CFA Institute®
Systemic Risk Council

SRC 2022 ANNUAL REPORT

January 2023

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.

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Welcome to the CFA Institute Systemic Risk Council (the Council or SRC) 2022 Annual Report. The past decade has seen an unprecedented number and frequency of major financial disruptions, each testing the resiliency of our global financial systems. Since 2013, the Council has embodied an independent, noncommercial voice for assessing such disruptions and offering recommendations for building a more robust process for systemic risk oversight. The Council provides an expert and unvarnished assessment of the readiness of global regulatory institutions to deal with evolving systemic vulnerabilities and advocates for improvements in detecting, monitoring, and responding to existing and emerging systemic threats.

Over the past year, global markets have experienced a cacophony of economic challenges not seen in decades. The year began with meager inflation and record low interest rates and equity markets near all-time highs. The prospects for 2022 looked economically enticing. Yet, over the course of just a few short months, the fortunes of a complex global economy were soon buffeting spiking inflation and geopolitical shocks. This annual report recaps a year of tumultuous economic shifts and the prospects for a world economy confronted with challenges not seen since the Great Financial Crisis (GFC).

— Kurt N. Schacht, Council Executive Director

LETTER FROM THE CO-CHAIRS

Dear Readers,

The CFA Institute Systemic Risk Council wishes you a happy 2023. As co-chairs of the Systemic Risk Council, we offer our many thanks to Council members for their continuing efforts and contributions to our collective activities this past year. We have hosted an engaging and productive series of debates on the many systemic risk challenges of 2022. As we have often discussed, markets and economies have enjoyed a decade-long run of record low interest rates, unprecedented fiscal stimulus, and a range of special government backstops.

Global leaders have long acknowledged the likelihood there would be an inflection point for this extended run of stimulus, for which troubling aftershocks would be likely. As one highly regarded research group noted, the tab for 13 years of zero-gravity monetary policy finally came due in 2022. The full economic costs of this extended zero-interest-rate condition and the inevitable unwind of rising inflation are yet to be tallied.

A productive, dynamic year: In 2022, the Council held 10 productive and informative meetings with presentations from a range of economic, regulatory, and systemic risk experts, including Rostin Behnam, chair, US Commodity Futures Trading Commission; Gary Gensler, chair, Securities and Exchange Commission (SEC); and John Berrigan, director-general, Financial Stability, Financial Services, and Capital Markets Union, of the European Commission (EC). These discussions not only allowed for a deeper understanding and analysis of the key systemic issues from these authorities, but also provided the opportunity for us to promote and elevate our views on these critical areas. The Council issued detailed comment letters this year to propose and advocate for our views on these issues, including unregulated stable coins and reforms to money market and other open-ended funds. As we embark on a new year, the breadth and complexity of the systemic risk environment has rarely been more challenging.

2022 key issues: Through the tumultuous economic twist and turns of 2022, several key issues developed as matters of building systemic concern. The Council continues to advocate for systemic awareness and preparedness in the following areas:

- The great inflation unwind and potential areas for systemic breakage
- Systemic implications of the Russia–Ukraine conflict
- Climate change and its implications for systemic risk
- The "Perfect Storm," a unique and complicated systemic risk confluence has emerged with escalating energy uncertainty, excessive levels of public and private debt, extended asset valuations, high inflation, and rapid changes in monetary policy
- Securities market threats, including growing cybersecurity hazards, crypto-asset proliferation, energy market disruptions, and money market fund liquidity
- Global regulatory concerns about opaque private markets with hidden leverage exposures and uncertain counterparty interconnectedness
- The risk of complacence—while reforms from the Great Financial Crisis (GFC) era have worked for that type of risk, large structural shifts in risk have occurred since then to private markets, nonbank financial institutions (NBFI), cybersecurity, climate effects, and digital assets that are outside much of the GFC reform package

The year ahead: Moving forward, the Council is concentrating on several matters that will present significant challenges to systemic resilience in 2023 and beyond, including the following:

