SUPERVISORY IMPLICATIONS OF GLOBAL FRAGMENTATION AND UNCERTAINTIES

TABLE OF CONTENTS

Overview

This Toronto Centre Insight[1] examines the supervisory implications of current developments and uncertainties.

Standard-setting bodies and supervisory authorities face mounting challenges in adjusting to the impact of global economic and political fragmentation and shifting economic paradigms.

These challenges include:

1. A marked shift towards a more protectionist approach to international trade, with the imposition of new tariffs – and the threat of further tariffs to follow – and retaliatory measures by other countries in response. The overall impact on world economic growth is likely to be negative, while rates of inflation may increase.
2. Governments are reducing their expenditure on and support for various international organizations and initiatives, including international assistance.
3. A deregulation agenda in some countries, including for the financial sector.
4. The scaling back in some countries of some policies and initiatives on climate change and diversity.
5. The impact on EMDEs of the (re) absorption of deported immigrants, and of cutbacks in aid budgets.

These challenges are in addition to or reinforce pressing supervisory concerns that have been developing over several years, including climate and biodiversity loss related risks; technology (including AI and machine learning risk); and geopolitical risks.

Issue 1: What risks to supervisory objectives do these challenges create?

The challenges listed above create several risks to supervisory objectives, including:

[1] This TC Insight is written by Clive Briault, Chair, Toronto Centre Banking Advisory Board.

a) **The direct impact of tariffs on the customers and counterparties of financial institutions.** Some financial institutions may benefit, while others may see an impact on their creditworthiness, the value of equity and debt they have issued, and market volatility. This in turn will be reflected in banks' loan books, and in the investments held by insurance companies, pension funds, and (position-taking) securities firms.

b) **The potential for tariffs to reduce economic growth and to increase unemployment and the rate of inflation.** Economic volatility might reduce access to affordable financial services, increase the cost of credit, and lead to greater financial exclusion. Additionally, a decline in the creditworthiness of borrowers, increased lapses in and lower levels of new written business for life insurers, and inflation-driven impacts on general insurers could exacerbate financial stability concerns.

c) **Continuing – and possibly accelerating – climate change and biodiversity loss.** This will lead to direct and indirect impacts on the customers and counterparties of financial institutions, including higher claims on insurance companies, the inability of borrowers to service their debt, and a reduction in the value of some assets (in particular residential and commercial properties in some regions) held as security or collateral against bank lending.

All of these are likely to threaten financial stability.

Issue 2: What do these challenges imply for global financial institutions and international standard setters?

Both the emerging challenges and the pre-existing supervisory concerns require urgent responses. Some of these can be undertaken at the national level, but others require a coordinated international response.

Despite widespread calls for enhanced international cooperation, tangible progress remains elusive. The role of international standard setters in fostering effective and consistent financial sector regulation and supervision is made more difficult.

Recent significant geopolitical and economic shifts are impacting international finance governance as well as the relevance of some international financial sector standards.

It remains to be seen how this will play out at organizations such as the Financial Stability Board, Basel Committee, IADI, IAIS, and IOSCO. Each of these organizations has very different memberships so the impact will vary in each case.

These international standard setters may become more cautious and restrained in pursuing some aspects of the climate agenda, other than the basics of mandating good risk management by financial institutions and some level of climate-related disclosures by both financial and non-financial firms.

There may also be reduced support for, and further delays to the implementation of, previously agreed international standards, such as Basel III and the IAIS International Capital Standard and Common Framework.

There may be a more uneven playing field. For example, U.S. financial institutions are likely to be subject to less onerous rules on climate-related reporting, disclosures, stress testing, and investment limits.

Issue 3: Implications for supervision

National supervisory authorities are facing unprecedented challenges.

As discussed above, they need to respond to multiple challenges, concerns, and uncertainties. Uncertainties about political support to supervisory objectives such as maintaining financial stability are increasing at the same time as pressures for deregulation increase, and the position of international standard setters is weakened.

One lesson of the failure of Silicon Valley Bank in March 2023 was that in the years running up to the failure, supervisory intensity had been reduced in line with a reduction in regulatory requirements. And the failure of Credit Suisse, also in March 2023, demonstrated that even the raft of post-Global Financial Crisis regulatory reforms for G-SIBs (capital surcharges, a higher level of supervisory intensity, higher standards of governance and internal controls, and recovery and resolution planning) were not sufficient to prevent this failure.

Equally, however, the severity of the materialized and potential risks in some countries, in particular from climate change and biodiversity loss, has led many national supervisors to become more active in this area. National climate-related disasters have had a significant negative impact on general insurers and many other financial institutions, leading to responses from both the financial institutions themselves (in terms of pricing and even withdrawing from some business activities) and their supervisors.

In some countries, supervisory authorities have already moved beyond risk management by financial institutions and disclosure requirements to considering requirements on financial institutions to align their financing of emissions with national climate targets.[2] Where we go from here is unclear; the risks are increasing, but an international climate agenda appears elusive.

Supervisors must remain focused on financial institutions' capital and solvency; liquidity; recovery planning; business models; and scenario analysis and stress testing. These are core supervisory issues that stay with us.

Given the increasing complexity of financial risk, supervisory authorities and central banks must also strengthen their focus on crisis preparedness and cross-border coordination. This includes enhancing stress-testing methodologies, updating recovery and resolution plans, and ensuring that liquidity backstops remain effective under multiple crisis scenarios. In an era of declining international cooperation, regional financial stability arrangements may become more critical in supplementing global frameworks.

[2] For more on this, see Toronto Centre's TC Note, [The Supervision of Financial Institutions' Climate-related Transition Planning](#).