TC Webinar Series:
Revised Core Principles for effective banking supervision
Part 1: Financial Risks and Macroprudential Supervision

Panelists:

Nathalie Aufauvre

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Bill Coen

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Moderator:

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Transcript:

Babak Abbaszadeh:

Hello everyone. It's such a pleasure to be with you again. This is one of the things that I really enjoy about my job, is interviewing fantastic people. I'm Babak Abbaszadeh, CEO of Toronto Centre. Welcome to our first panel on the revised Basel Core Principles. Today we will focus on financial risks and macroprudential supervision. We plan to hold four more of these. By the way, we have had about 400 people register for this webinar from 80 countries representing 100 agencies.

So this is quite an impressive turnout and it's really a testament to the strong speakers that we have recruited. I'll talk to you about them in a second. But Bill and Nathalie, I think it's fair to say that you are the equivalent of Taylor Swift in supervision, so we're very grateful to have you here. So since our establishment in 1998, Toronto Centre has trained more than 26,000 financial supervisors from 190 countries and territories to build more stable, resilient, and inclusive financial systems. Our mission is sponsored by Global Affairs Canada, Swedish Sida, the IMF, and other valued international partners.

Let me congratulate the Basel Committee on their 50th anniversary – quite a milestone. The April 2024 revisions acknowledge the rapidly evolving landscape of the financial sector and provide guidance on how to strengthen the macroprudential aspects of supervision, promote operational resilience, reinforce corporate governance and risk management practices, and address new and emerging risks, including digitalization of finance and climate-related financial risks.

By providing guidance on key supervisory issues, the revised Core Principles ensure that supervisors are equipped with the tools and frameworks needed to address the challenges of today and tomorrow as they safeguard the integrity of our financial system for the benefit of us all. Today, our distinguished panelists will help us unpack some of these issues, given their wealth of insights and expertise. They have appeared at Toronto Centre webinars before and so I'm sure they're very familiar to many of you.

Natalie Aufauvre is the Secretary General of the French Prudential Supervision and Resolution Authority (ACPR) at Banque de France. Bill Coen is the former Secretary General of the Basel Committee on Banking Supervision, and we're also very grateful that he's a member of our board and the Chair of Finance, Audit and Risk Committee of Toronto Centre. So welcome to our speakers.

Now let's start with the questions themselves. Right now, we're going to have three rounds. Also, I encourage you to please write in your questions, take advantage of the expertise that's here, and we will try to get through as many of your questions as we can.

The first round is going to focus on Basel standards and systemic risk. So Bill, you are the former Secretary General of the Basel Committee and during a very difficult time, the Global Financial Crisis (GFC), and I think our viewers might be curious about your take on the types of efforts, balancing acts, and stakeholder relations that go into revising or creating standards. So a bit of a view from the inside. Can you please share your insights with us about what goes into that kind of preparation and production? Thank you.

Bill Coen:

Thank you Babak, and let me start by saying many thanks for the invitation. Very happy to be here and it is an honour to participate in this with Nathalie. And Nathalie, it's very nice to be reconnected. We got to know one another through my Basel Committee days.

Babak, the standard-setting process is a huge effort. There are 27 countries on the Basel Committee. There are 45 central banks and supervisory authorities that comprise the Basel Committee. It's actually much more than that. There are a number of countries and organizations like the IMF or the European Commission, and there are some countries that are at the Basel Committee table as observers. Also, the Basel Consultative Group that's comprised of about 20 different countries, supervisors from around the world. And so, the Basel Consultative Group played an especially important role when revising the Basel Core Principles. So it really is an inclusive process, an encompassing process, a global process.

I think it's important to point out there really isn't one country that dominates. When I was in Basel, I testified a number of times before the E.U. Parliament as well as U.S. Congress. E.U. Parliament would say, wow, Bill, we know the process is dominated by the Americans. I'd go to Congress a week later and they'd say, we know that the Basel Committee is a European construct. There are nine European E.U. members, and it's a European process. And I would say to both of them, that's just not the way it works. It's not a reflection of reality. It is a wide-ranging, really, really inclusive process. There is a clear recognition at the Basel Committee that this now is, it is a global standard that Basel Committee sets. Maybe this wasn't always the case, in the very early days of Basel I, but I think there is this recognition that what the Basel Committee creates is a global standard.

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> Toronto Centre

It's important to point out it's also a minimum standard. And I think, as an example, when we were developing the responses to the Global Financial Crisis, things like the leverage ratio or higher calibration of minimum capital standards, or better-quality capital that's meant to absorb losses, I would visit countries, these regional supervisory groups all around the world – Asia, Africa, Latin America, Eastern Europe – and I would talk about these things, leverage ratio capital, higher-quality capital. And I think the reaction was, no big deal, we already do this. So I think it's important to point out that they're minimum standards, there was a recognition that they're, they're going to be applied globally – and that's important because of the Financial Sector Assessment Program that's conducted by the IMF and, to a lesser extent, the World Bank.

