U.S. DEPARTMENT OF THE TREASURY

Remarks by Under Secretary for International Affairs Jay Shambaugh at the Institute of International Bankers' Annual Washington Conference

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As Prepared for Delivery

Thank you for that introduction, Beth.

I would like to thank the IIB for inviting me to speak today. The IIB is an important voice in efforts to promote a well-functioning financial system, which makes this a good setting to discuss where we stand in those efforts. I'd will talk about our recent experience, the lessons learned, and the important work we still must undertake.

The global economy has been hit by two major shocks in less than three years: the COVID pandemic and Russia's illegal and unprovoked invasion of Ukraine.

In March 2020, the World Health Organization declared that COVID-19 was a pandemic, and countries across the world introduced measures to combat the spread of the disease. The pandemic, the containment measures to combat it, along with peoples' own actions to avoid the disease, had an immediate impact and unprecedented effect on the global economy and the global financial system. Uncertainty and fear led to strain in virtually every asset class. Funding costs rose dramatically; credit spreads widened sharply; and implied volatility jumped to levels not seen even in the wake of Lehman Brothers' failure.

In February 2022, as a nascent recovery was taking hold, Russia's attack on Ukraine sent a new shock reverberating around the world. This immoral invasion was a shock to the world's conscious but was also a shock to the global economy. Ukraine is a vital exporter of key agricultural products like wheat, barley, vegetable oil and other agricultural products. Oil and gas prices spiked, and other commodities followed suit. The global economy was hit by the sharp contraction in available exports of key commodities, complicating inflation and debt dynamics but also creating widespread risks to food and energy security for many, particularly the most vulnerable.

These global shocks have had a terrible toll in terms of lives lost, livelihoods disrupted, rising poverty, and slower economic growth. These effects would have been far worse if compounded by a financial crisis. Moments like this always put financial systems to the test. Financial institutions

and markets are part of the circulatory system of the economy, and are inevitably exposed during a period of economic crisis. COVID-19 and Russia's invasion were particularly harsh tests for the system – significant, novel, and in many ways unprecedented. But in response, the financial system showed remarkable resilience.

In 2020, U.S. GDP dropped 30 percent at an annual rate during one quarter, unemployment rose to 14%, equity markets fell by over one-third in one month between mid-February 2020 and mid-March. And as economic and financial market recovery was just taking hold, in 2022 we saw a land war begin in Europe, oil prices hit $112 per barrel, and equity prices drop around 15% during the first eight months of the war. And yet, the financial crisis that many expected did not happen. The financial stability we observed over the past three years is a testament to skillful policymaking in the face of adversity, but also to the significant progress we – both financial authorities but just as importantly the financial services industry - have made in achieving our objectives of increased resilience and improved vulnerabilities monitoring. This work has been ongoing for more than a decade following the global financial crisis and was carried out both domestically by Treasury and the regulators and internationally through bodies like the Financial Stability Board and the Basel Committee on Banking Supervision.

BANKING SYSTEM / FINANCIAL STABILITY

Understandably, a major focus of financial regulatory reform since the Global Financial Crisis has been on the banking system. The strength of the U.S. banking system played a significant role in helping navigate the recent shocks. During the COVID-19 crisis, banks were able to lend to otherwise creditworthy firms that faced a temporary evaporation of demand. In doing so, the banking sector helped provide necessary support that prevented the sorts of cascading bankruptcies and asset fire-sales that made the Global Financial Crisis so destructive. This underscored the importance of banking reforms to broader economic stability.

Today, banking regulators across the world are working to finalize implementation of Basel III in order to complete this critical effort. Once implemented, these rules will further bolster the safety and soundness of the global banking system. In the United States, our three Federal Banking Agencies are hard at work drafting their proposal for endgame reforms, which, as they have clearly stated, will align with Basel III. Our counterparts in the EU and the UK have released their own draft proposals and we are watching their implementations closely. For our part, we will continue to engage with other jurisdictions and through international fora to promote the rigorous application of Basel III across the globe.

