

Basel iii Compliance Professionals Association (BiiiCPA)
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Basel iii News, February 2021

Dear members and friends,

We will start with the introductory remarks by Mr. Agustín Carstens, General Manager of the BIS, at the Asia School of Business Conversations on Central Banking webinar, "Finance as information", in Basel.



Public policy for big techs in finance

Introduction

The financial sector has always been information-hungry and an avid adopter of technology.

It is said that in the Renaissance, Venetian traders were among the first adopters of the telescope, to keep watch for incoming ships.

Early information could give traders an edge in buying and selling assets.

Financial institutions were also among the first adopters of the telegraph and of satellite images, again aiming to achieve an information advantage.

Over time, the volume of information available has grown and grown – and finance has continued to use this information to allocate funds and risks in the economy.

Is today any different? We have smartphones, machine learning and blockchains, but are we seeing fundamental changes in the role of information?

In my remarks, I'd like to focus on one thing that has changed, namely who is offering financial services.

Recently, we've seen the entry of big techs, which are able to exploit their massive data, networks and range of activities.

The entry of big techs requires a comprehensive public policy approach that combines financial regulation, competition policy and data privacy.

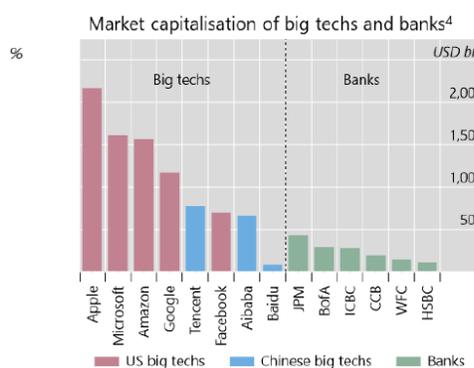
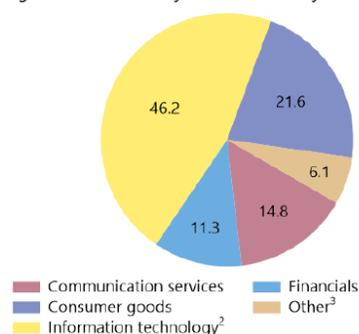
Big techs operate a broad range of business lines and have grown very large.

Big techs have done something quite remarkable: within less than two decades: they have gone from being startups to dominating a range of markets. This is unprecedented.

Today, their reach extends across a wide range of industries, of which finance is only one. You can see this in the left-hand panel of Slide 1. Indeed, financial services make up only 11% of big techs' revenues so far.

Big techs operate a broad range of business lines and have grown very large

Big techs' revenues by sector of activity¹



¹ Shares based on 2018 total revenues, where available, as provided by S&P Capital IQ; where not available, data for 2017. The sample includes Alibaba, Alphabet, Amazon, Apple, Baidu, Facebook, Grab, Kakao, Mercado Libre, Rakuten, Samsung and Tencent. ² Information technology can include some financial-related business. ³ Includes health care, real estate, utilities and industrials. ⁴ Data for 14 Jan 2021.

Sources: BIS, "Big tech in finance: opportunities and risks", *Annual Economic Report 2019*, June, p 55–79; Refinitiv.

And – to quote the Latin proverb “nomen est omen” (“the name is a sign”) – they have become very large.

As a result of their control over key digital platforms in e-commerce, search and social media, big techs are able to gather, process and communicate huge volumes of data.

Not surprisingly, they have become among the largest companies in the world, operating in multiple jurisdictions. As seen in the right-hand panel of Slide 1, big techs like Google, Apple, Facebook and Amazon in the United States and Alibaba and Tencent in China have market capitalisations that far surpass those of the largest banks.

Why? The DNA of big techs

Why have they gotten so large? Big tech business models rest on enabling direct interactions among a large number of users. This may be in e-commerce – such as Alibaba and Amazon; social media – such as Tencent or Facebook; or search – such as Baidu or Google.

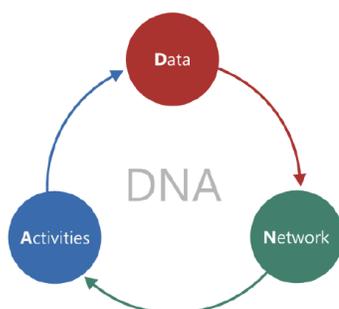
An essential by-product of their business is the massive user data they collect. They exploit natural network effects, generating further user activity.

As an example, payment services generate transaction data, network externalities facilitate the interaction among users, and this helps serve needs related to other activities (such as credit).

But these activities will provide further data and will again fuel the DNA feedback loop.

Data analytics, network externalities and interwoven activities (DNA) constitute the key features of big techs' business models (Slide 2). These three elements reinforce each other.

Data-**N**etwork-**A**ctivities loop



To read more: <https://www.bis.org/speeches/sp210121.pdf>

BIS Working Papers No 922

Does regulation only bite the less profitable? Evidence from the too-big-to-fail reforms

Tirupam Goel, Ulf Lewrick and Aakriti Mathur, Monetary and Economic Department, January 2021



Regulatory reforms following the financial crisis of 2007–08 created incentives for large global banks to lower their systemic importance.

We establish that differences in profitability shape banks' response to these reforms. Indeed, profitability is key because it underpins banks' ability to generate capital and drives the opportunity cost of shrinking.

Our analysis shows that only the less profitable banks lowered their systemic footprint relative to their equally unprofitable peers that were unaffected by the regulatory treatment.

The more profitable banks, by contrast, continued to raise their systemic importance in sync with their untreated peers.

Introduction

Banking regulation builds on the premise that capital requirements can make banks internalise the negative externalities they impose on the financial system.

The case for regulation is particularly strong for large global banks. As the financial crisis of 2007–08 highlighted, the size, complexity and interconnectedness of these banks implies that their failure risks undermining financial stability.

The crisis experience has sparked a stream of research on too-big-to-fail concerns in banking, giving rise to new measures of systemic risks and deepening our understanding of their origin (e.g., Acharya et al. (2012), Adrian and Brunnermeier (2016), Brownlees and Engle (2016), Acharya et al. (2017)).

However, much less is known about the effectiveness of policy reforms to mitigate such risks. A case in point is the framework for global systemically important banks (G-SIBs), which is one element of the broader post-crisis agenda to address too-big-to-fail concerns. By applying higher capital surcharges to banks that are more systemically important, the G-SIB framework intends to bolster their resilience.

At the same time, it creates incentives for these banks to lower their systemic footprint in order to benefit from capital relief.

In this paper, we assess whether the introduction of the framework – the regulatory treatment – has led G-SIBs to reduce their systemic importance. Our focus is on exploring the framework’s differential impact on banks given that the strength of regulatory incentives can vary.

Incentives to lower their systemic importance are likely to be particularly strong for banks that face high costs of raising capital. Yet banks that stand to sacrifice a lot of revenue by downsizing may have few incentives to reduce their systemic footprint.

Our main finding is that profitability plays a determining – but typically overlooked – role in shaping banks’ response to the framework. The framework caused the less profitable G-SIBs, measured in terms of their pre-treatment return on assets (ROA), to cut back their systemic importance relative to the less profitable Non G-SIBs (the untreated peers).

The contraction was even stronger for those G-SIBs that were close to the regulatory thresholds that determine their capital surcharges. By contrast, the more profitable G-SIBs have continued to raise their systemic footprint in sync with the more profitable Non G-SIBs.

The wedge in the footprint of the more and less profitable G-SIBs has thus widened substantially post treatment. Nevertheless, the concentration of systemic importance within our global sample of banks has declined somewhat during the period of observation.

The contraction by the less profitable G-SIBs has thus more than compensated for the increase in systemic importance of the more profitable banks.

Moreover, we assess jointly the changes in banks’ systemic importance and their market-implied default risks to approximate the evolution of the banks’ systemic risk contribution.

This assessment points to a significant decline in the less profitable G-SIBs’ systemic risk contribution, and a small but insignificant increase in case of the more profitable G-SIBs.

Our findings are based on a difference-in-differences (DD) specification, which allows us to benchmark G-SIBs’ responses to the framework against those of Non G-SIBs.

The DD approach lays the ground for our main analysis based on a triple interaction of G-SIB designation, profitability, and the regulatory treatment.

Throughout our analysis, we control for fixed and time-varying bank characteristics, as well as for differences in the economic or regulatory developments across jurisdictions over time.

To read more: <https://www.bis.org/publ/work922.pdf>

The Federal Reserve's New Framework: Context and Consequences

Remarks by Richard H. Clarida, Vice Chair, Board of Governors of the Federal Reserve System, at “The Road Ahead for Central Banks,” a seminar sponsored by the Hoover Economic Policy Working Group, Hoover Institution, Stanford University, Stanford, California



On August 27, 2020, the Federal Open Market Committee (FOMC) unanimously approved a revised Statement on Longer-Run Goals and Monetary Policy Strategy, which represents a robust evolution of its monetary policy framework.

At its September and December FOMC meetings, the Committee made material changes to its forward guidance to bring it into line with the new policy framework.

Before I discuss the new framework in detail and the policy implications that flow from it, please allow me to provide some background on the reasons the Committee felt that our framework needed to evolve.

Motivation for the Review

As my FOMC colleagues and I indicated from the outset, the fact that the Federal Reserve System chose to conduct this review does not indicate that we believed we were poorly served by the framework in place since 2012.

Indeed, I would argue that over the past eight years, the framework served us well and supported the Federal Reserve's efforts after the Global Financial Crisis (GFC) first to achieve and then, for several years, to sustain—until cut short this spring by the COVID-19 pandemic—the operation of the economy at or close to both our statutorily assigned goals of maximum employment and price stability in what became the longest economic expansion in U.S. history.

Nonetheless, both the U.S. economy—and, equally importantly, our understanding of the economy—have clearly evolved along several crucial dimensions since 2012, and we believed that in 2019 it made sense to step back and assess whether, and in what possible ways, we might refine and

rethink our strategy, tools, and communication practices to achieve and sustain our goals as consistently and robustly as possible in the global economy in which we operate today and for the foreseeable future.

