Promoting Financial System Stability

The Federal Reserve monitors financial system risks and engages at home and abroad to help ensure the system supports a healthy economy for U.S. households, communities, and businesses.

What Is Financial Stability? .................................................. 56
Monitor Risk across the Financial System .............................. 57
Macroprudential Supervision and Regulation of Large, Complex Financial Institutions ......... 65
Domestic and International Cooperation and Coordination ...... 68
The Federal Reserve was created in 1913 to promote greater financial stability and help avoid banking panics like those that had plunged the country into deep economic contractions in the late nineteenth and early twentieth centuries.

Over the past century, as the U.S. and global financial system have evolved, the Federal Reserve's role in promoting financial stability has necessarily changed with it. The 2007–09 financial crisis and the subsequent deep recession revealed shortcomings in the financial system infrastructure and the framework for supervising and regulating it (see figure 4.1). Indeed, reforms enacted under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 assigned the Federal Reserve new responsibilities in the effort to promote financial system stability and keep pace with changing dynamics and innovation in the broader economy.

Figure 4.1. The financial system: key participants and linkages

Key participants in the U.S. and global financial system include the lenders and savers who are matched up with borrowers and spenders through various markets and intermediaries. The Federal Reserve monitors the financial system to ensure the linkages among these three entities are well-functioning and adjusts its policymaking or engagement with other policymakers to address any emerging concerns.

What Is Financial Stability?

A financial system is considered stable when financial institutions—banks, savings and loans, and other financial product and service providers—and financial markets are able to provide households, communities, and businesses with the resources, services, and products they need to invest, grow, and participate in a well-functioning economy.

These resources and services include

- business lines of credit, mortgages, student loans, and the other critical offerings of a sophisticated financial system; and
- savings accounts, brokerage services, and retirement accounts, among many others.

Effective Linking of Savers and Investors with Borrowers and Businesses

A healthy and stable financial system links, at the lowest possible cost, savers and investors seeking to grow their money with borrowers and businesses in need of funds. If this critical role of intermediation between savers and borrowers is disrupted in times of stress, the adverse impact will be felt across the economy.

And such disruption can carry a very high price. As a result, financial stability in its most basic form could be thought of as a condition where financial institutions and markets are able to support consumers, communities, and businesses even in an otherwise stressed economic environment.

Keeping Institutions and Market Structures Resilient

To support financial stability, it is critical that financial institutions and market structures are resilient, so that they are able to bend but not
The 1907 panic led to the creation of the National Monetary Commis-
sion, whose 1911 report was a major impetus to the Federal Reserve Act, signed into law by President Woodrow Wilson on December 23, 1913. Upon enactment, the process of organizing and opening the Board and the Reserve Banks across the country began. On November 16, 1914, the Federal Reserve System began full-fledged operations.

In the words of one Federal Reserve Act author, U.S. Senator Robert Latham Owen of Oklahoma, “It should always be kept in mind that . . . it is the prevention of panic, the protection of our commerce, the stability of business conditions, and the maintenance in active operation of the productive energies of the nation which is the question of vital importance.”


break under extreme economic pressures. Such a dynamic does not mean that market prices will never rise or fall quickly. Volatility may reflect changes in economic conditions and would be a concern with respect to financial stability only when institutions and markets are not adequately prepared. Financial stability depends on firms and critical financial market structures having the financial strength and operational skills to manage through volatility and continue to provide their essential products and services to consumers, communities, and other businesses.

Monitoring Risk across the Financial System

The Federal Reserve and other bank regulators have long supervised individual banks and financial institutions to make sure they are run in a “prudent” and “safe and sound” manner and are not taking excessive risks. The goal of this traditional “microprudential” supervisory
approach is to ensure individual banks and financial institutions are less likely to fail and to help avoid any associated adverse circumstances for their customers.

In the heat of the 2007–09 financial crisis, however, it became clear this microprudential focus did not adequately identify risks that developed across and between markets and institutions and that, in turn, threatened to set off a cascade of failures that could have undermined the entire financial system. Thus, a central element of the Dodd-Frank Act—the landmark legislative response to the 2007–09 crisis—is the requirement that the Federal Reserve and other financial regulatory agencies look across the entire financial system for risks, adopting a macroprudential approach to supervision and regulation.

