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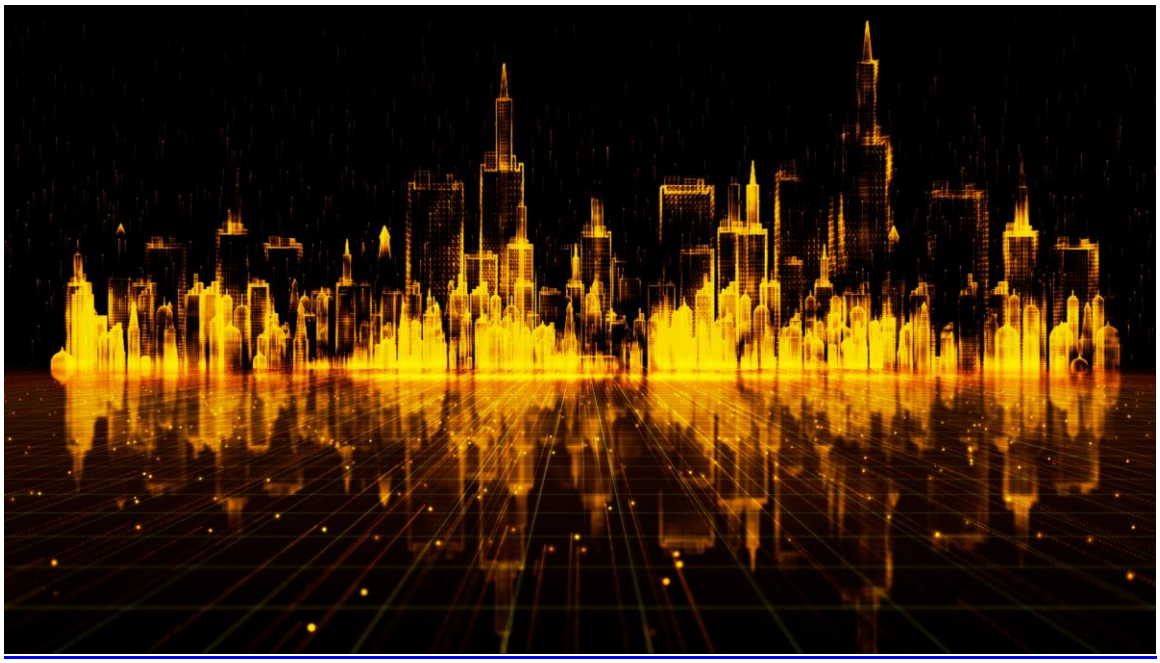


Basel iii News, November 2021

Dear members and friends,

We have the new progress report on the adoption of the Basel regulatory framework.

The Basel Committee on Banking Supervision (BCBS) and its oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS) have set as high priority the full, timely and consistent implementation of all aspects of the Basel III framework.

This includes the finalised Basel III post-crisis reforms published by the Committee in December 2017 and set to go into effect on 1 January 2023 with a five-year phase-in.

Continuing the periodic monitoring initiated a decade ago, this report sets out the adoption status of Basel III standards for each of the BCBS member jurisdictions as of end-September 2021.

It is part of the broader Committee's Regulatory Consistency Assessment Programme (RCAP) established to monitor progress in introducing corresponding domestic regulations, assessing their consistency and analysing regulatory outcomes. Despite the disruptions resulting from Covid-19 and the required shift in regulatory and supervisory priorities,

further progress has been made in the implementation of the Basel III standards especially those with deadlines that have already passed.

In fact, many jurisdictions used the existing flexibilities in the Basel framework to provide regulatory relief during the pandemic.

All jurisdictions now have final rules in force for the countercyclical capital buffer (CCyB). Overall, in respect of the outstanding capital standards there have been 11 new adoptions.

This includes three additional jurisdictions which have adopted final rules with regard to total loss-absorbing capacity (TLAC), and two additional jurisdictions which have adopted final rules with regard to the standardised approach for measuring counterparty credit risk exposure (SA-CCR) and capital requirements for equity investments in funds.

An additional four jurisdictions have adopted the Net Stable Funding Ratio (NSFR) standard.

Further, across the disclosure parts of the framework there have been seven additions.

In respect of the Basel III standards which have a deadline in the future, there have been new adopters of the revised operational risk framework and revised standardised approach for credit risk.

The report excludes standards that had previously been implemented by all jurisdictions such as the Liquidity Coverage Ratio (LCR) and capital conservation buffers (CCoB) and is based on Basel adoption status updates submitted by jurisdictions as of end-September 2021.

A complete view by standard and jurisdiction is provided in the Overview section followed by summary information about the implementation status and adoption plans for each of the 27 jurisdictions and the EU.

Table 1: Member jurisdictions that have issued final rules

Standard		Number of jurisdictions as of end-May 2020	Number of jurisdictions as of end-September 2021	Increase in adoption
Capital	Countercyclical capital buffer	26	27	1
	Margin requirements for non-centrally cleared derivatives	19	20	1
	Capital requirements for CCPs	21	22	1
	Capital requirements for equity investments in funds	19	21	2
	SA-CCR	23	25	2
	Securitisation framework	21	22	1
	TLAC holdings	18	20	3*
	Revised standardised approach for credit risk	1	2	1
	Revised operational risk framework	2	5	3
Liquidity	Net Stable Funding Ratio (NSFR)	22	26	4
Disclosure	CCyB, Liquidity, Remuneration, Leverage ratio (revised)	20	21	1
	Key metrics, IRRBB, NSFR	15	18	3
	Composition of capital, RWA overview, Prudential valuation adjustments, G-SIB indicators	19	20	1
	TLAC Disclosure	15	17	2

* The increase in adoption is actually three in 2021 rather than two. This is because one jurisdiction revised its TLAC status from fully adopted (4) to not applicable (na) during this period.

Table 1 highlights the progress made since the last report published in July 2020 by listing the standards with an increase in the number of jurisdictions with final rules in place.

The shaded area indicates the standards with deadlines in the future. Further evaluation of the consistency of jurisdictional implementation is addressed through the RCAP assessments. The outstanding RCAP on NSFR and large exposures framework (LEX) are expected to resume soon after they were suspended last year in response to Covid-19.

Overview of implementation

	Basel standards	Deadline	AR	AU	BR	CA	CN	HK	IN	ID	JP	KR	MX	RU	SA	SG	ZA	CH	TR	UK	US	EU
Capital	Countercyclical capital buffer	Jan 2016	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4	4
	Margin requirements for non-centrally cleared derivatives	Sep 2016	1	4	4	4	1	4	2	2	4	3	2	2	4	4	4	4	1	4	4	4
	Capital requirements for CCPs	Jan 2017	4	4	4	4	1	4	3	2	4	4	1	2	4	4	4	4	2	3	3	4
	Capital requirements for equity investments in funds	Jan 2017	4	4	4	4	1	2	na	na	4	4	*	4	4	4	4	4	4	3	1	4
	SA-CCR	Jan 2017	4	4	4	4	4	4	3	4	4	4	1	4	4	4	4	4	2	3	3	4
	Securitisation framework	Jan 2018	4	4	4	4	1	4	4	4	4	4	1	4	4	4	2	4	1	4	1	4
	TLAC holdings	Jan 2019	na	4	4	4	2	4	1	na	4	1	4	4	4	4	2	4	1	4	4	4
	Revised standardised approach for credit risk	Jan 2023	1	2	2	2	1	1	1	2	2	3	4	2	1	2	1	1	1	1	1	1
	Revised IRB approach for credit risk	Jan 2023	na	2	1	2	1	1	1	na	2	3	1	4	1	2	1	1	1	1	1	1
	Revised CVA framework	Jan 2023	1	1	1	2	1	1	1	2	2	1	1	1	1	2	1	1	1	1	1	1
	Revised minimum requirements for market risk	Jan 2023	1	1	*	2	1	1	1	2	2	1	1	1	2	2	1	1	1	1	1	*
	Revised operational risk framework	Jan 2023	1	3	1	2	1	1	1	3	2	3	4	4	2	2	1	1	1	1	1	1

Status classification code (numerical code):

4=Final rule in force: the domestic legal or regulatory framework has been published and is implemented by banks;

3=Final rule published: the domestic legal or regulatory framework has been published but is not implemented by banks;

2=Draft regulation published: a draft law, regulation or other official document has been made public and is specific enough to be implemented;

1=Draft regulation not published: no draft law, regulation or other official document has been made public to detail the planned content of the domestic regulatory rules.

This status includes cases where a jurisdiction has communicated high-level information about its implementation plans, but not detailed rules.

* = Cases where the implementation status for the full standard is partial are indicated with an asterisk;

na = not applicable.

Applicable standards for which the agreed implementation deadline has passed receive a colour code to reflect the status (colour code):
green = adoption completed;
yellow = adoption in process (at least some draft regulation published);
red = adoption not started (no draft regulation published yet).

A standard is deemed to be adopted and implemented when the numerical code is 4 and the colour code is green.

To read the report: https://www.bis.org/bcbs/publ/d525.pdf

Statistical release: BIS international banking statistics and global liquidity indicators at end-June 2021

• Banks' cross-border claims declined by $308 billion during the second quarter of 2021, settling at $36 trillion. Their year-on-year growth rate edged up to 2%.

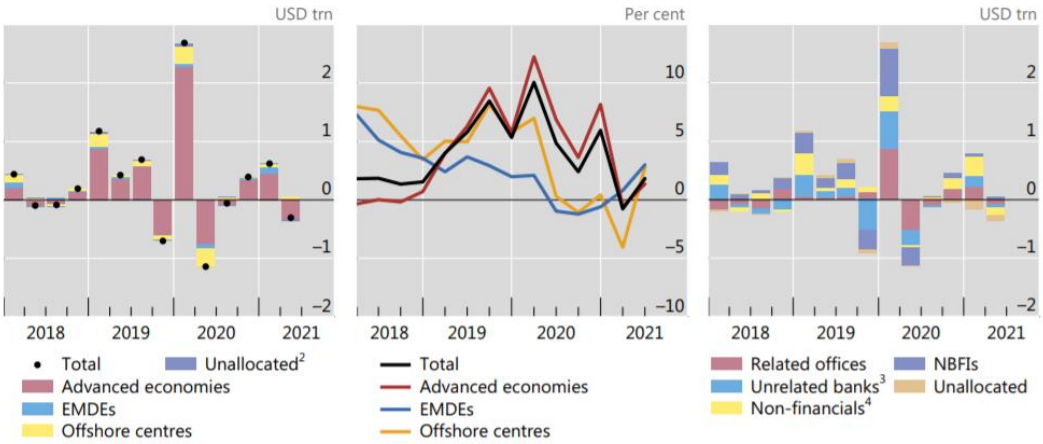
• In contrast, cross-border claims on emerging market and developing economies (EMDEs) expanded in the second quarter (by $7 billion), driven by greater credit to the Asia and Pacific region, as well as to Africa and the Middle East.

• Banks' consolidated foreign claims on China alone stood at more than $970 billion at end-Q2 2021, representing almost 18% of foreign claims on EMDEs.

• The share of offshore claims – ie claims denominated in a currency foreign to both the lending bank and borrower – has continued to fall in major currencies.

• Foreign currency credit growth, an indicator of global liquidity, held up for credit to non-residents denominated in US dollars and euros. Yen-denominated credit, particularly to EMDEs, slumped. The rate of growth in credit to residents returned to pre-pandemic levels while bond financing continued to outpace bank lending.

Banks' global cross-border claims[1] — 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 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.

Cross-border claims decline in the second quarter of 2021

The BIS locational banking statistics (LBS) show that internationally active banks' cross-border claims declined by $308 billion during the second quarter of 2021 (Graph 1, left-hand panel).

This left the stock outstanding at $36 trillion. Despite the quarterly drop in Q2, the year-on-year (yoy) growth rate of cross-border claims edged up from –1% to +2% due to a positive base effect following the sharp contraction a year earlier at the onset of Covid-19 (centre panel).

Claims on EMDEs and offshore centres expanded by 3% yoy each.

The drop in cross-border claims in Q2 2021 was almost entirely due to falling claims on advanced economies (AEs, –$338 billion) (Graph 1, left-hand panel).

Claims on non-banks in AEs fell by $140 billion, mostly driven by banks located in Japan (–$150 billion).

The drop reported by these banks was mainly vis-à-vis non-bank borrowers in the United States, reflecting recurrent factors.

In particular, the decline in Q2 2021 follows an outsized increase during the previous quarter; this pattern, which straddles the fiscal year-end in Japan in March, has been evident for several years.

Cross-border claims make up the bulk of international banking activity, which also includes local claims (on residents) in foreign currency.

Examining international claims separately by currency shows the extent to which overall growth is driven by either banks and borrowers located inside the respective currency area as opposed to those located outside.

