Jeremy Grantham (GMO.com, 31 August 2022): GMO's cofounder warned that overvalued equities, bonds, and housing will collide with high rates and inflation to cause more economic trouble. The US stock market superbubble has yet to pop. His comments were picked up widely, including Bloomberg.com (behind a paywall) and *Fortune* (behind a paywall), and also were featured on *CNBC*.
- *Hits and Misses of the Fed's Inflation Strategy* by Richard Herring (*Knowledge at Wharton*, Wharton School of the University of Pennsylvania, 6 September 2022): Early actions by the Fed averted a financial crisis following the pandemic, but its later policies enabled an acceleration of inflation. The Fed misread the signs for inflation, which led to distortions in the financial markets and exacerbated wealth inequalities.
- *Survey: Women Put Their Money (and Jobs) Where Their Mouths Are* (Ellevest, 22 September 2022): Sallie Krawcheck and team at Ellevest report results from a new survey indicating that women are in worse financial shape today than they were in the depths of the pandemic among other key insights. Coverage was picked up by *Fortune*, *NPR*, and other media.

RECENT NEWS ON SYSTEMIC RISK ISSUES

In case you missed it: Following is a selection of recent important news reports on systemic risk to keep us all up to date.

- *Investment Manager Janus Henderson Set to Cut 100 Jobs* (*Financial Times*, behind a paywall, 10 October 2022): Janus Henderson will seek to reduce its operating expenses to reflect the impact of volatile markets and sharpen focus on the company's future growth opportunities.
- *Crypto Needs More Rules and Better Enforcement, Regulators Warn* (*New York Times*, 3 October 2022): The Financial Stability Oversight Council released its Report on Digital Asset Financial Stability Risks and Regulation indicating the growing crypto market could pose risks to the broader financial system.
- *Top Regulator in Europe Warns of Big Financial Stability Risks* (*Wall Street Journal,* 30 September 2022): The European Systemic Risk Board issued an unprecedented warning about risks to financial stability because of a toxic combination of high inflation and energy prices, an economic downturn, and possible sharp falls in asset prices.
- *The Fed is Breaking Things – Here's What has Wall Street on Edge as Risks Rise Around the World* *(CNBC, 1 October 2022)* As the Federal Reserve ramps up efforts to tame inflation, sending the dollar surging and bonds and stocks into a tailspin, concern is rising that the central bank's campaign will have unintended and potentially dire consequences.
- *Fed's Exit Puts World's Biggest Bond Market on Shakier Ground* *(New York Times,* 11 September 2022): Traders are worried about the $25 trillion US Treasury market, the world's largest and most important government bond market, as the Federal Reserve quickens the pace at which it removes one of its primary pandemic supports.

SYSTEMIC RISK COUNCIL MEMBERS

Chair: Simon Johnson

SRC Co-Chair and former IMF Chief Economist

Chair: Erkki Liikanen

SRC Co-Chair and Chair of the IFRS Foundation Board of Trustees

Kurt N. Schacht, JD, CFA

Executive Director, CFA Institute Systemic Risk Council

Senior Advisor: Sheila C. Bair

Founding Chair of Systemic Risk Council and former FDIC Chair

Senior Advisor: Jean-Claude Trichet

Former President of the European Central Bank

Members:

Paul P. Andrews

Managing Director, Research, Advocacy, and Standards, CFA Institute; former Secretary General of the International Organization of Securities Commissions (IOSCO)

Brooksley Born

Former U.S. Commodity Futures Trading Commission Chair

Sharon Bowles

Former Member of European Parliament and former Chair of the Parliament's Economic and Monetary Affairs Committee

Bill Bradley

Former US Senator (D-NJ)

Marina Brogi

Full Professor of Banking and Capital Markets at Sapienza University of Rome and a former member of the Securities and Markets Stakeholder Group at the European Securities and Markets Authority (ESMA)

Andreas Raymond Dombret

Former member of executive board Deutsche Bundesbank, founding member of the Supervisory Board of the European Central Bank, and board member of the Bank of International Settlements

William Donaldson

Former US SEC Chair

José Manuel González-Páramo

Spanish economist who served as a member of the Executive Board of the European Central Bank (ECB), member of the Executive Board of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), and member of the Executive Board of the Bank of Spain

Jeremy Grantham

Co-founder and Chief Investment Strategist, Grantham Mayo Van Otterloo (GMO)

Richard Herring

Wharton School of the University of Pennsylvania

Sallie Krawcheck

CEO and Co-Founder, Ellevest, former Senior Executive, Citi and Bank of America Wealth Management

Ira Millstein

Senior Partner, Weil Gotshal & Manges LLP

John S. Reed

Former Chair and CEO of Citicorp and Citibank