Still, there were areas of the financial system that showed significant vulnerabilities during these recent shocks, suggesting some risks remain. In addition, the financial system continues to evolve through innovation and, in some cases, by deliberate efforts to get around regulations. Regulators need to be both vigilant in their monitoring of shifting vulnerabilities and nimble in updating financial regulation and the regulatory perimeter. International cooperation is critically important to those efforts – markets are global, and risks in one jurisdiction often find their way into others. Today, I want to highlight three important areas for further work, where the need for international cooperation is particularly clear:

First, addressing remaining risks in the non-bank financial intermediation sector. Second, adapting our regulatory frameworks to the ongoing evolution of the financial system driven by changes in financial technology. And third, helping the financial sector to cope with new challenges from a changing climate, while also being ready to take advantages of new opportunities.

NON-BANK FINANCIAL INTERMEDIATION

I want to start with remaining risks in non-bank financial intermediaries, or "NBFIs". NBFIs are an important channel of capital into the financial system and provide vital funding to the global economy. However, the market dislocations of 2007-2009 and again in March 2020 demonstrated that some NBFIs remain vulnerable in times of stress. In the past few years, we've seen strains in non-bank financials related to the holdings of insurance companies, leverage strategies used by pension funds, or the structure of commodity markets raise threats to the overall system. Structural vulnerabilities related to liquidity mismatch mean that certain NBFIs are prone to run risks. And, the use of opaque leverage by some NBFIs can amplify and transmit stress to the broader financial system. If regulators can't see where the risk is, that is sometimes because the firms themselves don't know where the risks are either – an even bigger concern.

We must continue to work on robust international standards to bolster the strength of the non-bank sector, while preserving its core functions and benefits. Treasury is committed to the FSB's ambitious workplan to enhance the resilience of the NBFI sector. And we are energized by G20 Finance Ministers and Central Bank Governors unwavering support for internationally coordinated NBFI work as noted in G20 statements.

Already, we have made important progress in the area of money market funds. In 2021, we worked with the FSB to secure an international commitment to improve the resilience of this sector, and soon we will begin efforts to will review the implementation and assess effectiveness of the measures taken by FSB member jurisdictions. Domestically, the Financial Stability Oversight

Council or FSOC, chaired by Secretary Yellen, has strongly supported the SEC's proposed rule that seeks to reduce the likelihood of money market fund runs during periods of stress and equip funds to better meet large redemptions, while addressing concerns about redemption costs and liquidity.

We are also engaged in work at the FSB to reduce the financial stability risks associated with liquidity mismatch in open-ended funds. Treasury is an active participant in the FSB open-end fund work group that will issue updated recommendations for the sector later this year, with the aim of improving their resilience. Even before this work at the FSB is complete, the SEC has led the way with recently proposed amendments regarding open-end funds liquidity risk management, swing pricing, and fund reporting – reforms that would address the financial stability risks from SEC-registered open-end funds.

FINANCIAL TECHNOLOGY AND DIGITAL ASSETS

Continued evolution in financial technology has presented its own set of new opportunities and risks. In recent months, these risks have been on prominent display in crypto-asset markets. In November 2021, the market capitalization of all crypto-assets reached highs of nearly $3 trillion. Just a few months later, market volatility and the subsequent failure of several prominent crypto-asset firms led to what some call a "crypto winter," with two-thirds of its total value lost. Little has recovered since.

In the aftermath of that stress, it has become clear that many crypto-asset trading platforms and crypto-asset hedge funds were engaged in very risky behavior and, in some circumstances, gross negligence or outright fraud. While crypto markets were growing, the firms appeared to make tremendous profits. But when markets turned, leveraged and interconnected firms pulled one another down. Many consumers who trusted crypto-firms with their money—sometimes their life savings—were left with nothing.