Whereas a traditional—or microprudential—approach to supervision and regulation focuses on the safety and soundness of individual institutions, the macroprudential approach centers on the stability of the financial system as a whole (see section 5, “Supervising and Regulating Financial Institutions and Activities,” on page 72, for more on micro- and macroprudential supervision).

Types of Financial System Vulnerabilities and Risks

Federal Reserve staff regularly and systematically assess a standard set of vulnerabilities as part of a Federal Reserve System macroprudential financial stability review:

- asset valuations and risk appetite
- leverage in the financial system
- liquidity risks and maturity transformation by the financial system
- borrowing by the nonfinancial sector (households and nonfinancial businesses)

These vulnerability assessments inform internal Federal Reserve discussions concerning both macroprudential supervision and regulatory

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**Microprudential supervision and regulation**

The Federal Reserve also “microprudentially” supervises and regulates the operations of large financial institutions—that is, it monitors the safety and soundness of these and other individual institutions—and integrates this monitoring into its macroprudential supervisory and regulatory efforts.

For more information, see section 5, “Supervising and Regulating Financial Institutions and Activities,” on page 72.
policies and monetary policy (see figure 4.2). They also inform Federal Reserve interactions with broader monitoring efforts, such as those by the Financial Stability Oversight Council (FSOC) and the Financial Stability Board.

**Asset Valuations and Risk Appetite**

Overvalued assets constitute a fundamental vulnerability because the unwinding of high prices can be destabilizing in the financial system and economy, especially if the assets are widely held and the values are supported by excessive leverage, maturity transformation, or risk opacity. Moreover, stretched asset valuations may be an indicator of a broader buildup in risk-taking.

However, it is very difficult to judge whether an asset price is overvalued relative to fundamentals. As a result, analysis typically considers a range of possible valuation metrics, developments in areas where asset prices are rising especially rapidly or into which investor flows have been considerable, or the implications of unusually low or high levels of volatility in certain markets.

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**Figure 4.2. Four standard components of financial system vulnerability review**

Four vulnerability assessments inform the broad efforts undertaken by the Federal Reserve—with entities both in the United States and abroad—to monitor financial system stability.

<table>
<thead>
<tr>
<th>Asset valuations and risk appetites</th>
<th>Financial system leverage</th>
<th>Liquidity risks/maturity transformation</th>
<th>Nonfinancial sector borrowing</th>
</tr>
</thead>
<tbody>
<tr>
<td>The “unwinding” of high prices of assets (e.g., housing prices in the mid-2000s) can destabilize the financial system and the economy</td>
<td>Financial system intermediaries (such as traditional banks, insurance companies, and hedge funds) with significantly more debt than equity can amplify an economic downturn</td>
<td>Traditional banks, money market funds, and exchange-traded funds are among the institutions that might experience a “run” by investors that amplifies an economic downturn</td>
<td>If credit exposure in U.S. households and nonfinancial businesses is high, these borrowers often curtail spending and disengage from other economic activity and may contribute to a severe downturn</td>
</tr>
</tbody>
</table>

Moreover, sufficiently large losses for highly leveraged institutions can result in credit contraction, which will have broader economic implications. For example, if a highly leveraged institution needs to shrink its balance sheet in response to an otherwise standard economic downturn, the resulting contraction in credit will have broader economic implications. Moreover, sufficiently large losses for highly leveraged institutions can

**Figure 4.3. Monitoring leverage in the financial system**

The collective financial strength of the banking sector—and its prevailing activities—can be an important indicator in understanding risks to the nation's financial stability. The Federal Reserve focuses on metrics like the ratio of common equity to risk-weighted assets in the banking sector, which has risen in recent years as a reflection of tougher capital standards for major banking institutions.

<table>
<thead>
<tr>
<th>Percent</th>
<th>18</th>
<th>16</th>
<th>14</th>
<th>12</th>
<th>10</th>
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<tr>
<td>1997 Q1</td>
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<td>1997 Q4</td>
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<td>1998 Q3</td>
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<td>1998 Q2</td>
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<td>2010 Q3</td>
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Note: Prior to 2014:Q1, the numerator of the common equity tier 1 ratio is tier 1 common capital. Beginning in 2014:Q1 for advanced-approaches bank holding companies (BHCs) and in 2015:Q1 for all other BHCs, the numerator is common equity tier 1 capital. The data for the common equity tier 1 ratio start in 2001:Q1. An advanced-approaches BHC is defined as a large internationally active banking organization, generally with at least $250 billion in total consolidated assets or at least $10 billion in total on-balance-sheet foreign exposure. The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research.

