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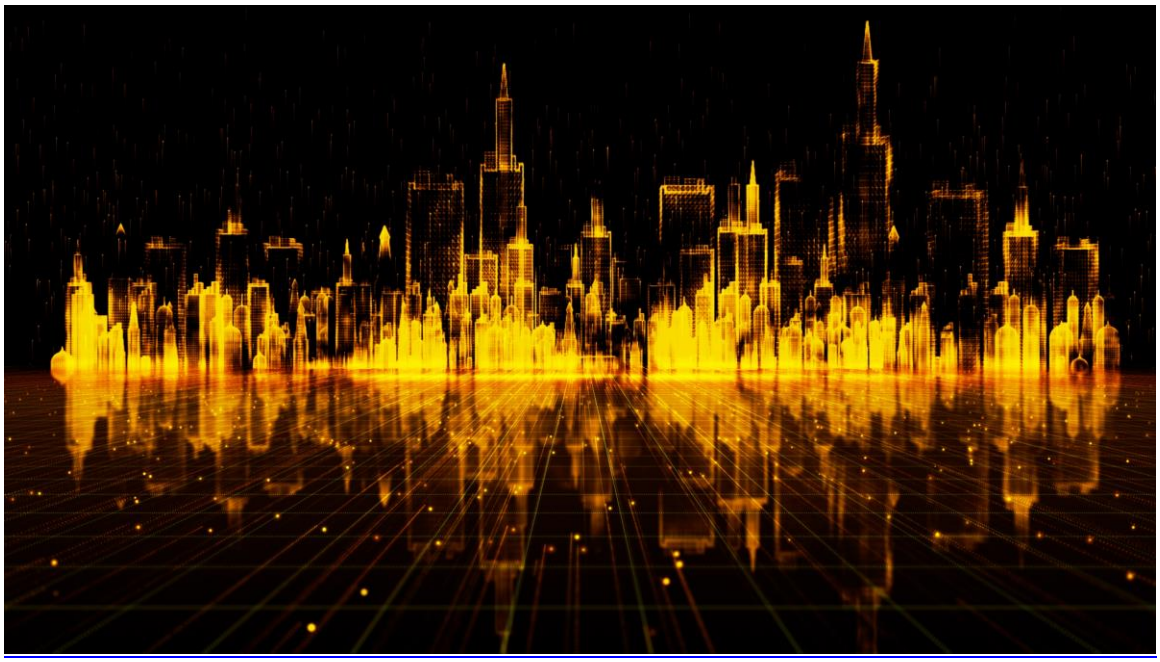


Basel iii News, October 2022

Dear members and friends,

The Group of Central Bank Governors and Heads of Supervision (GHOS), the oversight body of the Basel Committee on Banking Supervision, reaffirmed its expectations on implementing Basel III and to provide direction on key areas of work by the Committee.

- The Basel Committee's oversight body reiterates its expectation to implement all aspects of the Basel Framework consistently and as fast as possible.

- Provides direction to the Basel Committee on its work on *climate-related financial risks and cryptoassets*.

- Reviews the Committee's work programme and reaffirms the importance of a stable regulatory framework to facilitate implementation.

The resurgence of inflation in many jurisdictions, coupled with a deteriorating macroeconomic outlook and tighter financial conditions, may expose vulnerabilities accumulated in the financial system.

While the global banking system has remained broadly resilient to date, thanks in part to the Basel III reforms implemented after the Great Financial Crisis, GHOS members underlined the importance of banks and supervisors continuing to closely monitor, assess and mitigate emerging risks and vulnerabilities.

The unwinding of public support measures – which were critical in shielding banks from losses over the past two years – places greater importance on the resilience of the banking sector to absorb potential shocks.

Basel III implementation

Against that backdrop, GHOS members took stock of the implementation status of the outstanding Basel III reforms.

These standards, finalised in 2017, seek to strengthen the resilience of bank capital by addressing some of the weaknesses in the regulatory framework that were exposed by the Great Financial Crisis, including by reducing excessive variability in risk-weighted assets and improving the comparability and transparency of banks' risk-based capital ratios.

Addressing these weaknesses remains as important today as it was pre-pandemic.

More than two thirds of jurisdictions plan to implement all, or the majority of, the standards in 2023 or 2024, with the remaining jurisdictions planning to implement Basel III in 2025.

There are only a limited set of technical standards that are particularly subject to an implementation delay.

GHOS members unanimously reaffirmed their expectation of implementing all aspects of the Basel III framework in a full and consistent manner, and as soon as possible, in order to provide a regulatory level playing field for internationally active banks.

These banks should continue preparing for the forthcoming implementation of the standards.

Basel Committee work priorities

The GHOS also reviewed the Committee's work on climate-related financial risks and cryptoassets.

On the former, GHOS members reaffirmed the scope of the Committee's work – which currently focuses on climate-related financial risks – and

endorsed the Committee's holistic approach to developing and assessing potential measures related to disclosure, supervision and/or regulation.

On cryptoassets, members reiterated the importance of designing a robust and prudent regulatory framework for banks' exposures to cryptoassets that promotes responsible innovation while preserving financial stability.

The GHOS tasked the Committee with finalising such a framework around the end of this year.

GHOS members also took note of the ongoing work by the Committee to evaluate the impact of Basel III standards already implemented on the resilience and behaviour of the banking system.

Members emphasised the importance of focusing on the implementation of outstanding Basel III reforms before considering any policy or supervisory implications related to findings of the Committee's evaluation work.

Basel III Monitoring Report

The report sets out the impact of the Basel III framework, including the December 2017 finalisation of the Basel III reforms and the January 2019 finalisation of the market risk framework.

To assess the impact of the Basel III framework on banks, the Basel Committee on Banking Supervision monitors the effects and dynamics of the reforms.

For this purpose, a semiannual monitoring framework has been set up on the risk-based capital ratio, the leverage ratio and the liquidity metrics using data collected by national supervisors on a representative sample of institutions in each country.

Since the end-2017 reporting date, the report also captures the effects of the Committee's finalisation of the Basel III reforms.

This report summarises the aggregate results using data as of 31 December 2021. It includes special features on Banks' exposures to cryptoassets – a novel dataset and Capital buffers and total CET1 requirements including Pillar 2.

The Committee believes that the information contained in the report will provide relevant stakeholders with a useful benchmark for analysis.

Information considered for this report was obtained by voluntary and confidential data submissions from individual banks and their national supervisors.

On jurisdictional level, there may be mandatory data collections ongoing which also feed into this report.

Data were included for 182 banks, including 117 large internationally active ("Group 1") banks, among them all 30 G-SIBs, and 65 other ("Group 2") banks.

Members' coverage of their banking sector is very high for Group 1 banks, reaching 100% coverage for some countries, while coverage is lower for Group 2 banks and varies by country.

In general, this report does not take into account any transitional arrangements such as grandfathering arrangements.

Rather, the estimates presented generally assume full implementation of the Basel III requirements based on data as of 31 December 2021.

No assumptions have been made about banks' profitability or behavioural responses, such as changes in bank capital or balance sheet composition, either since this date or in the future.

Furthermore, the report does not reflect any additional capital requirements under Pillar 2 of the Basel III framework, any higher loss absorbency requirements for domestic systemically important banks, nor does it reflect any countercyclical capital buffer requirements.