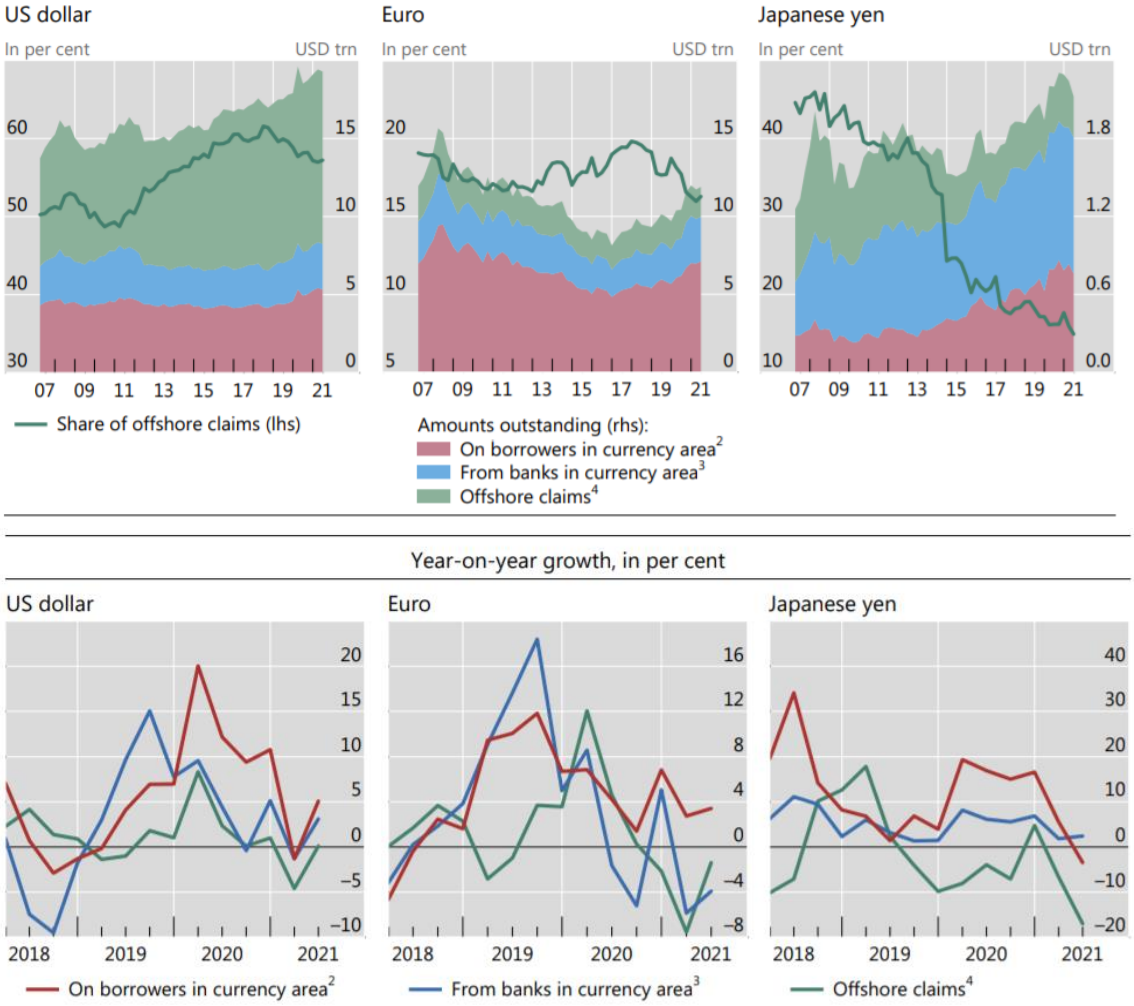
Graph 2 provides an overview of international claims denominated in three major currencies – the US dollar, the euro and the Japanese yen – and highlights three market segments for each.

International claims denominated in US dollars reached $19 trillion at end-Q2 2021 (top left-hand panel), continuing the relatively sustained growth observed since 2011.

During much of the past decade, offshore claims – or claims denominated in a currency that is foreign to both the lending bank and the borrower (green area) – drove the overall expansion in dollar-denominated international claims. But since late-2018, cross-border dollar claims on

borrowers in the United States (red area) and, to a lesser extent, cross-border claims of banks in the United States on borrowers abroad (blue area), have grown more rapidly. As a result, the share of offshore dollar claims in total dollar international claims has fallen from 62% in mid-2018 to less than 57% in mid-2021 (top left-hand panel).

International claims by currency and market segment[1] Graph 2



[1] International claims comprise cross-border claims and local claims (on residents) in foreign currencies. [2] Cross-border claims on residents of the currency area reported by banks abroad (in the centre panels, euro-denominated cross-border claims within the euro area are included). Claims are in the domestic currency from the perspective of the borrower. [3] Cross-border claims booked by banks in the currency area on non-resident counterparties outside the currency area. Claims are in a foreign currency from the borrower's perspective. [4] International claims booked by banks located outside the currency area on non-residents outside the currency area. Claims are denominated in a currency that is foreign to both the lending bank and the borrower.

Source: BIS locational banking statistics by residence.

To read more: https://www.bis.org/statistics/rppb2110.pdf

Bottlenecks: causes and macroeconomic implications

BIS Bulletin No 48, Daniel Rees and Phurichai Rungcharoenkitkul

Key takeaways

• Bottlenecks in the supply of commodities, intermediate goods and freight transport have given rise to volatile prices and delivery delays.

• Bottlenecks started out as pandemic-related supply disruptions amid strong demand from the global economic recovery. But they have been aggravated by the attempts of supply chain participants to build buffers in already lean production networks – so-called bullwhip effects.

• Bottlenecks have been particularly severe in upstream industries – ie those that supply inputs used in many other products. These constraints have led to large international spillovers through global value chains.

• The direct inflationary effect of bottlenecks will likely be limited after relative prices have adjusted. However, sustained inflationary pressures could emerge if bottlenecks persist long enough to trigger an upward shift in wage growth and inflation expectations.

Introduction

As the global recovery gains traction, demand for key raw materials, intermediate inputs and logistical services has outstripped available supply, leading to rising and volatile prices, and delivery delays.

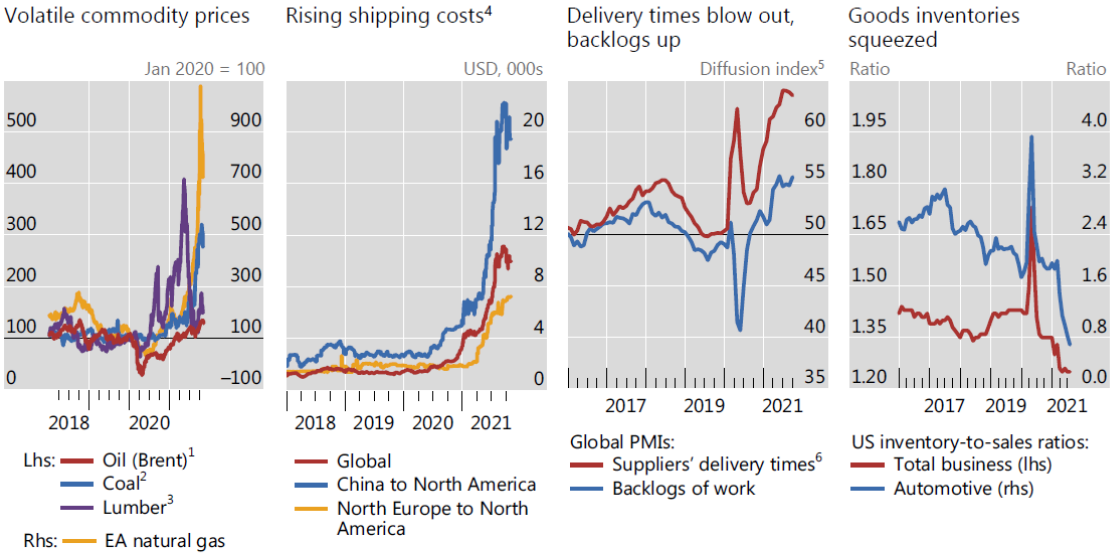
The resulting mismatches have put supply chains under pressure, causing bottlenecks that arise when the demand for an upstream production input suddenly and significantly exceeds the maximum amount that can be produced and delivered.

Current bottlenecks have persisted longer than anticipated, weighed on output growth and helped to raise global inflation. This Bulletin outlines the sectors subject to bottlenecks, investigates their causes and assesses their macroeconomic implications.

Where have bottlenecks emerged?

Recent bottlenecks have been most severe in raw materials, intermediate manufactured goods and freight transport. For raw materials, prices rose sharply as shortages emerged and firms scrambled to secure supplies, followed in several cases by sudden price declines as production ramped up or demand ebbed (Graph 1, first panel).

Bottlenecks reflected in prices and quantities — Graph 1



[1] In US dollars/barrel. [2] Generic first futures price, coking coal on Dalian Commodity Exchange. [3] Generic first futures price, random length lumber. [4] Freightos Baltic daily containerised freight rate index. Seven-day moving average. [5] A value of 50 indicates that the number of firms reporting improvement is the same as the number reporting deterioration. [6] Delivery times displayed on an inverted scale.

Sources: Federal Reserve Bank of St. Louis, FRED; Bloomberg; Datastream; IHS Markit; BIS calculations.

In the manufacturing sector, prices have increased substantially for certain computer chips in high demand, forcing some customers to pause production and others to build precautionary stockpiles to maintain production.

Meanwhile, shipping costs have shot up for trade between Asia and North America (second panel) and delivery times have lengthened.

Ships have been forced to queue for days to access ports, clogging distribution across the supply chain. Truck and air freight prices have also soared, exacerbated by labour shortages.

These bottlenecks have had knock-on effects through production networks. Unable to secure inputs, firms slowed or stopped production, causing order backlogs and blowing out delivery times (Graph 1, third panel).

At the retail level, goods inventories have sunk to historic lows, particularly for durable items such as cars and furniture with high transport costs (fourth panel).

In several countries, energy inventories are also at record lows, leading to blackouts and rationing. These, in turn, have weighed on production of raw materials and manufactured goods, intensifying bottlenecks further.

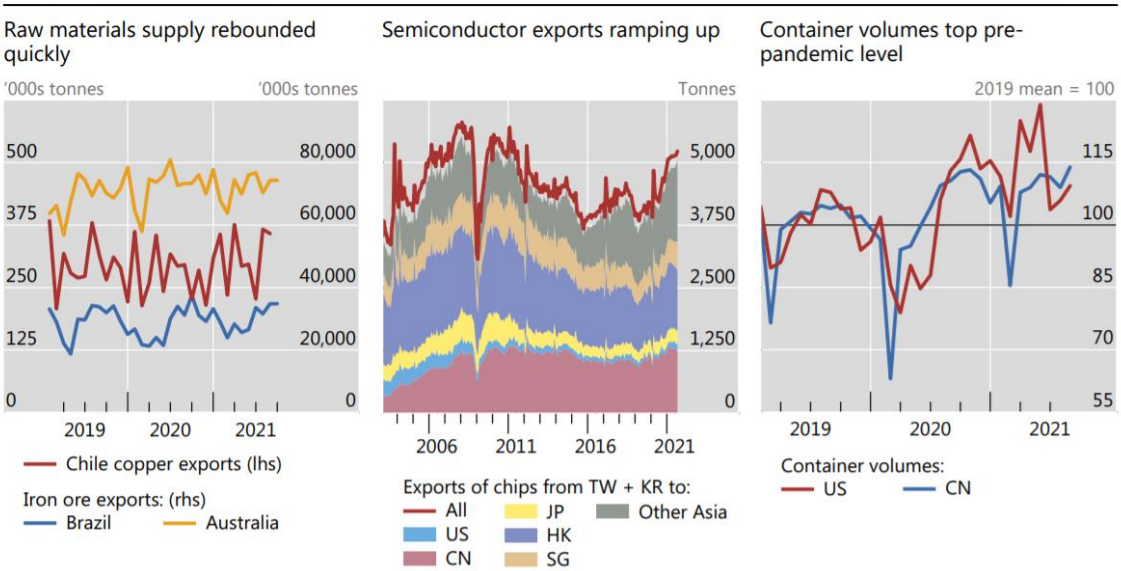
Why have bottlenecks appeared and why are they so severe?

Pandemic-induced supply disruptions have clearly been a major cause of bottlenecks, especially in the early stages of the global recovery. Producers who had severed relationships with suppliers early in the pandemic found it hard to re-establish them when demand picked up.

Asynchronous lockdowns disrupted shipping, while sporadic virus outbreaks led to further dislocations. But there are also other causes. Unexpected natural events have intensified supply pressures.

A lack of investment in the years leading up to the pandemic left some industries with little spare capacity. The investment shortfall was particularly severe for oil and resource commodities, due in part to the transition away from fossil fuel energy.

Supply struggling to keep pace with demand — Graph 2



Sources: CPT Single Window; Korea Customs Service; United States Department of Transportation; Bloomberg; CEIC; Refinitiv Eikon; BIS calculations.

At the same time, rising prices for some items went hand in hand with high volumes, suggesting an important role for demand.

Prices for many resource commodities surged against a backdrop of stable supply – at least in aggregate – which was hardly affected by the pandemic (Graph 2, left-hand panel). And semiconductor exports from Asia considerably exceed the 2019 level (centre panel), in part reflecting trend increases in demand for IT and electronics goods.

Meanwhile, ports in the United States and China have been processing a larger volume of shipping containers than pre-pandemic, albeit with considerable month-to-month volatility (right-hand panel).

To read more: https://www.bis.org/publ/bisbull48.pdf

Financial Stability Report, November 2021

This report presents the Federal Reserve Board's current assessment of the resilience of the U.S. financial system. By publishing this report, the Board intends to promote public understanding and increase transparency and accountability for the Federal Reserve's views on this topic.

Promoting financial stability is a key element in meeting the Federal Reserve's dual mandate for monetary policy regarding full employment and stable prices.

In an unstable financial system, adverse events are more likely to result in severe financial stress and disrupt the flow of credit, leading to high unemployment and great financial hardship.

Monitoring and assessing financial stability also support the Federal Reserve's regulatory and supervisory activities, which promote the safety and soundness of our nation's banks and other important financial institutions.

Information gathered while monitoring the stability of the financial system helps the Federal Reserve develop its view of the salient risks to be included in the scenarios of the stress tests and its setting of the countercyclical capital buffer (CCyB).

The Board's Financial Stability Report is similar to those published by other central banks and complements the annual report of the Financial Stability Oversight Council (FSOC), which is chaired by the Secretary of the Treasury and includes the Federal Reserve Board Chair and other financial regulators.

Framework

A stable financial system, when hit by adverse events, or "shocks," continues to meet the demands of households and businesses for financial services, such as credit provision and payment services.

By contrast, in an unstable system, these same shocks are likely to have much larger effects, disrupting the flow of credit and leading to declines in employment and economic activity.

