Remarks by Under Secretary for Domestic Finance Nellie Liang at the Institute of International Bankers’ Annual Washington Conference

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As prepared for delivery

Let me start by thanking the Institute for International Bankers for inviting me to join you today.

I prepared remarks for today focusing on financial system resilience. But first I want to acknowledge the heroic resilience of the Ukrainian people as they fight for their country against Russia’s unprovoked attack. We support the Ukrainian people in their fight for their homes and their democracy.

Together, the Treasury Department and finance ministries around the world have isolated the Russian economy. Eighty percent of its banking assets are now under Treasury restrictions, and we, along with our allies, have immobilized about half the assets in Russia’s central bank.

The success of these sanctions illustrates the joint responsibility that we—policymakers and industry alike—have as part of the global financial system to prevent it from being used to facilitate illegal or terrorist activity. Your institutions are on the front lines of this important effort, and we thank you.

Since the Russian aggression commenced and sanctions put in place, the ruble has fallen and the Russian stock market has closed. Commodity prices have surged and equity prices have fallen, and by more in economies more closely tied to Russia. Market liquidity has thinned and volatility has increased. Markets have continued to function well as the financial system works through implementing the broad scale of new sanctions, albeit with some signs of strain such as wider bid-ask spreads and slightly higher term unsecured funding costs. Investors are meeting elevated margin calls without delay. Moreover, investors show little concern about solvency or liquidity stresses at domestic financial institutions. With the situation changing rapidly, the Financial Stability Oversight Council (FSOC) convened last week to discuss financial developments and actions to mitigate risks. We are talking to our global regulatory
colleagues, who are also closely monitoring the situation. We will continue to be alert to fallout from the recent events.

My remarks today will focus on financial reforms taken since the global financial crisis more than a decade ago, and more recent efforts to address newer, more novel risks, specifically climate change and increasing digitization of assets. US and global policymakers have been striving to establish regulatory and supervisory frameworks to ensure that financial systems will be resilient. Resilience means the system can continue to provide critical functions to support economic activity and growth, importantly providing credit, payment, and risk transfer services even in the face of unexpected shocks. Clearly, the system now is much more resilient than when these efforts started.

Looking forward, regulators will need to be nimble in their approaches to ensure the financial system continues to be resilient as some key emerging risks look to be different from those in the past. To illustrate these differences, we can look back to the weaknesses that precipitated the global financial crisis. They were largely within the financial sector. Commercial and investment banking firms did not have sufficient capital or liquidity, or adequate risk management practices. These and other financial structures, like money market funds and asset-backed commercial paper conduits, were highly vulnerable to runs. These structural weaknesses amplified the steep fall in house prices, and led to runs and failures, and spilled over to the real economy, with tremendous costs to our households, communities, and businesses for many years.

Global regulators came together in the aftermath and made significant changes to prevent such a crisis from ever happening again. They required stronger standards and prudential oversight, as well as resolution planning for banks, mandated central clearing for derivatives and stronger regulations for CCPs, and enhanced market transparency to bolster financial system resilience.

In early 2020 at the onset of the COVID-19 pandemic, the benefits of the reforms were apparent. The banks and CCPs performed relatively well, though these intermediaries along with the real economy benefitted from the extraordinary measures taken by the Federal Reserve and fiscal support from the Administration and the Congress. But vulnerabilities in the nonbank financial sector were made more salient by that episode. For some time, financial regulators had been concerned about liquidity mismatch and leverage in nonbank activities, and their contribution to market dysfunction in March 2020 strengthened the resolve of regulators to make changes. For example, FSOC has called for additional reforms
to money market funds to reduce run risk, and is evaluating the liquidity mismatch in open-end mutual funds and the leverage of hedge funds. Regulators also are evaluating possible reforms to address the surprising liquidity stresses in Treasury markets during March 2020. The Financial Stability Board (FSB) also is looking at these same issues on a global basis.

Today, two emerging risks—climate change and increased digitization of assets—are presenting new challenges to the financial system. These risks reflect broad external changes that can manifest in the financial system in part through traditional channels, but existing supervisory and regulatory frameworks and practices may not be sufficient. I will discuss these two risks in more detail.