Overview of results — Table 1

	30 June 2021			31 December 2021		
	Group 1	Of which: G-SIBs	Group 2	Group 1	Of which: G-SIBs	Group 2
Initial Basel III framework						
CET1 ratio (%)	13.2	12.9	16.2	13.3	13.1	17.2
Target capital shortfalls (€ bn);[2] of which:	0.0	0.0	0.0	0.0	0.0	0.0
CET1	0.0	0.0	0.0	0.0	0.0	0.0
Additional Tier 1	0.0	0.0	0.0	0.0	0.0	0.0
Tier 2	0.0	0.0	0.0	0.0	0.0	0.0
TLAC shortfall 2022 minimum (€ bn)	24.2	24.2		7.5	7.5	
Total accounting assets (€ bn)	76,606	53,753	2,808	82,175	56,627	3,034
Leverage ratio (%)[3]	6.3	6.1	5.9	6.4	6.3	6.4
LCR (%)	143.8	142.7	224.6	141.3	138.7	224.2
NSFR (%)	124.5	125.9	129.6	125.1	126.9	134.0
Fully phased-in final Basel III framework (2028)						
Change in Tier 1 MRC at the target level (%)	3.3	3.7	8.4	2.4	2.2	5.7
CET1 ratio (%)	12.7	12.5	15.2	13.0	12.9	14.5
Target capital shortfalls (€ bn); of which:	2.3	2.3	1.3	0.1	0.1	1.2
CET1	0.0	0.0	0.4	0.0	0.0	0.4
Additional Tier 1	0.0	0.0	0.4	0.0	0.0	0.4
Tier 2	2.3	2.3	0.5	0.1	0.1	0.5
TLAC shortfall 2022 minimum (€ bn)	11.5	11.5		7.9	7.9	
Leverage ratio (%)[3]	6.2	6.1	5.9	6.4	6.3	6.2

See Table A.4 for the target level capital requirements. [1] The values for the previous period may slightly differ from those published in the end-December 2020 report at the time of its release. This is caused by data resubmissions for previous periods to improve the underlying data quality and enlarge the time series sample. [2] Uses the 2017 definition of the leverage ratio exposure measure. [3] The leverage ratios reflect temporary exclusions from leverage exposures introduced in some jurisdictions.

• Compared with the end-June 2021 reporting period, the average Common Equity Tier 1 (CET1) capital ratio under the initial Basel III framework increased slightly to 13.3% for Group 1 banks.

The increase to 17.2% for Group 2 banks is driven by sample changes.

• The average impact of the final Basel III framework on the Tier 1 Minimum Required Capital (MRC) of Group 1 banks is lower (+2.4%) when compared to the 3.3% increase at end-June 2021.

• The total capital shortfalls under the fully phased-in final Basel III framework as of the end-December 2021 reporting date for Group 1 banks further decreased to €0.1 billion in comparison to end-June 2021 at €2.3 billion.

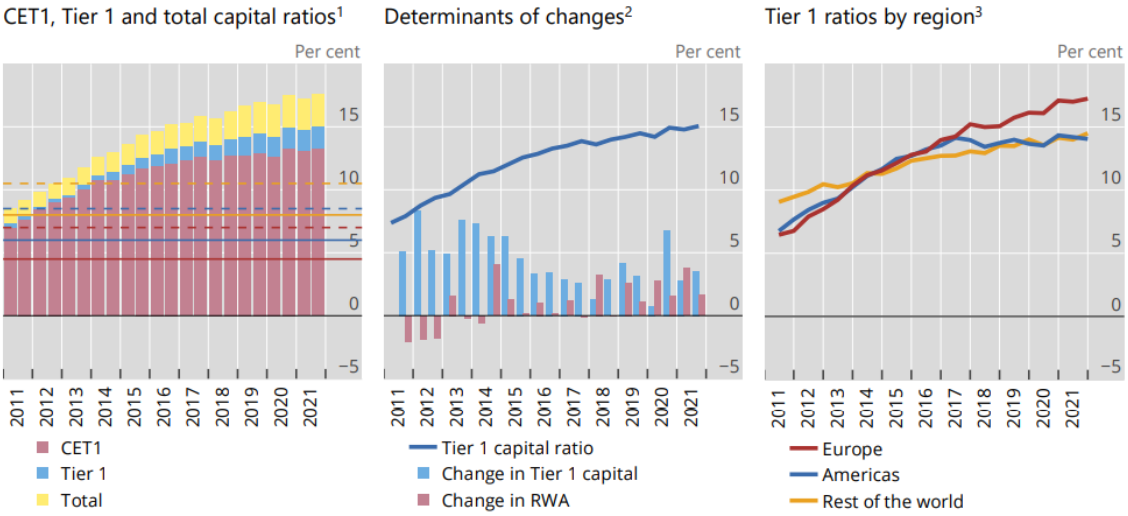
• Applying the 2022 minimum TLAC requirements and the initial Basel III framework, one of the 25 G-SIBs reporting total loss-absorbing capacity (TLAC) data reported an aggregate incremental shortfall of €7.5 billion.

• Group 1 banks' average Liquidity Coverage Ratio (LCR) decreased from 143.8% to 141.3% while the average Net Stable Funding Ratio (NSFR) increased from 124.5% to 125.1%.

For Group 2 banks, there was also a decrease for the LCR and a significant increase by more than four percentage points for the NSFR. The latter is driven by sample changes.

Initial Basel III capital ratios increase to the highest level since the beginning of the exercise

Group 1 banks, balanced data set — Graph 1



[1] The solid lines depict the relevant minimums, the dotted lines the minimums plus the capital conservation buffer. See Table A.4 for the relevant levels. [2] Exchange rates as of the current reporting date. [3] See Table B.1 for the composition of the regions.

Source: Basel Committee on Banking Supervision. See the Excel data file for underlying data and sample size.

• The balanced data set for Group 1 banks showed a slight increase in initial Basel III capital ratios in H2 2021, driven by an increase in Tier 1 capital that was higher than the increase in RWA.

Capital ratios are at the highest level since the beginning of the exercise. The overall CET1 capital ratios for Group 1 banks in the balanced data set were 13.3% in June 2021.

• Currently, the Tier 1 capital ratios are higher in Europe than in the Americas and the rest of the world region.

However, when compared with data starting from 2011, this relationship used to be reversed before 2014.

The report: https://www.bis.org/bcbs/publ/d541.pdf

Banks' exposures to cryptoassets – a novel datase

Since 2018, the Basel Committee has been pursuing a multi-pronged set of analytical, supervisory and policy initiatives related to cryptoassets.

As part of this work, a new cryptoasset data collection template was introduced starting with the current Basel III monitoring exercise based on end-2021 data.

The template was specifically designed to support the Committee's two consultative documents on the prudential treatment of banks' cryptoasset exposures, which were published on 10 June 2021 and 30 June 2022.

It collects granular information on banks' holdings of cryptoassets, including information at the level of individual cryptoassets. This special feature provides some analysis on banks' exposures to cryptoassets based on the data collected.

Overall, 19 banks submitted cryptoasset data – 10 from the Americas, seven from Europe and two from the rest of the world (Graph , left panel).

All reporting banks are Group 1 banks, except for three Group 2 banks (of these, two Group 2 banks do not participate in the wider Basel III monitoring exercise and appear to specialise in cryptoassets).

These banks make up a relatively small part of the wider sample of 182 banks considered in the Basel III monitoring exercise – 2.4% of total RWA, and 7.2% of overall leverage ratio exposure measure (LREM) (Graph 1, right panel), with banks from the Americas contributing to approximately three quarters of these amounts.

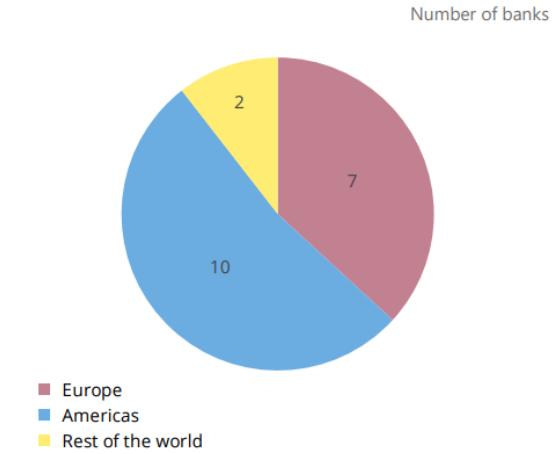
As this is the first data collection using the new template, the results in this special feature are subject to a number of data quality caveats and potential biases.