- Remaining focused directly on NBFI concerning improved disclosures, data tracking, and modeling of leverage and counterparty interconnectedness
- Maintaining strong bank capital ratios and resisting market-based temptations to roll back the SLR (supplemental leverage ratio)
- Finishing the work of ensuring that money market funds and other open-end fund products have adequate liquidity risk management tools to eliminate the need for government intervention
- Supporting further efforts to assess and prepare our global economic system for the potential financial shock waves likely to occur as a result of climate change

The Council will remain focused and steadfast in its commitment to address regulatory and structural issues relating to global systemic risk, by providing a credible and independent voice for reforms that best promote financial stability.

Sincerely,

Simon Johnson,

SRC Co-Chair and
Former IMF Chief Economist

Erkki Liikanen,

SRC Co-Chair and
Chair of the IFRS Foundation

2022 KEY SYSTEMIC RISK ISSUES IN REVIEW

Key activities and actions for 2022: Given the hectic pace of change facing the global market, we provide a retrospective on matters of systemic importance over these past 12 months, as well as key actions and perspectives from the Council.

Crypto Regulation: Sounding the Alarm for Regulatory Clarity and Legislative Action

Consistent advocacy: Government authorities in the United States, including US Congress, the Biden administration, and the US SEC, and in the European Union, including the EU's Financial Stability Board, are eyeing the crypto space for systemic threats. These authorities have indicated the need for more specific legislative authority and regulatory adjustments to keep pace with the emerging technologies and products involved. Thus far, little meaningful regulatory or legislative action has advanced to oversee the ever-expanding crypto-asset marketplace. A clear and sustained effort is more important than ever given recent crypto dislocations, as exemplified by the pending FTX bankruptcy. The Council has beat a steady drum on this issue, including specific recommendations and guidance for stablecoin product reforms.

SRC comment letter on stablecoins: In February, the Council released a letter to Treasury Secretary Janet Yellen and members of the Financial Stability Oversight Council (FSOC) urging the group to act on growing risks to US financial stability posed by unregulated stablecoins. The Council urged the FSOC to work with Congress to enact new legislation authorizing needed regulations on stablecoin issuers and the stablecoin market. Pending a legislative response, the Council also urged regulators to simultaneously pursue other routes. A two-pronged strategy was proposed (1) encouraging the FSOC to move quickly to designate stablecoins as systemically important payment, clearing, and settlement activities; and (2) asking each of the FSOC member agencies, including the banking regulators, the SEC, the Commodity Futures Trading Commission (CFTC), and the Consumer Financial Protection Bureau (CFPB), to use their existing authorities to regulate stablecoins.

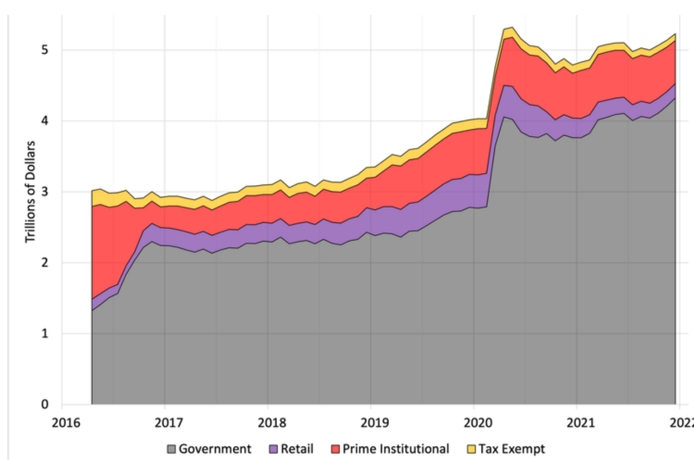
A Global approach to stablecoin reserves: The Council urged US regulators to immediately limit the creation and use of fractional reserve stablecoins—i.e., electronic tokens that are not backed one-for-one with insured bank deposits or short-term US government debt. The goal is to reduce the risk of runs, contagion, and further expansion of the shadow banking sector. Importantly, many stablecoin operators are located overseas and are being used to facilitate value transfers internationally, which raises policy issues for global payment system design. The Council encouraged the FSOC and its member agencies to work closely with other global regulators and stablecoin issuers worldwide to ensure a coordinated global approach.