* Leverage ratio is the ratio of tier 1 capital to total assets.


**Leverage in the Financial System**

Highly leveraged financial system intermediaries—those with significantly more debt than equity—can amplify the effect of negative shocks in the financial system and broad economy (see figure 4.3).

For example, if a highly leveraged institution needs to shrink its balance sheet in response to an otherwise standard economic downturn, the resulting contraction in credit will have broader economic implications. Moreover, sufficiently large losses for highly leveraged institutions can
lead to “fire sales,” where assets are unloaded quickly at extremely low prices. Fire sales, in turn, increase the potential for runs on banks—and even on nonbanks—if liabilities have short maturities.

The Federal Reserve monitors leverage in the banking sector with the help of an extensive data collection program. Nevertheless, these monitoring efforts are complicated by off-balance-sheet exposures and rapidly changing trading exposures. Monitoring leverage in the nonbank sector (hedge funds, for example) proves even more difficult, but periodic surveys of the providers of leverage through the Senior Credit Officer Opinion Survey (SCOOS) offers valuable insights.

**Liquidity Risks and Maturity Transformation by the Financial System**

One key benefit provided by the financial system is to transform short-maturity (or liquid) liabilities into long-maturity (illiquid) assets. This function is done primarily through the traditional banking system or other depository institutions, but it also occurs outside the banking system, for example, through money market mutual funds.

Liquidity and maturity transformation is productive in the sense that it allows investment projects to be funded with long-term financing while still satisfying the liquidity needs of lenders. However, the experience of the 2007–09 financial crisis demonstrated that liquidity and maturity transformation introduces systemic vulnerabilities that can threaten the broader economy (see box 4.2, “Responding to Financial System Emergencies: The Lender of Last Resort Concept in Central Banking”).

When a systemwide shock results in all lenders demanding liquidity at the same time, institutions engaged in this maturity transformation are at risk of being run. Deposit insurance provides protection within the traditional banking system. Nevertheless, some assets such as repurchase agreements (or “repos”), asset-backed commercial paper (ABCP), or money market funds are also subject to run risk and, indeed, came under considerable pressure during the crisis. For this reason, the Federal Reserve actively monitors, as best it can given available data and...
Promoting Financial System Stability

**Figure 4.4. Monitoring borrowing in the nonfinancial sector**

Borrowing by households and nonfinancial sector businesses can also influence financial stability. The Federal Reserve focuses on metrics like the ratio of household and nonfinancial business credit to nominal U.S. gross domestic product. This ratio dropped below peaks around the time of the 2007–09 crisis.

Note: The shaded bars indicate periods of business recession as defined by the National Bureau of Economic Research.


measurement, both liquidity risk and the degree of maturity transformation in the financial system.

**Borrowing by the Nonfinancial Sector**

Excessive credit in the private nonfinancial sector can provide a transmission channel for a disruption in financial markets to affect the real economy (see figure 4.4). Highly indebted households and nonfinancial businesses may have a difficult time withstanding negative shocks to incomes or asset values, and may be forced to curtail spending in ways that amplify the effects of financial shocks. In turn, losses among households and businesses can lead to mounting losses at financial institutions, creating an adverse feedback loop. The Federal Reserve monitors measures of vulnerabilities in the nonfinancial sector includ-
ing, for example, leverage and debt service burdens as well as underwriting standards on new loans to households and businesses.

This monitoring program is complemented by a broader effort to foster greater transparency in financial markets through improved data collection and enhanced disclosures by regulated financial market participants. Greater transparency helps lead to meaningful implementation of macroprudential regulatory and supervisory policies to target building vulnerabilities and to pre-position the financial system to be better able to absorb shocks.