Consistent with this view of financial stability, the Federal Reserve Board's monitoring framework distinguishes between shocks to and vulnerabilities of the financial system.

Shocks, such as sudden changes to financial or economic conditions, are typically surprises and are inherently difficult to predict.

Vulnerabilities tend to build up over time and are the aspects of the financial system that are most expected to cause widespread problems in times of stress.

As a result, the framework focuses primarily on monitoring vulnerabilities and emphasizes four broad categories based on research.

1. Elevated **valuation pressures** are signaled by asset prices that are high relative to economic fundamentals or historical norms and are often driven by an increased willingness of investors to take on risk. As such, elevated valuation pressures imply a greater possibility of outsized drops in asset prices.

2. Excessive **borrowing by businesses and households** leaves them vulnerable to distress if their incomes decline or the assets they own fall in value. In the event of such shocks, businesses and households with high debt burdens may need to cut back spending sharply, affecting the overall level of economic activity. Moreover, when businesses and households cannot make payments on their loans, financial institutions and investors incur losses.

3. Excessive **leverage within the financial sector** increases the risk that financial institutions will not have the ability to absorb even modest losses when hit by adverse shocks. In those situations, institutions will be forced to cut back lending, sell their assets, or, in extreme cases, shut down. Such responses can substantially impair credit access for households and businesses.

4. **Funding risks** expose the financial system to the possibility that investors will "run" by withdrawing their funds from a particular institution or sector. Many financial institutions raise funds from the public with a commitment to return their investors' money on short notice, but those institutions then invest much of the funds in illiquid assets that are hard to sell quickly or in assets that have a long maturity.

This liquidity and maturity transformation can create an incentive for investors to withdraw funds quickly in adverse situations.

Facing a run, financial institutions may need to sell assets quickly at "fire

sale" prices, thereby incurring substantial losses and potentially even becoming insolvent.

Historians and economists often refer to widespread investor runs as "financial panics."

These vulnerabilities often interact with each other. For example, elevated valuation pressures tend to be associated with excessive borrowing by businesses and households because both borrowers and lenders are more willing to accept higher degrees of risk and leverage when asset prices are appreciating rapidly.

The associated debt and leverage, in turn, make the risk of outsized declines in asset prices more likely and more damaging. Similarly, the risk of a run on a financial institution and the consequent fire sales of assets are greatly amplified when significant leverage is involved.

It is important to note that liquidity and maturity transformation and lending to households, businesses, and financial firms are key aspects of how the financial system supports the economy.

For example, banks provide safe, liquid assets to depositors and long-term loans to households and businesses; businesses rely on loans or bonds to fund investment projects; and households benefit from a well-functioning mortgage market when buying a home.

The Federal Reserve's monitoring framework also tracks domestic and international developments to identify near-term risks—that is, plausible adverse developments or shocks that could stress the U.S. financial system.

The analysis of these risks focuses on assessing how such potential shocks may play out through the U.S. financial system, given our current assessment of the four areas of vulnerabilities.

While this framework provides a systematic way to assess financial stability, some potential risks do not fit neatly into it because they are novel or difficult to quantify.

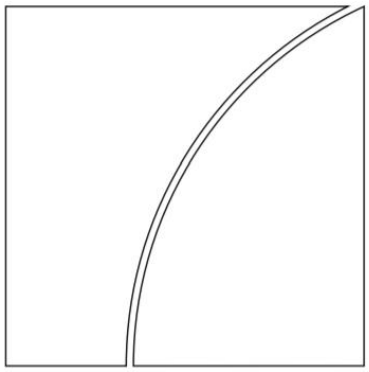
In addition, some vulnerabilities are difficult to measure with currently available data, and the set of vulnerabilities may evolve over time.

Given these limitations, we continually rely on ongoing research by the Federal Reserve staff, academics, and other experts to improve our measurement of existing vulnerabilities and to keep pace with changes in the financial system that could create new forms of vulnerabilities or add to existing ones.

The report:
https://www.federalreserve.gov/publications/files/financial-stability-report-20211108.pdf

Contents

Big techs in finance: on the new nexus between data privacy and competition



BIS Working Papers

No 970

Big techs in finance: on the new nexus between data privacy and competition

by Frederic Boissay, Torsten Ehlers, Leonardo Gambacorta and Hyun Song Shin

Monetary and Economic Department

October 2021

Focus

Large technology companies such as Alibaba, Amazon, Facebook, Google and Tencent have started to provide financial services. The activities of big techs in finance are a special case of broader fintech innovation.

While fintech companies are set up to operate primarily in financial services, big tech firms offer financial services as part of a much wider set of activities. Big techs' foray into finance raises both opportunities and risks.

Contribution

The contribution of this paper is threefold.

First, it describes big techs' business models and analyses the potential benefits in their provision of financial services such as financial inclusion and reduced asymmetric information problems in the supply of credit.

Second, it evaluates the potential costs, including the new risks of price discrimination, abuse of market power, anti-competitive behaviour and limits to data privacy.

Third, it lays out the complex public policy trade-off between the objectives of efficiency and privacy, and discusses the policy options

Findings

Big techs' entry in finance builds on their established digital platforms in e-commerce, search and social media, and holds the prospect of efficiency gains and greater financial inclusion.

Their business model rests on enabling direct interactions among a large number of users.

An essential by-product of their business is their large stock of user data, which are used as an input for a range of services that exploit natural network effects, generating further user activity.

Increased user activity then completes the circle, as it generates yet more data.

The self-reinforcing loop between data, network externalities and activities, is the DNA of big techs.

Big techs have the potential to become dominant through the advantages afforded by the data-network-activities DNA loop – raising competition and data privacy issues.

How to define and regulate the use of data has become an important policy issue for authorities and increases the need to coordinate policies at both the domestic and international level.

Abstract

The business model of big techs rests on enabling direct interactions among a large number of users on digital platforms, such as in e-commerce, search and social media.

An essential by-product is their large stock of user data, which they use to offer a wide range of services and exploit natural network effects, generating further user activity.

Increased user activity completes the circle, as it generates yet more data.

Building on the self-reinforcing nature of the data- network-activities loop, some big techs have ventured into financial services, including payments, money management, insurance and lending.

The entry of big techs into finance promises efficiency gains and greater financial inclusion.
At the same time, it introduces new risks associated with market power and data privacy.

The nature of the new trade-off between efficiency and privacy will depend on societal preferences, and will vary across jurisdictions.

This increases the need to coordinate policies both at the domestic and international level.

You may visit: https://www.bis.org/publ/work970.pdf

FSB Chair's letter to G20 Finance Ministers and Central Bank Governors

This letter from the FSB Chair, Randal K. Quarles, to G20 Finance Ministers and Central Bank Governors ahead of their meeting on 13 October focuses on two key areas of the FSB's work on which the FSB has submitted reports to the upcoming G20 meeting:

Developing a more resilient NBFI sector

The letter notes that, following the market turmoil in March 2020, the FSB agreed on an ambitious multi-year workplan to enhance NBFI resilience.

A key priority of this workplan has been work to address vulnerabilities in money market funds (MMFs), conducted in collaboration with the International Organization of Securities Commission (IOSCO). The FSB has delivered to the G20 a final report with policy proposals to enhance money market fund resilience.

Table of Contents

You may visit:
https://www.fsb.org/2021/10/policy-proposals-to-enhance-money-market-fund-resilience-final-report/

FSB members are assessing, or will assess, MMF vulnerabilities in their jurisdiction and will address them using the framework and policy toolkit in the report, in line with their domestic legal frameworks.

The FSB, working with IOSCO, will then take stock of progress made and assess the effectiveness of the measures taken. The FSB and IOSCO will also carry out further work, complementing MMF policy reforms, to enhance the functioning and resilience of short-term funding markets.

The letter also notes the considerable progress made on assessing vulnerabilities and identifying policy considerations in other areas within NBFI, including open-ended funds; the impact of margin calls; and the structure of core funding markets.

The FSB will leverage insights from the analysis in these areas to develop a systemic risk perspective on NBFI and policies to address such risks. The FSB will submit to G20 Leaders later this month a full progress report on its work to enhance resilience of NBFI, including areas where continued focus is needed.

Addressing challenges in cross-border payments

The COVID Event has brought into even sharper focus the need to address the limitations of current arrangements for cross-border payments.

Last year, the FSB delivered a roadmap to enhance cross-border payments, so they are faster, more inclusive, less expensive and more transparent.

Taking forward work on the roadmap, the FSB is submitting to the G20:
- a progress report on the roadmap to enhance cross-border payments, which also confirms steps for next year and beyond;

- quantitative targets for addressing the challenges of cost, speed, transparency and access experienced by end-users; and

- a report on the progress made on the implementation of the FSB's high-level recommendation for the regulation, supervision and oversight of "global stablecoin" arrangements.

The letter notes that the FSB will also be submitting its latest work on cyber incident reporting, which brings together cross-sectoral expertise to explore whether harmonisation in cyber reporting can be achieved and what additional work needs to be undertaken.

To read more: https://www.fsb.org/wp-content/uploads/P111021-1.pdf

How Long is Too Long? How High is Too High?: Managing Recent Inflation Developments within the FOMC's Monetary Policy Framework

Governor Randal K. Quarles, at the 2021 Milken Institute Global Conference "Charting a New Course," Beverly Hills, California

Thank you to the Milken Institute for the opportunity to join you today. This morning I'd like to outline my view of current economic conditions and the economic outlook and then turn to the implications for monetary policy.

In particular, with employment still well below its February 2020 peak, I will focus on how the escalation in inflation this year is testing the monetary policy framework adopted by the Federal Open Market Committee (FOMC) in August 2020.

Outlook for Economic Growth

Recent data suggest that growth in the third quarter is likely to be lower than we had expected, but the foundations remain in place for strong economic growth over the remainder of this year and next.

Employment is growing, financial conditions are accommodative, businesses are investing, and households, in the aggregate, have a large stock of savings to draw on for future spending.

Weaker growth in payrolls in August and September, along with uneven consumer spending in July and August, appear to reflect ongoing concerns in some parts of the country about the spread of COVID-19, especially in high-contact service industries.

Supply bottlenecks and labor shortages that have been more widespread and persistent than many expected are camouflaging continued strong underlying demand for goods, services, and workers.

Supply constraints are particularly evident in interest-sensitive parts of the economy, such as residential investment and vehicle sales, limiting the scope for additional monetary accommodation to stimulate activity in those sectors.

I expect that these developments, however, have for the most part simply postponed activity temporarily and that robust growth will return in the

coming months. There is evidence in recent weeks that we seem to be moving into a new phase of the economy.

Nominal retail sales rose seven-tenths of 1 percent in September on the heels of a nine-tenths increase in August, an indication that consumers kept up their pace of spending.

Robust business investment in equipment and intangibles continued in the second quarter, and indicators suggest another gain in the third quarter. Forward indicators of business spending and the need for firms to replenish depleted inventories point to strong investment into next year.

The Labor Market Continues to Strengthen

Without a doubt, the headline job gains in August and September were lower than expected, but, as I will show, based on almost every other major labor market indicator, there is ample evidence that the demand for labor is strong.

At last measure, the Labor Department reported that job openings remained near a record high in August, and a record number of workers were voluntarily quitting their jobs, an indicator of their confidence in finding a better one.

Other measures of job openings by education level indicate that jobs are plentiful even for less-skilled workers who have been affected the most by the COVID event.

Another indicator I've been watching closely is the so-called U-6 unemployment rate, which consists of people who are working part time but prefer full-time work and discouraged workers who want a job but have given up looking.

U-6 unemployment declined significantly over the past two months to 8.5 percent in September, roughly the same level as in the middle of 2017, when most everyone considered the job market to be quite healthy.

In fact—and this will not be news to most of you—shortages of skilled workers in many occupations predated the COVID event and are likely to persist after its effects have faded.

Some of this shortage reflects the aging of the workforce, changes in the types of jobs people want to do, and the time it takes to train workers. Strong demand for labor is outpacing supply, and, naturally, that development is putting upward pressure on wages. Through September, average hourly wages are up 4.6 percent over the past 12 months, the largest and most sustained increase in wages for workers since the 1990s.

I noted the imbalance between the demand and supply for labor, and some of the labor market indicators that are still well short of pre-COVID levels are those related to labor force participation, which has been about unchanged this year on balance.

I expect that as conditions normalize, this measure will pick up, but it is unlikely to return to its February 2020 level.

One reason is that a disproportionate number of older workers responded to the initial shock of the COVID event by retiring, which may be an area where participation and employment struggle to retrace lost ground.

Longer-lasting changes in labor force participation could make wage pressures more persistent and have implications for the assessment of maximum employment.

Tapering Asset Purchases

Since the middle of last year, the Fed has been increasing its holdings of Treasury securities and agency mortgage-backed securities by $120 billion a month to foster smooth market functioning and to support the economy by putting downward pressure on interest rates.

Conditions had improved considerably by the time we announced our forward guidance for asset purchases in December, but the unemployment rate remained at 6.7 percent, near-term growth was being constrained by heightened social-distancing restrictions amid surging hospitalizations from COVID-19, and inflation was running significantly below 2 percent.

As we sit here today, demand for labor is strong, and unemployment has declined to 4.8 percent. We have exceeded the previous high for real gross domestic product and are close to reaching the pre-COVID trend. Inflation, about which I will say more shortly, is running at more than twice the FOMC's longer-run goal.

Taking all of the evidence into account, I think it is clear that we have met the test of substantial further progress toward both our employment and our inflation mandates, and I would support a decision at our November meeting to start reducing these purchases and complete that process by the middle of next year.

Bear in mind that asset purchases are pressing down on the accelerator, adding each month to the amount of accommodation the Fed is providing to the economy through downward pressure on longer-term interest rates.

Reducing purchases and ending them on this schedule is not monetary tightening, but a gradual reduction in the pace at which we are adding accommodation.