As the cryptoasset market is fast evolving, it is difficult to ascertain whether some banks have under- or over-reported their exposures to cryptoassets, and the extent to which they have consistently applied the same approach to classifying any exposures.

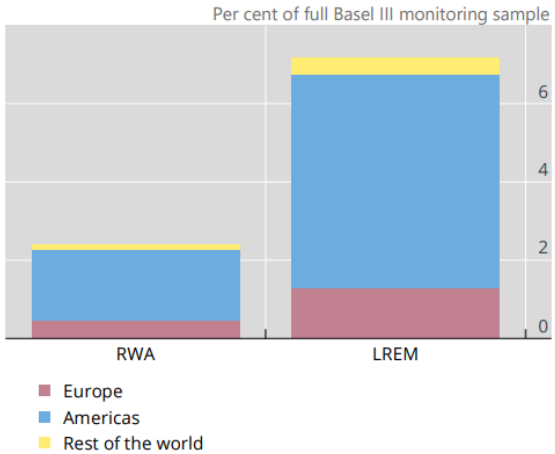
As such, while they are helpful in providing a broad indication of banks' cryptoasset activity, they should interpreted with a degree of caution.

A small proportion of banks reported crypto exposures at end-2021 Graph 1

Number of banks reporting cryptoasset exposures[1]



Proportion of banks reporting crypto exposures[2]

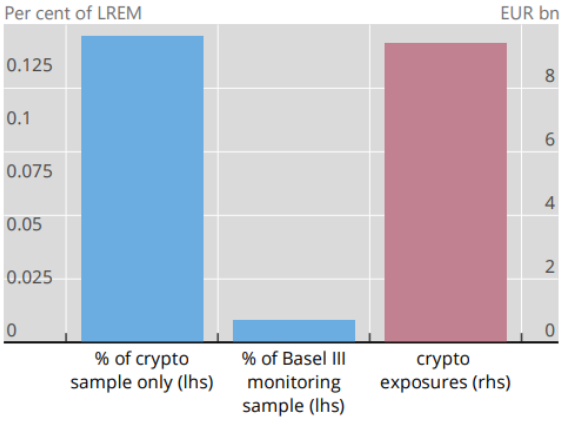


[1] All reporting banks are Group 1 banks, except for three Group 2 banks. Two Group 2 banks participated only in the crypto exercise and did not participate in the wider Basel III monitoring exercise. [2] The denominators used also account for the amounts of the two Group 2 banks which only participate in the crypto exercise and are not included in the general analysis of the Basel III monitoring exercise.

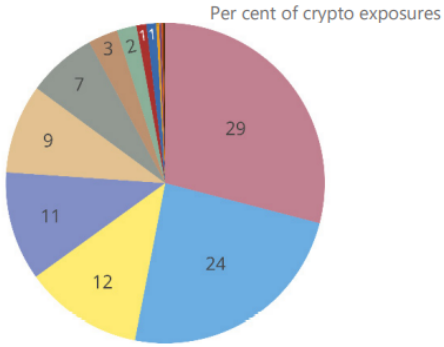
Source: BCBS end-2021 data collection and Secretariat calculations.

Crypto exposures are relatively small and unevenly distributed across banks Graph 2

Reported crypto exposures



Distribution of total crypto exposures across banks[1]



[1] Each slice represents one of the banks which reported crypto exposures.

Source: BCBS end-2021 data collection and Secretariat calculations.

Overall amounts

Total cryptoasset exposures reported by banks amount to approximately €9.4 billion. In relative terms, these exposures make up only 0.14% of total exposures on a weighted average basis across the sample of banks reporting cryptoasset exposures.

When considering the whole sample of banks included in the Basel III monitoring exercise (ie also those that do not report cryptoasset

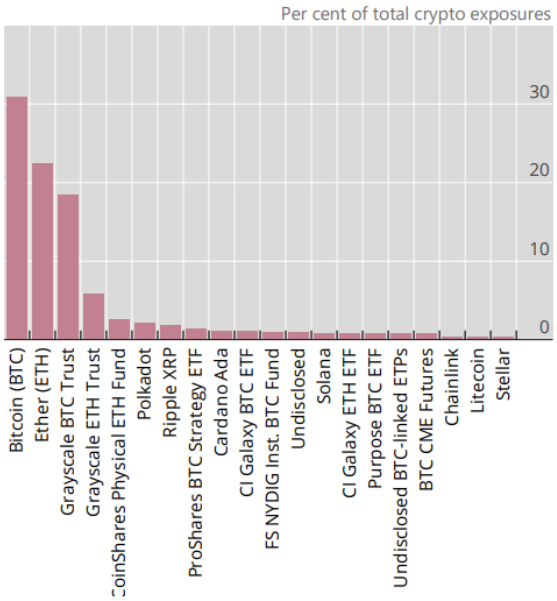
exposures), the amount shrinks to 0.01% of total exposures (Graph 2, left panel).

Cryptoasset exposures are distributed unevenly across reporting banks, with two banks making up more than half of overall cryptoasset exposures, and four more banks making up just below 40% of the remaining exposures (Graph 2, right panel).

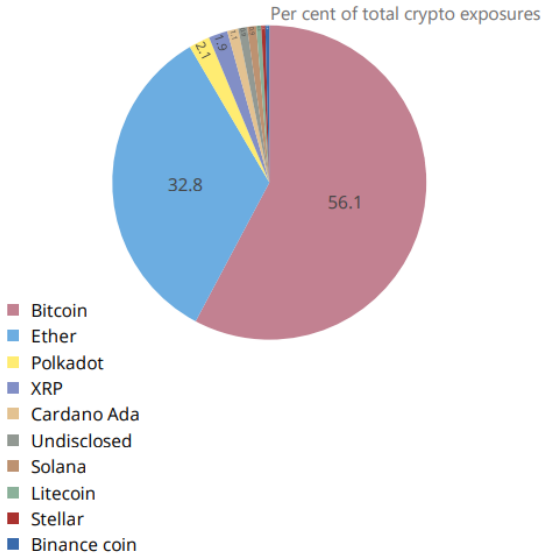
Bitcoin, Ether and related cryptoassets make up the vast majority of crypto exposures

Graph 3

Top 20 reported cryptoassets by exposure amount



Top 10 reported cryptoassets grouped by underlying asset



Source: BCBS end-2021 data collection and Secretariat calculations.

Composition across cryptoassets

Reported cryptoasset exposures are primarily composed of Bitcoin (31%), Ether (22%) and a multitude of instruments with either Bitcoin or Ether as the underlying cryptoassets (25% and 10% respectively).

Together, these make up almost 90% of reported exposures (Graph 3).

Focusing on the top 20 reported cryptoassets by exposure amount, other relatively significant reported cryptoassets include Polkadot (2% of reported exposures), Ripple XRP (2%), Cardano Ada (1%), Solana (1%), Litecoin (0.4%) and Stellar (0.4%).

These exposures would likely be classified as Group 2 cryptoassets under the current consultative proposal of the Basel Committee.

Banks also reported, in smaller amounts, a stablecoin (USD coin) and tokenised assets (not shown).

To read more: https://www.bis.org/bcbs/publ/d541_crypto.pdf

EBA publishes its work programme for 2023

The European Banking Authority (EBA) published today its annual work programme for 2023, describing the key strategic areas of work for the Authority for the coming year, as well as related activities and tasks.

In 2023, the EBA will continue delivering on the priorities defined for the period 2022-2024 in its programming document.

Its focus will be on:

i) finalising the Basel implementation in the EU,

ii) running an enhanced EU-wide stress test,

iii) providing data to all stakeholders,

iv) addressing the new challenges arising from the digitalisation of finance, and

v) further contributing to the build-up of the capacity to fight ML/FT and to protect consumers in the EU.