To read more: <https://www.bis.org/review/r210114a.pdf>

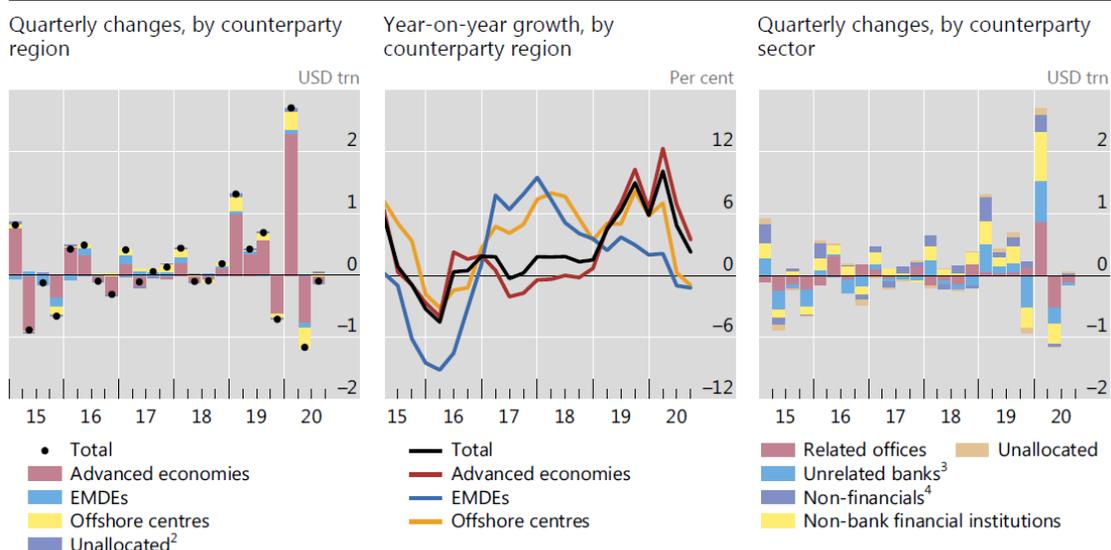
Statistical release: BIS international banking statistics



- Global cross-border claims changed little in aggregate in Q3 2020 after large fluctuations in Q1 and Q2.
- Cross-border claims on emerging market and developing economies continued to fall, driven again by claims on Latin America and the Caribbean.
- Since the start of the pandemic, the size of banks' balance sheets has increased sharply with the accumulation of claims on governments and monetary authorities.
- A new interactive chart for visualising bilateral cross-border positions based on the locational banking statistics is now available online.

Global cross-border claims declined modestly in Q3 2020 after large fluctuations¹

Graph 1



¹ Quarterly changes are adjusted for breaks in series and exchange rate fluctuations. The year-on-year growth rates are calculated based on the adjusted changes for the past four quarters. ² Includes international organisations and unallocated cross-border claims. ³ Includes central banks and banks unallocated by subsector between intragroup and unrelated banks. ⁴ Includes non-banks unallocated by subsector.

Source: BIS locational banking statistics.

Global cross-border claims barely budged

Banks' cross-border claims registered a modest contraction of \$93 billion in the course of Q3 2020 on an FX- and break-adjusted basis (Graph 1, left-hand panel). This quarterly contraction was quite muted (0.3% of previous quarter stock) compared with the large fluctuations in Q1 and Q2 2020, of +\$2.7 trillion and -\$1.2 trillion, respectively.

Year-on-year growth rates continued to fall from their recent Q1 2020 peak, when cross-border positions had surged (centre panel).

Claims on both advanced economies (AEs, $-\$131\text{bn}$) and emerging market and developing economies (EMDEs, $-\$13\text{bn}$) declined. As earlier in the year, these movements were in part driven by intragroup positions (Graph 1, right-hand panel).

The decline in claims on AEs centred on related offices ($-\$114\text{bn}$), especially on those in the United States ($-\$81\text{bn}$). The unwinding of central bank dollar swap lines, which had swelled intragroup positions in Q1, contributed to this decline.

By contrast, claims on offshore centres expanded by $\$41\text{bn}$ (left-hand panel), especially vis-à-vis Hong Kong SAR ($+\$39\text{bn}$) and the Cayman Islands ($+\$24\text{bn}$). More than half of the increase on Hong Kong was in the form of intragroup claims.

Some of the larger movements vis-à-vis AEs involved non-bank financial institutions (NBFIs).

Claims on the United Kingdom ($-\$50\text{bn}$), the Netherlands ($-\50bn), Luxembourg ($-\$46\text{bn}$), France ($-\40bn) and Italy ($-\$39\text{bn}$) all fell, mostly vis-à-vis NBFIs. These declines were partly offset by increases in claims on Japan ($+97\text{bn}$) and Germany ($+65\text{bn}$), notably on their resident banks and NBFIs.

The modest aggregate decline also conceals large differences on the creditor side. Banks located in China, France and the United Kingdom saw the greatest increases in cross-border claims while those in Spain, Germany and the United States reported outside declines.

To read more: <https://www.bis.org/statistics/rppb2101.pdf>

Statement of Acting Chair Lee and Commissioners Peirce, Roisman, and Crenshaw Regarding Recent Market Volatility

Acting Chair Allison Herren Lee, Commissioner Hester M. Peirce, Commissioner Elad L. Roisman, Commissioner Caroline A. Crenshaw



The Commission is closely monitoring and evaluating the extreme price volatility of certain stocks' trading prices over the past several days.

Our core market infrastructure has proven resilient under the weight of this week's extraordinary trading volumes.

Nevertheless, extreme stock price volatility has the potential to expose investors to rapid and severe losses and undermine market confidence.

As always, the Commission will work to protect investors, to maintain fair, orderly, and efficient markets, and to facilitate capital formation.

The Commission is working closely with our regulatory partners, both across the government and at FINRA and other self-regulatory organizations, including the stock exchanges, to ensure that regulated entities uphold their obligations to protect investors and to identify and pursue potential wrongdoing.

The Commission will closely review actions taken by regulated entities that may disadvantage investors or otherwise unduly inhibit their ability to trade certain securities.

In addition, we will act to protect retail investors when the facts demonstrate abusive or manipulative trading activity that is prohibited by the federal securities laws.

Market participants should be careful to avoid such activity.

Likewise, issuers must ensure compliance with the federal securities laws for any contemplated offers or sales of their own securities.

The Commission will continue our work on behalf of investors and the markets.

In this regard, we hope to facilitate a robust public dialogue among market participants and investors on the structure and operation of our securities markets.

Members of the public can submit tips or complaints through the Commission's website using this online form.

Members of the public with questions should contact the Commission's Office of Investor Education and Advocacy at 1-800-732-0330, ask a question using this online form, or email us at Help@SEC.gov.

On the origin of systemic risk

Staff Working Paper No. 906 - by Mattia Montagna, Gabriele Torri and Giovanni Covi.



BANK OF ENGLAND

Abstract

Systemic risk in the banking sector is usually associated with long periods of economic downturn and very large social costs.

On one hand, shocks coming from correlated exposures towards the real economy may induce correlation in banks' default probabilities thereby increasing the likelihood for systemic tail events like the 2008 Great Financial Crisis.

On the other hand, financial contagion also plays an important role in generating large-scale market failures, amplifying the initial shocks coming from the real economy.

To study the sources of these rare phenomena, we propose a new definition of systemic risk (ie the probability of a large number of banks going into distress simultaneously) and thus we develop a multilayer microstructural model to study empirically the determinants of systemic risk.

The model is then calibrated on the most comprehensive granular dataset for the euro-area banking sector, capturing roughly 96% or €23.2 trillion of euro-area banks' total assets over the period 2014–2018.

The outputs of the model decompose and quantify the sources of systemic risk showing that correlated economic shocks, financial contagion mechanisms, and their interaction are the main sources of systemic events.

The results obtained with the simulation engine resemble common market-based systemic risk indicators and empirically corroborate findings from existing literature.

This framework gives regulators and central bankers a tool to study systemic risk and its developments, pointing out that systemic events and banks' idiosyncratic defaults have different drivers, hence implying different policy responses.

Introduction

The 2008 Great Financial Crisis revealed, once again, the endogenous instability of our economic and financial system.

Size, interconnectedness, opacity and complexity were among the traits of the financial industry which caused a real economic shock to become a systemic financial event, where a very large number of banks and other financial institutions world-wide were affected with large social and public costs.

A core message has been indeed that financial stability can't be analyzed by looking at banks in isolation, but instead must be observed as intrinsically related to the micro structure of the financial system and its connection to the real economy.

When studying systemic risk, it is therefore necessary to have an holistic view of the financial system to encompass the internal and external feedback dynamics at the very core of financial systemic events.

As those feedbacks have been proven to be driven by the way financial institutions interact with each other and the real economy, it is necessary to have microstructural a model to reproduce financial crisis.

Nevertheless, despite the growing interest, the concept of systemic risk remains difficult to measure and quantify (Hansen, 2012).

Several theoretical frameworks have been proposed to assess systemic risk.

Some focus on measuring tail interdependence between assets market indices (e.g. Acharya et al., 2017; Adrian and Brunnermeier, 2016) or on gauging the risk stemming from interconnectedness (Billio et al., 2012; Diebold and Yilmaz, 2008). Other models encompass the multidimensionality of systemic risk by aggregating multiple market indicators to assess the level of stress in the system (Hollo et al., 2012; Committee, 2011).

Finally, an increasingly popular class of models use microstructural approaches in which interactions among agents are individually modelled, in order to describe the evolution of a complex system and to study the diffusion of financial contagion via multiple channels in reaction to an exogenous initial shock (see e.g. Allen and Gale, 2000; Gai and Kapadia, 2010; Acemoglu et al., 2012; Montagna and Kok, 2016).

To read more:

<https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2021/on-the-origin-of-systemic-risk.pdf?la=en&hash=65ACCEE42828B7ED04046E296A8E7BAF37A0E72C>



BANK OF ENGLAND

Staff Working Paper No. 906

On the origin of systemic risk

Mattia Montagna, Gabriele Torri and Giovanni Covi

The sovereign-bank-corporate nexus – virtuous or vicious?

Isabel Schnabel, Member of the Executive Board of the European Central Bank, at the LSE conference on Financial Cycles, Risk, Macroeconomic Causes and Consequences, Frankfurt am Main.



One year after the first cases were reported in Europe, the coronavirus (COVID-19) pandemic continues to take a tragic human toll and to pose enormous challenges to workers, firms, the financial system and policymakers in the euro area.

Without the forceful responses of fiscal, monetary and prudential authorities the economic and social costs of this crisis would have been significantly higher.

Governments, in particular, have stabilized aggregate demand and incomes by absorbing economic and financial risks of the private sector as the crisis unfolded.

Through the generous issuance of guarantee schemes, governments secured a continuous flow of credit to firms, which supported economic growth and protected financial stability.

Monetary policy has complemented these efforts by providing ample liquidity and restoring favourable financing conditions.

As a consequence, the policy response to the pandemic has visibly intensified the interdependencies between sovereigns, banks and firms. It has created a “sovereign-bank-corporate” nexus.

In my remarks today, I will argue that the extent to which such interdependencies may create challenges in the future depends, to a large extent, on the types of feedback loops they create.

Broad fiscal and monetary policy support today minimise the realisation of contingent liabilities in the future, and thus limit the scarring effects of the pandemic on the economy, creating a virtuous circle.