Money Market Funds: Systemic Vulnerabilities Persist

SRC comment letter: In April, the Council responded to the SEC and other members of the President's Working Group on Financial Markets request for comments on further reforms to money market and other open-ended funds. In the view of the Council, the March 2020 systemic disorder of these fund products was an accident waiting to happen given that the post-GFC reforms designed to fix these issues were inadequate. The systemic vulnerabilities of these fund products were once again triggered in 2020, this time by pandemic, revealing once again the wider problem of shadow banking, which undermines the resilience of the financial system. The Council letter lays out its views for preventing even bigger problems down the road.

Money fund liquidity: Time for swing pricing? Specifically, the Council noted that 2020 events clearly demonstrated the failure of *ex post* liquidity fees and gates as adequate prevention for dangerous runs. Rather, enhanced *ex ante* liquidity requirements and swing pricing are needed to reduce the externalities associated with prime funds. Enhanced stress testing should also be considered along with capital requirements for various money fund products, if necessary. Such measures will increase costs for funds during normal times, but those costs are minimal compared with the much greater costs of monetary instability.

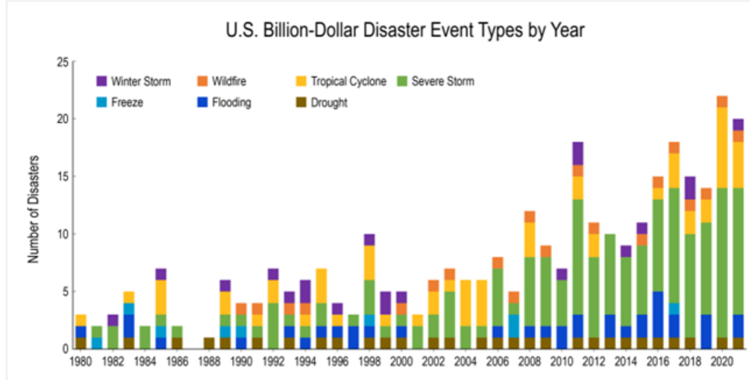
US MMMF assets by fund category (trillions of dollars), April 2016–December 2021



Source: Office of Financial Research US Money Market Fund Monitor

Climate Change: When Does It Become Systemic?

As the pace of climate change accelerates, the potential for systemic crisis continues to grow. The Council has been meeting with various experts to discuss how the effects of climate change may play out for global economics and systemic risk. Accordingly, the systemic implications of climate change have continued to move up on the agendas of central banks and policy makers around the globe.



Source: USGCRP

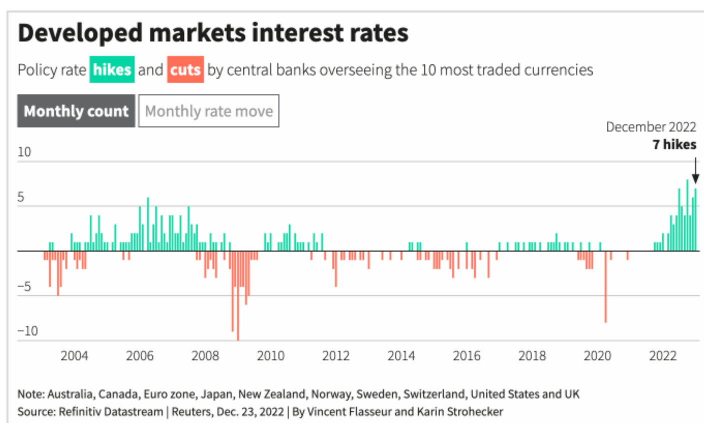
Weighing in on climate reporting proposals: The Council is reviewing the latest approaches proposed for formal corporate reporting on climate and other environmental, social, and governance (ESG) matters. The bottom-line issue is understanding what information is actually needed to plausibly measure and assess a corporation's climate risk exposure and whether such information can be aggregated across all registrants, sectors, or industries and modeled to better understand and prepare for systemic implications, possibly across entire segments of the global economy. This task is proving to be no small feat. Approaches include:

- **International Sustainability Standards Board (ISSB) Proposals:** ISSB suggests requiring a company to disclose information that enables investors to assess the effect of significant sustainability-related risks and opportunities on its enterprise value to establish a baseline for more consistent disclosure requirements.
- **US SEC 2022 Proposals:** The SEC recommends requiring registrants to provide certain climate-related information in their registration statements and annual reports, including disclosures about the registrant's carbon footprint.
- **European Union Sustainability Reporting Standards:** The EU proposes requiring certain large companies to disclose information on the way they operate and manage social and environmental challenges.

Global consistency: The Council has underscored the importance of having a consistent, comparable, and reliable approach to how companies report on these matters to assess climate change developments more accurately. The global debate on whether and how such information should be disclosed is intensifying as the demand for such disclosures grows.

The Ukraine Conflict: Continuing Systemic Implications

Unpredictability manifests extreme volatility: The global impact of the ongoing conflict in Ukraine, including effects and vulnerabilities around price shocks, energy pipeline, telecommunications, and internet security, continues to be of utmost concern. The EU region has been working diligently to implement demand reduction programs and build gas and oil reserves. The United States has focused on orderly market function and resilience amid high volatility across a number of markets. Planning and action are progressing, and security efforts have ramped up, but the region is likely to face further challenges.



The Great Inflation Unwind: Potential Breakage

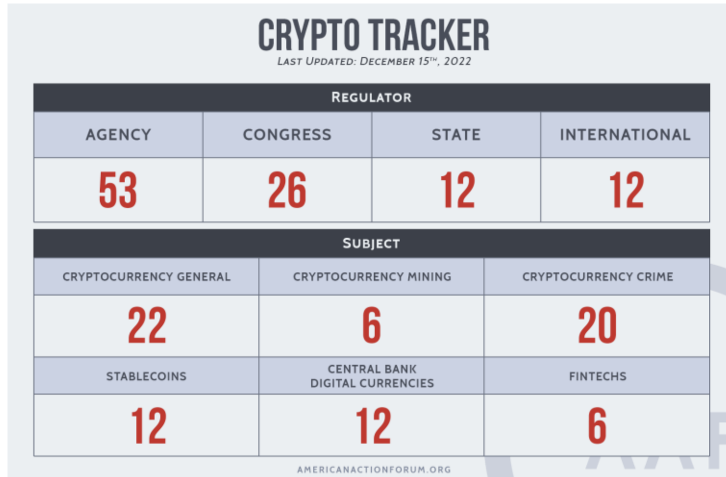
Fork in the road: The economy is in the midst of a formidable economic inflection point. The withdrawal from a decade-long run of record low interest rates, unprecedented fiscal stimulus, and a range of special government bailouts and backstops is underway. Even as 2022 dawned in the face of supply chain disruptions, soaring consumer demand, and record asset valuations, the US Federal Reserve Board and other central banks were reluctant to tighten monetary policy. In addition, fiscal policy remained accommodative and global economies were operating at high speed. Not unexpectedly, so was inflation and central banks were soon forced into rate hikes, slowly at first, but recently with great zeal. The Great Inflation Unwind is now playing out, regardless of whether or not markets and economies are ready. Most central banks have been caught in the inflation conundrum and are at a fork in the inflation road. Each path has the potential for breakages of one degree or another, many of which can be quite severe including triggering market illiquidity, frozen credit markets, margin calamities, and severe asset price declines (see article).