To read more:
https://www.federalreserve.gov/newsevents/speech/quarles20211020a.htm

Islamic finance and the Fiqh of crisis management

Abdul Rasheed Ghaffour, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the 16th International Shariah Scholars Forum (ISSF) "Islamic Finance and the Fiqh of Crisis Management".

Assalamualaikum w.b.t and a very good afternoon to all distinguished guests and fellow participants. It is a pleasure and honour for me, to be part of what I believe will be another stimulating and thought-provoking dialogue.

I would like to record the Bank's appreciation to ISRA for hosting this annual platform, and also more broadly, for its continued dedication in advancing the frontiers of applied Shariah knowledge in Islamic finance towards greater heights and prominence.

The chosen theme "Islamic finance and thefiqh of crisis management" is very apt and timely. With the persisting rage of the Covid-19 pandemic, our economic and financial backdrop is gripped with unprecedented challenges that emerged within a very short period of time – priced with great health, economic and social costs.

The forecasted statistics are rather staggering, sparing no countries from economic fallout and social regress. With as many as 150 million people globally estimated to be pushed into extreme poverty by 2021, exacerbated with the fact that global unemployment is expected to hit more than 200 million people by 2022, the impact from the crisis has disproportionately affected the most vulnerable.

At the same time, disruptions and displacements due to the long-term threats of climate change events continue to persist. Collectively, these present serious ramifications to macro and socio-economic development.

Implicit from this crisis is the valuable lesson which compels us to rethink on how we can and should navigate more inclusive and sustainable development, and the role of finance. This presents a prime opportunity for Islamic finance to deliver greater values and impact.

With principles of maqasid Shariah that are universally aligned with the vision of sustainable, balanced, and inclusive economic growth, Islamic finance can meaningfully contribute towards delivering maslahah

(benefits) at large and preventing mafsadah (intensified harm) to the economy and livelihood of the people.

Indeed, Islamic finance and Islamic financial institutions can provide clear leadership on this front. As the global economy heads towards recovery, a challenge upon us is to address the heavy impact from the crisis. With the commencement of rebuilding efforts, it is crucial for us to embrace reform towards more responsible and meaningful financial intermediation activities.

It is therefore our collective responsibility to be laser-focused in combatting the impact to prevent permanent scarring to the economy and social resilience.

To materialise this, at least three (3) attributes come to mind on how Islamic finance can play a catalytic role as the impetus towards sustainable and inclusive economic recovery.

First, Islamic finance is primed to offer value-based solutions. This is given the inherent value of maqasid Shariah that strives for attainment of benefit and prevention of harm.

By placing value-based and sustainability consideration at the core of the economic recovery plan, enormous opportunities lie for Islamic finance to support sustainable solutions towards postpandemic recovery. With deeper materialisation of these principles nurtured into modern financial context, it could create a seismic change in mainstreaming value-based consideration as an anchor to any business and commercial decisions.

This encourages the embedment of Shariah values in financial offerings to deliver positive outcomes. The wisdom, diligence, and inquisitive mind of Shariah scholars are thus undoubtedly the integral component within a financial system in providing impactful and practical Shariah advice amid the fast-changing business environment. More so, during the time of crisis. We see this transpiring.

Through an industry-driven initiative, Islamic banking institutions in Malaysia are committed to adopt “Value-based Intermediation” (VBI) which advocates for positive and sustainable impact through the practices, offerings, and conduct of institutions.

Guidance is also provided in incorporating SDG-oriented risk considerations in financing and investment decision making process, through the Value-based Intermediation Financing and Investment Impact Assessment Framework (VBIAF).

Similar importance has also been recognised in the takaful industry, with the recent introduction of VBI for Takaful Framework. The framework focuses on integrating VBI principles into the underwriting and investment decisions, as well as business operations of takaful and retakaful operators that will reshape and sharpen practices of the industry towards delivering economic and societal outcomes more sustainably.

This brings me to my second point, for Islamic financial institutions to leveragethe versatility and diversity of Shariah contracts, to consistently innovate and keep pace with the rapidly evolving economic landscape and demographic changes.

In Malaysia, the universal scope of business under the Islamic Financial Services Act (IFSA) 2013 allows Islamic financial institutions to mobilise a wide range of solutions both on the asset and liability sides, towards delivering meaningful impact, beyond the traditional norms. For example, the adoption of mudarabah contract in Investment Account provides risk absorbent funding avenue for high-risk businesses to raise capital.

The gaining traction of Investment Account helps to diversify the funding structure of Islamic banks, which is now close to 12% of total funding as of June 2021. Large potential to spur innovation therefore lies beyond the traditional adoption of Shariah contracts. The entrenched versatile feature within Shariah itself offers the latitude for innovation and creativity. This includes smart contracts, without compromising the fundamentals of Shariah.

Optimising technological advancement brings wealth of benefits to efficiency and transparency, as well as manages risk effectively. This is particularly vital considering multiple applications of Shariah contracts in Islamic products and services that demand higher degree of transparency and disclosure, alongside ensuring information symmetry to customers and strengthening confidence to Islamic finance.

Ultimately, we can become more inclusive by leveraging digital infrastructure through greater outreach to the underserved segment of the society. As we see more of this in the horizon, we are then able to realign the current business thinking to a fresher lens of value-based financial dealings that resonate with Shariah, which propagates equitable access and circulation of wealth, with no one left behind.

As efforts continue to sustainably rejuvenate the economy, a great headway to embark on is to build stronger capacity and support in real and productive economic sectors. An example is to enhance wider trade facilitation to spur growth in Islamic trade finance, which has promisingly surged to USD186 billion in size and is growing both in scale and demand.

This signifies huge opportunities to be tapped on. Surely, more needs to be explored to widen the spectrum of Shariah-compliant trade finance offerings by the financial sector. A funding option for businesses can perhaps be tailored to the lifecycle of production.

This allows companies to obtain short-term liquidity via the sale of current assets such as receivables and inventories to financial institutions without increasing indebtedness – which is in parallel with the maqasid of preservation of wealth, particularly on striving to avoid excessive debt beyond one's ability to afford.

The delivery of financial solutions therefore is compelled to reflect the needs of the economy and consumers, without eluding the broader benefits to the environment and people.

The third and my final point relates to advancing the balanced responsibility in building social resilience. The International Monetary Fund (IMF) reports that the pandemic has aggravated the pre-existing inequalities in the labour and income market.

This predominantly affects the lower skilled workers who are at risk of lay-offs or are already being displaced and facing daunting challenges to shift to the new norm, and those with daily incomes that are halted due to suspension of certain economic sectors.

The disparity shoves wider. It is indeed a sobering wake up call for us. I reminisce on how Islamic history is replete with prophetic precedence on the importance of positioning inclusive and equitable growth and wealth as the foundational principle.

We have learned from the exemplary leadership under the reign of Khalifah Umar bin Abdul Aziz, where social finance instruments such as zakat, waqf and sadaqah were optimised to reduce poverty and empower the community.

In today's landscape, we do acknowledge efforts in similar light. Institutionalised forms of social finance which blend social dimension and financial returns are being pursued to provide alternative funding options for micro-entrepreneurs to venture, sustain, and grow their business.

Such integration of diverse social finance instruments into micro financial products is envisioned to address the growing concerns on over-dependence on debt-based instruments that could reduce the financial flexibility of businesses in supporting their recovery.

Before I conclude, I would like to touch on the importance to future-proof the industry and the role of Shariah scholars. As we navigate beyond the

pandemic, agility in thinking, approach and process is the way forward in dealing with the transformed future.

This is where the Shariah community has to elevate itself, providing guidance that serves as the setting compass for institutions in charting new strategies and enabling the structuring of new innovative solutions.

One way to sail through this is by establishing parameters and guidelines as readily implementable approaches. This involves ongoing experimentation, assessment, and learning in any uncertain environment.

Shariah recommendations need to accommodate different permutations in varying situations, given the flexibility afforded in Shariah. It is in this spirit that the Bank is currently finalising the Discussion Paper onHajah that serves as a toolkit in applying hajah, taking into consideration the different magnitude and severity of situations.

Hajah application, however, should not be considered as a permanent solution, but it is rather a temporary way out to accommodate certain justified need and necessity. Hence, a clear interpretation of hajah from the context of contemporary financial practices, supplemented with in-depth understanding of its impact will unlock uncharted opportunities for Islamic financial institutions to explore more diversified approaches in delivering financial solutions within the safe boundaries of Shariah compliance.

This nudges a refreshed Shariah viewpoint in steering commercial decisions, pushing beyond the frontiers of traditional norms. The implementation of hajah should thus be oriented by robust and detailed governance process and assessment, commensurate to the size and business of financial institutions.

As the operating environment becomes more complex, so will the Shariah issues. While reaching consensus is ideal, differing views and preferences would enrich and flourish the critical thinking and independent reasoning to produce a pragmatic ijtihad that is contextualised from practical realities.

A dedicated platform for scholars to exchange ideas and perspectives is thus paramount to cultivate greater understanding and to mutually benefit each other.

Towards this end, the Bank, through the Roundtable Meeting of Centralised Shariah Advisory Authorities in Islamic Finance (CSAA), will endeavour to achieve this outcome.

The Roundtable serves as an important avenue to strengthen connectivity among centralised Shariah advisory authorities to foster mutual

appreciation and respect in Shariah, to promote knowledge sharing, and to identify common issues across jurisdictions and explore viable solution.

Conclusion

It is my fervent hope that this platform today would continue to spearhead a constructive discourse on Shariah issues for greater benefit to the global Islamic finance industry.

In closing, I would like to share an inspiring verse in Surah Al-Maidah -"Help one another in acts of piety and righteousness, and do not assist each other in acts of sins and transgression."

Let's embrace this message and together we strive to propagate good courses in commercial conduct and businesses that are beneficial to the environment and society at large, in line with commandment of Allah s.w.t.

On that note, I wish everyone an engaging and productive days ahead. Wa billahi taufiq wal hidayah, assalamualaikum warahmatullahi wabarakatuh.

ECB publishes consolidated banking data for end-June 2021

- Total assets of EU-headquartered credit institutions increased by 2.90%, from €29.71 trillion in June 2020 to €30.57 trillion in June 2021

- EU non-performing loans ratio dropped by 0.19 percentage points year on year to 2.32% over same period

- EU average return on equity was 3.62% and Common Equity Tier 1 ratio was 15.75% in June 2021

Chart 1

Total assets of credit institutions headquartered in the EU

(EUR billions)

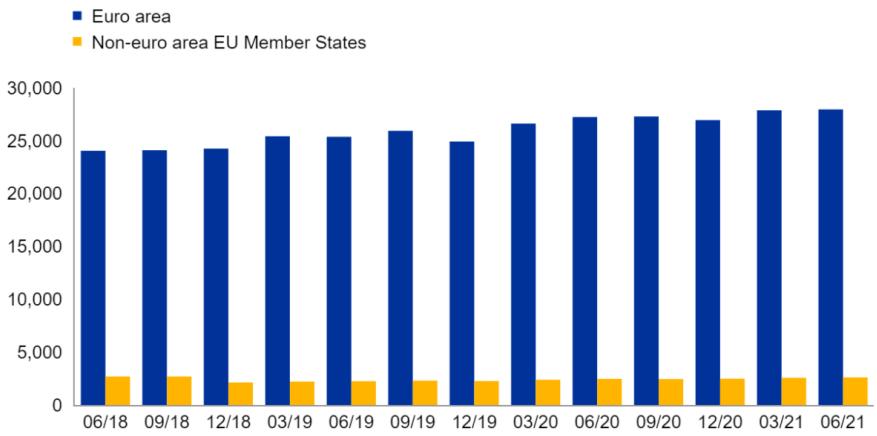
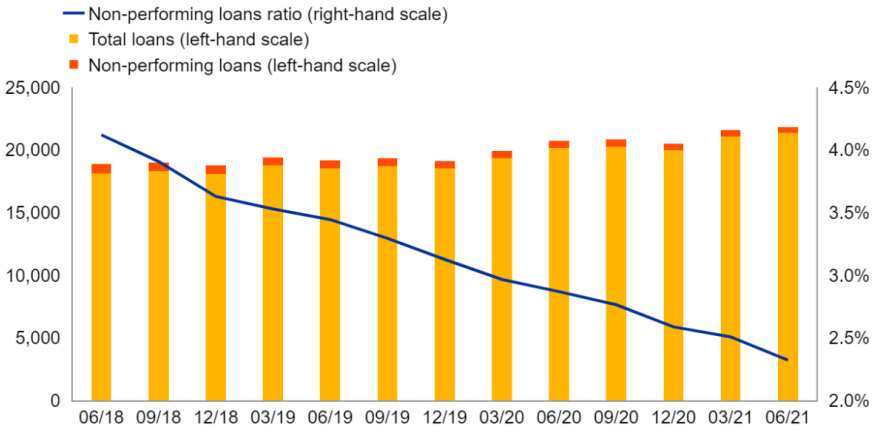


Chart 2

Non-performing loans ratio of credit institutions headquartered in the EU

(EUR billions; percentages)

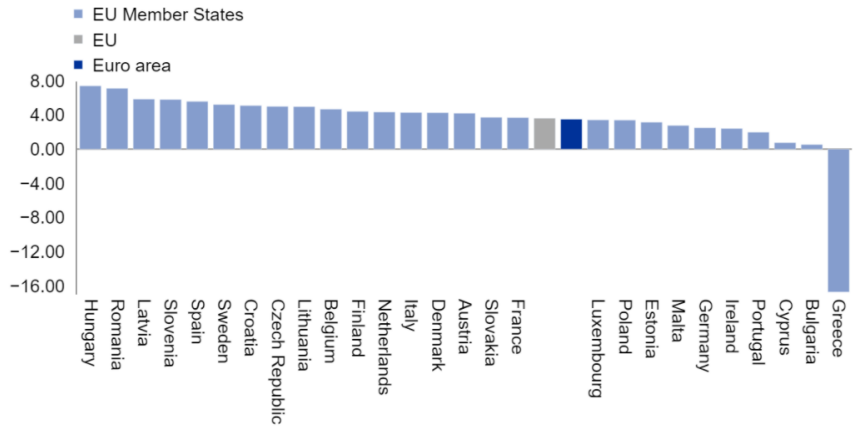


Note: The non-performing loans ratio is defined as the ratio of non-performing loans to total loans.