Let me turn first to climate change. Climate change is an existential threat to our environment and ecosystems, and is creating increasing and significant economic costs. According to the National Oceanic and Atmospheric Administration (NOAA), there were twenty billion-dollar-or-more weather and climate disasters in 2021, which caused a combined $145 billion in damages. This is a 50 percent increase in damages from 2020. Scientific consensus indicates that the world must halve emissions by 2030 to avoid the most extreme consequences of climate change. President Biden has put forward a target for the United States in line with that imperative.

Financial regulators have a responsibility to ensure the resilience of the financial system to climate change, and they are taking important steps. But actions by the financial sector alone cannot counteract the drivers of climate change. Actions must be complementary to broader policies to reduce global greenhouse gas emissions to facilitate the transition to net-zero. The longer it takes to address the underlying causes of climate change, the greater the risk that policies will need to be implemented in an abrupt fashion and have disorderly effects on economic activity and asset values.

In November 2021, FSOC published a report on climate-related financial risks, which identified that climate change is an emerging threat to financial stability. It also recognized that the scope and uncertainties of climate change on the financial sector represents a new challenge to existing regulatory frameworks and supervisory practices. Broadly, the report recommended that financial regulators take actions to better assess and measure climate-related financial risks in order to enhance the resilience of the financial system to these risks. It also recommended that regulators improve disclosures so that investors would have more useful information to be able to assess climate risks.
Since then, Treasury and its FSOC colleagues have been working to implement the FSOC recommendations. First, we’re expanding capacity to assess, monitor, and quantify climate-related financial risks. The FSOC formed an inter-agency staff committee, the Climate-related Financial Risk Committee (CFRC), to coordinate activities and provide a forum for analysts and researchers to share experiences with developing data, risk metrics, and models. An immediate focus is to advance climate-related scenario analysis, importantly informed by the scenarios produced by the Network for the Greening of the Financial System (NGFS). A significant challenge is that climate-related impacts are historically unprecedented, and their timing and scope are uncertain. Scenario analysis can give a useful sense of vulnerabilities based on possible future outcomes, but our understanding of vulnerabilities and transmission channels should be expected to evolve as we gain experience over time.

Second, U.S. regulators continue to incorporate climate risks into their regulatory and supervisory programs. The development of ways to quantify risks requires concerted focus and new climate expertise, and agencies are making progress. The Federal Reserve has established two committees which are focused on climate-related risks at supervised financial firms and for financial stability, and is developing a program for scenario analysis. The Fed, the OCC, and Federal Insurance Office have joined the NGFS. Some regulators have pilot projects with the Office of Financial Research to better integrate climate data with financial data. More recently, the Office of the Comptroller of the Currency (OCC) released draft principles for identifying and managing climate-related financial risks for large banks that generally align with Basel III and NGFS efforts. The FDIC recently announced its plans to seek comment on guidance designed to help banks manage climate-related risks.

Agencies also will draw on the learnings of our international colleagues on how best to identify data gaps and direct modeling efforts, and to establish supervisory principles. We understand from their experiences that this work will take time. To date, no advanced economy has established direct capital implications for financial firms. But many financial firms themselves are assessing their own risks, and this information is being incorporated into their own decision making, even apart from regulatory requirements. We collectively know that there are significant costs of not making progress and that it is important that resources be dedicated on a sustained basis to this work.

The FSOC report also emphasized the importance of disclosure, recognizing the urgent need to provide markets with the information necessary to price climate related risks. SEC staff is working on a rulemaking proposal to improve the quality and extent of climate risk disclosure.
by public issuers, building on a previous guidance. A robust disclosure framework, however, will need to include both private and public companies, and encompass a broad range of assets. Recognizing this need, Treasury recently held a roundtable last week with state and local finance officials that discussed best practices for climate risk disclosure in municipal debt markets. SEC staff have also begun to review whether fund managers should disclose criteria and data related to ESG and green claims.

International work to promote more consistent climate-related financial disclosures is critical. The recently-created International Sustainability Standards Board (ISSB) plans to issue a climate disclosure standard in 2022, building on the work of the TCFD. The FSB is tracking international progress on climate disclosure and considering how to support consistent and comparable disclosures across jurisdictions and sectors. These standardization efforts will help to promote a level playing field across countries, which in turn, promotes global competition and efficiency.

I would like to highlight two other efforts related to climate change. The first is to ensure market integrity for investors who invest in climate-aligned investments. Countries representing 90 percent of global GDP have committed to some form of net-zero target by mid-century or shortly thereafter, and more than $130 trillion in global assets under management have committed to a mid-century net zero goal. A key challenge for policy makers is how to ensure that these targets are achieved in an orderly, expeditious, and transparent manner, and with credibility and “high-integrity.” Treasury is looking closely at how financial institutions and markets can actively support the net-zero transition, including serving as co-chair of the G20 Sustainable Finance Working Group to promote accountability and best practices.