KEY SYSTEMIC PRIORITIES AHEAD

Consistent Regulation of Cryptocurrency and Stablecoins

Growth in activity and possible regulation: The Council will continue to urge well-designed congressional and regulatory actions to address the growing risks to US financial stability posed by unregulated crypto assets, particularly, the wild west of stablecoins. Despite the dozens of crypto-related regulatory and legislatives proposals advanced, as noted by the Crypto Tracker from the American Action Forum, very little was actually completed. Whether introduced by regulatory agencies or legislative authorities, 2022 was a year of dead-end proposals and missed opportunities. Global authorities now say time is of the essence for political and industry groups to coalesce on the appropriate level of regulation for various crypto markets, coins, and businesses. The Council will support various global central bankers and regulators as they assess and plan for the growth of crypto assets. The lesson from the FTX calamity and other recent missteps by various crypto players is clear: regulators need to act collectively and be prepared for crypto-asset-related activities that clearly pose risks to safety and soundness, consumer protection, and, potentially, financial stability.

Crypto Tracker: Crypto and Fintech Developments in the Biden Administration



Source: americanactionforum.org

Consistent voice for stablecoin guidelines: The Council plans to remain a consistent advocate for determining which parts of the crypto industry represent a systemic risk threat, particularly the vulnerabilities created by stablecoin products. It will offer advice on regulatory initiatives that are properly calibrated and fit for purpose. To become mainstream, these markets and assets must bridge the current gap in transparency, accountability, and regulatory certainty. The Council supports common-sense regulation and proper market structure that will detect and thereby limit systemic impacts.

Maintaining Strong Bank Capital Ratios and Enhanced Stress Testing

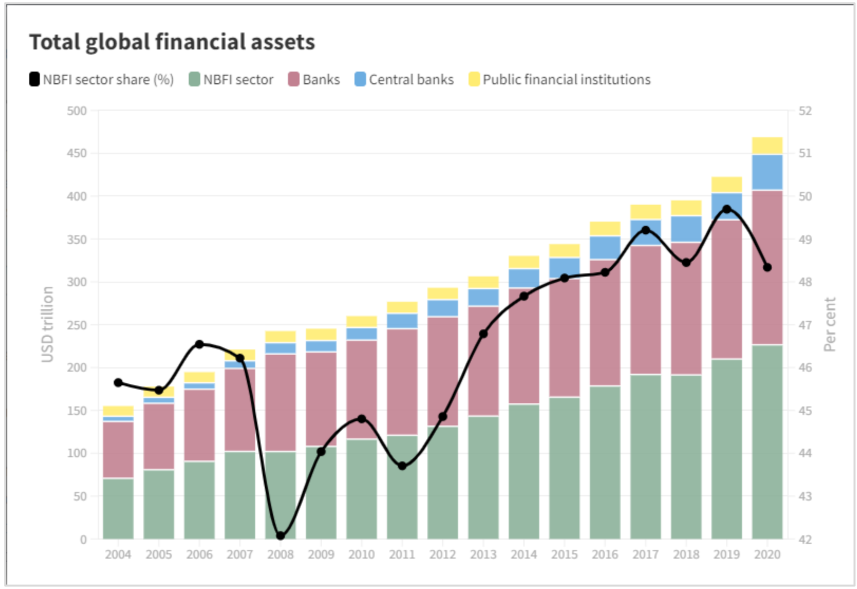
Examining capital regulation: For 2023, the Council is paying close attention to recent Federal Reserve Board (FRB) discussions around the adequacy and effectiveness of bank capital standards. The FRB regularly examines the effects and efficiencies of bank capital standards as a key component for the safety and soundness of banks and the stability of the financial system. Recent comments from FRB leaders have noted the complexity of the capital standards analysis, not only in terms of how such standards are working in today's market environment but also how such standards may work in the future under changing market conditions. The Council agrees that in the final analysis, all such considerations must be balanced against the public benefit of higher capital, particularly for larger more complex banks and in light of the new proclivity of our financial system to experience more frequent and unexpected shocks to financial stability.