Moreover, it will continue to pay particular attention to the European ESG agenda, in its regulatory and risk assessment mandates, as well as in its own organisation, building on its recent EU Eco-Management and Audit Scheme (EMAS) registration.

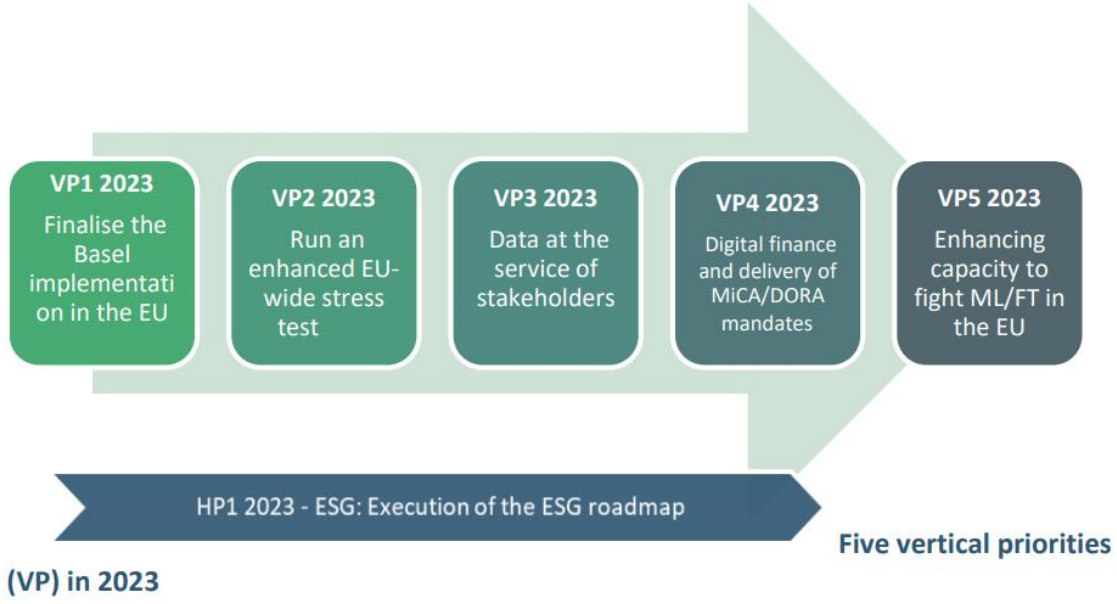
Given the political agreements reached in 2022 on the Digital Operational Resilience Act (DORA) and Markets in Crypto-Assets (MiCA) legislations, the EBA will also actively start its preparations to be able to discharge the new oversight responsibilities it will receive, together with the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA).

Against this background, it will continue to foster all possible internal and external synergies, working closely with Competent Authorities and other European bodies, and carry out the modernisation of its organisation engaged in recent years.

Against that background, the number of over-arching activities was further reduced to facilitate coordination and readability.

The work programme benefitted from the recommendations of the EBA's Advisory Committee on Proportionality.

The executive summary of the EBA work programme for 2023 will be made available in all EU official languages.



To read more:
https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2022/1039834/2023%20EBA%20Work%20Programme.pdf

Federal Reserve Board announces that six of the largest banks will participate in a pilot climate scenario analysis exercise

The Federal Reserve Board has announced that six of the nation's largest banks will participate in a pilot climate scenario analysis exercise designed to enhance the ability of supervisors and firms to measure and manage climate-related financial risks.

Scenario analysis—in which the resilience of financial institutions is assessed under different hypothetical climate scenarios—is an emerging tool to assess climate-related financial risks, and there will be no capital or supervisory implications from the pilot.

The pilot exercise will be launched in early 2023 and is expected to conclude around the end of the year.

At the beginning of the exercise, the Board will publish details of the climate, economic, and financial variables that make up the climate scenario narratives.

Over the course of the pilot, participating firms will analyze the impact of the scenarios on specific portfolios and business strategies.

The Board will then review firm analysis and engage with those firms to build capacity to manage climate-related financial risks.

The Board anticipates publishing insights gained from the pilot at an aggregate level, reflecting what has been learned about climate risk management practices and how insights from scenario analysis will help identify potential risks and promote risk management practices.
No firm-specific information will be released.

Climate scenario analysis is distinct and separate from bank stress tests. The Board's stress tests are designed to assess whether large banks have enough capital to continue lending to households and businesses during a severe recession.

The climate scenario analysis exercise, on the other hand, is exploratory in nature and does not have capital consequences.
By considering a range of possible future climate pathways and associated economic and financial developments, scenario analysis can assist firms

and supervisors in understanding how climate-related financial risks may manifest and differ from historical experience.

The banks in the pilot exercise are:

- Bank of America,
- Citigroup,
- Goldman Sachs,
- JPMorgan Chase,
- Morgan Stanley,
- Wells Fargo.

In coming months, the Board will provide additional details on how the exercise will be conducted and the scenarios that will be used in the pilot.

Agencies reaffirm commitment to Basel III standards

Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency

Federal bank regulatory agencies reaffirmed their commitment to implementing enhanced regulatory capital requirements that align with the final set of "Basel III" standards issued by the Basel Committee on Banking Supervision in December 2017.

The implementation of these standards for large banking organizations would strengthen the resilience of the domestic banking system and is a priority for the agencies.

Strong capital requirements have proven to be a critical element of the bank regulatory framework, allowing the banking industry during times of economic stress to serve as a source of strength for the U.S. economy and to lend to creditworthy households and businesses.

The agencies plan to seek public input on the new capital standards for large banking organizations and are **currently developing a joint proposed rule** for issuance as soon as possible.

Community banking organizations, which are subject to different capital requirements, would not be impacted by the proposal.

BIS Working Paper No 1039

Cyber risk in central banking

by Sebastian Doerr, Leonardo Gambacorta, Thomas Leach, Bertrand Legros and David Whyte - Monetary and Economic Department

The rising number of cyber attacks in the financial sector poses a threat to financial stability and makes cyber risk a key concern for policy makers.

This paper presents the results of a survey among members of the Global Cyber Resilience Group on cyber risk and its challenges for central banks.

The survey reveals that central banks have notably increased their cyber security-related investments since 2020, giving technical security control and resiliency priority.

Central banks see phishing and social engineering as the most common methods of attack, and the potential losses from a systemically relevant cyber attack are deemed to be large, especially if the target is a big tech providing critical cloud infrastructures.

Generally, respondents judge the preparedness of the financial sector for cyber attacks to be inadequate. While central banks in most emerging market economies provide a framework for the collection of information on cyber attacks on financial institutions, less than half of those in advanced economies do.

Cooperation among public authorities, especially in the international context, could improve central banks' ability to respond to cyber attacks.

The survey reveals four main insights.

First, central banks from AEs and EMEs differ in their assessment of the frequency and cost of different cyber attacks. All central banks deem phishing and other forms of social engineering as the most likely type of attack vectors. AE central banks are significantly more worried about supply chain attacks than their EME counterparts.

When it comes to the costs resulting from an attack, advanced persistent malware and ransomware attacks rank highest. Turning to the who of these attacks, AE central banks deem organised crime and state-sponsored entities to be the main perpetrators. Among EME central banks, it is organised crime and individuals or activists.

Second, central banks actively discuss and develop policy responses to cyber attacks and have increased their cyber security-related investments notably since 2020.

Technical security control and resiliency feature high on the priority list in terms of areas for investment in cyber security.

Training existing staff on cyber security or hiring new staff with the relevant skills are also considered important, especially among EME central banks. Beyond investments, central banks focus on developing concrete policy responses.

All central banks put a high focus on developing an incident response plan in case their own institution is attacked, and several central banks are also developing a formal strategy for responding to an attack on the financial system at large.

All central banks run internal exercises to simulate cyber attacks, and the most frequently modelled scenarios are an attack on the system of the central bank itself, as well as an outage of the payments system or other critical FMI.