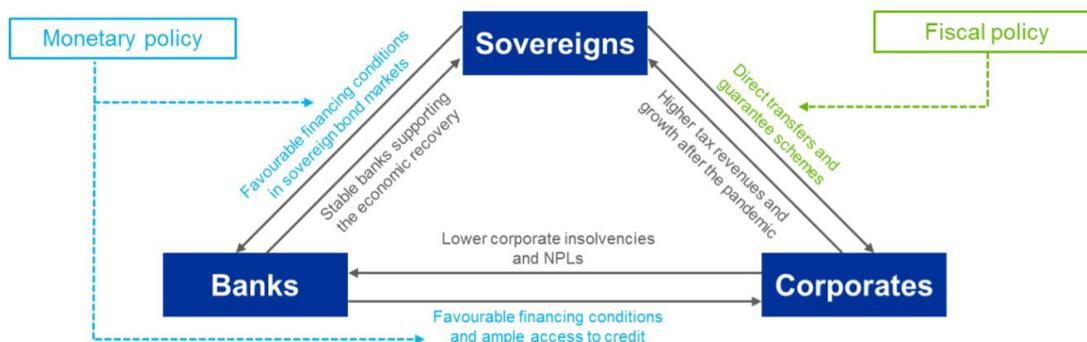
So, contrary to the vicious “sovereign-bank” nexus that plagued the euro area throughout most of the last decade, the current nexus, if managed properly, can be an engine for a faster recovery, which also supports the ECB’s price stability mandate.

A virtuous circle between sovereigns, banks and corporates

At the onset of the pandemic, the strict lockdown measures hit large parts of the corporate sector hard, raising its vulnerability to levels last seen during the global financial crisis (Chart 1).

Many firms saw their revenues collapse and were facing acute liquidity shortages that threatened to turn into solvency problems.

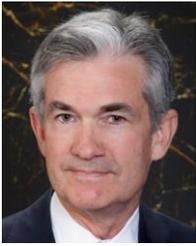
To read more: <https://www.bis.org/review/r210129b.pdf>



Source: ECB.

Getting Back to a Strong Labor Market

Chair Jerome H. Powell, Chair of the Board of Governors of the Federal Reserve System, at the Economic Club of New York.

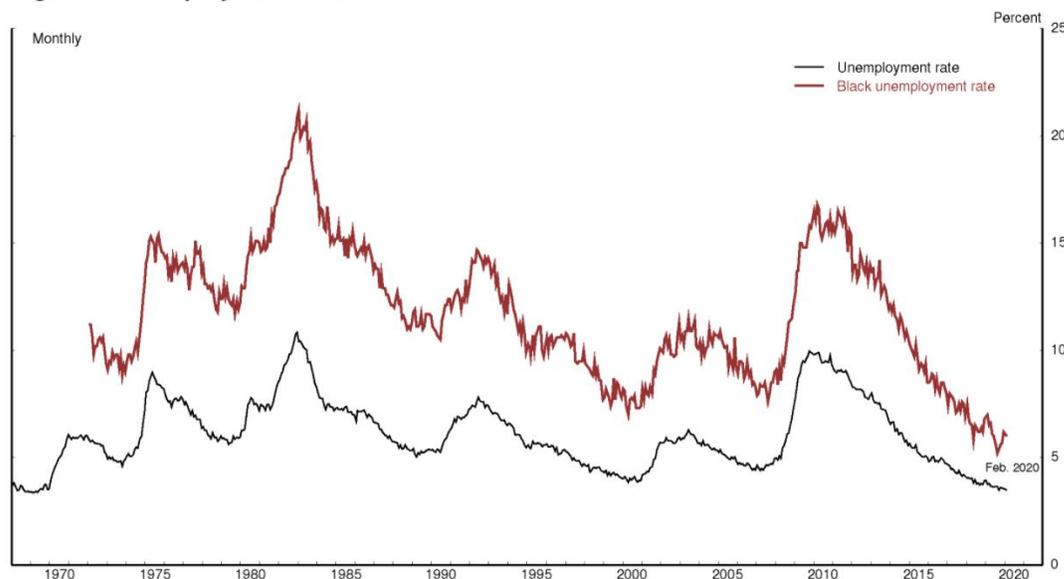


Today I will discuss the state of our labor market, from the recent past to the present and then over the longer term. A strong labor market that is sustained for an extended period can deliver substantial economic and social benefits, including higher employment and income levels, improved and expanded job opportunities, narrower economic disparities, and healing of the entrenched damage inflicted by past recessions on individuals' economic and personal well-being.

At present, we are a long way from such a labor market. Fully realizing the benefits of a strong labor market will take continued support from both near-term policy and longer-run investments so that all those seeking jobs have the skills and opportunities that will enable them to contribute to, and share in, the benefits of prosperity.

The Labor Market of a Year Ago

Figure 1. Unemployment Rate



Note: Published data on unemployment rates by race start in 1972.
Source: Bureau of Labor Statistics.

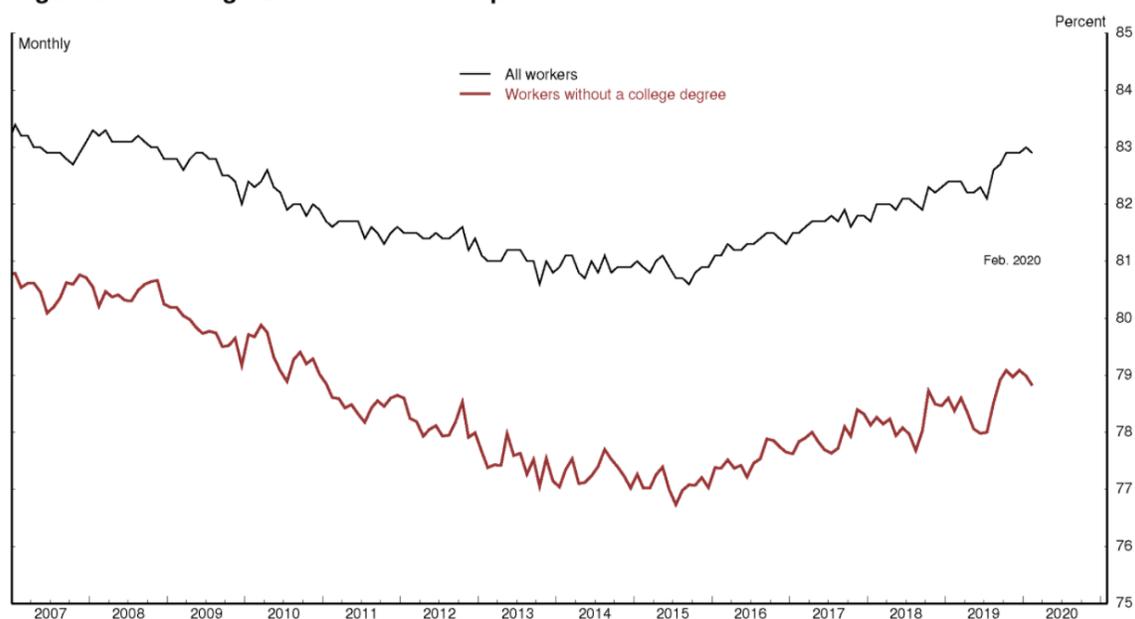
We need only look to February of last year to see how beneficial a strong labor market can be. The overall unemployment rate was 3.5 percent, the lowest level in a half-century. The unemployment rate for African

Americans had also reached historical lows (figure 1). Prime-age labor force participation was the highest in over a decade, and a high proportion of households saw jobs as "plentiful."

Overall wage growth was moderate, but wages were rising more rapidly for earners on the lower end of the scale. These encouraging statistics were reaffirmed and given voice by those we met and conferred with, including the community, labor, and business leaders; retirees; students; and others we met with during the 14 Fed Listens events we conducted in 2019.

Many of these gains had emerged only in the later years of the expansion. The labor force participation rate, for example, had been steadily declining from 2008 to 2015 even as the recovery from the Global Financial Crisis unfolded.

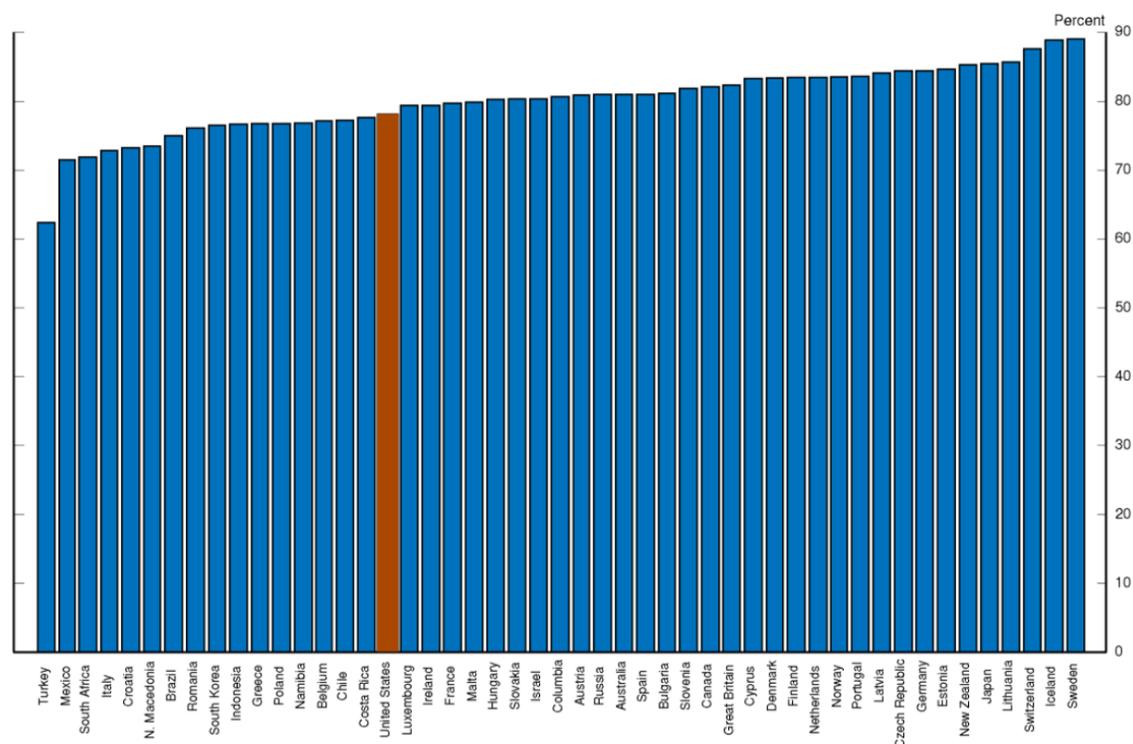
Figure 2. Prime-Age Labor Force Participation



Note: Prime age refers to ages 25 to 54.
Source: Bureau of Labor Statistics and Board staff calculations using microdata from the Current Population Survey.

In fact, in 2015, prime-age labor force participation—which I focus on because it is not significantly affected by the aging of the population—reached its lowest level in 30 years even as the unemployment rate declined to a relatively low 5 percent. Also concerning was that much of the decline in participation up to that point had been concentrated in the population without a college degree (figure 2).