Chart 3

Return on equity of credit institutions headquartered in the EU in June 2021

(percentages)

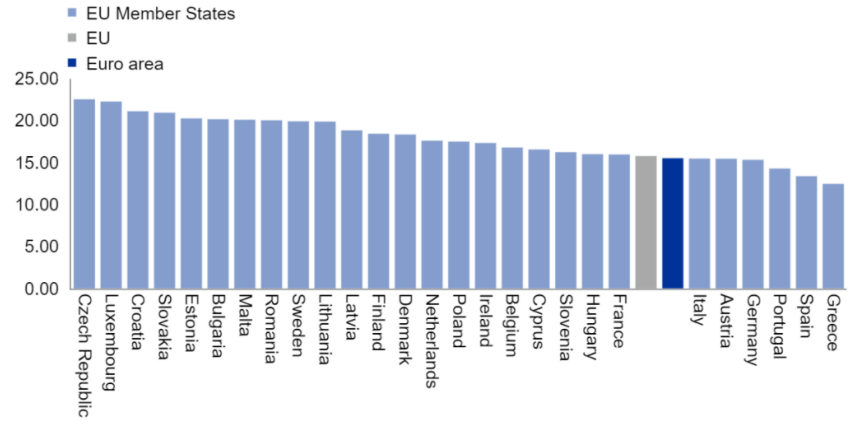


Note: Return on equity is defined as the ratio of total profit (loss) for the year to total equity. The data show the return on equity calculated on the basis of figures for the second quarter of 2021.

Chart 4

Common Equity Tier 1 ratio of credit institutions headquartered in the EU in June 2021

(percentages)



Note: The Common Equity Tier 1 ratio is defined as the ratio of Common Equity Tier 1 capital to the total risk exposure amount.

To read more:
https://www.ecb.europa.eu/press/pr/date/2021/html/ecb.pr211104~53b12e96ac.en.html

The EBA sets examination programme for prudential supervisors for 2022

The European Banking Authority (EBA) published the European Supervisory Examination Programme (ESEP) for 2022, which identifies key topics for supervisory attention across Europe.

The ESEP is aimed at informing prudential supervisors' planning processes and shaping their supervisory practices.

In line with its mandate, the EBA proactively drives the convergence in supervisory practices through the selection of topics deserving European traction based on its expertise in EU-wide risk analysis and policy development, and its role in supervisory colleges.

The practical experience of competent authorities has also been channeled into the examination programme to ensure that the selected key topics indeed reflect the most prevalent supervisory concerns.

The ESEP is also relevant for supervisory colleges as converging practices and methodologies are indispensable in the context of cross-border banking groups.

Five key topics have been identified for supervisory attention for 2022:

- impact of the COVID-19 pandemic on asset quality and adequate provisioning;
- information and communication technology (ICT) security risk and ICT outsourcing risk, risk data aggregation;
- digital transformation and FinTech players;
- environmental, social and governance (ESG) risk; and
- anti-money laundering and countering the financing of terrorism (AML/CFT).

The interaction of the 2022 ESEP with the Union Strategic Supervisory Priorities, the forward-looking considerations, that the EBA is also mandated to set, is also ensured.

The EBA will follow up on how the key topics put forward by the ESEP are:

i) embedded in competent authorities' priorities for 2022 as well as

ii) reflected in their respective activities throughout the year.

The report:

https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1023994/European%20Supervisory%20Examination%20Programme.pdf

1. Impact of the COVID-19 pandemic on asset quality and adequate provisioning

Focus areas:

- **Loans exiting moratoria and concentrations in vulnerable sectors**
- **Potential inadequate developments of estimates or realised IRB parameters**
- **Adequate provisioning and management of NPLs**
- **Role of internal control function**
- **Robust underwriting standards – loan origination practices**

2. ICT security risk and ICT outsourcing risk, risk data aggregation

Focus areas:

- **Cyber risk, cyber testing, security awareness and management**
- **Inherent risks in material outsourced ICT services**
- **Risk data aggregation capabilities**

3. Digital transformation and FinTech players

Focus areas:

- **Digital transformation strategies and the role of the management body**
- **Implementation of the digital transformation strategy**
- **Approach towards innovative FinTech solutions**

Central Banks and Climate: not the only game in town, but more committed than ever

François Villeroy de Galhau, Governor of the Banque de France, Climate Finance Day – Paris, 26th October 2021

BANQUE DE FRANCE
EUROSYSTÈME

Ladies and Gentlemen,

It is always a pleasure to attend this landmark event for sustainable finance. But on the eve of COP 26 opening, climate emergency is such that I owe you more than just another speech.

I see it as my duty both to report the great progress we have made in this area and to set out the enormous challenges that lie ahead: in very concrete and practical terms, what we have achieved since the last Climate Finance Day in October 2020 (I), and what we have to further achieve in the coming year, notably on a better understanding of the macroeconomic effects of climate change (II).

I. Our climate action has accelerated over the past year

I am proud to stress that the Banque de France, and more generally Central banks have never been more committed.

Addressing climate change is part of our missions as supervisor and Central bank: we are acting in the very name of our mandates. Our actions revolve along two axes, as stylised in this quadrant.

Against the vertical axis, as **supervisors**, we have made significant progress to identify and help contain climate-related **risks** born by financial institutions.

The ACPR took a decisive step forward with the very first climate related stress tests, whose results were published in May 2021.

A large number of major banks and insurance companies took part on a voluntary basis. The two key takeaways from this pilot exercise are that

(i) financial risks are better contained in the context of an early and orderly transition to a greener economy,

(ii) all main supervisors should now follow suit, as for instance the ECB and the Bank of England will in spring 2022.

When it comes to climate stress tests, learning by doing is much better than waiting for the perfect solution before taking any action.

On voluntary disclosure of risks, the TCFD increased its footprint; it now has more than 2,600 supporters (a number that has more than doubled since last year), including more than 50 central banks.

The European Union is about to make a significant step forward, as it will implement mandatory disclosure for corporates through a new standard developed by the EFRAG with the Corporate Sustainability Reporting Directive (CSRD), which should hopefully be adopted by mid-2022.

Some might always argue – passionately – that Europe and France never do enough.

Yes we must do more but we should value the reality of action to rhetorical over-bidding. We must avoid discouraging those who are doing the most while excusing those who do the least.

I very much hope we will soon have this mandatory disclosure everywhere.

I welcome the US endeavour here under the sponsorship of the SEC.

Ultimately we need internationally harmonised disclosure frameworks – at least a basic common ground on which jurisdictions can further elaborate.

To this end, interoperability of standards will be key, and the coordination between the EFRAG and the IFRS Foundation, should be the cornerstone of a successful globalisation of non-financial reporting standards.

On financial opportunities (let me turn now to the lower part of the axis), the market momentum has been impressive this year again.

More than half a trillion USD of green bonds will be issued this year, which is an all-time high, with record debut for the EUR 12 bn NextGeneration EU green bond.

Inflows into sustainable funds represented more than USD 262bn in the first half of this year, close to half of the overall inflows (USD 545bn) over the same period.

On the horizontal axis, which brings together our missions as a Central bank, we collectively achieved a major breakthrough last July with the conclusion of the ECB monetary policy strategy review under Christine Lagarde's leadership.

The Banque de France contributed decisively.

The ECB is pioneer in having decided an ambitious action plan by 2024, including the three following steps:

(1) make economic projections, and therefore model. This dimension of economic research is often overlooked: it is nevertheless crucial to grasp complex interdependencies between physical and economic phenomena, across sectors and countries, and across time horizons – I will come back to it;

(2) disclose: impose transparency requirements including on counterparties;

(3) incorporate climate risk, into our operations on corporates (on both asset purchases and collateral policies).

As regards asset purchases, the CSPP should take into account climate-related factors, including the alignment of issuers with the Paris agreement, and will adjust purchases on the primary and secondary markets accordingly.

Moreover, regarding euro-denominated non-monetary portfolios, Eurosystem central banks committed last February to implement sustainable and responsible investment strategies and to report the first results by end of 2022.

Banque de France's policy has been exemplary since 2018 regarding the management of its own funds, whose alignment on a 2° C objective is already effective.

We won't stop there though: we started to exit from non-conventional oil and gas earlier this year, we announced that we are exiting totally from coal by end 2024. We now commit to work toward aligning our own portfolios with a 1.5°C objective.

One additional word about the international context of these developments. Here again, we saw a major improvement this last year with the new American involvement: climate-related issues are now firmly on the agenda of the G20, the G7, the FSB and all other standard setting bodies.

The NGFS, created in Paris in December 2017, is a unique knowledge hub. It now has 95 members, including the US Fed since last December and this number will still grow in coming weeks.

The Banque de France provides its global secretariat with 15 staff, and we created last April our Climate Change Centre chaired by Nathalie Aufauvre.

We are indeed making good progress across the board. But each year that passes without sufficient emission reductions makes the issue more severe, and the solutions more radical.

To grapple with this dynamic situation, it is imperative that we are able to better understand and forecast the macroeconomic impacts of climate developments.

2. An imperative for the year to come: forge models that gauge the interaction between climate and the economy

One aspect of the ECB's action plan launched on the back of the strategy review may have received too little attention: macroeconomic modelling and scenario analyses.

The challenge is huge as we face a triple source of uncertainty: first, how climate change will materialise, second, what the transition could look like and, third, how both will translate to the macroeconomy.

The NGFS has produced detailed macro financial scenarios and the corresponding data that provide the most comprehensive framework to date for financial risk assessment.

To make such scenarios possible, the central banking community – with a strong involvement of Bank of England and Banque de France among others - has collaborated with first tier research institutes in climate science and economic modelling.

This is a huge step forward. Our objective is now to propose a common set of plausible and differentiated futures, built with the best available science and anchored in the last available IPCC results.

Each jurisdiction or region will use them as they want, for their own stress tests and economic simulations, but there is no reason to base them on alternative set of scenarios.

The purpose of the NGFS is to prepare and publish these common macro financial climate scenarios, just as the IPCC does for physical scenarios. Having this common language, instead of numerous local ones, will make our international discussion much easier. To this end, we are considering several significant steps forward.

By next summer, the NGFS scenarios will not only be updated with the latest figures, but also upgraded to align with the new set of comprehensive scenarios to be released in March by the IPCC and to incorporate the more extreme ones.

The NGFS should also work on understanding the impact of climate-related risks on various prices and ultimately on overall inflation.

Scanning the horizon, we can already see that climate change is accelerating, and that some regions are likely to be affected sooner and on a larger scale.

In addition, transition effects might be more front-loaded as they are increasingly anticipated by markets, producers and consumers, which would be good news.

The forthcoming NGFS work should therefore also focus on shorter-term horizons (2030, and not only 2050) as the transition to a low-carbon economy may be less linear than anticipated, with tipping points accelerating the transition in a disorderly way.

[Slide] We generally need to better understand the long-term trade-off, in terms of GDP, between transition and physical risks and the cost of delayed action.

The chart breaks down the GDP losses under three scenarios into the costs of transition and physical damages.

Under the “Paris Agreement” scenario, GDP would be 5% lower in 2060 and around 7% lower in 2100, and most of this reduction can be attributed to transition policies.

Under the two “Too-little too-late” scenarios, the transition costs are limited, but by the end of the century the impact of physical risks becomes much larger, leading to overall losses that could range between at least 10 and 20% of world GDP level.

From an economic and rational standpoint, the prescription is clear-cut: an orderly transition would require a governmental forward-looking guidance, sending long-term signals and anchoring credible but ambitious commitments.

This “climate forward guidance” should include an appropriate pricing of carbon; and as long as we don’t have such global pricing, a carbon border adjustment mechanism (CBAM), as recently put forth by the EU in order to prevent carbon leakage is appropriate.

We all know how politically sensitive these issues are, domestically as well as internationally. But the political scene on climate has already been changing dramatically and it will continue to change - hopefully for the better.

Looking back at how far we have come in developing green finance over the last six years, one may wonder: “Is it useful?” – certainly yes; “Is it enough?” –certainly not.

Let me remind everyone of one simple – and dreadful number: according to the IPCC, we have less than six years of greenhouse gases budget left if we want to have 83% chance to stay below 1.5°C.

Let’s not fool ourselves: we have been making very significant progress to make sure that the financial system is fit to the challenge of the transition. But there is still much work to do on our side, starting with mandatory and harmonised disclosures, and a close monitoring of transition paths.

Still more fundamentally, what we are doing only makes sense if this is part of a wider collective endeavour. Finance, and still more Central banks, cannot be the only green game in town.

A few days ahead of Glasgow, it is the right time to listen to the Pink Floyd again and the Dark Side of the Moon: “And then one day you find ten years have got behind you; no one told you when to run, you missed the starting gun”4. It is not too late yet, but let us hear the starting guns. I thank you for your attention.

To read more:
https://www.banque-france.fr/sites/default/files/medias/documents/discours_20211026_climate-finance-day_en.pdf

Irving Fisher Committee on Central Bank Statistics

IFC Bulletin No 55 - New developments in central bank statistics around the world

BANK FOR INTERNATIONAL SETTLEMENTS

New developments in official statistics – A central banking perspective after Covid-19, Alfonso Rosolia, Silke Stapel-Weber and Bruno Tissot

Executive summary

The experience of central banks has underlined the potential of alternative data sets to deliver statistics that are higher-frequency as well as more timely, flexible and granular than traditional ones.

These are urgently needed to help policymakers follow macroeconomic developments and support policy decisions.