Why Proactive Monitoring of Domestic and Foreign Markets Matters

The changing nature of risks and fluctuations in financial markets and the broader economy require timely monitoring of the effects of conditions in domestic and foreign financial markets on financial institutions and even in the nonfinancial sector in order to identify the buildup of vulnerabilities that might require further study or policy action.

To this end, the Federal Reserve maintains a flexible, forward-looking financial stability monitoring program to help inform policymakers of the financial system’s vulnerabilities to a range of potential adverse events or shocks. Such a monitoring program is a critical part of a broader Federal Reserve System effort to assess and address vulnerabilities in the U.S. financial system. In the case of individual institutions, the Federal Reserve may take more direct action and in various ways (for more information, see “Macroprudential Supervision and Monitoring” on page 98 in section 5, “Supervising and Regulating Financial Institutions and Activities”).

Examination Causes, Effects, and Remedies for Financial Instability

A macroprudential approach to ensuring financial stability builds on a substantial and growing body of research on the factors that lead to
The idea that a central bank should provide liquidity to support the financial system was refined by nineteenth-century economist Walter Bagehot, who suggested that during times of financial panic or crisis, a central bank should lend quickly and freely, at a penalty rate of interest, to any borrower with good collateral.

In an emergency, the Federal Reserve has the power to provide liquidity to depository institutions using standard, traditional tools, like open market operations and discount window lending. Under section 13(3) of the Federal Reserve Act, the U.S. central bank also has authority to provide liquidity to nondepository institutions in “unusual and exigent circumstances.” Although the Federal Reserve has rarely exercised this LOLR clause enacted in 1932, it did use it during the 2007–09 financial crisis to prevent harm to the U.S. economy.

Broad-based lending only. Under amendments enacted under the Dodd-Frank Act, emergency lending programs under section 13(3) of the Federal Reserve Act must be broad-based and not designed to support a single institution, among other requirements. In addition, Congress requires that the Federal Reserve ensure that taxpayers are protected against losses. For a fuller discussion of how each of these lending tools works, see section 3, “Conducting Monetary Policy,” on page 20 (see also the 2013 Federal Reserve paper “Financial Stability Monitoring,” www.federalreserve.gov/pubs/feds/2013/201321/201321pap.pdf).

Federal Reserve lending under normal and “unusual and exigent” circumstances

As a major financial crisis began to unfold in 2007 and its magnitude became clearer, the Federal Reserve invoked its statutory authority to lend to qualified institutions with adequate collateral. At its peak, Federal Reserve credit outstanding reached more than $1.2 trillion—but within four years it had abated to near pre-crisis levels as economic and financial conditions improved.
vulnerabilities in the financial system and how government policies can mitigate such risks.

The Federal Reserve actively engages in financial stability research to improve understanding of issues related to financial stability and to engage with the broader research community on crucial policy matters. This engagement often involves collaboration with researchers at other domestic and international institutions.

Macroprudential Supervision and Regulation of Large, Complex Financial Institutions

Large, complex financial institutions interact with financial markets and the broader economy in a manner that may—during times of stress and in the absence of an appropriate regulatory framework and effective supervision—lead to financial instability. The Federal Reserve promotes the safety and soundness of these institutions through robust supervision and regulation programs, two components of which are integral to its macroprudential efforts.

Monitoring Systemically Important Financial Institutions

The macroprudential approach informs Federal Reserve supervision of systemically important financial institutions (SIFIs)—including large bank holding companies (BHCs), the U.S. operations of certain foreign banking organizations (FBOs), and financial market utilities (FMUs). In addition, the Federal Reserve serves as a “consolidated supervisor” of nonbank financial companies that the FSOC has determined should be supervised by the Federal Reserve Board and subject to prudential
standards. (See “Domestic and International Cooperation and Coordination” on page 68 for more information on the FSOC.)

The Federal Reserve actively monitors indicators of the riskiness of SIFIs, both individually as well as through interlinkages in the broader network of financial institutions, to help identify vulnerabilities. It also imposes certain regulatory requirements on SIFIs in order to limit potentially risky activities by these institutions and to mitigate spillover of distress into the broader economy. If a SIFI were to become distressed, disruptions in the financial system could arise from direct losses imposed on SIFI counterparties, contagion, fire sales effects, or a loss of critical services.