Figure 3. Labor Force Participation Rate in OECD Countries: 25-64 Year Olds, 2019



Note: OECD is Organisation for Economic Co-operation and Development.
Source: OECD (2021), "Labour force participation rate" (indicator), <https://doi.org/10.1787/8a801325-en> (accessed on February 1, 2021).

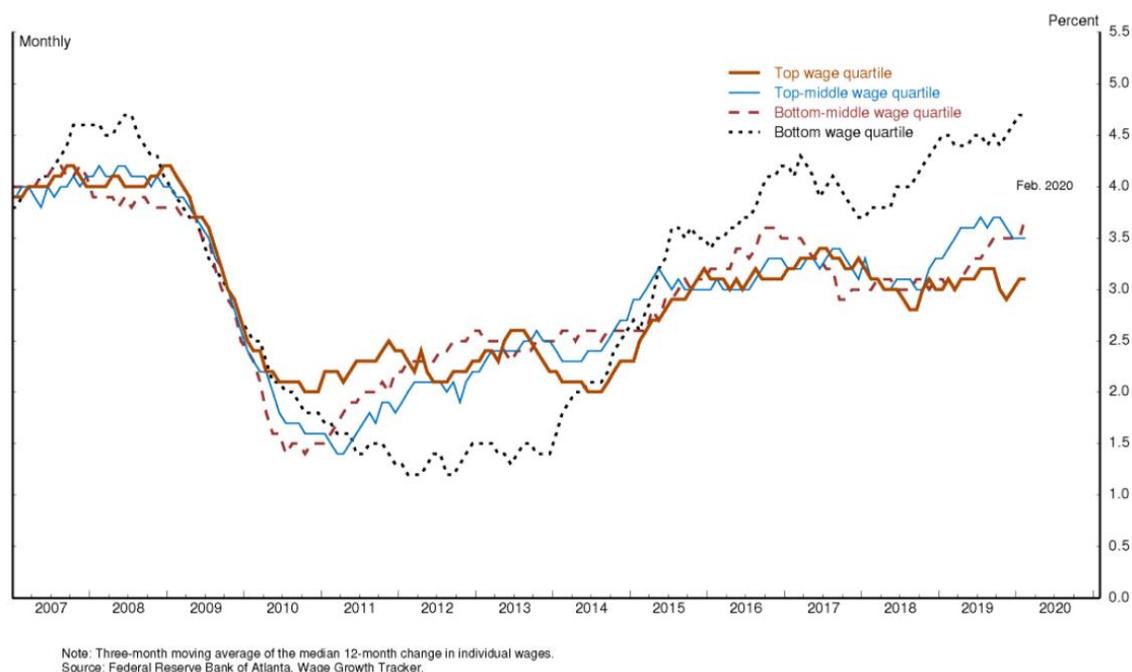
At the time, many forecasters worried that globalization and technological change might have permanently reduced job opportunities for these individuals, and that, as a result, there might be limited scope for participation to recover.

Fortunately, the participation rate after 2015 consistently outperformed expectations, and by the beginning of 2020, the prime-age participation rate had fully reversed its decline from the 2008-to-2015 period.

Moreover, gains in participation were concentrated among people without a college degree. Given that U.S. labor force participation has lagged relative to other advanced economy nations, this progress was especially welcome (figure 3).

As I mentioned, we also saw faster wage growth for low earners once the labor market had strengthened sufficiently. Nearly six years into the recovery, wage growth for the lowest earning quartile had been persistently modest and well below the pace enjoyed by other workers.

At the tipping point of 2015, however, as the labor market continued to strengthen, the trend reversed, with wage growth for the lowest quartile consistently and significantly exceeding that of other workers (figure 4).

Figure 4. Wage Growth for Low Earners Compared with Other Workers

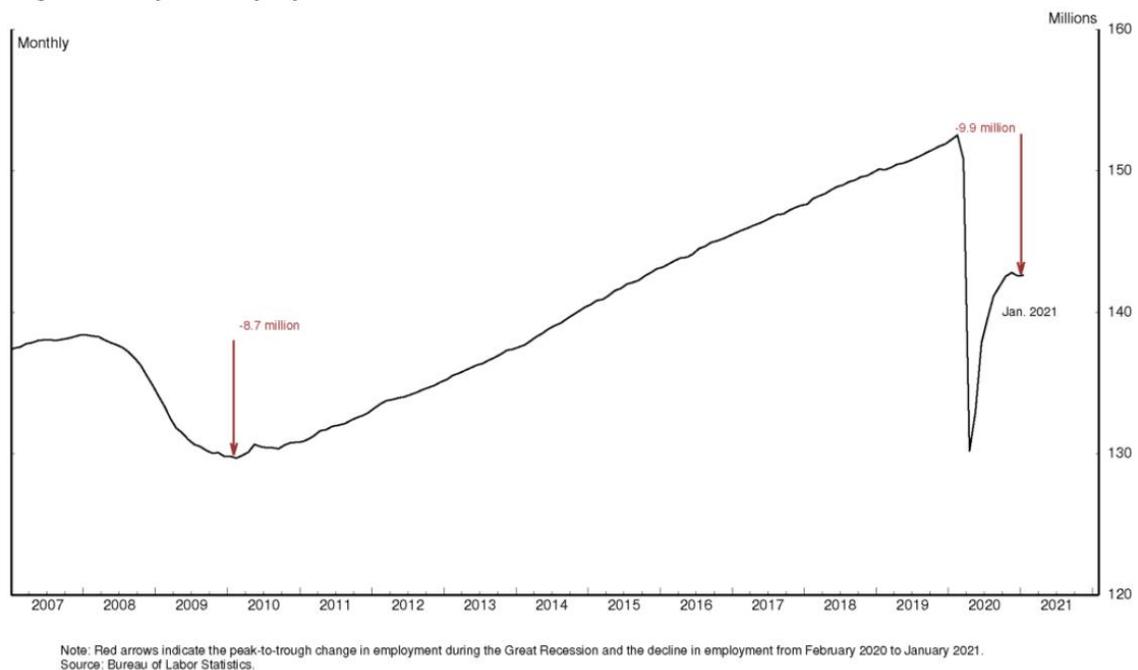
At the end of 2015, the Black unemployment rate was still quite elevated, at 9 percent, despite the relatively low overall unemployment rate. But that disparity too began to shrink; as the expansion continued beyond 2015, Black unemployment reached a historic low of 5.2 percent, and the gap between Black and white unemployment rates was the narrowest since 1972, when data on unemployment by race started to be collected. Black unemployment has tended to rise more than overall unemployment in recessions but also to fall more quickly in expansions.

Over the course of a long expansion, these persistent disparities can decline significantly, but, without policies to address their underlying causes, they may increase again when the economy ultimately turns down.

These late-breaking improvements in the labor market did not result in unwanted upward pressures on inflation, as might have been expected; in fact, inflation did not even rise to 2 percent on a sustained basis. There was every reason to expect that the labor market could have strengthened even further without causing a worrisome increase in inflation were it not for the onset of the pandemic.

The Labor Market Today

The state of our labor market today could hardly be more different. Despite the surprising speed of recovery early on, we are still very far from a strong labor market whose benefits are broadly shared. Employment in January of this year was nearly 10 million below its February 2020 level, a greater shortfall than the worst of the Great Recession's aftermath (figure 5).

Figure 5. Payroll Employment

After rising to 14.8 percent in April of last year, the published unemployment rate has fallen relatively swiftly, reaching 6.3 percent in January. But published unemployment rates during COVID have dramatically understated the deterioration in the labor market.

Most importantly, the pandemic has led to the largest 12-month decline in labor force participation since at least 1948. Fear of the virus and the disappearance of employment opportunities in the sectors most affected by it, such as restaurants, hotels, and entertainment venues, have led many to withdraw from the workforce. At the same time, virtual schooling has forced many parents to leave the work force to provide all-day care for their children.

All told, nearly 5 million people say the pandemic prevented them from looking for work in January. In addition, the Bureau of Labor Statistics reports that many unemployed individuals have been misclassified as employed. Correcting this misclassification and counting those who have left the labor force since last February as unemployed would boost the unemployment rate to close to 10 percent in January (figure 6).

Unfortunately, even those grim statistics understate the decline in labor market conditions for the most economically vulnerable Americans. Aggregate employment has declined 6.5 percent since last February, but the decline in employment for workers in the top quartile of the wage distribution has been only 4 percent, while the decline for the bottom quartile has been a staggering 17 percent (figure 7).