While supervisory authorities in most EMEs provide a framework for the collection of information on cyber attacks on financial institutions, less than half of those in AEs do.

Similarly, while supervised firms are mandated to report losses related to cyber attacks to the central bank in almost all EMEs, only two-thirds of AE respondents report that such disclosure is required.

No jurisdiction requires firms to disclose such losses publicly, however.

Third, central banks deem the potential losses from a systemically relevant cyber attack to be large, and think that losses from cyber attacks in the financial sector have increased over the past year.

Only a few central banks fully agree that the financial sector is adequately prepared for cyber attacks, and over half of the respondents think that investment in cyber security has been inadequate over the past year.

Beyond traditional financial institutions, respondents reported that they see fintechs to be more at risk from a cyber attack than big techs, even though most respondents agree that a successful attack on a big tech would lead to materially higher aggregate costs than an attack on a fintech.

And **fourth,** central banks in AEs and EMEs already cooperate widely on a range of topics. Bilateral cooperation among central banks, as well as cooperation in bodies at the regional and global levels, is the norm.

When it comes to specific topics related to cooperation, information sharing, simulations and policy formulations to improve cyber resilience stand out in AEs. Among EMEs, central banks frequently cooperate in the realms of information sharing and policy formations.

In addition, over two-thirds of respondents develop common standards and protocols for the financial sector.

The BIS supports central banks' cyber security work, as well as global cooperation in this domain, in several ways – for example, through its Cyber Resilience Coordination Centre or projects of the BIS Innovation Hub.

To read more: https://www.bis.org/publ/work1039.pdf

The Economic Outlook: Time to Let the Data Do the Talking

Governor Christopher J. Waller, Board of Governors of the Federal Reserve System, 17th Annual Vienna Macroeconomics Workshop, Vienna, Austria

Thank you, Klaus, and thank you for the invitation to speak at this workshop, which I have been attending since its very beginning in 2004.

Something that I love about this conference that has kept me coming back almost every year is its tradition of open inquiry and even some fun, on the one hand, combined with rigorous, critical analysis, on the other.

I am a supporter, and I guess a practitioner, of rigorous criticism, because, as you may have heard, the conference award given each year for "outstanding critic" was named for me.

Based on the standard I set, the person who wins the award is also known as the "most annoying participant." I suppose it was only karma that a guy like me who likes to dish out the criticism would end up in a job that receives plenty of it.

Kidding aside, I do consider being the namesake for this award a great honor, and just to make sure I don't get too much of a swelled head, by tradition the conference organizers purposefully misspell my name.

My subject today is the outlook for the U.S. economy and the Federal Reserve's ongoing campaign to bring down inflation and achieve our 2 percent objective.

There are three takeaways from my speech today. First, inflation is far too high, and it is too soon to say whether inflation is moving meaningfully and persistently downward.

The Federal Open Market Committee (FOMC) is committed to undertake actions to bring inflation back down to our 2 percent target. This is a fight we cannot, and will not, walk away from.

The second takeaway is that the fears of a recession starting in the first half of this year have faded away and the robust U.S. labor market is giving us the flexibility to be aggressive in our fight against inflation.

For that reason, I support continued increases in the FOMC's policy rate and, based on what I know today, I support a significant increase at our next meeting on September 20 and 21 to get the policy rate to a setting that is clearly restricting demand.

The final takeaway is that I believe forward guidance is becoming less useful at this stage of the tightening cycle.

Future decisions on the size of additional rate increases and the destination for the policy rate in this cycle should be solely determined by the incoming data and their implications for economic activity, employment, and inflation.

Based on all of the data that we have received since the FOMC's last meeting, I believe the policy decision at our next meeting will be straightforward.

Because of the strong labor market, right now there is no tradeoff between the Fed's employment and inflation objectives, so we will continue to aggressively fight inflation.

Inflation is widespread, driven by strong demand that has only begun to moderate, by an ongoing lag in labor force participation, and by supply chain problems that may be improving in some areas but are still considerable.

For these reasons, I expect it will take some time before inflation moves back to our 2 percent goal, and that the FOMC will be tightening policy into 2023. But the answers to questions of "how high?" and "for how long?" will depend solely on incoming data.

Since I last spoke in July, I think the argument that we entered a recession in the first half of 2022 has pretty much ended—we didn't. With each passing week, the absence of any indication of a recession in spending or employment data buries that recession argument a little deeper.

We understand some of the factors that lowered the gross domestic product (GDP) numbers in the first half, and a debate continues about other possible factors, such as mismeasurement, potentially underreporting GDP.

What we can say is that after the Fed telegraphed its policy pivot to tightening in the latter months of 2021 and began raising rates in the first quarter of this year, demand and economic activity slowed in the first half of 2022 from the strong pace of 2021.

Data suggest an uptick in consumption growth in the third quarter. Meanwhile, the Atlanta Fed's GDPNow model forecasts real GDP will grow

2.6 percent this quarter, though other estimates are a touch below this prediction.

Spending data are supportive of continued expansion. Nominal retail sales overall were flat in July, but that is mainly because falling gasoline and auto prices—which is good news—held back sales in those sectors.

Excluding that, retail sales rose 0.7 percent, suggesting that discretionary spending grew solidly. Businesses also continued to expand production and spending. Total industrial production increased 0.6 percent in July, standing 3.9 percent above its level a year ago.

Forward-looking indicators of manufacturing activity, such as new orders indexes in various manufacturing surveys, are softer than earlier in the year, but most (and in particular the positive August reading from the ISM) are not suggestive of a material pullback in manufacturing activity.

Meanwhile, the non- manufacturing ISM report suggests continuing growth, with its new orders index rising to a solid level last month.

But there are signs of moderation in economic activity, which is what the FOMC is trying to achieve by tightening monetary policy. Not surprisingly, higher interest rates this year are slowing activity in the housing market.

There have been declines in construction of single-family homes for a number of months, with permits and home starts both decreasing in July.

Sales of existing and new single-family homes have also slowed. Existing home sales fell by 5.9 percent to a seasonally adjusted annual rate of 4.8 million homes in July.

While the imbalance between housing supply and demand remains significant, it has meaningfully improved. The inventory of unsold new and existing homes has more than doubled since January.

While the three months supply of existing home is still below levels before the pandemic, the eleven months of new home inventory is the highest since the spring of 2009.

This latter statistic has raised concerns by some about a significant downturn looming in the housing market, but an important caveat is that much of the current elevated inventory reflects the recent low rate of housing completion due to continued supply constraints.

Many of these new homes for sale are still under construction, and as supply constraints ease, builders will be able deliver more completed homes to a market where the supply of existing homes remains tight. All that said,

the housing market is a significant channel for monetary policy, and I will be watching this sector carefully.

The FOMC's goal is that the tightening in monetary policy slows aggregate demand so that it is in better alignment with supply across all sectors of the economy.

My expectation is that strong household savings, the tight labor market, and additional availability of manufactured goods as supply chains constraints continue to resolve will allow households to make long-awaited purchases, which will provide a partial offset to tighter policy. That will support a slowing, rather than a contraction, in demand.

Turning to the very strong labor market, private payroll employment has been increasing at an average of nearly 400,000 a month over the last several months.

Unemployment rose two tenths of a percent in August to 3.7 percent, in part reflecting an increase in the labor force participation rate, but still stands at a very low level.

The increase in participation was welcome news, but this rate is still far below that achieved before the pandemic, when unemployment was roughly as low as today.

We are facing worker shortages in many sectors of the economy. Job openings have started to decline a bit but remain very elevated. These data confirm that the Fed is hitting its full employment mandate, so all my attention is on bringing inflation down.

Inflation slowed in July, which was a very encouraging development. Headline inflation for both the consumer price index and the index derived from personal consumption expenditures (PCE)—the Fed's preferred measure—slowed, largely due to continuing declines in prices for gasoline and other petroleum products.

Excluding volatile energy and food prices, core inflation for these two indexes also stepped down from the rapid increases of earlier this year, but it is still too early to say that inflation is moving meaningfully and persistently downward.