In particular, the new, unconventional sources of information that have emerged with the digital transformation of our societies show a lot of promise (Hammer et al (2017)).

They can cover many realms of the economic and financial sphere that are still difficult to capture through more traditional data collections. And they are potentially available in near real time, facilitating the conduct of economic policy especially in the face of unexpected shocks.

Yet these new data sources can come with huge numbers, multiple formats and high noise-to-signal ratios, making them difficult to use systematically in policymaking and statistical production.

Some of these challenges might be addressed with appropriate engagement rules between public agencies and private data providers; others require further adequate improvement in our statistical and analytical methodological work.

Meeting all these challenges will make life easier for the statistical and policymaking communities.

It's worth noting here that what may at first sight look like an information gap does not necessarily reflect a lack of relevant data, but rather a failure to transform existing indicators into useful knowledge (Drozdova (2017)).

This is even more the case in today's evolving information society: torrents of data are constantly generated, collected and stored by both public and private agents.

This means that perceived information gaps do not necessarily require new reporting exercises, as they may arguably be filled if statisticians and policymakers can quickly tap into existing data that could be turned into useful information, for instance to get timelier or higher-frequency measures of common phenomena or to cover new, unexplored statistical domains.

Introduction

Central banks have an almost unique perspective on official statistics, being at the forefront of both the production and the application of economic and financial data.

On the one hand, they produce statistics on a wide variety of domains, especially the financial system, that are of key relevance for a broad range of economic policymakers.

On the other hand, central banks make extensive use of diverse data sources in pursuing their objectives, especially their monetary policy and financial stability goals.

Both roles demand constant attention to the economic and financial environment and the fitness-for-purpose of statistics and analytical tools and products.

A key challenge is that this environment is constantly changing, which requires the official statistical framework to evolve continuously.

In Japan, for instance, digitalisation has brought new types of service (eg internet advertising) that need to be considered when measuring inflation; this has also called for the development of new types of statistical method at the Bank of Japan, eg to adjust for quality changes.

Moreover, while available statistical products and methods are designed to describe what is known to be relevant to decision-makers, this knowledge is not fixed in time, since new policy issues constantly emerge.

These discontinuities in both the supply of statistics and the demand for them can be substantial, especially when large and unusual shocks occur that expose gaps in economic and financial information.

The vulnerabilities underlying the 2007–09 Great Financial Crisis (GFC), for example, went almost unnoticed by policymakers at first because of the lack of suitable statistics.

However, through swift and globally coordinated action, the most critical data gaps were singled out and action plans designed to address them,

especially via the Data Gaps Initiative (DGI) endorsed by the G20 (FSB and IMF (2009)).

In the decade or so since the GFC, extensive work has been done to close the most pressing data gaps and strengthen the ability to monitor global economic financial developments.

These improvements proved their worth when the pandemic struck: policymakers had at their disposal statistics of a quality and variety that would have been barely possible a few years ago (IFC (2021b)).

The potential of this new information for monitoring risks in the financial and non-financial sector as well as for the analysis of interconnectedness and cross-border spillovers was underlined during the Covid-induced financial markets turmoil in March 2020 (FSB (2020)).

New lessons have emerged from the pandemic. One is the sheer speed of developments during a crisis, underlining the importance of high-frequency, well documented and timely indicators to support evidence-based policy.

This calls for statistical frameworks to become more flexible and granular with the aim of addressing the evolving needs of users and help them monitor fragilities (De Beer and Tissot (2020)).

Another lesson is that the (unexpected) nature of the shock has clearly expanded the range of statistics that central banks must look at.

The unpredictability of the data needs that arise when a shock hits the economy means that instruments and arrangements are needed for the key phenomena to be measured as soon as they become relevant.

A third lesson is that the disruptions caused to the traditional statistical production process, for example, due to the suspension of key surveys, have highlighted the need to look at less conventional and still untapped sources of alternative information (Biancotti et al (2021)).

To read more (506 pages) you may visit:
https://www.bis.org/ifc/publ/ifcb55.pdf

Reflections on Stablecoins and Payments Innovations

Christopher J. Waller, Member Board of Governors of the Federal Reserve System, at "Planning for Surprises, Learning from Crises" - 2021 Financial Stability Conference, cohosted by the Federal Reserve Bank of Cleveland and the Office of Financial Research, Cleveland, Ohio

The U.S. payment system is experiencing a technology-driven revolution.

Shifting consumer preferences and the introduction of new products and services from a wide variety of new entities have led to advancements in payments technology.

This dynamic landscape has also sparked an active policy debate—about the risks these new developments pose, how regulators should address them, and whether the government should offer an alternative of its own.

Earlier this year, I spoke about the last of these questions: whether the Fed should offer a general-purpose central bank digital currency (CBDC) to the American public.

My skepticism about the need for a CBDC, which I still hold, comes in part from the real and rapid innovation taking place in payments.

My argument—simple as it sounds—is that payments innovation, and the competition it brings, is good for consumers.

The market and the public are telling us there is room for improvement in the U.S. payment system.

We should take that message to heart and provide a safe and sound way for those improvements to occur.

My remarks today focus on "stablecoins," the highest-profile example of a new and fast-growing payments technology.

Stablecoins are a type of digital asset designed to maintain a stable value relative to a national currency or other reference assets.

Stablecoins have piggybacked off the recent increase in crypto-asset activity, and their market capitalization has increased almost fivefold in just the past year.

Stablecoins can be thought of in two forms.

Some serve as a "safe, liquid" asset in the decentralized finance, or DeFi, world of crypto-trading.

Examples include Tether and USD Coin.

Alternatively, there are stablecoins that are intended to serve as an instrument for retail payments between consumers and firms.

Although these types of stablecoins have not taken off yet, some firms are working to assess the viability of such stablecoins as a retail payment instrument.

This growth in usage of stablecoins and their potential to serve as a retail payment instrument has prompted regulatory attention, including a new report from the President's Working Group on Financial Markets (PWG).

This report urges the Congress to limit the issuance of "payment stablecoins" to banks and other insured depository institutions.

Fostering responsible payments innovation means setting clear and appropriate rules of the road for everyone to follow.

We know how to handle that task, and we should tackle it head-on.

The PWG report lays out one path to responsible innovation, and I applaud that effort.

However, I also believe there may be others that better promote innovation and competition while still protecting consumers and addressing risks to financial stability.

This is the right time to debate such approaches, and it is important to get them right.

If we do not, these technologies may move to other jurisdictions—posing risks to U.S. markets that we will be much less able to manage.

Stablecoins: What's Old, and What's New

Stablecoin arrangements involve a range of legal and operational structures across a range of distributed ledger networks.

They are a genuinely new product, based on genuinely new technology. But despite the jargon surrounding stablecoins, we can also understand them as a new version of something older and more familiar: the bank deposit.

As I have said before, both the government and the private sector play indispensable roles in the U.S. monetary system.

The Federal Reserve offers both physical "central bank money" to the general public in the form of physical currency and digital "central bank money" to depository institutions in the form of digital accounts.

Commercial banks, in turn, give households and businesses access to "commercial bank money," crediting checking and savings accounts when a customer deposits cash or takes out a loan.

This privately created money serves as a bridge between the central bank and the public.

Commercial bank money is a form of private debt.

The bank issuing that debt promises to honor it at a fixed, one-to-one exchange rate with central bank money.

The bank itself is responsible for keeping that promise. However, the bank is supported in that task by a tried-and-true system of public support.

That includes regulation and supervision, which ensure banks are safe and sound, not taking imprudent risks in their day-to-day business; the availability of discount window credit, which ensures well capitalized banks can meet their emergency liquidity needs; and deposit insurance, which protects consumer deposits if the bank fails.

Put together, those programs leave very little residual risk that a depositor in good standing will ever have to leave the teller empty handed.

They make a bank's redemption promise credible, and they make commercial bank money a near-perfect substitute for cash.

As a result, households and businesses overwhelmingly use commercial bank money for everyday transactions.

This arrangement has many advantages. Small retail customers do not have to spend their time vetting the safety and soundness of their banks—regulators and supervisors do that for them.

Consumers have a safe place to keep their savings and a nearly risk-free way to make payments, which are settled in ultrasafe central bank liabilities.

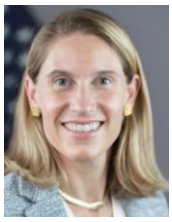
Banks can focus their effort on investments, products, and services from a place of safety and soundness.

Communities and customers benefit from those efforts in the form of more efficient capital allocation and higher-quality, lower-cost financial products.

To read more:
https://www.federalreserve.gov/newsevents/speech/files/waller20211117a.pdf

Controlling Internal Controls

Remarks at the PepsiCo-PwC CPE Conference, SEC Commissioner Caroline A. Crenshaw



Thank you for the kind introduction Kevin [Gould]. It's a pleasure to be here today at the annual PepsiCo-PwC CPE conference, which I understand is a tradition going back 18 years now. I appreciate the opportunity to speak, and I look forward to answering your questions today.

It's not often—even in this job—that I find myself speaking before such a large group of controllers, accountants and other finance professionals of public companies. And I welcome it because it means we can get a bit more technical and talk about financial reporting issues.

I suspect many of you will not be surprised that Kevin and his team have shared with me that ESG is top of mind for this group. I understand there is an interest in hearing what ESG means to the SEC and what ESG regulations are on the horizon. It's a big question, and spoiler alert – I cannot speak for the Commission and tell you what is to come.

I have to caveat my statements today with the standard disclaimer that any views I express today are my own and do not reflect the views of my fellow Commissioners, the Commission or its staff. But I am an U.S. Army reservist, and the Soldier in me truly appreciates your commitment to readiness. So even though I cannot speak for the Commission, today I will discuss how I have been thinking about ESG in the public issuer context.

I. ESG Risks Facing Today's Investors & Public Companies

ESG is not a monolithic concept. As you know, it generally refers to environmental, social and governance risks, and these are some of the most pressing issues companies are facing.

In March of this year, the Commission sought public comment on climate change disclosure.

We received hundreds of responses; many of which also addressed disclosures concerning other ESG risks.
An overwhelming number of comment letters state that investors view ESG information as material to financial performance and that investors need

consistent and reliable disclosures of ESG information to inform their investment decisions.

According to commenters, ESG related information helps investors assess the long-term sustainability or value of an investment.

And this makes sense if you think about the position investors are in today. Many Americans are no longer able to rely on defined-benefit retirement plans.

They must, instead, rely on themselves in order to save for their children's education or for their own retirement. And they must, in doing so, take on the risks associated with managing the money themselves.

Investors increasingly need to consider how companies will "weather" over a longer time horizon when making investment decisions.

That requires looking at the risks today's companies face and analyzing how these risks will impact future financial performance.

With ESG now front and center, the reliability of corporate ESG risk disclosures, and their potential impact on and connectivity to financial statements, is critical. As you know, corporate internal controls play a crucial role in ensuring such risk disclosures are consistent and reliable.

The term "internal accounting controls" refers to an organization's plan, methods, and procedures related to safeguarding a company's assets and ensuring the reliability of corporate financial records.

These controls broadly include systems designed to ensure transactions are authorized and recorded in a way that maintains accountability for assets and allows for financial statement preparation in conformity with GAAP.

They also include procedures that control access to assets and the systems designed to test the effectiveness of internal controls.

The concept of accounting controls is intentionally broad, because a company's system for tracking its assets and recording transactions – regardless of their form – is vital to accurate financial reporting.

And it is vital to identifying risks to the financial statements so leadership can manage them and prepare GAAP-compliant financial statements and disclosures accordingly.

At the end of the day, management is responsible for establishing and maintaining an effective system of internal controls that reasonably safeguards corporate assets from risk.

So as you think about and discuss ESG risks during this conference, I encourage you to think about them in the context of your internal accounting controls and audit functions.

II. Internal Accounting Controls and ESG Risks

To best serve their function, internal accounting controls must be dynamic enough to consider and respond to changes in the markets, such as those posed by ESG issues.

Companies have to evolve over time because the market place is constantly changing in response to new developments and challenges.

These changes can be prompted by new technology, developments in the global economy, or even by our planet.

Change drives innovation for not just corporate America, but investors, consumers and citizens.

Change can be a good thing. But as markets change, so do the risks that can impact a company's financial statements.

Corporate internal accounting controls must evolve as well. Although these are relatively technical matters often thought of as within the remit of accounting and legal professionals of a specific company, I am regularly reminded that, in the aggregate, these details matter to all Americans.

These details impact the companies whose aggregate financial performance undergirds the retirement savings of tens of millions of workers, and retirees.

To read more:
https://www.sec.gov/news/speech/crenshaw-controlling-internal-controls-20211116

Driving different decisions today: putting climate scenarios into action

Sarah Breeden, at the MIT Golub Center for Finance and Policy 8th Annual Conference

Sarah Breeden speaks about the system-wide and economy-wide impacts of climate change, using insights from the most recent work we have led through the central banks and supervisors Network for Greening the Financial System (NGFS) on climate scenarios.

She shares lessons we have learned from designing and applying climate scenarios, as well as some thoughts on their future, including the vital contribution research needs to make.

Introduction

We are now only 11 days away from COP26 in Glasgow.

Climate science tells us that the planet has already warmed by about 1.1 degree Celsius since pre-industrial times.

Indeed, the news is full of the devastating effects of physical changes already taking place around us. And existing commitments from countries to reduce greenhouse gas emissions are not enough to keep warming to well below 2 degrees, let alone 1.5.

The United Nations Intergovernmental Panel on Climate Change (IPCC) estimates we will reach 1.5 degrees by 2040 even under their 'very low emissions' scenario.

Failure to formulate more ambitious commitments and deliver against them this decade will mean we miss the last opportunity significantly to deter the course of climate change.

The case for action is clear - the question is whether our actions will match that case, in particular whether we turn aspiration into action on the scale required. Delivering a path to net zero requires all of us to take necessary steps – governments and business, investors and individuals, as well as central banks and financial regulators.