Figure 6. Official and Alternative Unemployment Rates

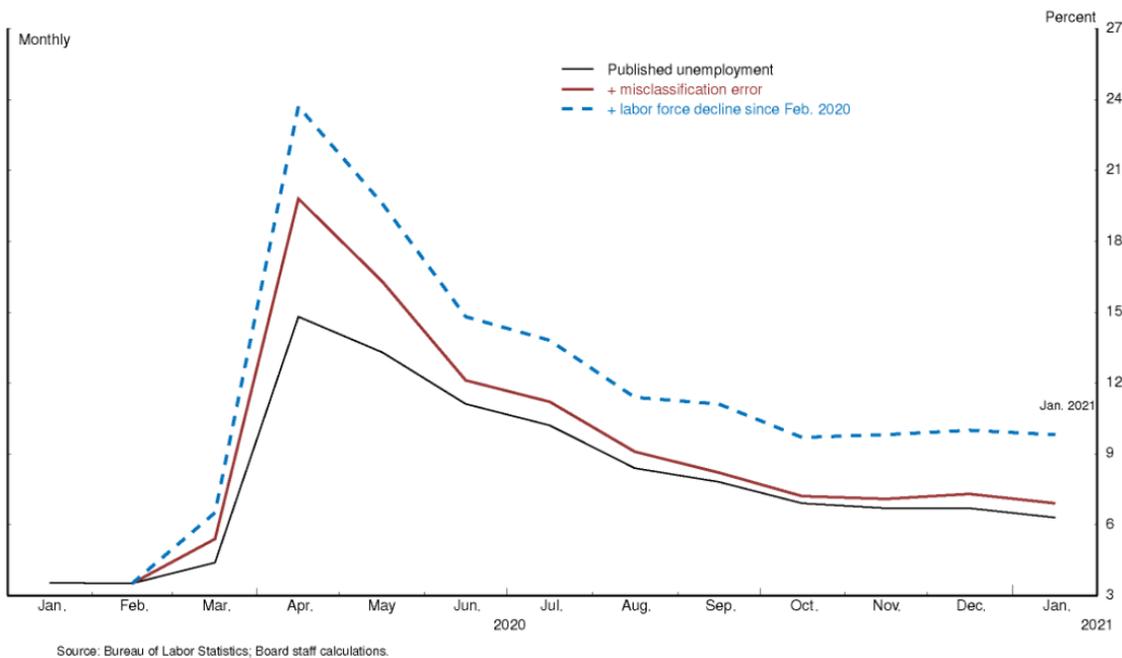
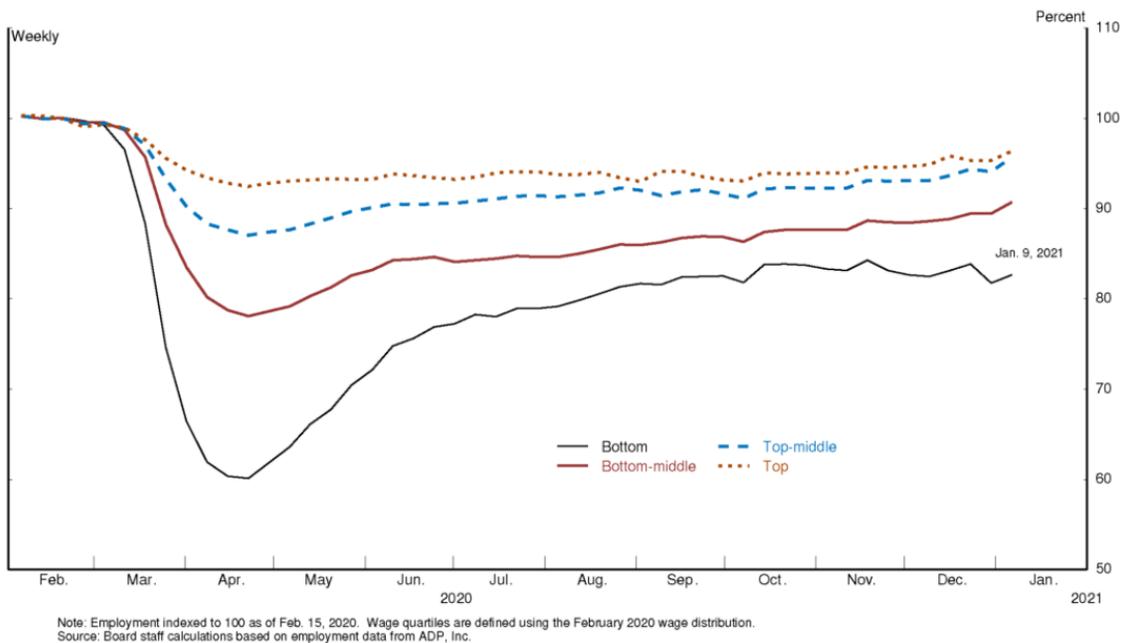
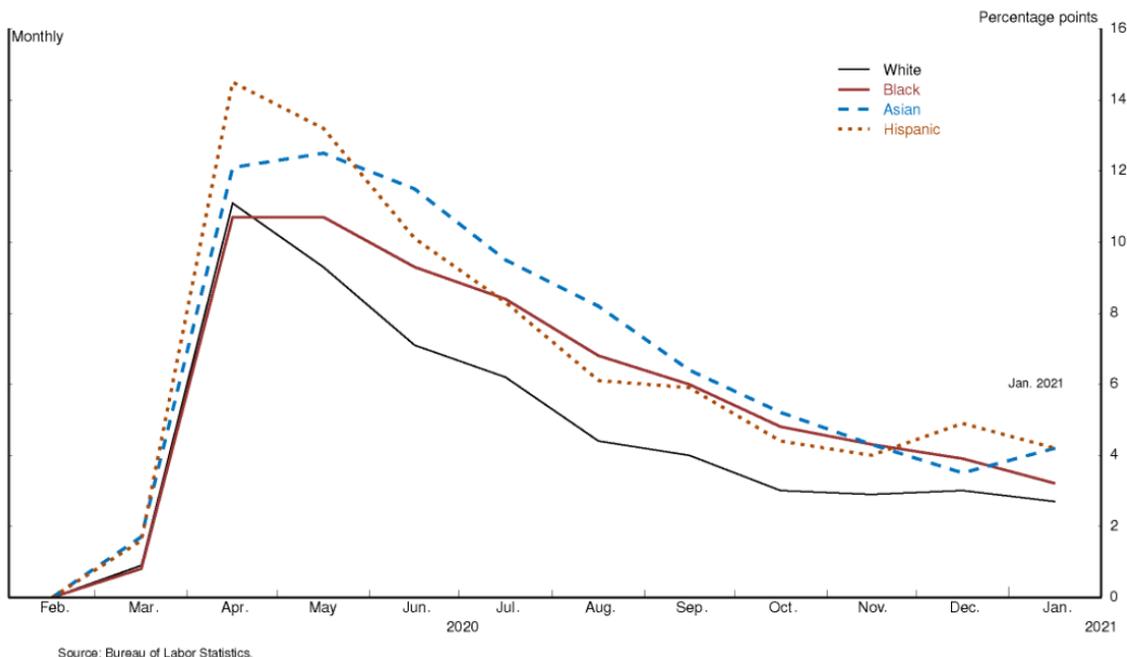


Figure 7. Employment by Wage Quartile



Moreover, employment for these workers has changed little in recent months, while employment for the higher-wage groups has continued to improve. Similarly, the unemployment rates for Blacks and Hispanics have risen significantly more than for whites since February 2020 (figure 8). As a result, economic disparities that were already too wide have widened further.

Figure 8. Change in Unemployment Rate by Race/Ethnicity since February 2020

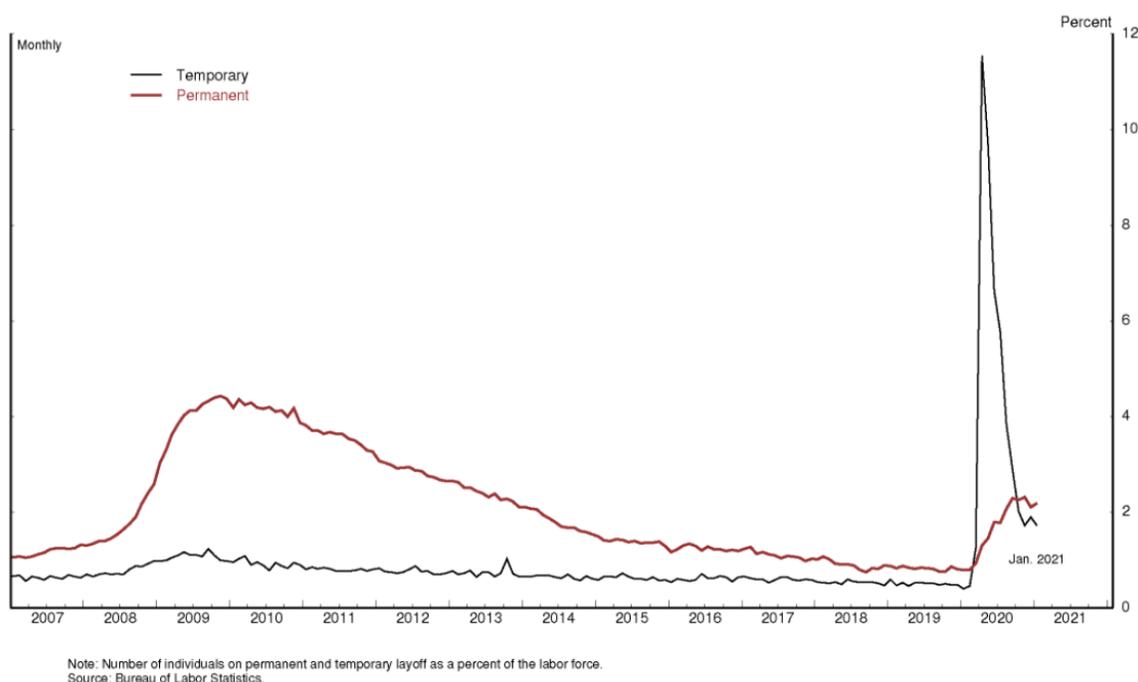


In the past few months, improvement in labor market conditions stalled as the rate of infections sharply increased. In particular, jobs in the leisure and hospitality sector dropped over 1/2 million in December and a further 61,000 in January. The recovery continues to depend on controlling the spread of the virus, which will require mass vaccinations in addition to continued vigilance in social distancing and mask wearing in the meantime.

Since the onset of the pandemic, we have been concerned about its longer-term effects on the labor market. Extended periods of unemployment can inflict persistent damage on lives and livelihoods while also eroding the productive capacity of the economy. And we know from the previous expansion that it can take many years to reverse the damage.

At the start of the pandemic, the increase in unemployment was almost entirely due to temporary job losses.

Temporarily laid-off workers tend to return to work much more quickly, on average, than those whose ties to their former employers are permanently severed. But as some sectors of the economy have continued to struggle, permanent job loss has increased (figure 9).

Figure 9. Permanent and Temporary Layoffs

So too has long-term unemployment. Still, as of January, the level of permanent job loss, as a fraction of the labor force, was considerably smaller than during the Great Recession. Research shows that the Paycheck Protection Program has played an important role in limiting permanent layoffs and preserving small businesses. The renewal of the program this year in the face of another surge in COVID-related job cuts is an encouraging development.

Of course, in a healthy market-based economy, perpetual churn will always render some jobs obsolete as they are replaced by new employment opportunities. Over time, workers and capital move from firm to firm and from sector to sector. It is likely that the pandemic has both increased the need for such movements and brought forward some movement that would have occurred eventually.

Getting Back to a Strong Labor Market

So how do we get from where we are today back to a strong labor market that benefits all Americans and that starts to heal the damage already done? And what can we do to sustain those benefits over time? Experience tells us that getting to and staying at full employment will not be easy.

In the near term, policies that bring the pandemic to an end as soon as possible are paramount. In addition, workers and households who struggle to find their place in the post-pandemic economy are likely to need

continued support. The same is true for many small businesses that are likely to prosper again once the pandemic is behind us.

Also important is a patiently accommodative monetary policy stance that embraces the lessons of the past—about the labor market in particular and the economy more generally. I described several of those important lessons, as well as our new policy framework, at the Jackson Hole conference last year.

I have already mentioned the broad-based benefits that a strong labor market can deliver and noted that many of these benefits only arose toward the end of the previous expansion. I also noted that these benefits were achieved with low inflation. Indeed, inflation has been much lower and more stable over the past three decades than in earlier times.

In addition, we have seen that the longer-run potential growth rate of the economy appears to be lower than it once was, in part because of population aging, and that the neutral rate of interest—or the rate consistent with the economy being at full employment with 2 percent inflation—is also much lower than before.

A low neutral rate means that our policy rate will be constrained more often by the effective lower bound. That circumstance can lead to worse economic outcomes—particularly for the most economically vulnerable Americans.

To take these economic developments into account, we made substantial revisions to our monetary policy framework, as described in the FOMC's Statement on Longer-Run Goals and Monetary Policy Strategy.

This revised statement shares many features with its predecessor, including our view that longer-run inflation of 2 percent is most consistent with our mandate to promote maximum employment and price stability. But it also has some innovations.