Inflation is still widespread. For both headline and core inflation, at least 60 percent of the underlying categories of different goods and services increased by 3 percent or more.

Prices for housing services are elevated and still rising. Core goods inflation continues to run well above its pre-pandemic level.

Inflation for services excluding housing has moved up this past year in part due to consumers shifting back to more normal activities outside the household as social distancing has eased.

Looking ahead, I will be focusing on a number of factors that will influence inflation. On housing services—rent and the so-called owners' equivalent rent —I expect to see sizable increases in this component of inflation for a while as the recent rise in new rentals makes its way into aggregate price measures.

In a speech in March, I noted that, based on various measures of asking rents, some analysts were predicting that the rate of rent inflation in the consumer price index could double in 2022, and so far it is on pace to more than double.

Owners-equivalent rent is similarly on pace to nearly double this year. Sometime early next year, though, I expect to see the upward pressure on inflation from these forces to ease as future increases in new or renewed leases moderate and the full effects of monetary policy tightening make their way to housing services prices.

Beyond housing, I expect goods price inflation to continue to moderate as monetary policy now and going forward slows the pace of increase in aggregate demand, supply problems ease, and supply and demand come into better balance.

There is some evidence that goods supply production and delivery problems tied to the pandemic are improving, with supplier delivery times and reports of items in short supply continuing to drop.

In terms of service price inflation, we saw a step-down in airfares and other travel-related services last month, but I am uncertain about how these services, as well as food services, and nonmarket services prices will evolve going forward.

Nominal wages have been growing quickly, and I'll be watching closely to see how wage growth evolves and feeds into inflation.

The Atlanta Fed's Wage Growth Tracker hit another record in July for its 24 years of data, a 12-month rate of 6.7 percent wage growth.

I don't expect wage increases to ease up much unless and until there is a significant softening in the labor market.

One way to anticipate future wage growth is through quit rates. Most people who quit their jobs are moving to others that pay significantly better, so I take quits as one signal about where wages are headed in the near term.

Quits are near their highest level over the 22 years that the government has tracked them, but they have come down from the start of this year, and further decreases would bring them closer to the level they were at immediately before the pandemic, when wages were growing much more slowly than today.

Another factor that I will be watching closely is longer-term inflation expectations, which I believe significantly influence inflation.

As inflation moved higher over the past year and a half, measures of short-term inflation expectations moved up notably, but measures of longer-term expectations rose only a little and generally stand near levels seen in the years before the pandemic, when inflation was low.

In fact, several measures of longer-term expectations have edged lower over the past couple of months. To me, this means that the public retains confidence that the Fed will be able to rein in inflation in the medium term.

To sum up, while I welcome promising news about inflation, I don't yet see convincing evidence that it is moving meaningfully and persistently down along a trajectory to reach our 2 percent target.

I keep in mind that a year ago we saw similarly promising evidence of inflation moderating for several months before it jumped up to a high and then very high level.

Those earlier inflation readings probably delayed our pivot to tightening monetary policy by a few months.

The consequences of being fooled by a temporary softening in inflation could be even greater now if another misjudgment damages the Fed's credibility.

So, until I see a meaningful and persistent moderation of the rise in core prices, I will support taking significant further steps to tighten monetary policy.

Now let me lay out the implications of this outlook for monetary policy. Since March, the FOMC has raised our policy target range from near zero to between 2-1/4 and 2-1/2 percent.

That puts the upper bound of the current target range at the median of FOMC participants' longer-run projection for the policy rate, as recorded in the June Summary of Economic Projections (SEP).

This long-run rate is effectively where participants think the policy rate would settle when the economy is growing at its potential and inflation is at our 2 percent target.

This is a good definition of success when employment and inflation are near our goals and no help is needed from monetary policy. But that isn't the case now; inflation is far from our goal, so more action is needed.

The policy rate will have to move meaningfully above this neutral level to further restrain aggregate demand and put more downward pressure on prices.

Looking ahead to our next meeting, I support another significant increase in the policy rate. But, looking further out, I can't tell you about the appropriate path of policy. The peak range and how fast we will move there will depend on data we will receive about the economy.

Earlier this year, when we were ending asset purchases, inflation was quite elevated, and we were lifting the target range off the effective lower bound, so it made sense to provide forward guidance to help convey the urgency the FOMC felt about tightening monetary policy.

Forward guidance was useful in helping the public understand how quickly we expected to tighten, and we saw longer-term interest rates move up quite rapidly as a result of these communications. And additional hikes should lead to further restraint in aggregate demand.

As we continue to raise rates, we need to see, month by month, how households and businesses are adjusting to the tighter financial conditions, and how that adjustment is affecting inflation. We shouldn't be estimating what the peak level of the target range will be and how quickly we will get there, because those details are much more dependent on what new economic data tell us than was the case when the only direction for the federal funds rate to go was up—and up by a lot.

This is not to suggest that I anticipate rate increases stopping very soon. I expect that getting inflation to fall meaningfully and persistently toward our 2 percent target will require increases in the target range for the federal funds rate until at least early next year.

But don't ask me about the policy path because I truly don't know—it will depend on the data.

Six months ago, I would not have thought that we would be where we are today, with inflation so far from our target, after significantly tightening policy with a series of large rate increases and by shrinking the balance sheet.

There are a range of possibilities for how the economy will perform, however, and we can talk about the implications of that range. Say, for example, that inflation follows the path laid out in the June SEP, which has core PCE inflation falling to 4.3 percent in the fourth quarter of 2022 and then moving toward 2 percent over 2023 and 2024. In that case, I would support our policy rate peaking near 4 percent.

But based on the experience of the past year and half, it would be foolish to express great confidence that this plausible path will come to pass. Instead, it is important to consider the range of possibilities and the appropriate policy responses.

For example, if inflation does not moderate or rises further this year, then, in my view, the policy rate will probably need to move well above 4 percent. Alternatively, if inflation suddenly decelerates, then, in my view, the policy rate might peak at less than 4 percent.

One thing that is more predictable and has a significant effect on tightening policy over time is the shrinking of the Fed's holdings of assets as maturing securities run off our balance sheet. Starting this month, the Fed is shedding $60 billion a month in Treasury securities and up to $35 billion a month in agency mortgage-backed securities.

This action effectively increases the supply of securities in the hands of private investors and will thus put upward pressure on interest rates, as private investors must now be enticed to hold these assets.

All told, the FOMC has taken unprecedented and decisive policy actions this year to quickly increase the policy rate in response to high inflation. But where we stand now is not good enough. Though the labor market is strong, inflation is too elevated.

So I support another significant hike in two weeks. After that, the tightening path will continue until we see clear and convincing evidence that inflation is moving meaningfully and persistently down to our 2 percent target.

The pace of tightening is uncertain; it will depend on the data. No matter what, I am ready and willing to do what it takes to bring inflation down.

To read more:
https://www.federalreserve.gov/newsevents/speech/waller20220909a.htm

Federal Reserve Board invites comment on updates to operational risk-management requirements for certain systemically important financial market utilities (FMUs) supervised by the Board

The Federal Reserve Board has invited comment on updates to operational risk-management requirements for certain systemically important financial market utilities (FMUs) supervised by the Board.

FMUs provide essential infrastructure to clear and settle payments and other financial transactions upon which the financial markets and the broader economy rely to function effectively.

The proposed updates generally provide more specificity to the existing requirements.

The broad operational risk, technology, and regulatory landscape in which FMUs operate has evolved significantly since the Board last updated its risk management requirements for FMUs in 2014.

New challenges have emerged, such as the global pandemic and cyber events, while new technological advancements may improve resilience. The proposed changes would promote effective risk management in this rapidly evolving risk environment.

"In light of the rapidly evolving risk landscape, the proposed changes will help ensure that key financial market utilities operate with a high level of resilience and remain a source of strength for the financial system," said Vice Chair Lael Brainard.