Basil III adjustments: In reviewing the current capital rules for US banks, the FRB is assessing the latest adjustments to the Basel III Accord that was implemented following the GFC. In part, it involves a new balance of risk-based capital requirements and non-risk-based leverage measures. The Council has repeatedly cautioned against weakening of capital measures and continues to support enhancements to risk-based capital requirements and stress testing. In 2018, the Council acknowledged that the capital framework must be dynamic, recognizing that revisions to capital requirements conceived of during previous market conditions will inevitably need to be updated as those conditions evolve.

Urging caution: The Council again urges caution in drawing policy conclusions from the argument that a constraining leverage cap pressures market making by dealers. Banking authorities worry this can create a prolonged reduction in Treasury market participation by member banks, triggering serious liquidity gaps, now or in the future. The Council remains concerned about a policy trade-off that views a weaker SLR as more important for Treasury market liquidity than any risk a weaker ratio may pose to systemic resilience.

NBFIs: Shadow Banks Loom Large

Unregulated activities: In the year ahead, there will be a renewed focus on shadow banks. Now referred to using the more politically neutral term nonbank financial institutions (NBFIs), there is specific interest in more detailed investment concentration and exposure data that will reveal hidden leverage and counterparty interconnectedness. Examples of NBFIs include a wide range of insurance industry firms, private market funds, currency exchanges, central clearing facilities, and a large variety of institutional-size investment firms. These NBFIs provide some bank-like services and are competitive to banks, but face less regulation and have far less transparency around overall leverage and interconnectedness to other financial institutions.



Source: 2023 | Financial Stability Board

Significant risk exposure: Over the course of 2022, the Council heard presentations from regulatory, banking, and economic experts highlighting the growing size of these nonbank players, now representing nearly half of all global financial assets. This volume, when combined with the lack of transparency and vulnerability to market shocks, creates significant systemic risk uncertainties across the global economy. Moreover, without the same types of regulatory oversight and liquidity and risk buffers required of regulated banks, NBFI uncertainties point in the wrong direction as a growing danger to economic instability. Global regulators must take action to identify key NBFI players; require more detailed data on position size, leverage, and counterparty exposures; and develop adequate tools to quickly address and prevent NBFI dislocations from overwhelming broader economic stability.

Finishing the Work on Money Market Mutual Funds and Open-End Fund Liquidity Risks

Is it time for swing pricing? The Council continues to offer support for regulatory efforts to remedy the systemic risk gaps that continue to vex the money market and open-end fund industry. Specifically, we have supported the SEC in its April 2022 consultation, recommending additional liquidity and resilience reforms. We believe that the SEC's plan to increase the daily and weekly minimum liquid asset requirements to 25% and 50%, respectively, and to require institutional prime and institutional tax-exempt money market funds to implement swing pricing policies and procedures will enhance resilience, shift the liquidity costs of redemptions to redeeming investors (where they belong), and reduce the likelihood of damaging financial panics. We also believe that the SEC should remove the liquidity fee and redemption gate rules that it promulgated in 2014, as these fees exacerbated rather than mitigated run risk in 2020.

Enhancing final rule: Given the significant externalities associated with potential runs on a range of open-end funds that offer real-time or daily liquidity but feature underlying assets that are far less liquid, we believe that the SEC should consider enhanced stress testing procedures for fund companies and individual funds. In extreme cases in which funds may create serious disruptions to entire markets (e.g., emerging market equities or high-yield bond) triggering knock-on effects to broader markets or asset classes, there may be a need to consider imposing capital requirements. It is expected that the SEC will offer final rule proposals in 2023 addressing fund liquidity issues once and for all.