The revised statement emphasizes that maximum employment is a broad and inclusive goal. This change reflects our appreciation for the benefits of a strong labor market, particularly for many in low- and moderate-income communities.

Recognizing the economy's ability to sustain a robust job market without causing an unwanted increase in inflation, the statement says that our policy decisions will be informed by our "assessments of the shortfalls of employment from its maximum level" rather than by "deviations from its maximum level."

This means that we will not tighten monetary policy solely in response to a strong labor market. Finally, to counter the adverse economic dynamics

that could ensue from declines in inflation expectations in an environment where our main policy tool is more frequently constrained, we now explicitly seek to achieve inflation that averages 2 percent over time.

This means that following periods when inflation has been running persistently below 2 percent, appropriate monetary policy will likely aim to achieve inflation moderately above 2 percent for some time in the service of keeping inflation expectations well anchored at our 2 percent longer-run goal.

Our January postmeeting statement on monetary policy implements this new framework. In particular, we expect that it will be appropriate to maintain the current accommodative target range of the federal funds rate until labor market conditions have reached levels consistent with maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time.

In addition, we will continue to increase our holdings of Treasury securities and agency mortgage-backed securities by \$80 billion and \$40 billion per month, respectively, until substantial further progress has been made toward our maximum-employment and price-stability goals.

The Broad Responsibility for Achieving Maximum Employment
Seventy-five years ago, in the wake of WWII, the United States faced the challenge of reemploying millions amid a major restructuring of the economy toward peacetime ends.

Part of Congress's response was the Employment Act of 1946, which states that "it is the continuing policy and responsibility of the federal government to use all practicable means . . . to promote maximum employment."

As later amended in the Humphrey-Hawkins Act, this provision formed the basis of the employment side of the Fed's dual mandate. My colleagues and I are strongly committed to doing all we can to promote this employment goal.

Given the number of people who have lost their jobs and the likelihood that some will struggle to find work in the post-pandemic economy, achieving and sustaining maximum employment will require more than supportive monetary policy. It will require a society-wide commitment, with contributions from across government and the private sector.

The potential benefits of investing in our nation's workforce are immense. Steady employment provides more than a regular paycheck. It also bestows a sense of purpose, improves mental health, increases lifespans, and benefits workers and their families.

I am confident that with our collective efforts across the government and the private sector, our nation will make sustained progress toward our national goal of maximum employment.

Lessons from the pandemic: Has the simpler post-2008 financial system held up? And where do we go from here?

Christina Segal-Knowles, Executive Director, Financial Market Infrastructure Directorate at the Bank of England, Official Monetary and Financial Institutions Forum



The topic of my talk today is lessons we can draw from the market turbulence we saw in March and April 2020.

But before we get there I want to talk about an earlier crisis.

Let's rewind to 2008. On September 15th, Lehman brothers collapsed taking with it one side of \$35 trillion in derivatives contracts.

Most of these derivatives were bilateral contracts – a spaghetti bowl of interconnectedness.

As Lehman collapsed and others teetered near the edge, no one knew who was holding the bag.

The result was panic, which, as explained by Ben Bernanke, may have been a key driver of the severity of the Great Recession.

Its early stages would have been significantly less severe without the confidence collapse on Wall Street.

1. Simpler

Now let's fast forward to 2020.

Pandemic. Economic crisis. Market turbulence. But no panic in the banking system.

There were a number of reasons. Banks were stronger. In the UK they were three times better capitalized than at end 2008. And to be clear –very significant government support and central bank interventions were required. I'll come back to this later.

But there is one other reason for the missing panic that I want to focus in on.

After the 2008 global financial crisis, the G20 put in place reforms designed to make the global financial system simpler - to untangle the spaghetti bowl of bilateral derivatives trades that had fed the 2008 panic.

They incentivised - and for many products mandated - central clearing of derivative trades.

Global clearing has as a result, grown significantly in the past decade.

Today, about 60% of credit default swaps are cleared, as well as 80% of interest rate contracts, up from about 10% and 40% respectively in 2008.

This brought greater stability to derivative markets by ensuring that if a major financial institution were to collapse, you needn't worry about a domino effect – with the failing firm's derivatives contracts potentially threatening the viability of any number of other firms.

One of the key ways central clearing counterparties – CCPs – help prevent panic is to be sure that as markets move, firms quickly pay for changes to their derivatives contracts, and insure against likely further changes.

First, when derivatives contracts change value, the holders of those contracts exchange money right away.

Losses and gains are promptly allocated to the firms on either side of the trade. This limits the chance that, if one side of the trade defaults, the other firm is left holding the bag for the defaulter's bad trades. This is called variation margin.

CCP margin protects against a Lehman-like scenario

	Exchange of Gains and Losses (variation margin)	Prevents build up of exposures
		Determined by market moves (ie: mark-to-market)
		Nets to zero across the CCP – passed between participants
		Cash
	Pre-Paid Self-Insurance (initial margin)	Protects against <i>most</i> market scenarios in a default event
		Determined by a model based on historical observations
		Held at the CCP
		Cash or collateral

Second, CCPs require firms to place pre-paid self-insurance with the CCP to cover the predicted liquidation costs in the event of their default.

Because derivatives markets can be fast moving, a key factor in how large

this self-insurance needs to be is how volatile the markets are. This is known as initial margin.

To read more: <https://www.bis.org/review/r210201a.pdf>

Financial Stability Institute, Occasional Paper No 17

Fintech regulation: how to achieve a level playing field

by Fernando Restoy, February 2021



The disruption created by technological progress in the market for financial services arises from

- (i) an expanded set of services offered to consumers;
- (ii) the processes and distributional channels followed by firms in offering those services; and
- (iii) the arrival of new (technological) suppliers of those services.

These developments are bound to generate profound changes in the market structure, as non-bank fintech² players are now becoming very active in offering services that in the past were predominantly offered by banks.

Their presence in the payment service area is already quite significant. However, they are also gaining weight in the provision of wealth management services, the sale of insurance products and loan underwriting.

Those services are increasingly being provided within established technology platforms run by large companies (big techs), where a variety of financial and nonfinancial products are offered by a plurality of suppliers that may or may not be linked to the platform owner (Frost et al (2019)).

A growing number of products and players increases supply, lowers the cost of financial services and encourages financial inclusion.

However, it may also generate risks for the stability and adequate functioning of the financial system.

So far, despite remarkable growth in the recent past, the scale of fintechs' operations is generally limited relative to the overall size of the financial services market.

Yet, in some jurisdictions, specific firms (Ant Group in China or Quicken Loans in the United States) have already gained leading market positions. Given significant economies of scale, data superiority and the large scope for network externalities, big techs could very well eventually achieve market dominance (De la Mano and Padilla (2018)).

There is an ongoing worldwide discussion on what the policy approach should be with respect to those market dynamics.

Within that discussion, a relevant question is whether the growth potential of fintech and big tech companies could be, in part, the consequence of lighter regulatory requirements compared with those for incumbent players such as commercial banks.

This argument could be based on the observation that financial institutions have specific (entity-based) obligations, such as those related to prudential requirements, which do not apply to other competitors in specific markets such as payment services, wealth management or credit underwriting.

Regulation specific to banks entail higher compliance costs and can therefore put them at a competitive disadvantage.

The existence of regulatory distortions could violate the principle of good regulation, which calls for any public intervention to limit market impact to the minimum required to achieve relevant objectives (OECD (2005)).

Unwarranted discrepancies between regulatory requirements for different types of market player could also disrupt banks' activities as intermediaries, thus posing risks to systemic stability (FSB (2019)).

Moreover, distorted market developments leading to big tech dominance could threaten competition in the financial services market (BIS (2019)), possibly affecting consumer protection and market integrity.

The banking industry has frequently stressed (eg IIF (2017)) that regulation could promote a level playing field through the adoption of an activity-based approach, as opposed to an entity-based one.

That would mean imposing similar requirements upon all active players in a particular market segment, regardless of the legal nature or other characteristics of those entities and, in particular, whether or not they hold a banking licence.

However, entity-based prudential rules for banks are based on specific policy objectives – such as financial stability – that are not subordinated to the achievement of a perfectly competitive landscape.

Therefore, level playing field considerations cannot be enough to support a radical overhaul of the current regulatory framework.

At the same time, it could be argued that fintechs – or, more likely, big techs – can also generate concrete threats to relevant policy objectives such as market integrity and stability or fair competition.

If that were the case, the introduction of specific rules for those entities, as they exist for banks, would not only contribute to primary policy goals but would also help promote a level playing field.

This paper discusses how level playing field considerations should affect the definition of the regulatory framework following the emergence of fintechs and big techs. It also analyses the extent to which activity-based and entity-based regulations could help achieve socially desirable objectives.

The structure of the rest of the paper is as follows. Section 2 outlines the current regulatory framework for banks and fintech players. Section 3 sets out some considerations that may help in assessing the current framework and the scope for a move towards more activity-based regulation. Section 4 assesses possible adjustments to specific regulations that could help achieve a better balance across different policy objectives. Section 5 concludes.

To read more: <https://www.bis.org/fsi/fsipapers17.pdf>

Precious metal investments: all that glitters is not gold



Four in ten investors have either already invested in gold or other precious metals or could imagine doing so in future. However, investments in precious metals are risky and speculative.

Gold glitters, and its reputation as a secure capital investment is equally dazzling.

There are two reasons for this: in a survey conducted on behalf of BaFin, 83% of those who had purchased or are considering purchasing precious metals believed this to be a secure investment. And in the current low interest rate environment, investments in gold, silver or platinum seem not only safe, but also lucrative. The risks and the costs of such investments are evidently being underestimated.

At a glance - Precious metals survey

In August 2020, on behalf of BaFin, the company OmniQuest Gesellschaft für Beratungsprojekte GmbH surveyed 1,000 consumers over the age of 18 that are resident in Germany about their attitudes towards physical precious metals as a capital investment.

The answers to the 18 questions included in the representative survey provided BaFin with insights into the form of investment favoured by investors, the sources of information they use most, their motivations for investing, and their views regarding the costs of purchasing precious metals.

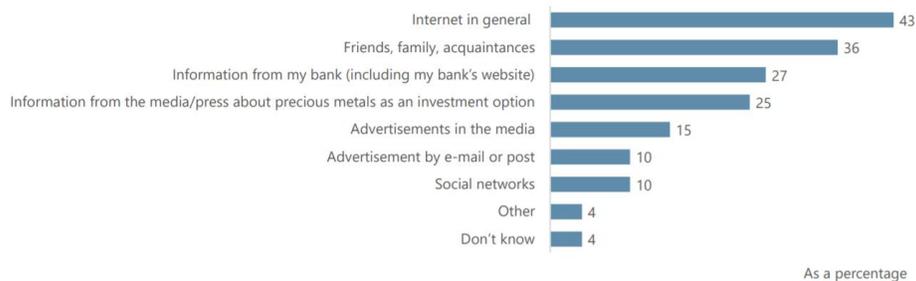


Physical precious metals as a possible
alternative investment during the period of
low/negative interest rates

Division VBS 2
14 October 2020

Use of information sources in decision-making

The majority of respondents who had already invested in physical precious metals stated that they had learned about the investment products on the internet (43%) or from friends, family and acquaintances (36%).



