FSB FINANCIAL STABILITY BOARD

THE CHAIR

28 August 2026

To G20 Finance Ministers and Central Bank Governors

The financial system has continued to absorb the substantial supply shock to the global economy brought about by the conflict in the Middle East. This demonstrates the benefits of the resilience built through post-crisis reforms. However, the global economic environment remains challenging, the conflict has exacerbated energy-driven inflationary pressures, and vulnerabilities in the financial system remain elevated. While energy and other commodity prices have fallen back from their initial peaks, prices remain sensitive to news on the conflict, and we are seeing renewed volatility across a range of asset classes. Market interest rates have risen since the start of the conflict and so financing costs have continued to increase, while valuations of risky assets remain elevated. We therefore cannot be complacent.

Markets remain vulnerable to a potentially disorderly correction that could spread across borders, particularly given fragilities in sovereign debt markets (including elevated issuance, shortening maturities, and the increased use of leverage by some market participants); vulnerabilities in private credit (including levels of interconnectedness with other parts of the financial system, liquidity mismatch and opacity); as well as stretched asset valuations (particularly artificial intelligence-related investments).

A further concern that has emerged more clearly in recent months is an increase in the use of leverage in equity markets. This includes greater use of leveraged exchange-traded funds (ETFs) and correlated momentum-driven investment strategies, including by retail investors. In addition, a growing footprint of leveraged entities, such as hedge funds in equity markets, which are also exposed to sovereign debt, increase the scope for contagion risk. As we have seen multiple times in the past, rising leverage is a feature of a maturing financial cycle. While it can reinforce rising markets, it can also intensify declines when sentiment turns, as recent weeks have demonstrated.

The issue is not simply that investors are borrowing more, but that leverage is interacting with high valuations and market concentration, in particular the increasing cross-investment between artificial intelligence (AI) companies and hyper scalers, in a way that could amplify a future market correction. I remain concerned therefore that a large shock or combination of shocks could concurrently trigger multiple vulnerabilities.

Frontier AI

The risk landscape has been further complicated by the emergence of frontier AI models, which are showing increasingly sophisticated autonomy and problem-solving abilities, as well as threat capabilities.

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This is particularly important from a financial stability perspective. The risks associated with frontier AI will not respect national borders. The global financial system is highly interconnected, and cyber disruption can spread across jurisdictions through common technology providers, shared infrastructure, and cross-border financial activity. Differences in legal frameworks, cyber capability, resilience and recovery capacity across jurisdictions could therefore have consequences well beyond the jurisdiction in which an incident originates and may themselves become a source of vulnerability.

For the financial system, the most immediate concern is the potential impact of frontier AI on cyber risk. Frontier AI may have the ability materially to alter the speed, scale and economics of cyber risk, which could undermine market confidence system-wide, especially due to highly concentrated third-party service providers. Firms and authorities should be prepared for a threat environment characterised by a higher volume of vulnerabilities and a faster pace of patching, recognising that these dynamics could themselves create operational and resilience challenges if change, testing and recovery processes are unable to adapt safely. Frontier AI offers significant opportunities to strengthen cyber defence; but recent developments highlight the importance of ensuring that advances in capability are matched by resilience and preparedness.

Financial institutions, financial market infrastructures, and technology providers will therefore need to strengthen vulnerability management, response and recovery capabilities, and prepare for more severe scenarios involving simultaneous disruption across multiple firms or shared technology dependencies. These developments reinforce the importance of robust response and recovery capabilities, including the ability to restore critical systems and data from “bare metal” following a significant cyber incident, as well as the importance of resilience amongst critical third-party technology providers and other common service providers, on which the financial system depends. While recognising that frontier AI issues are cross-sectoral and involve government authorities more broadly, the FSB is exploring particular issues associated with the safe deployment of frontier models for cyber defence by financial services firms, as well as ways to enhance capabilities to respond to and recover from significant operational disruptions.

Recent developments have also highlighted to me that many jurisdictions do not have the protocols in place to manage the development, release, and deployment of advanced frontier AI models, heightening risks for the financial sector and beyond. Taking appropriate steps to support safe and responsible model release and deployment on a global basis should in my view be a priority and would benefit all sectors of the economy, including by supporting financial stability and economic growth.

Conclusion

These developments are another reminder of the pace at which the financial system continues to evolve. New technologies and changing market structures present significant opportunities, but they also require continued vigilance and international cooperation.

The FSB remains focused on identifying emerging vulnerabilities, strengthening resilience and ensuring that innovation is consistent with financial stability.

Yours sincerely,



Andrew Bailey