SIFIs are also subject to additional capital and liquidity regulations imposed by the Federal Reserve in order to help mitigate some of the additional risks they pose to the financial system as a whole, given their size and interconnectedness.

Moreover, during the 2007–09 financial crisis, the lack of effective resolution strategies contributed to the pernicious spillovers of distress at or between individual institutions and from those institutions to the broader economy. The Federal Reserve, in collaboration with other U.S. agencies, has continued to work with large financial institutions to develop a range of recovery and resolution strategies in the event of their distress or failure. Improvements in resolution planning are intended to, among other things, mitigate adverse effects from perceptions of “too big to fail” and contribute to more orderly conditions in the financial system if institutions face strains or fail. (For more information on recovery and resolution planning activity, see section 5, “Supervising and Regulating Financial Institutions and Activities,” on page 72.)

**Stress Testing of Key Financial Institutions**

One important element of enhanced supervision of SIFIs is the stress-testing process, which includes the Dodd-Frank Act stress tests and the
Comprehensive Capital Analysis and Review. In addition to fostering the safety and soundness of the participating institutions, the stress test program includes macroprudential elements such as

- examination of the loss-absorbing capacity of institutions under a common macroeconomic scenario that has features similar to the strains experienced in a severe recession and which includes, as appropriate, identified salient risks;
- conducting horizontal testing across large institutions to understand the potential correlated exposures; and
- consideration of the effects of counterparty distress on the largest, most interconnected firms.

The macroeconomic and financial scenarios that are used in the stress tests have proved to be an important macroprudential tool. The Federal Reserve adjusts the severity of the macroeconomic scenario used in the stress tests in a way that counteracts the natural tendency for risks to build within the financial system during periods of strong economic activity. The scenarios can also be used to assess the financial system’s vulnerability to particularly significant risks and to highlight certain risks to institutions participating in the testing.

**Intersection of Financial Stability and Monetary Policy**

Promotion of financial stability strongly complements the primary goals of monetary policy—maximum employment and price stability. A smoothly operating financial system promotes the efficient allocation of saving and investment, facilitating economic growth and employment. And price stability contributes not only to the efficient allocation of resources in the real economy (that is, the part of the economy that produces goods and services), but also to reduced uncertainty and efficient pricing in financial markets that, in turn, supports financial stability.
Domestic and International Cooperation and Coordination

Economic and financial volatility in any country can have negative consequences for the world, but sizable and significant spillovers are almost assured from an economy that is large.

In its role promoting financial stability, the Federal Reserve cooperates and coordinates with many other domestic and international regulatory and policy entities. The FSOC is an important forum for cooperation with other domestic agencies (see figure 4.5). The primary venues for international cooperation occur through the Basel Committee on Banking Supervision and the Financial Stability Board.

**Domestic Engagement through the Financial Stability Oversight Council**

The FSOC, created in 2010 under the Dodd-Frank Act and chaired by the U.S. Treasury Secretary, draws on the expertise of the Federal Reserve and other regulators to proactively identify risks to financial stability, promote market discipline, and respond to emerging threats. The Chair of the Federal Reserve is a member of the FSOC, and the Federal Reserve works to support the activities of the FSOC and other U.S. government agencies in the pursuit of financial stability.

Through collaborative participation in the FSOC, U.S. financial regulators monitor not only institutions but the financial system as a whole. The Federal Reserve plays an important role in this macroprudential framework: it assists in monitoring financial risks, analyzes the implications of those risks for financial stability, and identifies steps that can be taken to mitigate those risks.

**Central banks around the world**

The central bank concept dates to 1668 when Sweden’s Riksbank was formed. As of December 2015, there were 178 central banks and monetary authorities around the world, and the Federal Reserve interacts with many of them in its efforts to promote financial stability in the U.S. and global economies. See [www.bis.org/cbanks.htm](http://www.bis.org/cbanks.htm) for a listing of central banks.