Q 8: How did you become aware of these products?

Number of respondents = 383

To read more:

https://www.bafin.de/SharedDocs/Downloads/EN/dl_Edelmetallumfrage_2020_en.html;jsessionid=2FoDC3A4934AD2CE5981CE83AD429CE5.2_cid392?nn=8813520

Certain credit institutions and other providers use the positive properties customers associate with gold to advertise investments. The websites BaFin analysed alongside the precious metal study often claim that gold is timeless, crisis-proof and that its value is stable.

Where investors purchase precious metals

Of the 1,000 respondents, 259 had already purchased precious metals and 124 could imagine doing so in future.

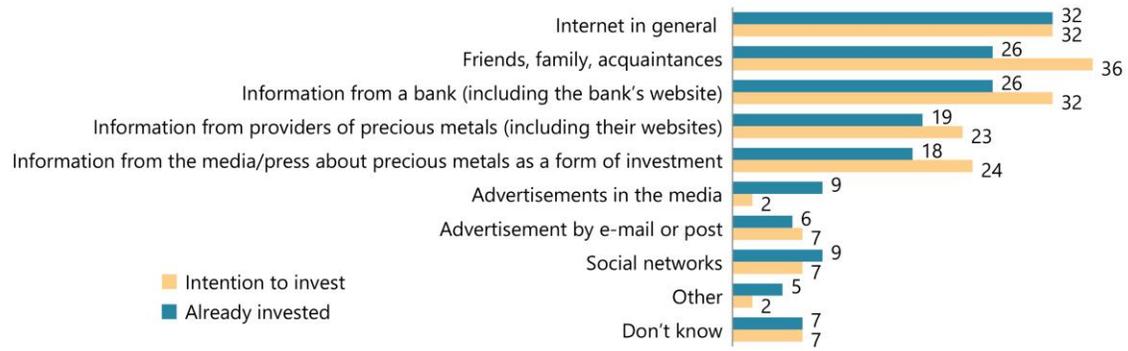
47% of investors purchased their precious metals from banks, whilst 53% used other providers.

63% of respondents who had purchased precious metals from a bank reported that their bank advisor had recommended the investment.

For 26%, information obtained from the bank was the most important factor in their decision to purchase precious metals. 32% of respondents who had not yet invested in precious metals but were interested in doing so in future believed information they received from their bank would influence their investment decision the most.

For investors, only other websites (32%) were reported as a more important source of information than banks.

Those interested in investing in future stated that information from friends, family and acquaintances would be most important (36%) (see Figure 1).



To read more:

https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2020/fa_bj_2012_Edelmetallumfrage_en.html

EU-wide stress testing

The European Banking Authority (EBA) will launch its 2021 EU-wide stress test exercise with the publication of the macroeconomic scenarios on 29 January at 18:00 CET. The EBA expects to publish the results of the exercise by 31 July 2021.



This section is dedicated to the EBA EU-wide stress tests and provides information about the methodologies and the scenarios used, as well as any additional supporting information released by the EBA during the conduct of the exercise.

EBA's role in stress testing

One of the responsibilities of the European Banking Authority (EBA) is to ensure the orderly functioning and integrity of financial markets and the stability of the financial system in the EU.

To this end, the EBA is mandated to monitor and assess market developments as well as to identify trends, potential risks and vulnerabilities stemming from the micro-prudential level.

One of the primary supervisory tools to conduct such an analysis is the EU-wide stress test exercise. The EBA Regulation gives the Authority powers to initiate and coordinate the EU-wide stress tests, in cooperation with the European Systemic Risk Board (ESRB).

The aim of such tests is to assess the resilience of financial institutions to adverse market developments, as well as to contribute to the overall assessment of systemic risk in the EU financial system.

The EBA's EU-wide stress tests are conducted in a bottom-up fashion, using consistent methodologies, scenarios and key assumptions developed in cooperation with the ESRB, the European Central Bank (ECB) and the European Commission (EC).

FSB Work Programme for 2021



The Financial Stability Board's (FSB) work programme for 2021 reflects a strategic shift in priorities in the COVID-19 environment.

The work programme aims to maximise the value of FSB work to foster global financial stability while preserving the capacity for the FSB to respond to new issues that may emerge.

The FSB will reinforce its forward-looking monitoring of developments to identify, assess and address new and emerging risks to global financial stability, and continue to assess the functioning of the regulatory framework put in place after the 2008 global financial crisis.

This note summarises the ongoing and planned FSB initiatives in 2021 organised by:

- (1) priority areas of work and new initiatives;
- (2) work programme items that are continuing or reaching completion; and
- (3) regular monitoring and reporting.

The Annex provides an indicative timeline of the FSB's publication planned for 2021.

Date	Report	Comment
February	Country peer review of Indonesia	
March	Country peer review of the United Kingdom	
April	Factors to be considered to prepare for an orderly unwinding of COVID-19 support measures	G20 deliverable
	Final report of the evaluation of TBTF reforms for banks	G20 deliverable
May	Quantitative targets for cross-border payments roadmap: Consultative document	
June	Practices paper for operationalising bail-in execution	

July	Policy proposals to enhance MMF resilience: Consultative report	G20 deliverable
	Lessons learnt from the COVID Event: Interim report	G20 deliverable
	Report on availability of data on climate-related financial stability risks and data gaps	G20 deliverable
	Promotion of globally comparable, high quality and auditable standards of disclosure in sustainability reporting	G20 deliverable
	Progress report on implementation of benchmark reform	G20 deliverable
October	Policy proposals to enhance MMF resilience: Final report	G20 deliverable
	Report on progress in the NBFi work programme	G20 deliverable
	Annual report on implementation and effects of financial regulatory reforms	G20 deliverable
	Lessons learnt from the COVID Event: Final report	G20 deliverable
	Progress report on the regulation, supervision and oversight of global stablecoins	G20 deliverable
	Report on cyber incident reporting	G20 deliverable
	Quantitative targets for cross-border payments roadmap: Final report	G20 deliverable
	Progress report on implementation of the cross-border payments roadmap	G20 deliverable
November	Identification of G-SIBs for 2021	
	2021 Resolution Report	
December	Annual Global Monitoring Report on NBFi	
	Report on financial resources for CCP resolution	

1. Priority areas of work and new initiatives

Supporting international cooperation and coordination on the COVID-19 response.

The FSB, with its broad and diverse membership of national authorities, international standard setters and international bodies, continues to promote financial stability during market stress related to COVID-19.

This work will continue to include: assessments of vulnerabilities in the global financial system; sharing information on policy responses; assessing their effectiveness and coordinating the future timely unwinding of the temporary measures taken; and monitoring, with the standardsetting bodies (SSBs), the use of flexibility and consistency of policy responses with existing international financial standards.

- Work on COVID-19 responses will continue in a flexible mode, including on specific COVID-19 related vulnerabilities and policy issues, and be adjusted as needed.
- As a new project, the FSB will work with SSBs to assess initial lessons learnt from COVID-19 for financial stability, and report them to the G20.

Enhancing the resilience of the non-bank financial intermediation (NBFi) sector, while preserving its benefits.

The FSB's holistic review of the March market turmoil¹ lays out a comprehensive and ambitious work programme for strengthening the resilience of NBFi.

The FSB will coordinate and oversee work on NBFi under this programme for 2021 and beyond, which will be carried out within the FSB as well as by SSBs and international organisations over the next two years.

- Work in 2021 will focus on the specific issues identified in the holistic review, including money market funds (MMFs), open-ended funds, margining practices, liquidity, structure and resilience of core bond markets, and cross-border USD funding. The FSB will also launch an evaluation on the effects of G20 financial reforms on bond market liquidity.
- Key deliverables under the NBFi work programme in 2021 are policy proposals to enhance MMF resilience and a report on progress in the work programme for strengthening NBFi resilience.

To read more: <https://www.fsb.org/wp-content/uploads/P200121.pdf>

Climate change and central banking

Keynote speech by Ms Christine Lagarde, President of the European Central Bank, at the ILF conference on Green Banking and Green Central Banking, Frankfurt am Main



In the famous fable "Belling the Cat", a group of mice gather to discuss how to deal with a cat that is eating them one by one.

They hatch a plan to put a bell on the cat so they can hear it coming and escape before being caught.

When it comes to who will actually do it, however, each mouse finds a reason why they are not the right mouse for the job, and why another mouse should do it instead.

The cat never does receive a bell – and the story ends poorly for the mice.

In many ways, that fable describes mankind's reaction to the threats posed by climate change.

Already in 1986, the front cover of Der Spiegel showed Cologne cathedral half-submerged by water and the headline declared a "Climate Catastrophe".

This is just one example, among many, that demonstrates that people were aware of the risks posed by climate change a generation ago.

Yet, while many people agreed on the seriousness of the issue, and that something had to be done, concrete action has been much less prevalent.

It is with this history in mind that I want to talk about the role of central banks in addressing climate change.

Clearly, central banks are not the main actors when it comes to preventing global heating.

Central banks are not responsible for climate policy and the most important tools that are needed lie outside of our mandate.

But the fact that we are not in the driving seat does not mean that we can simply ignore climate change, or that we do not play a role in combating it.

Just as with the mice in the fable, inaction has negative consequences, and the implications of not tackling climate change are already visible.

Globally, the past six years are the warmest six on record, and 2020 was the warmest in Europe.

The number of disasters caused by natural hazards is also rising, resulting in \$210 billion of damages in 2020.

An analysis of over 300 peer-reviewed studies of disasters found that almost 70% of the events analysed were made more likely, or more severe, by human-caused climate change.

That said, there are now signs that policy action to fight climate change is accelerating, especially in Europe.

We are seeing a new political willingness among regulators and fiscal authorities to speed up the transition to a carbon neutral economy, on the back of substantial technological advances in the private sector.

This increased action is often considered as a source of transition risk, which we need to take into account and reflect in our policy framework.

This is not "mission creep", it is simply acknowledging reality.

Yet the transition to carbon neutral is not so much a risk as an opportunity for the world to avoid the far more disruptive outcome that would eventually result from governmental and societal inaction.

Scenarios show that the economic and financial risks of an orderly transition can be contained.

Even a disorderly scenario, where the economic and financial impacts are potentially substantial, represents a much better overall outcome in the long run than the disastrous impact of the transition not occurring at all.

It now seems likely that faster progress will be made along three interlocking dimensions.

Each of them lies outside the remit of central banks, but will have important implications for central bank balance sheets and policy objectives.

Including, informing and innovating

The first dimension along which we expect rapid progress is including the true social and environmental cost of carbon into the prices paid by all sectors of the economy.