Despite its magnitude, turmoil in the crypto-asset market did not spill over into the traditional financial sector. That fact does not bring complete relief. Although recent disruptions did not cause broader financial stress, the amount of damage done, particularly to consumers, should be cause for deep concern by itself. It is also noteworthy that many of the firms that displayed the worst behavior and contributed the most severely to distress in the crypto-asset ecosystem chose to operate offshore. Consumers frequently interact with digital asset firms across borders without recognizing that protections may change when they leave certain financial regulatory jurisdictions. When one jurisdiction fails to catch serious risks in their early stages, consumers, investors, and firms in many others may bear the cost.

This means that addressing the risks of digital assets must be a common cause. The international community has started to pick up the mantle. In October, the FSB released proposed recommendations on the regulation, supervision, and oversight of crypto-asset activities and markets and proposed updates to recommendations for global stablecoin arrangements. These recommendations cover risk management, governance, data collection, and risks posed by interconnectedness.

The FSB's draft recommendations are a noteworthy start, but there is much more to do. We will continue to work with our partners at the FSB and G20 in taking steps to finalize these recommendations and make them operational. And we continue to lead efforts at the Financial Action Task Force to monitor digital assets and encourage the implementation of FATF standards. We must share these lessons with a wide range of jurisdictions, not just advanced economies. Digital assets pose distinct sets of opportunities and challenges for emerging market economies, even as the task of regulating those assets is a broad and common one. We all share the task of preventing havens for risky conduct in digital assets from threatening financial stability.

The same tensions between challenges and opportunities are on display in other areas of fintech. Third party service providers, for example, can offer access to technologies that make institutions more resilient to outages, attacks, and other types of operational risk. But just like financial institutions, third-party providers are also exposed to a range of physical and cyber threats. We recently saw this when ION, a technology group that provides services to financial institutions around the world, was affected by a ransomware attack. While there are elements of the incident that are concerning, arguably our response highlighted significant progress authorities and the financial sector have made on this front. After the attack occurred, Treasury worked closely with federal regulators, the private sector, and foreign counterparts to rapidly assess the impact to the firm and global markets. Our incident response plan and the international relationships we've developed over the last decade made this process quicker and more comprehensive than it would have been five or ten years ago. We were able to assess the impact to U.S. financial institutions and push out proactive messaging to curb speculation. We understand that now most firms have reconnected back to ION's services. Now we can turn our attention to assessing lessons learned for future policy development.

Reliance on third-party providers isn't new – from mainframes to routers to databases, the financial sector has been harnessing technology this way for decades. Today, we're seeing an evolution towards using the cloud services. Public cloud is far more scalable than on-premises mainframes and makes access to the most sophisticated computing infrastructure and software more equitable, rather than only for only big tech giants. This infrastructure is essential to exploring the next frontier in artificial intelligence for consumer facing applications and for risk modeling powered by

the public cloud. It also can enable resilience to physical risks by allowing data to be replicated easily in multiple, independent data centers. For many financial institutions, they powered the remote working applications that kept the financial sector running through the pandemic. And most recently, in Ukraine, the rapid migration to the cloud helped safeguard over 10 million gigabytes of critical information infrastructure, from government to banking records.

But greater reliance on cloud-based technologies has raised an important set of policy questions for the financial sector, and Treasury is tackling these issues head on. We spent nine months working closely with U.S. financial regulators to take a forward-looking approach to the state of cloud adoption in financial services. Just a few weeks ago, we published a report on cloud adoption in the U.S. financial system. In the report, we lay out the clear benefits of cloud-based technologies, from powering innovation to providing financial institutions more. At the same time, we identified six key challenges in the current state of adoption, ranging from information asymmetries to a shortage of expertise. Critically, one challenge is the fragmentation of the international regulatory landscape. Even within the G7, companies face challenges in navigating a range of regulatory frameworks before, during, and after an incident. That fragmentation drives home the potential benefits of working with key allies – and the risks of not doing so.