Here at the Bank of England, we have taken a range of actions in line with our objectives – including setting expectations for banks and insurance

companies on their approaches to managing climate-related financial risks, running a system wide climate scenario exercise, and setting out how to green our corporate bond purchase scheme – to play our part in the transition to a net zero economy.

Through all this work, one thing has become abundantly clear – that the actions we take today will determine the consequences we face in the years to come. And so if we are to take the right decisions, we must stretch our horizons, taking different decisions today well before the consequences of inaction manifest at scale.

This needs to occur across the entire economy. And the financial system needs to be a key enabler. As central bank and financial regulator, these implications put climate change squarely within our remit.

We cannot solve climate change and drive the transition – those with the responsibility and tools to do this sit elsewhere in government and industry. But we must ensure that the financial system is resilient to climate-related financial risks, that it can support the transition, and that we understand its macroeconomic impacts.

Today, I want to speak specifically on the system-wide and economy-wide impacts of climate change, using insights from the most recent work we have done on climate scenarios through the central banks and supervisors Network for Greening the Financial System (NGFS).

I will cover three things: first, lessons we've learned from designing climate scenarios; second, lessons we've learned from applying them; and third, I will share some thoughts on the future of scenario analysis – including the vital contribution research needs to make.

To read more:
https://www.bankofengland.co.uk/speech/2021/october/sarah-breeden-keynote-presentation-at-the-mit

The Lack of New Bank Formations is a Significant Issue for the Banking Industry

Governor Michelle W. Bowman, at the 2021 Community Bankers Symposium: Banking on the Future, Federal Reserve Bank of Chicago, Chicago, Illinois

Good morning. I appreciate the opportunity to be part of this symposium on "Banking on the Future," especially since the future of banking is one of the highest priorities in my work at the Board.

Today, I will focus my remarks on the importance of community banks to our financial system and the challenges they face. In particular, I will focus on the formation of new banks and pose two key questions concerning the recent scarcity of these "de novo" banks.

The first question: Why have there been so few de novo bank formations over the last decade? And second, what can be done to encourage more de novo banks? I will begin with some background on community banks and bank formations.

The Importance of Community Banks

By serving communities, households, and businesses that may be underserved by larger institutions, community banks play a key role in advancing diversification in the U.S. banking system.

First and foremost, community banks provide critical financial services to their communities and to many customers who might have limited geographic access to banking services.

Because community bankers are active participants and leaders in their communities, they typically know their customers and their needs better than a banker at a branch of a larger institution.

Community banks draw upon this knowledge and conduct "relationship" lending versus relying on automated underwriting models that are typical in larger institutions.

Therefore, community banks are more willing to underwrite loans to creditworthy customers based on an assessment of qualitative factors that automated models do not consider.

Since community bankers are part of the fabric of their communities, they better understand the local market and economic conditions in the area compared to larger institutions that are not resident within the community.

Collectively, community banks are critical in advancing the health and stability of the U.S. economy as evidenced by their participation in the Small Business Administration's Paycheck Protection Program (PPP). Community banks made 4.7 million PPP loans, totaling $429 billion, which accounted for nearly 60 percent of the program's total loan amount.

In comparison with the banking industry as a whole, these banks provided more loans to traditionally underserved communities and population segments: community banks provided 87 percent of total PPP loans to minority-owned businesses, 81 percent to women-owned businesses, and 69 percent to veteran-owned businesses.

Trends in Community Banking

Despite the local and national significance of community banks, their numbers, as well as the number of insured banks in general, have been declining for several years.

This erosion of community bank charters is not just an issue in our rural communities. In urban areas, these banks, including minority-owned banks, serve businesses and households that may also be overlooked by larger institutions.

I am concerned that the contraction of community banks could lead to an unhealthy level of similarity in the banking system. As a result, this could limit the ability of households and small businesses to access credit and other types of financial products and services.

The beauty of community banks is in their differences—whether in their personality or business model. Each is unique in its mission, service delivery, and profile.

While I am troubled by the declining community bank footprint, I am not surprised that banks are choosing to merge or to be acquired. I am well aware of the significant challenges that smaller banks face. Since joining the Board, and increasingly over the past year, I have met with many state member bank CEOs who share these challenges with me.

These CEOs have expressed frustrations with ever-increasing compliance burden, which distracts their attention from prudent revenue generating activities.

As I discussed in recent remarks at the community bank research conference in late September, public policymakers must avoid adding regulatory burden on the smallest banks, particularly on those that maintain a more traditional business model.

Therefore, policymakers need to achieve a meaningful balance in our supervisory approach for community banks. Otherwise, community banks will continue to face a regulatory and supervisory framework that is ill-suited for a lower-risk profile and activities that are less complex than those of larger institutions.

Why Have There Been So Few De Novo Bank Formations over the Last Decade?

The underlying question remains: why have there been so few de novo bank formations over the last decade?

There have been only a handful of new bank charter applications over the past decade. In fact, only 44 de novo banks have been established, which include both state and national charters. A 2014 study by Federal Reserve Board economists noted that from 1990 to 2008, over 2,000 new banks were formed, which on average is more than 100 per year.

In contrast, the study noted that only seven new banks were formed from 2009 to 2013. The 2014 Board study suggests that "low interest rates and depressed demand for banking services—both of which depress profit for banks, and particularly new banks—may also have discouraged entry."

The conclusions from a Federal Reserve Bank of Kansas City study completed this year align with observations from the 2014 Board study. In this more recent study, the authors noted that new bank formations tend to be cyclical, accelerating during periods of economic expansion and slowing during recessions.

While regulatory burden has also contributed to depressed de novo formations, the authors pointed to the weak economy following the 2007-2009 financial crisis and low profitability for banking as overriding factors.

A recurring theme that has surfaced through my discussions with bankers and other industry stakeholders is the regulatory burden imposed upon de novo banks. In particular, community bankers noted the challenges in raising the capital required to establish a new bank.

The 2014 Board study noted that the states' statutory capital requirements for a new state-chartered bank could be as low as $10 million, but in practice could be as high as $30 million.

Given the high initial capital requirement, a de novo bank has a small margin of error in implementing its business strategy and meeting profit projections.

In establishing a new bank, bank executives explained the challenges in developing a business plan and risk-management framework that addresses how the bank can generate a sufficient profit to provide an adequate return to shareholders.

For a de novo bank, the cost and burden of starting from ground zero in establishing their risk-management and internal controls are high. De novo banks make strategic decisions in establishing risk-management processes and controls that may delay the launch of revenue-generating products and services.

Further, a de novo bank faces the pressure to grow quickly, which in turn, may lead to riskier lending and other activities. Indeed, experience has shown that pronounced problems often surface in the early years of a de novo bank's operations, which explains the elevated capital and supervisory expectations for these banks.

The Federal Reserve and the other banking agencies generally expect a de novo bank to maintain a Tier 1 leverage ratio of at least 8 percent for the first three years of its existence and they examine the bank on a more frequent schedule.

For a de novo bank, there is a heightened need to hire experienced staff who are quickly able to establish the bank and show progress in meeting the operating goals and profit projections in the business plan.

As we all know, difficulty in finding skilled workers is an issue more broadly in the economy, but community bankers frequently tell me of their ongoing challenges in attracting and retaining experienced staff.

These challenges are even more acute for de novo banks who require staff with experience in regulatory compliance and internal controls.

A Kansas City Reserve Banks study echoes these anecdotes, which indicate that the volume and complexity of regulations require specialized expertise that can be costly and difficult to find.

The competitive landscape for financial services and products is also a key consideration in developing and executing a de novo bank's business plan. I often hear the perspective from bankers that non-regulated financial entities have a competitive advantage over regulated financial institutions in providing financial services and products.

It would be helpful to appropriately acknowledge this competitive disadvantage for banks and tailor the regulatory framework based on the risks and complexity of their activities.

As a result, the economic, regulatory, and market realities discourage the formation of de novo banks, as investors have many other options for entry into the financial services market.

For example, they may choose to acquire an existing bank charter and subsequently establish branches in new markets. Further, they can acquire a branch office from an existing bank. And finally, they may choose to establish or acquire a nonbank financial firm that is subject to less regulation than a chartered and insured financial institution.

What Can Be Done to Encourage More De Novo Banks?

So, let's address the second question: what can be done to encourage more de novo banks?

Simply the fact that I am speaking about this topic today should give you the sense that I am concerned about the impact of the declining number of community banks. While the loss of a single community bank may be inconsequential to U.S. financial stability, that loss may have profound consequences to households and businesses in that community.

This is particularly true in rural communities and remote areas and in certain urban areas when the loss of the local bank may leave customers in a banking desert, void of tangible, relationship-based financial services.

But we should also be concerned about how a continued decline in the number of community banks, in part due to the lack of de novo formations, will affect the banking and financial services system more broadly. When banking services are limited, it is much more difficult for people to fully participate in the economy, or to manage their finances when times are tough. A shrinking community bank sector may lead to a weaker banking system and weaker economy.

It is crucial to provide a balanced, transparent, and effective regulatory framework that promotes a vibrant community bank sector.

Public policymakers need to ensure that the regulatory and supervisory framework promotes safety and soundness, while recognizing the reduced risk of these banks' noncomplex services and activities.

As large institutions and nonregulated financial companies expand their reach into markets traditionally served by community banks, policymakers

need to ensure that the regulatory and supervisory framework does not exacerbate this competitive disadvantage.

If we are not able to achieve an appropriate balance, I am concerned that there will continue to be fewer de novo banks as well as a decline in the overall population of community banks.

These banks are a key segment of the industry in that they provide financial services and products to a wide range of consumers and businesses.

Looking to the future, policymakers need to appropriately refine the regulatory and supervisory framework to minimize unnecessary compliance costs for smaller banks and address impediments to bank formations.

Closing

In conclusion, I have raised two important questions about why there so few de novo banks and what can be done to encourage new bank formations.

It is important for us to fully understand why we have seen the steady decline in bank formations, and to continue to explore ways to encourage community banks in such a competitive environment.

Identifying answers to these questions should enable the federal banking agencies to identify potential regulatory and policy constraints on the formation of new banks.

To further this effort, I have asked Federal Reserve staff to continue to study trends in community banking so that we can fully understand the economic and regulatory factors that constrain the ability of community banks to form, compete, and thrive.

I appreciate the opportunity to raise these questions with you. And I look forward to further discussions about tailoring our regulatory and supervisory framework to ensure that community banks remain an essential part of the future of the U.S. financial system.

BaFin amends its BAIT

In the current amendment to the BAIT, BaFin clarifies its expectations for IT and information security at banks.
Thorsten Sämisch, BaFin IT Supervision Group

On 16 August 2021, BaFin published the new version of its BAIT, the Supervisory Requirements for IT in Financial Institutions. The amendment came into force on the same date.

BaFin is using this amendment to set out the overall conditions it now expects for secure information processing and information technology.

There are no transitional periods because BaFin is not imposing any fundamental new requirements, but has clarified existing requirements.

Background to the amendment

Guidelines issued by the European Banking Authority (EBA) in November 2019 form part of the backdrop to the BAIT amendment. You may visit: https://www.eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-ict-and-security-risk-management

In its Guidelines on ICT and security risk management (EBA/GL/2019/04), the EBA had previously responded to the European Commission's FinTech action plan and introduced standardised requirements for the entire single market: for credit institutions, investment firms and payment service providers.

The EBA thus established the corresponding framework for the supervisory practice of the national competent authorities.

Together with the Deutsche Bundesbank, BaFin then examined whether, and to what extent, the BAIT would have to be supplemented and adapted. Experience gained from supervisory practice was also expected to be incorporated into the work.

The IT expert committee, whose members are representatives of the trade associations of the banking sector, smaller and larger institutions, as well as BaFin and Bundesbank staff, was also closely involved in the amendment. The Federal Ministry of Finance also participated.

A public consultation on the BAIT amendment was launched in autumn 2020.

Because the content of the BAIT builds on the Minimum Requirements for Risk Management (MaRisk) , the BAIT amendment was developed in parallel with the sixth amendment to MaRisk, and both circulars were published at the same time.

Significant amendments

Even though there were no fundamental changes, some parts of the BAIT were expanded and adapted.

In the new "Operational information security" chapter, for example, BaFin sets out requirements for the design of effectiveness controls of information security measures that have already been implemented in the shape of tests and exercises.

Such effectiveness controls, for example gap analysis, vulnerability scans, penetration tests and simulated attacks, are a key element of any effective, sustainable information security management system.

The institutions must verify the security of the IT systems regularly and on an event-driven basis. They must avoid conflicts of interest when they do so: for example, anybody involved in planning and implementing security measures cannot subsequently test them.

The institutions have to analyse the results of such effectiveness controls, identify any need for improvement and manage risks appropriately.

The institutions are expected to document the new requirements in an internal policy that BaFin now calls for in the "Information security management" chapter.

This chapter also contains requirements relating to logging and monitoring, in other words recording results and real-time monitoring, as well as the identification and analysis of security-related events.

For example, potentially security-related information must be evaluated suitably promptly, using a rule-based approach, and must be held available for an appropriate period for subsequent evaluation.

To do this, a portfolio of rules for identifying security-related events must be defined and updated.

The expanded AT 7.3 "Contingency management" in the new MaRisk forms the basis for the new BAIT chapter "IT contingency management".

It stipulates the establishment of restart, emergency operation and recovery plans for time-critical processes and activities.

According to the BAIT, the institutions must verify annually that these three types of IT contingency plan are effective – based on an IT testing concept.

The new third chapter in the BAIT is called "Managing relationships with payment service users".

It is taken from the new circular "Supervisory Requirements for IT in Payment Services and Electronic Money Institutions" (ZAIT). Its content is also relevant for large parts of the BAIT target group.