Appropriate pricing can come via direct carbon taxes or through comprehensive cap and trade schemes.

Both are used to some extent in the EU.

It is likely, though, that the next steps in Europe will come mainly via the EU's Emissions Trading System (ETS), a cap and trade scheme.

The ETS is an essential infrastructure, although it has not always been successful in the past at delivering a predictable price of carbon.

Moreover, it currently covers only around half of EU greenhouse gas emissions and a significant amount of allowances continue to be given for free.

The effective price of carbon is expected to rise if the EU's targets for reducing emissions are to be reached.

Modelling by the OECD and the European Commission suggests that an effective carbon price between €40–60 is currently needed, depending on how stringent other regulations are.

The introduction of the ETS Market Stability Reserve and the review of the ETS scheduled for this year should provide the opportunity to deliver a clear path towards adequate carbon pricing.

The second dimension where we expect to see progress is greater information on the exposure of individual companies.

At present, information on the sustainability of financial products – when available – is inconsistent, largely incomparable and at times unreliable.

That means that climate risks are not adequately priced, and there is a substantial risk of sharp future corrections. Yet for an open market economy to allocate resources efficiently, the pricing mechanism needs to work correctly.

This requires a step change in the disclosure of climate-related data using standardised and commonly agreed definitions.

While TCFD-based disclosures have underpinned public/private efforts to better inform, disclosure needs to be at a far more granular level of detail than is currently available.

In Europe climate disclosures are governed by the Non-Financial Reporting Directive (NFRD), which is currently under review.

The Eurosystem has advocated for mandatory disclosures of climate-related risks from a far greater number of companies, including non-listed entities.

Moreover, disclosures should be complemented by forward-looking measures that assess the extent to which both financial and non-financial firms are aligned with climate goals and net zero commitments.

The European Taxonomy Regulation that entered into force last year is also an important milestone along this path.

But it still needs to be fleshed out with concrete technical criteria and complemented by an equivalent taxonomy for carbon-intensive activities.

A further essential step is the consistent and transparent inclusion of climate risks in credit ratings. Here, again, we have high hopes that progress will now speed up.

While adequate carbon prices and greater information on exposures will help provide incentives to decarbonise, that economic transformation cannot take place without the third dimension: substantial green innovation and investment.

Both, however, require a complex ecosystem of which finance is a key element, so we expect to see increasing availability of green finance.

Green bond issuance by euro area residents has grown sevenfold since 2015, reaching €75 billion in 2020 – this represents roughly 4% of the total corporate bond issuance.

We need to see funding for green innovation increasing from other market segments as well, especially as recent analyses point to the beneficial role of equity investors in supporting the green transition.

Assets under management by investment funds with environmental, social and governance mandates have roughly tripled since 2015, and a little more than half of these funds are domiciled in the euro area.

Completing the capital markets union should provide a further push to support equity-based green finance by fostering deep and liquid capital markets across Europe.

Simultaneous progress along each of these three dimensions increases the likelihood of substantial economic change in the near term.

That is so because movement along each dimension reinforces progress along the others and magnifies the effectiveness of climate policy.

For example, the economic impact of higher carbon prices depends on the availability of alternative green technologies.

In the past, a sudden and substantial increase in carbon taxes could have resulted in an economic downturn, substantial stranded assets and threats to financial stability.

Today, however, solar power is not only consistently cheaper than new coal or gas-fired plants in most countries, but it also offers some of the lowest cost electricity ever seen.

Green finance and innovation are also developing rapidly.

Introducing well-signalled carbon pricing therefore becomes more feasible and could further sharpen incentives both to develop new technologies and to carry out the substantial investment required for the widespread adoption of the green technologies that already exist.

Climate change and central banks

Today, then, central banks face two trends – more visible impacts of climate change and an acceleration of policy transition.

Both trends have macroeconomic and financial implications and have consequences for our primary objective of price stability, for our other areas of competence including financial stability and banking supervision, as well as for the Eurosystem's own balance sheet.

Central banks are both aware of those consequences, and determined to mitigate them.

Much has already been accomplished and more is under way:

The founding of the Network for Greening the Financial System (NGFS), with membership including all major central banks, is testament to that collective engagement with climate change.

At the ECB, we are now launching a new climate change centre to bring together more efficiently the different expertise and strands of work on climate across the Bank. Climate change affects all of our policy areas.

The climate change centre provides the structure we need to tackle the issue with the urgency and determination that it deserves.

In the area of financial stability and banking supervision, the ECB has taken concrete steps towards expanding the financial system's understanding of climate risks and its ability to manage them.

We have issued a guide on our supervisory expectations relating to the management and disclosure of climate-related and environmental risks.

A recent survey of the climate-related disclosures of 125 banks suggests there is still a way to go. It evaluated climate disclosures across several basic information categories.

Only 3% of banks made disclosures in every category, and 16% made no disclosure in any category.

ECB Banking Supervision has requested that banks conduct a climate risk self-assessment and draw up action plans, which we will begin assessing this year.

We will conduct a bank-level climate stress test in 2022.

The ECB is also currently carrying out a climate risk stress test exercise to assess the impact on the European banking sector over a 30-year horizon.

Preliminary results from mapping climate patterns to the address-level location of firms' physical assets show that in the absence of a transition, physical risks in Europe are concentrated unevenly across countries and sectors of the economy.

But there is more: climate change also impacts our primary mandate of price stability through several channels. This is why climate change considerations form an integral part of our ongoing review of our monetary policy strategy.

Climate change can create short-term volatility in output and inflation through extreme weather events, and if left unaddressed can have long-lasting effects on growth and inflation.

Transition policies and innovation can also have a significant impact on growth and inflation.

These factors could potentially cause a durable divergence between headline and core measures of inflation and influence the inflation expectations of households and businesses.

The transmission of monetary policy through to the interest rates faced by households and businesses could also be impaired, to the extent that

increased physical risks or the transition generate stranded assets and losses by financial institutions.

According to a recent estimate by the European Systemic Risk Board, a disorderly transition could reduce lending to the private sector by 5% in real terms.

And climate change can also have implications for our monetary policy instruments.

First, the Eurosystem's balance sheet itself is exposed to climate risks, through the securities purchased in the asset purchase programmes and the collateral provided by counterparties as part of our policy operations.

Furthermore, several factors associated with climate change may weigh on productivity and the equilibrium interest rate, potentially reducing the space available for conventional policy.

For example, labour supply and productivity may diminish as a result of heat stress, temporary incapability to work and higher rates of mortality and morbidity.

Resources may be reallocated away from productive use to support adaptation, while capital accumulation may be impaired by rising destruction from natural hazards and weaker investment dynamics related to rising uncertainty.

And the increase in short-term volatility and accelerated structural change could hamper central banks' ability to correctly identify the shocks that are relevant for the medium-term inflation outlook, making it more difficult to assess the appropriate monetary policy stance.

Our strategy review enables us to consider more deeply how we can continue to protect our mandate in the face of these risks and, at the same time, strengthen the resilience of monetary policy and our balance sheet to climate risks.

That naturally involves evaluating the feasibility, efficiency and effectiveness of available options, and ensuring they are consistent with our mandate.

The ECB is also assessing carefully, without prejudice to the primary objective of price stability, how it can contribute to supporting the EU's economic policies, as required by the treaty.

Europe has prioritised combating climate change and put in place targets, policies and regulations to underpin the transition to a carbon-neutral economy.

While the Eurosystem is not a policy maker in these areas, it should assess its potential role in the transition.

We recognise that our active role in some markets can influence the development of certain market segments. The ECB currently holds around a fifth of the outstanding volume of eligible green bonds.

Standardisation helps nascent markets gain liquidity and encourages growth. And our eligibility criteria can provide, in this context, a useful coordination device.

For example, since the start of this year, bonds with coupon structures linked to certain sustainability performance targets have been eligible as collateral for Eurosystem credit operations and for outright purchases for monetary policy purposes.

We have also taken action with regards to our non-monetary policy portfolio, namely our own funds and pension fund.

The ECB raised the share of green bonds in its own funds portfolio to 3.5% last year and is planning on raising it further as this market is expected to grow in the coming years.

Investing parts of the own funds portfolio in the green bond fund of the Bank for International Settlements marks another step in this direction.

A shift of all conventional equity benchmark indices tracked by the staff pension fund to low-carbon equivalents last year significantly reduced the carbon footprint of the equity funds. Other central banks are also aligning decisively their investment decisions with sustainability criteria.

Conclusion

Let me conclude.

Climate change is one of the greatest challenges faced by mankind this century, and there is now broad agreement that we should act. But that agreement needs to be translated more urgently into concrete measures.

The ECB will contribute to this effort within its mandate, acting in tandem with those responsible for climate policy.

Unlike the mice in the fable, not only do we have to recognise that we cannot keep waiting for someone else to act, we also must recognise that the burden cannot fall on one party alone.

There is no single panacea for climate change, and combating it requires rapid progress along several dimensions.

Relying on just one solution, or on one party, will not be enough to avoid a climate catastrophe. And here we can actually learn something from mice. As the Roman playwright Plautus wrote, "How wise a beast is the little mouse, who never entrusts its safety to only one hole."

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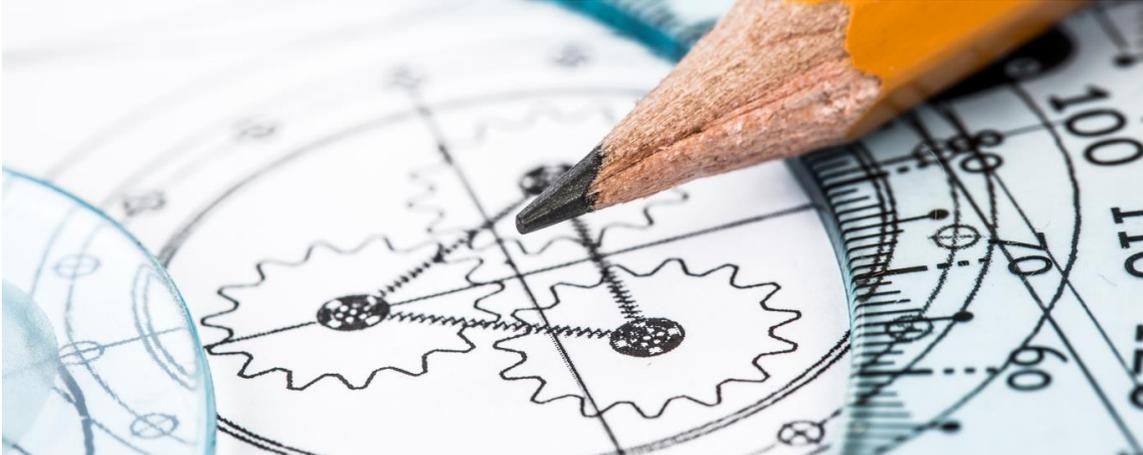
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