Last year, we stood up a new dialogue with the Federal Reserve and authorities from nine other jurisdictions to discuss how to manage policy issues and promote international cooperation around critical third-party providers. As co-chair of the G7 Cyber Expert Group, Treasury was deeply involved in the revisions to the Fundamental Elements of Third-Party Cyber Risks. At the FSB, we are also finalizing work on greater convergence in cyber incident reporting and developing a toolkit for managing risks from critical third-party services. International cooperation on this topic isn't going to materialize overnight, but we think that these initiatives serve as an important starting point to ensure that, globally, we can realize the promise of these technologies while still managing the risks.

CLIMATE CHANGE

Finally, I would like to address the important ways in which financial regulation interacts with climate change. First, it is important to note the substantial policy actions that the United States is taking to combat climate change. As Secretary Yellen has noted, climate change poses meaningful risks to our economy. A whole of economy transition is needed to meet the climate challenge; this transition is necessary to reduce our risk exposure and will also offer opportunities to those that embrace it.

The Inflation Reduction Act, or IRA, coupled with the Bipartisan Infrastructure Law, have given the United States a path to meeting its climate commitment to reduce greenhouse gas emissions by at least half from 2005 levels by 2030. The IRA will catalyze significant private capital toward climate-friendly investments through a combination of demand- and supply-side incentives. It provides long-term clarity and certainty around key power sector incentives for clean power generation and battery energy storage systems. It introduces new incentives to help scale emerging technologies such as clean hydrogen, sustainable aviation fuel, and direct air capture. And it promotes investment in clean energy supply chains, which are highly concentrated in China today.

Investments spurred by this legislation will accelerate the transition to a clean energy economy and increase the resilience of the U.S. energy supply against global price shocks. They will position America to help meet growing global demand for low-carbon products and technologies. And they will help realize significant opportunities in high-growth industries and create good-paying jobs, including via place-based incentives for investments in underserved or at-risk communities. The Treasury Department, the IRS, and other agencies are working hard to implement the IRA, so the country can realize these benefits as quickly as possible.

Many financial institutions have made net-zero commitments as part of financing this transition. These commitments are an important step in aligning the global economy with a net-zero economic trajectory and have the potential to align trillions of dollars with a net-zero pathway. To deliver on those commitments, financial institutions will have to transition their activities to align with a net-zero world, and work with their clients to do the same. It is a significant task, and an important one, and there is no precedent or road map for accomplishing it. As these efforts move forward, the Treasury Department is engaging with financial institutions to better understand how they are setting, implementing, and accounting for net-zero financing activities. As co-chair of the G20 Sustainable Finance Working Group, last year Treasury helped lead on work to enhance comparability across institutions' commitments, provide clarity on recommended elements of a credible net-zero commitment, and advance efforts that will support bringing these commitments to fruition. We are interested in finding ways to encourage progress toward shared climate goals as well as to facilitate a smooth and just economic transition.

Institutions face a second challenge in identifying, assessing, and managing the financial risks of climate change. The U.S. agencies are taking significant steps to address this challenge, from guidance on risk management to proposed rules on climate-related financial disclosures. Here, again, international engagement is essential to tackling the issue effectively and quickly, while avoiding unnecessary fragmentation. The Financial Stability Board's Roadmap for Addressing Climate-related Financial Risk provides a clear direction of travel for this work, by charting out a path for international coordination to promote a financial system that is resilient to these risks. This

year, for example, the FSB plans to begin assessing climate-related vulnerabilities in its regular financial stability assessment. We view this exercise a key starting point on which to build on the group's monitoring work.

We are also undertaking work to identify and manage climate-related financial risks. As chair of the FSOC, Secretary Yellen has prioritized work to bolster the resilience of our financial system to climate-related risks. In 2021, FSOC for the first time identified climate change as an emerging threat to the financial stability of the United States. Agencies have already taken steps to start incorporating climate-related financial risks into their work. For example, the Federal Reserve Board has initiated a pilot "climate scenario analysis" exercise with six large banks to enhance the ability of supervisors and firms to measure and manage climate-related financial risks. And the Federal Reserve Board, the OCC, and FDIC have each proposed principles for climate-related financial risk management for large financial institutions.