**Regular reporting on FSOC activities**

The Financial Stability Oversight Council (FSOC) meets routinely to coordinate on financial stability topics that might affect the U.S. economy and publishes both its monthly meeting minutes and annual report. For more information, see the FSOC website ([www.treasury.gov/initiatives/fsoc/pages/home.aspx](http://www.treasury.gov/initiatives/fsoc/pages/home.aspx)).
Figure 4.5. The framework for monitoring U.S. financial system stability

The Financial Stability Oversight Council, a blend of federal and state regulators, meets routinely to coordinate on financial stability topics that might affect the U.S. economy and makes publicly available its meeting minutes, annual report, and various other studies and statements. For more information, see the FSOC website (www.treasury.gov/initiatives/fsoc/pages/home.aspx).

1 Non-voting member serves two-year term.
2 Non-voting member.
What happens in the global economy can influence—sometimes greatly—the stability of the U.S. economy. Because the U.S. dollar is a widely used global currency and because the world’s economies are interdependent, the Federal Reserve works closely with central banks and other public authorities around the world to address international financial issues and promote financial stability.

### Table: International authority/deliberative body

<table>
<thead>
<tr>
<th>International authority/deliberative body</th>
<th>Overview/Federal Reserve engagement</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Central banks</strong></td>
<td>Nearly all developed and developing nations maintain central banks to promote a sound and stable financial system and well-functioning economies. Indeed, Federal Reserve officials engage regularly and collectively with other central banks to discuss broad trends affecting the global financial system; one-on-one bank engagement also occurs in special circumstances where coordination and cooperation can help keep the global financial system operating smoothly.</td>
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<tr>
<td><strong>Bank of International Settlements</strong></td>
<td>The Bank of International Settlements seeks, among other things, to foster discussion and facilitate collaboration among central banks and supports dialogue with other authorities that are responsible for promoting financial stability. The Federal Reserve participates in the deliberations of this financial organization, whose members include 60 member central banks, representing countries from around the world that together make up about 95 percent of world gross domestic product.</td>
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<tr>
<td><strong>Financial Stability Board</strong></td>
<td>The Financial Stability Board (FSB), successor to the Financial Stability Forum, promotes stability in the international financial system through enhanced cooperation among various national and international supervisory bodies and international financial institutions. The Federal Reserve Board and other U.S. agencies participate in FSB efforts, which specifically seek to coordinate the development of regulatory, supervisory, and other financial sector policies.</td>
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<tr>
<td><strong>G7 &amp; G20</strong></td>
<td>The Group of Seven (G7) is an informal bloc of industrialized democracies (also including Canada, France, Germany, Italy, Japan, and the United Kingdom) that meets annually to discuss global economic issues. Federal Reserve officials engage regularly with the G7 and G20 to discuss macroeconomic policy surveillance, the international financial system, and a wide range of policy issues such as development and policy proposals to encourage strong, sustainable, and balanced growth.</td>
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<tr>
<td><strong>International Monetary Fund</strong></td>
<td>The International Monetary Fund (IMF) works to &quot;foster global monetary cooperation, secure financial stability, facilitate international trade, promote high employment and sustainable economic growth, and reduce poverty around the world.&quot; The Federal Reserve is a member of the International Monetary and Financial Committee, which advises and reports to the IMF Board of Governors on the supervision and management of the international monetary and financial system, including on responses to unfolding events that may disrupt the system.</td>
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<tr>
<td><strong>Organisation for Economic Co-operation and Development</strong></td>
<td>The Organisation for Economic Co-operation and Development (OECD) promotes &quot;policies that will improve the economic and social well-being of people around the world.&quot; The Federal Reserve participates in several OECD forums to discuss current economic issues and projections for the global economic outlook, and to promote policies that will improve global economic well-being.</td>
</tr>
<tr>
<td><strong>World Bank</strong></td>
<td>The World Bank functions as a cooperative of 189 member countries. These member countries, or shareholders, are represented by a board of governors, who are the ultimate policymakers at the World Bank. Generally, the governors are member countries’ ministers of finance or ministers of development. The Federal Reserve interacts informally with the World Bank, largely through the International Monetary Fund.</td>
</tr>
</tbody>
</table>
Engagement with Regulatory Authorities Abroad

The Federal Reserve participates in international bodies, such as the Basel Committee on Banking Supervision and the Financial Stability Board, to address issues associated with the interconnected global financial system and the global activities of large U.S. financial institutions (see figure 4.6).

Through both venues, the Federal Reserve is engaged with the international community in monitoring the global financial system and promoting the adoption of sound policies across countries.