The proposal addresses four key areas: incident management and notification; business continuity management and planning; third-party risk management; and review and testing of operational risk management measures.

For example, the proposal would explicitly require FMUs to establish an incident management framework and would emphasize the need for FMUs to continue to advance their cyber resilience capabilities. The proposed updates are largely consistent with existing measures that FMUs take to comply with the current requirements.

Comments on the proposed changes must be submitted within 60 days from the date of publication in the Federal Register.

For media inquiries, email media@frb.gov or call (202) 452-2955.

To read more:
https://www.federalreserve.gov/newsevents/pressreleases/bcreg20220923a.htm

The Financial Stability Oversight Council Releases Report on Digital Asset Financial Stability Risks and Regulation

Note: The Financial Stability Oversight Council (FSOC or Council) was established by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The purposes of the Council under the Dodd-Frank Act are:

(1) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;

(2) to promote market discipline by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies, that the Government will shield them from losses in the event of failure; and

(3) to respond to emerging threats to the stability of the United States (U.S.) financial system.

Executive Summary

Crypto-asset activities could pose risks to the stability of the U.S. financial system if their interconnections with the traditional financial system or their overall scale were to grow without adherence to or being paired with appropriate regulation, including enforcement of the existing regulatory structure.

The scale of crypto-asset activities has increased significantly in recent years. Although interconnections with the traditional financial system are currently relatively limited, they could potentially increase rapidly.

Participants in the cryptoasset ecosystem and the traditional financial system have explored or created a variety of interconnections. Notable sources of potential interconnections include traditional assets held as part of stablecoin activities.

Crypto-asset trading platforms may also have the potential for greater interconnections by providing a wide variety of services, including leveraged trading and asset custody, to a range of retail investors and traditional financial institutions. Consumers can also increasingly access crypto-asset activities, including through certain traditional money services

businesses. Some characteristics of crypto-asset activities have acutely amplified instability within the crypto-asset ecosystem.

Many crypto-asset activities lack basic risk controls to protect against run risk or to help ensure that leverage is not excessive.

Crypto-asset prices appear to be primarily driven by speculation rather than grounded in current fundamental economic use cases, and prices have repeatedly recorded significant and broad declines.

Many crypto-asset firms or activities have sizable interconnections with crypto-asset entities that have risky business profiles and opaque capital and liquidity positions.

In addition, despite the distributed nature of crypto-asset systems, operational risks may arise from the concentration of key services or from vulnerabilities related to distributed ledger technology.

These vulnerabilities are partly attributable to the choices made by market participants, including crypto-asset issuers and platforms, to not implement or refuse to implement appropriate risk controls, arrange for effective governance, or take other available steps that would address the financial stability risks of their activities.

Many nonbank firms in the crypto-asset ecosystem have advertised themselves as regulated.

Firms often emphasize money services business regulation, though such regulation is largely focused on anti-money laundering controls or consumer protection requirements and does not provide a comprehensive framework for mitigating financial stability vulnerabilities arising from other activities that may be undertaken, for example, by a trading platform or stablecoin issuer.

While some firms in the crypto-asset ecosystem have attempted to avoid the existing regulatory system, other firms have engaged with the existing regulatory system by obtaining trust charters or special state-level crypto-asset-specific charters or licenses.

Compliance with and enforcement of the existing regulatory structure is a key step in addressing financial stability risks. For example, certain crypto-asset platforms may be listing securities but are not in compliance with exchange or broker-dealer registration requirements.
In addition, certain crypto-asset issuers have offered and sold crypto-assets in violation of federal and state securities laws, because the offering and sale were not registered or conducted pursuant to an available exemption.

Regulators have taken enforcement actions over the past several years to address many additional instances of non-compliance with existing rules and regulations, including illegally offered crypto-asset derivatives products, false statements about stablecoin assets, and many episodes of fraud and market manipulation.

In addition, false and misleading statements, made directly or by implication, concerning availability of federal deposit insurance for a given product, are violations of the law, and have given customers the impression that they are protected by the government safety net when they are not.

Further, misrepresentations by crypto-asset firms about how they are regulated have also confused consumers and investors regarding whether a given crypto-asset product is regulated to the same extent as other financial products.

Though the existing regulatory system covers large parts of the crypto-asset ecosystem, this report identifies three gaps in the regulation of crypto-asset activities in the United States.

First, the spot markets for crypto-assets that are not securities are subject to limited direct federal regulation. As a result, those markets may not feature robust rules and regulations designed to ensure orderly and transparent trading, prevent conflicts of interest and market manipulation, and protect investors and the economy more broadly.

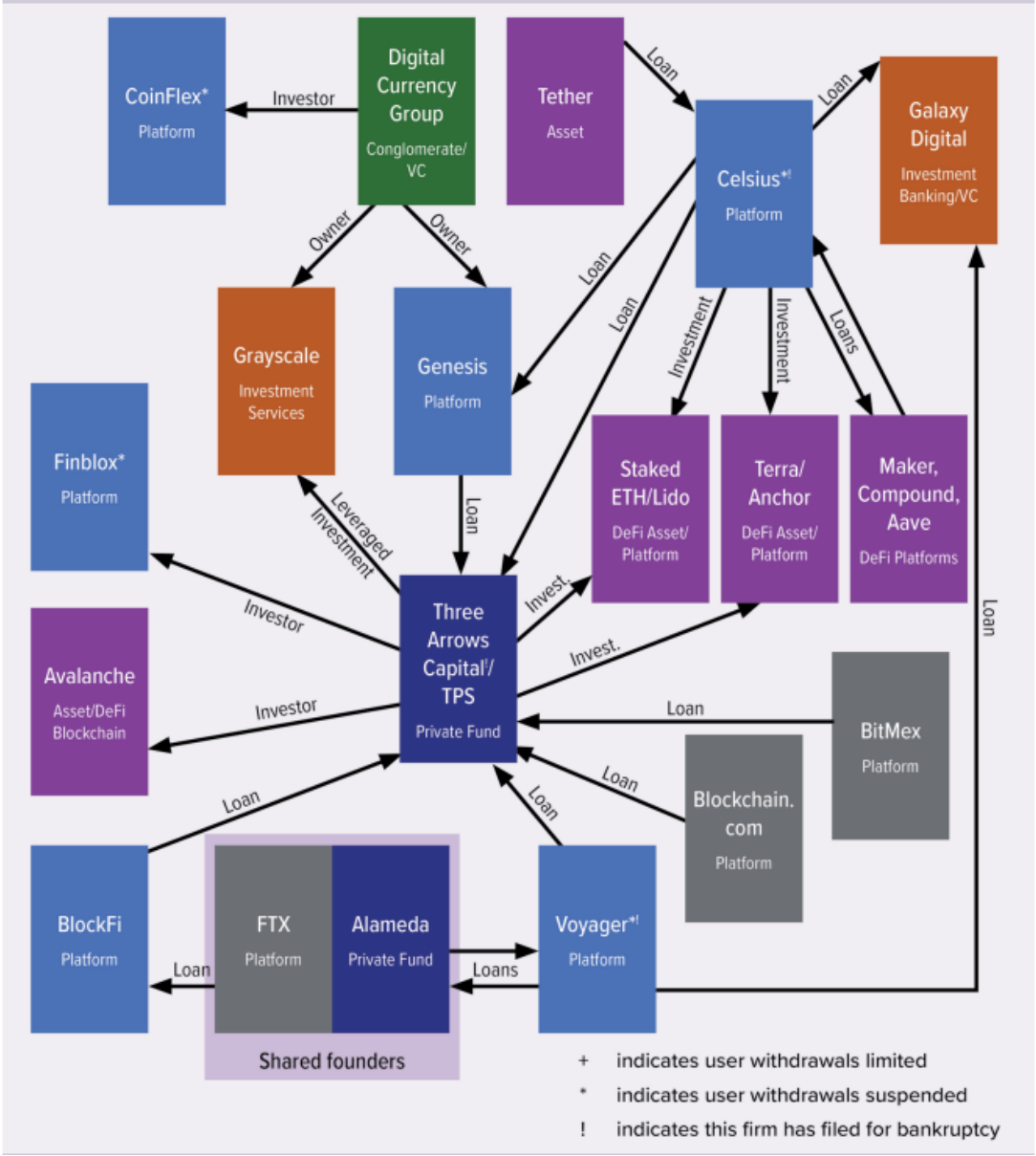
Second, crypto-asset businesses do not have a consistent or comprehensive regulatory framework and can engage in regulatory arbitrage. Some crypto-asset businesses may have affiliates or subsidiaries operating under different regulatory frameworks, and no single regulator may have visibility into the risks across the entire business.