High quality information is vital to the strength of the U.S. financial system. We believe that climate-related disclosures are essential. They enable market participants to take climate-related risks and opportunities into account in their investment strategies. Treasury believes that by providing investors with reliable information, U.S. companies will be better able to attract capital and stay competitive in the global economy.

Internationally, a broad range of jurisdictions and international bodies, such as the International Sustainability Standards Board or ISSB, are working to finalize their disclosure standards and requirements. In this respect, the Financial Stability Board's work to track progress on this is important. As we move forward, it is critical that all actors work together to promote disclosure regimes that are interoperable and avoid unnecessary market fragmentation. We look forward to advancing that objective in the months and years ahead.

TREASURY'S PRIORITIES AND FINANCIAL STABILITY

Beyond just crypto, cloud, or climate-risks, financial stability is intimately connected to Treasury's broader mission of sound and supportive macroeconomic management. Financial regulators build up prudential regulatory standards to ensure resilience. But a macroeconomic shock can lead to such a rapid and substantial collapse in risk appetite and asset prices that the sector cannot withstand the shock. Preventing such shocks from occurring is the ideal outcome, but appropriately managing these shocks when they occur is often the reality. Outside of the financial regulatory space, other Treasury efforts speak directly to reducing systemic vulnerabilities identified during the COVID-19 and Ukraine shocks. Taking actions to address the underlying causes of these

vulnerabilities, for example building up pandemic prevention efforts and supply chain integrity, can make the system more shock resistant and safer.

A substantial part of our international engagement is based around trying to ensure inclsuvie and stable global growth. We encourage countries to pursue policies we think will be good for them – and by extension – us. We work with our G7 allies to think about risks in the world and how we can approach them together. We use the G20 forum to communicate with major trading partners, assess vulnerabilities, and work towards solutions. Recently, that has included efforts around macroeconomic policies to reduce global economic risks as countries seek to rein in inflation, solve global debt vulnerabilities through the creation of the Common Framework, work to coordinate tax policies that can help avoid trade conflicts, and support vulnerable countries through challenges to food insecurity.

Two specific new processes that the recent shocks have highlighted the need for are supply chain risks and pandemic risks.

Russia's war against Ukraine and COVID-19 showed us the significant risks and vulnerabilities associated with undiversified supply chains. This had not previously been a focus for policymakers, but supply chain issues have become a predominant concern for macroeconomic management. This has contributed to the inflationary pressures that policymakers are working to address across the world. We have already taken action through the Inflation Reduction Act to promote supply chain diversification to address some of these issues and will be working with our allies in the G7 to discuss how best to improve supply chain resilience.

Drawing inspiration from the post-GFC success of the FSB at a forum for international coordination and standard-setting, and aware of the importance of preparing for future pandemics, the G20 launched a Finance-Health Task Force. Think of this as an "FSB for health." We were woefully inadequate in our efforts to prevent pandemics before COVID-19, and we hope that group can help take steps to bring together health and economic policymakers in a way that was not done before. This group has already shown its success in laying some of the groundwork that led to the launching of the Pandemic Fund, which has real money going toward improving our ability to prevent, prepare for, and respond to pandemics. We are aiming for the group to continue to enhance finance-health coordination and take steps to understand economic vulnerabilities to pandemics, discuss best practices for pandemic response, and start to think through a "playbook" for how to respond in the event of a future pandemic.

Over the past three years, the system has, in a way, undergone a real-life stress test. And, similar to hypothetical stress tests, the system's strengths and weaknesses have been partially revealed. We have seen the beneficial results of some of our achievements over the past ten years as global

financial stability was maintained. But we have also become more aware of what needs to be done going forward. We will continue to work domestically and with our international partners to address remaining risks in the financial system. We will adapt our frameworks to account for evolution in financial technology, ensuring that new pockets of risk are not created without appropriate regulation in place. And we will work closely with all parts of the financial services industry as we navigate the climate transition.