Information security instead of IT security

It was also important for BaFin and the Deutsche Bundesbank to follow the objective of "information security" in the BAIT and not the – narrower – objective of "IT security".

Traditional IT security is limited to the field of information technology, whereas information security aims to protect relevant information, regardless of the form it takes. The area of information security therefore encompasses everything related to information processing.

In the context of information security and information risk management (ISM/IRM), it is now spelled out more clearly that the business processes concerned must take effect across the entire organisation, and that it is not enough to provide adequate resources to IT operations and application development alone.

The BAIT requirements now clarify, for example, that the institutions must develop a comprehensive training and awareness programme for their staff on the topic of information security.

The BAIT reflect the requirement in the EBA guidelines referred to earlier for a clear allocation of responsibilities by designating additional roles and tasks of information security and information risk management and differentiating them from responsibilities for business processes.

Among other things, the organisational units that are responsible for the individual business processes are responsible for determining and documenting the protection requirements of the relevant processes. By contrast, information risk management is responsible for verifying this determination and documentation.

In light of the complexity of cyber threats, the BAIT now expressly emphasise how important it is for institutions to keep themselves informed about current external and internal threats and vulnerabilities, and to

notify the management board about the risk analysis and changes in the risk situation.

The BAIT chapter "Information risk management" now clarifies that threats and vulnerabilities must also be taken into account by information risk management if they could pose risks to the organisation.

Several BAIT chapters address requirements for physical security, as described in the EBA guidelines.

For example, the institutions must develop a physical security policy, implement physical access controls and establish an adequate perimeter protection using state-of-the-art technology. Perimeter protection means protecting the area between the building and the property boundary.

To read more:
https://www.bafin.de/SharedDocs/Veroeffentlichungen/EN/Fachartikel/2021/fa_bj_2108_BAIT_en.html

Fiscal Year 2022, Bank Supervision Operating Plan

Office of the Comptroller of the Currency, Committee on Bank Supervision

The Office of the Comptroller of the Currency's (OCC) Committee on Bank Supervision (CBS) strategy planning guidance sets forth the agency's supervision priorities and objectives.

The agency's fiscal year (FY) for 2022 begins October 1, 2021, and ends September 30, 2022.

The FY 2022 Bank Supervision Strategy Planning Guidance outlines the OCC's supervision priorities and aligns with "The OCC's Strategic Plan, Fiscal Years 2019–2023" and the National Risk Committee's (NRC) priorities.

The strategy planning guidance facilitates the development of supervisory strategies for individual national banks, federal savings associations, federal branches, and agencies of foreign banking organizations (collectively, banks), as well as identified service providers.

CBS managers and staff will use this plan to guide their supervisory priorities, planning, and resource allocations for FY 2022.

Priority Objectives for CBS Operating Units

The FY 2022 strategy planning guidance and the FY 2022 Bank Supervision Operating Plan establish priority objectives across the CBS operating units.

CBS operating units and managers should use this guidance to develop and execute individual operating unit plans and risk-focused bank supervisory strategies.

While the objectives are similar for the Large Bank Supervision and Midsize and Community Bank Supervision, CBS managers will differentiate bank size, complexity, and risk profile when developing individual bank supervisory strategies.

CBS operating plans include resources and support for risk-focused examinations of technology and significant service providers that provide critical processing and services to banks.
The OCC will adjust supervisory strategies, as appropriate, during the fiscal year in response to emerging risks and supervisory priorities.

For FY 2022, supervision will focus on the impacts of the pandemic and resulting economic, financial, operational, and compliance implications.

In addition to the baseline supervision to assign ratings, examiners will focus on the safety and soundness of strategic and operational planning, including:

• **Guarding against complacency:** Examiners should focus on strategic and operational planning to ensure banks maintain stable financial positions, especially regarding capital, the allowances for credit losses, management of net interest margins, and earnings.

Examiners should ensure banks remain vigilant when considering growth and new profit opportunities and will assess management's and the board's understanding of the impact of new activities on the bank's financial performance, strategic planning process, and risk profile.

• **Credit:** Examiners should evaluate banks' actions to manage credit risk given changes in market condition, termination of pandemic-related forbearance, uncertainties in the economy, and the lasting impacts of the COVID-19 pandemic.

Supervisory focus should ensure that risk management functions are providing an appropriate credible challenge. Examiners will evaluate underwriting practices on new or renewed loans for easing in structure and terms. Reviews will focus on new products, areas of highest growth, or portfolios that represent concentrations.

Supervisory focus should include those portfolios hard hit by the pandemic that may experience amplified impacts from changes in market conditions.

• **Allowance for loan and lease losses (ALLL)/allowance for credit losses (ACL):** For all banks, examiners should focus on ALLL and ACL adequacy considering any stress on credit portfolios.

U.S. Securities and Exchange Commission (SEC) filers, except small reporting companies as defined by the SEC, were required to adopt the current expected credit losses (CECL) accounting standard in 2020 but could delay adoption until 2022.

All other banks are required to implement CECL by 2023. For banks that have not yet adopted CECL, examiners should evaluate preparedness, including bank implementation plans and use of third parties to assist in the development of the loss estimation methodology, modeling techniques, and management information systems.

Additional impacts may include post-hardship performance of borrowers assisted with streamlined deferral and loan modifications.

For banks that have adopted CECL, examiners should evaluate the effectiveness of the methodology at estimating lifetime expected credit losses.

• **Cybersecurity:** Operational risk, resilience, incident response, and data recovery and business resumption should be supervisory focal points. Examinations should assess the bank's capabilities to recover from destructive malware attacks.

Examinations should emphasize threat vulnerability and detection, authentication and access controls, network management, data management, and managing third-party access.

Examiners should perform assessments of internal controls and operational processes that changed during the pandemic.

• **Third parties and related concentrations:** Examiners should determine whether banks are providing proper oversight of their significant third-party relationships, including partnerships.

Examiners should identify where those relationships are critical to bank operations and understand whether they represent significant concentrations or impact resiliency.

Examiners should also be aware of the cyber-related risks emanating from third parties and evaluate the bank assessments of the third party's cybersecurity risk management and resilience capabilities.

• **Bank Secrecy Act, consumer compliance, and fair lending:**

- **BSA/AML and Office of Foreign Assets Control:** Strategies should continue to focus on BSA/AML compliance, with emphasis on evaluating the effectiveness of BSA/AML risk management systems relative to the complexity of business models, products and services offered, and customers and geographies served; evaluating technology and modeling solutions to perform or enhance BSA/AML oversight functions; and determining the adequacy of suspicious activity monitoring and reporting systems and processes in providing meaningful information to law enforcement.

  Examiners should also begin to assess bank change management plans for implementing changes to existing BSA/AML compliance programs that will be required regulatory changes to implement the Anti-Money Laundering Act of 2020.

- **Consumer compliance:** Examiners should focus on compliance management systems, including third-party risk management and higher risk products and services such as overdraft protection programs, particularly focusing on how the programs are implemented and how terms of the programs are disclosed.

  Examiners should consider the effect that earnings pressure has had on banks, monitoring the effect that may have had on the compliance risk management functions, if any, through cutting personnel or waiving audits.

- **Fair lending:** Examiners should focus on assessing fair lending risk, considering changes to the bank's products, services, and operating environments.

  These should be based upon the bank's fair lending risk profile and the annual Home Mortgage Disclosure Act data screening process. Fair lending supervision activities should consider the full lifecycle of credit products (e.g., mortgages).

- **CRA:** OCC Bulletin 2020-99, "Community Reinvestment Act: Key Provisions of the June 2020 CRA Rule and Frequently Asked Questions," provides updated guidance following issuance of the OCC's June 2020 rule.

  Examiners should be familiar with this set of policies and procedures and plan accordingly for examinations that cover calendar years before and during the time that the 2020 rule is in effect.

  In addition, the OCC has proposed to rescind the June 2020 rule and replace it with rules largely like the 1995 CRA rules. Examiners should plan on additional training on these rule changes and to incorporate new CRA policy or process guidance issued during FY2022.

• **Interest rate risk:** Examiners should assess the impact of a low-rate environment on banks' business models, strategies, asset and liability risk exposures, net interest margin, funding stability, and modeling capabilities.

• **London Interbank Offered Rate (LIBOR):** Examiners should evaluate each bank's implementation and execution of alternative reference rates given the December 30, 2021, cessation of LIBOR.

Banks should fully understand all their exposures and be nearly complete with remediation efforts. Examiners should evaluate operational, reputation, and consumer impact assessments and change management related to an alternative index for pricing loans, deposits, and other products and services.

• **Payments:** Examiners should evaluate payment systems products and services that banks offer or plan to offer, with a focus on new or novel products, services, or channels for wholesale and retail customer relationships.

Examiners should consider potential risks including operational, compliance, strategic, credit, and reputation and how these risks are incorporated into institution-wide risk assessments and new product review processes, if applicable.

• **Fintech/Cryptocurrency:** Examiners should identify banks that are implementing significant changes in their operations using new technological innovations and evaluate implementation, including use of cloud computing, artificial intelligence, and digitalization in the risk management processes.

Examiners should evaluate the appropriateness of governance processes when banks undertake significant changes.

• **Climate:** The OCC is working to better understand how the financial risks associated with climate change may affect the safety and soundness of institutions including their ability to serve all parts of their communities.

During FY2022, the agency will continue information gathering efforts and plan on conducting additional industry outreach.

At the largest banks, examiners should focus on establishing a baseline understanding of the effects of physical and transition risks including the development of climate risk management frameworks and governance processes.

Resources should focus on significant risks in FY2022 while considering appropriate coverage of other areas. Strategies should focus on control functions and leverage the institutions' audit, loan review, and risk management processes when the OCC has validated reliability.
To facilitate an agency-wide view of risk on selected topics, the CBS operating units will prioritize and coordinate resources and conduct horizontal risk assessments during the fiscal year. The CBS may direct horizontal assessments during the supervisory cycle.

The OCC will provide periodic updates about supervisory priorities, emerging risks, and horizontal risk assessments in the Semiannual Risk Perspective report.

Transforming risk culture: observations from APRA's pilot survey

- APRA's risk culture survey is internationally leading regulatory practice that expands its supervisory toolkit to transform risk culture.

- Survey results provide a unique employee view of the risk management practices and behaviours in an entity.

- APRA will benchmark up to 60 more entities in the next 12 months, and will share additional insights with industry.

A strong risk culture is essential for effective risk management outcomes that support an organisation's financial and operational resilience.

Ultimately, organisations with a strong risk culture that supports sound risk management practices and behaviours are better placed in terms of financial performance and fair, quality outcomes for their customers.

Under Prudential Standard CPS 220 Risk Management, the boards of APRA-regulated entities are required to form a view of the risk culture in the institution that they govern, and identify any desirable changes to the risk culture necessary to ensure that culture supports the ability of the institution to operate consistently within its risk appetite.

APRA aims to reinforce, support and assess the work regulated entities are doing to build and maintain an effective risk culture. To this end, APRA has introduced an industry-wide risk culture survey recently piloted with 10 general insurance entities.

The survey is a key initiative that supports APRA's expanded supervisory toolkit designed to transform governance, risk culture, remuneration and accountability (GCRA) practices across regulated entities.

APRA's pilot risk culture survey, conducted between March and April 2021, provides insights from employees on perceived risk behaviours and the effectiveness of the risk management structures within their entities.

The responses, over time, will determine the extent to which positive changes to risk culture are (or are not) taking place within individual entities, and correspondingly, will identify areas where an entity's risk culture can be improved.

The survey also provides the opportunity to benchmark results across a number of regulated entities within an industry sector (for example,

insurance), providing an opportunity for entity leaders and APRA supervisors to understand how the entity's results compare to others in its peer group.

APRA is one of the only regulatory bodies worldwide that directly collects survey data at an industry level, so APRA's risk culture survey represents internationally leading regulatory practice.

What is risk culture?

Risk culture refers to an entity's attitudes and behaviours towards risk management. Specifically, it is the behavioural norms and practices of individuals and groups that shape an entity's ability to identify, understand, openly discuss, escalate and act on its current and emerging risks.

A strong risk culture creates an environment where employees are comfortable speaking up and voicing concerns with their leaders. It produces better decisions by ensuring a broader range of views are considered, and allows ideas that present heightened risks to be appropriately challenged during decision-making.

It incentivises boards and senior executives to prioritise effective risk management. In doing these things, a strong risk culture helps to deliver better business and customer outcomes for organisations. APRA is committed to enhancing and reinforcing a strong risk culture across all regulated entities.

In particular, an entity's risk culture is influenced and shaped by two key aspects:

- *Risk behaviours:* the observable actions and behaviours of individuals and groups (for example, role modelling, operating practices and symbols, such as discussion of risk management as a standing agenda item in team meetings), and

- *Risk architecture:* the formal structures and arrangements that support the management of risks (for example, systems, policies, procedures and governance structures).

APRA's Risk Culture 10 Dimensions

APRA has developed a framework called the Risk Culture 10 Dimensions to assess the risk culture of regulated entities. The Risk Culture 10 Dimensions articulate the key aspects of an entity's risk behaviours and risk architecture that contribute to its risk culture. Each of the survey questions in the pilot (approximately 40) aligned with one of APRA's Risk Culture 10 Dimensions.

The Risk Culture 10 Dimensions – coupled with the survey results – allow APRA to access comparable data in a consistent way across regulated entities in order to assess and benchmark risk culture.

Figure 1: APRA's Risk Culture 10 Dimensions

APRA's Risk Culture 10 Dimensions is not a prescriptive framework, and APRA does not expect entities to adopt it. While the 10 Dimensions framework provides insights into how APRA assesses risk culture, an entity should have a risk culture framework that fits its own particular circumstances (such as its size and complexity).

This framework should allow an entity to measure, monitor and report on its risk culture in a consistent and meaningful way.

To read more:
https://www.apra.gov.au/transforming-risk-culture-observations-from-apra%E2%80%99s-pilot-survey

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