Third, a number of crypto-asset trading platforms have proposed offering retail customers direct access to markets by vertically integrating the services provided by intermediaries such as broker-dealers or futures commission merchants. Financial stability and investor protection implications may arise from retail investors' exposure to certain practices commonly proposed by vertically integrated trading platforms, such as automated liquidation.

To ensure appropriate regulation of crypto-asset activities, the Council is making several recommendations in part 5 of this report, including the consideration of regulatory principles, continued enforcement of the existing regulatory structure, steps to address each regulatory gap, and bolstering member agencies' capacities related to crypto-asset data and expertise.

FSOC Report on Digital Asset Financial Stability Risks and Regulation

Figure B-1: Reported Interconnections of Three Arrows Capital



FSOC

FINANCIAL STABILITY OVERSIGHT COUNCIL

Report on Digital Asset Financial Stability Risks and Regulation

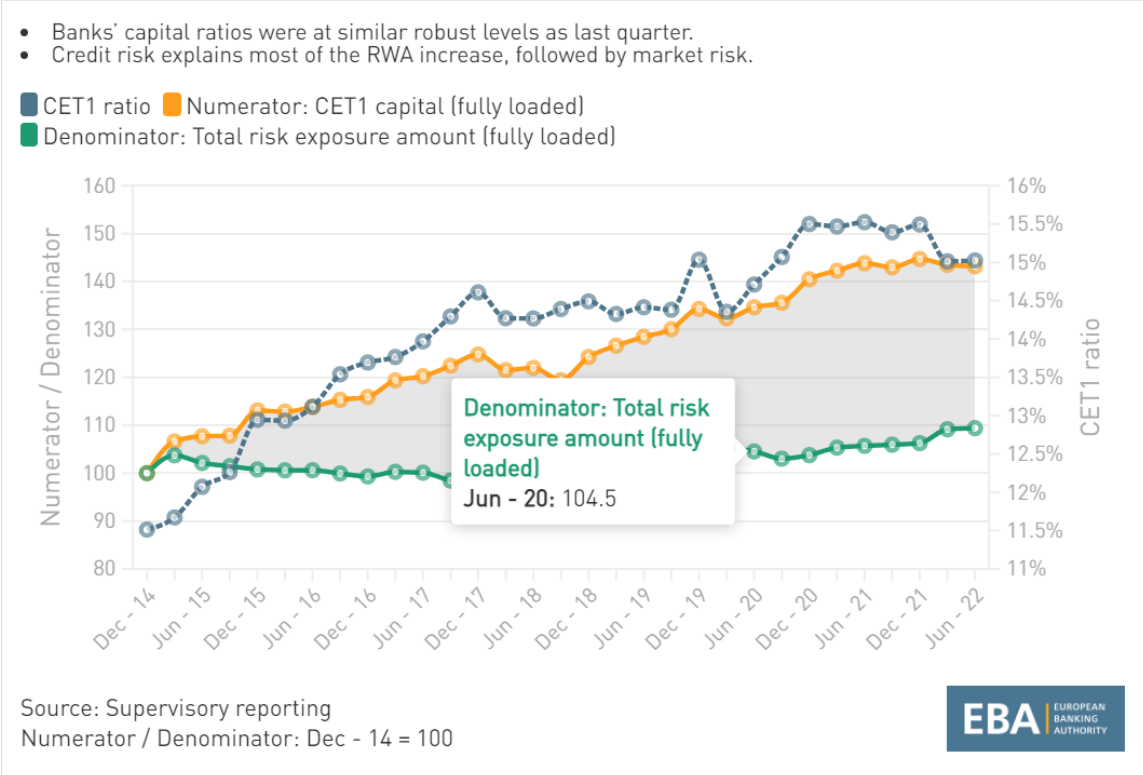
2022

The report:
https://home.treasury.gov/system/files/261/FSOC-Digital-Assets-Report-2022.pdf

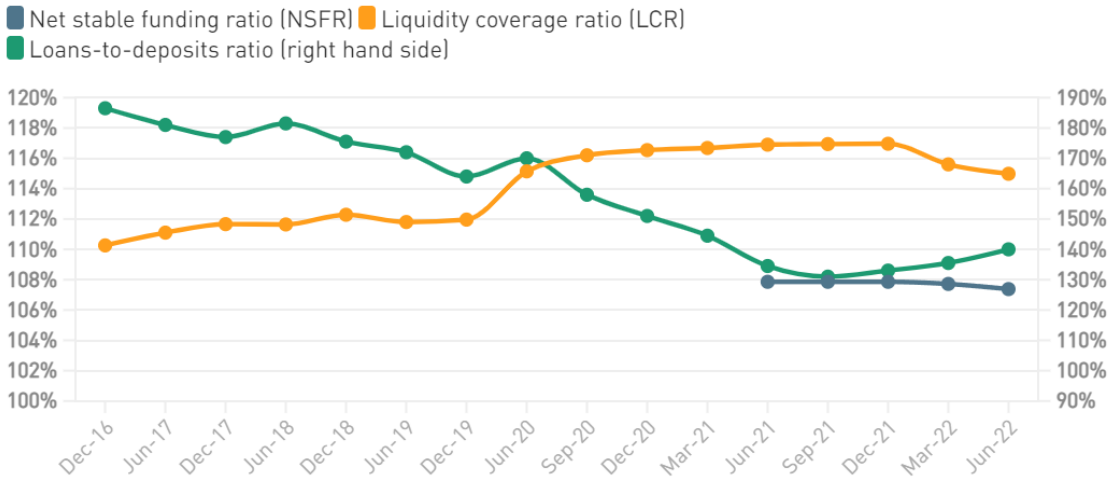
EBA Risk Dashboard shows that capital ratios remained broadly stable and liquidity ratios declined slightly

The European Banking Authority (EBA) has published its quarterly Risk Dashboard covering the main risks and vulnerabilities in the EU banking sector.

- The average CET1 fully loaded ratio remained unchanged at 15%.
- Overall, banks reported robust liquidity ratios with the average liquidity coverage ratio (LCR) reaching 164.9% and the net stable funding ratio (NSFR) standing at 126.9%.
- While EU/EEA banks' NPL ratio kept on declining (from 1.9% to 1.8%), the Stage 2 ratio was again on the rise (from 9.1% to 9.5%).
- EU/EEA banks' return on equity (RoE) stood at 7.9% (6.7% in Q1 2022). The rise in profitability was particularly supported by net interest income.



- The **LCR** stood at 164.9% although moving down from its high of 174.8% in Q4 2021. Even banks at the lowest end of the distribution showed an LCR well above the minimum.
- The **NSFR** also decreased slightly (126.9% in Q2 vs 128.6% in Q1). Going forward, the ratio might fall further amid the further nearing of maturing TLTRO funding.
- The **loan to deposit ratio** stood at 110% (109.1% in Q1 2022) due to a slightly higher increase in loans than in deposits to households and NFCs.



Source: Supervisory reporting

To read more:
https://www.eba.europa.eu/eba-risk-dashboard-shows-capital-ratios-remained-broadly-stable-and-liquidity-ratios-declined

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