A second effort is to help improve the resilience of the most vulnerable households and communities to the risks of climate change. Studies by the Environmental Protection Agency and others show a high correlation between low-income communities and major climate events, such as flooding and extreme heat, and such weather-related disasters can have a lasting effect on the financial well-being of more vulnerable households. Treasury, as chair of the inter-agency Financial Literacy and Education Commission (FLEC), has initiated a study to improve understanding of the risks of vulnerable households, and to provide recommendations to increase or improve awareness of available resources to improve resilience of households to climate events. This work is underway by “FLEC and friends,” the
23 FLEC agencies plus science and environmental agencies as well as the Federal Reserve Banks, and they plan to produce a report this fall.

Let me turn next to digital assets. If well-designed and appropriately regulated and supervised, digital asset innovations could enhance financial system efficiency and resiliency, as well as help provide access to financial services for those outside of the traditional banking system. Treasury supports responsible innovation that promotes global economic growth, financial stability, and financial inclusion. At the same time, it is committed to ensuring that new financial products do not pose new, significant risks to financial system resilience.

Stablecoins are an important part of the emerging set of digital assets. Their distinguishing feature, as compared to other digital assets, is that they are designed to maintain a stable value relative to a reference asset, often the U.S. dollar. Because of their offer of stable value, they could become widely used as money. Indeed, many companies are working to create stablecoins to be used by households and businesses for payments. They have the potential to make payments faster and more efficient, but they could also pose significant concerns for users and the broader financial system if they are not stable or cannot reliably provide payment services.

Last November, the Presidents Working Group on Financial Markets (PWG), with the OCC and FDIC, issued a report highlighting certain prudential risks of stablecoins associated with their use for payments, notably run risk, payment risk, and concerns related to concentration of economic power. The report also importantly highlighted gaps in the current regulatory framework to address these risks. Some of the largest stablecoin issuers operate with limited regulatory oversight, and even where there is oversight, supervisors lack the visibility into the broader ecosystem supporting the stablecoin. Existing regulations also are not designed to address the financial stability or payment system risks for new products based on distributed ledger technology, which has the potential to significantly change how some financial services are provided.

To fill this regulatory gap, the PWG Report recommends legislation to require that stablecoins be subject to a consistent and comprehensive regulatory framework that is proportionate to the risks posed. Such legislation would complement existing authorities with respect to market integrity, investor and consumer protection, and illicit finance.

Specifically, the PWG report recommended: limiting issuance of stablecoins to insured depository institutions which would reduce the risk of investor runs; giving supervisors of stablecoin issuers authority to set risk management standards for critical activities related to
use of stablecoin as a means of payment, helping to ensure the resilience of critical payment systems; and certain measures to reduce concerns related to concentration of economic power that would limit competition and harm consumers.

As noted earlier, stablecoins are a subset of the larger and quickly evolving digital assets market. At Treasury, we have made strides to better understand and address the implications of digital assets for the financial system. The FSOC has identified digital assets as one of its priorities for 2022 and plans to bring together its member agencies to assess any potential risks that digital assets may pose and ways to make the financial system more resilient to those risks. These efforts are part of a broader Biden-Harris Administration strategy to develop a comprehensive strategy for all digital assets that calls for policies that will result in real benefits for households and businesses, financial inclusion, and the nation as a leader in the global financial system. At the same time, it will work to prevent increased use for illicit finance, risks to financial stability, and harm to consumers and investors.

International groups continue to prioritize similar work on digital assets. This work includes the G7’s consideration of potential implications of new forms of money for the functioning of the international monetary system, the G20’s focus on cross border payments, and the FSB’s ongoing assessment of growing risks to global financial stability posed by crypto-assets. We at Treasury look forward to continuing to partner with our international colleagues in these important endeavors.

To conclude, risks to the financial system deriving from climate change and digital assets that I highlighted today present new challenges to our existing regulatory and supervisory framework. At Treasury, we are actively working to address these risks, with colleagues domestically and internationally. We share the goal of ensuring a stable financial system in the years to come.

Thank you for letting me join you today and I look forward to continuing to work with the IIB and its members in the future.

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