SRC MEMBERS WEIGH IN ON SYSTEMIC RISK ISSUES

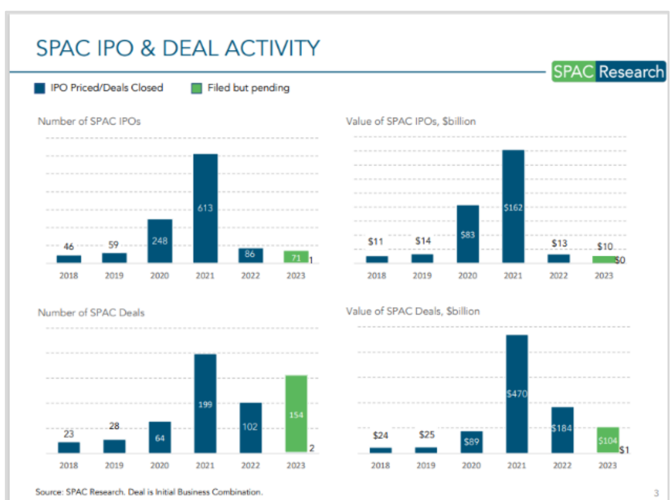
Independent voices: The SRC is pleased to share a selection of our members' recent perspectives and publications.

- Sheila Bair, "I Feel For The Regulators. You're Damned If You Do And You're Damned If You Don't," *Financial Times* (behind a paywall), 14 December 2022: In an interview, Sheila Bair, founding SRC chair, and former FDIC chair, weighed in on distorted interest rates, the dangers of the "shadow" banking sector, and home prices and the supply-strained residential housing market.
- Economic Affairs Committee: Hearing on Systemic Risk, 22 November 2022: The Lords Economics Committee took evidence from Sir Paul Tucker, former SRC chair, and Erkki Liikanen, SRC co-chair, on protecting the public from financial instability. Topics included the greatest sources of risk to the global financial system, volatility of cryptocurrencies, increased sovereign credit risk, and NBFIs.
- Lords Industry and Regulators Committee, The Pensions Regulator and Financial Conduct Authority, 14 November 2022: Sharon Bowles, current member of the House of Lords, former member of European Parliament, and former chair of the Parliament's Economic and Monetary Affairs Committee, joined the discussion on the use of liability-driven investment (LDI) by pension funds and on the roles and risks associated with LDI strategies in the pensions sector.
- "Why London and the EU Still Need a Financial Services Deal," *Financial News*, 11 November 2022: Andreas 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, provided commentary on why it is in both the current UK government and the EU's interests to get back around the table to try to break its impasse on financial services.
- House of Lords, Financial Markets: Stability, Volume 825, 3 November 2022: Sharon Bowles participated in the debate on financial markets stability.

SYSTEMIC RISK IN THE NEWS

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

- Enhancing the Resilience of Non-Bank Financial Intermediation (NBFI), Progress Report, 10 November 2022: The FSB issued a report addressing factors that contribute to large liquidity imbalances in NBFI and their amplification in times of stress. The FSB report identifies a set of activities and types of entities that may particularly contribute to aggregate liquidity imbalances, proposes policies to address these imbalances, and describes further work to enhance NBFI resilience.
- Reply to Parliamentary Question on Prudential Treatment of Singapore Banks' Crypto Asset Exposure**:** 28 November 2022**:** The Monetary Authority of Singapore (MAS) plans to adopt the Basel Committee on Banking Supervision (BCBS) framework, which would require Singapore banks to apply a 1250% risk weight for exposures to Bitcoin and Ether.
- Board of Governors of the Federal Reserve System, Financial Stability Report, November 2022: The Federal Reserve issued its Financial Stability Report, a current assessment of the stability of the US financial system, including analyzing vulnerabilities related to valuation pressures, borrowing by businesses and households, financial-sector leverage, and funding risks.
- SPAC Euphoria Turns into Painful Reckoning as Liquidity Runs Dry, *Bloomberg*, 15 December 2022: One of the hottest pandemic-era trends in investing is receding back into obscurity after more than a billion dollars in losses for backers of special-purpose acquisition companies.
- The Great Inflation Unwind: Can We Avoid Breakage?, *Nasdaq.com,* 21 December 2022: CFA Institute Managing Director Paul Andrews explains that trying to unwind the inflation effects of massive, unfunded, pandemic stimulus in a way that avoids serious impacts to market values, employment, and economic growth is a sizeable challenge.



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SRC Co-Chair and former IMF Chief Economist

Chair: Erkki Liikanen

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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)

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

Bill Bradley

Former US Senator (D-NJ)

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