What it is not: so, it's a global process. It's a global minimum standard. But what it is not, the whole standard-setting process I'm talking about now, it's not a negotiation between regulators and the banking industry. I think the industry has this impression that this is a negotiation. That the Basel Committee starts out at something, let's say 100, the industry says "no, 50 is the better number. Let's negotiate, let's compromise at 75." That's not really the way it is supposed to work. These are minimum prudential standards. It's one of the reasons why the Quantitative Impact Studies (QIS) are such an important part of the standard-setting process. It is important to know what the impact is going to be. It's got to be a full awareness on the Basel Committee side. It's got to be a full awareness of business practices and the variation in business practices around the world. And the QIS really helps to inform that.

So I think that whole feedback mechanism through the consultative process, the comments that we receive, or the bilateral discussions with trade associations, with academics, with consultants, it's such an important part of the process, because that's how those on the regulatory side have a full understanding of both the impact but also the practices in different parts of the world.

So let me just kind of sum up, what did I just say, Babak? The bottom line. It's the standard-setting process. A lengthy, inclusive, thorough process. It is a minimum standard. It does take account of all stakeholder views from all regions of the world. It's not a negotiation between the industry and supervisors.

And one last thing, and maybe this is the most important thing, what I've talked about for the last couple of minutes, standards: Now the standards are set by the Basel Committee, countries, or jurisdictions like the European Union or countries like the U.S., Japan, and the others. They take that standard and they transpose it into a rule, a regulation, a law, a directive, whatever it's called in that region, that jurisdiction. But we're talking about regulation. What about supervision? It is the Basel Committee on Banking Supervision. And that's so important to point out. I think people kind of forget the fact that you can't really have a safe, sound, stable financial system based on robust, rigorous regulations. You have to have good supervision. And that's a simple part of what I was saying in my final six months, final year of my role as Secretary General of the Basel Committee, you have to continue to focus on good, strong supervision. So I'll leave it at that.

Babak Abbaszadeh:

Well Bill, thank you. I think that was a very good explanation. And it struck me – in my former life I used to be working with elected officials and there, back then we were saying don't try to figure out how legislation is made, it's like watching sausage being made. What I'm hearing from you is that it's a much more rational process, focusing on the minimums so that others can do better. So that's very important. Also, for the viewers, I mean Toronto Centre is in a very interesting position right now. We have four very key former Basel people on our board: Bill and Karen Rogers as former Secretary Generals, the current Chair of the Basel Committee is on our board, the former Chair of the Basel Committee is also on our board. So what Basel does, what Basel says is very important to us. I'd like to also thank the team at Toronto Centre who worked so hard making this webinar possible.

Nathalie, let's go to you. So going from the general to more specific, what has been the most significant driver of systemic risk in your jurisdiction? You can define your jurisdiction as France or the E.U. What macroprudential tools have you found most useful in addressing these risks? Thank you.

Nathalie Aufauvre:

Thank you Babak. And first I would like to thank you for the invitation, I'm so pleased to see you again, and Bill. So that's really nice. And maybe a small reaction to Bill's introduction. I would also say that Basel Committee discussion is a way to develop trust among supervisors and it's very important in order to be able to react in a period of crisis. So we develop methodology, common methodology, common languages, and trust. And I think it is also a very precious aspect of this committee and its functioning.

So now, coming to your question, Babak, maybe first I would like to also add a comment regarding developments since the Global Financial Crisis, which is to say that banks have continued to build their resilience to financial risks. It was really the aim of the Basel III discussion and they were underpinned by stronger regulatory and supervisory frameworks, including the Basel III standards and of course the Core Principles for effective banking supervision, revised earlier this year.
This has been notably the case in France and more broadly in the euro area.

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> Banque de France

And despite significant episodes of stress over the past two years, including, as you know, geopolitical tensions, bank failures in the U.S., and the forced takeover of Credit Suisse, so many, many big events over the last two years, the soundness of the European and French banking sector has been confirmed both from the solvency and liquidity perspective. For example, the CET 1 ratio of France's six main banking groups (it's very concentrated in France) was 15.5% at the end of December 2023. That is well above regulatory requirements and their aggregate liquidity coverage ratios stood at around 150% – just to show that they have improved a lot their resilience. That said, there is no room for complacency.

And the post GFC period has also reaffirmed the importance of applying a system-wide macro perspective to the supervision of banks to assist in identifying, analyzing systemic risks, and taking preemptive actions to address them. In France and in the E.U. we have adopted and made wider use of such a macro perspective, not only with the creation of national macroprudential authorities and, at the European level, of the European Systemic Risk Board (ESRB), to address both the cyclical and structural dimensions of systemic risk. In France, the authority responsible for setting up macroprudential tools is the High Council for Financial Stability (HCSF), which brings together eight members including the Bank of France and the ACPR. And actually because of these big events, the HCSF has been active in using macroprudential tools both on the cyclical and structural dimensions. So we have now a range of complimentary tools in place and tailored to the French situation.

The systemic risks that the HCSF identified in recent years have exhibited a cyclical component, the main driver of such risks being the impact of monetary tightening on the financial sector – the impact of higher interest rates. But we also have remained alert to other and more permanent risks that we considered as elevated in comparison with what we observed in the euro area, namely the high level of non-financial, private-sector indebtedness, which stood at nearly 140% of GDP in France – so quite a high level, compared to the average in the euro area, which is at 108%. So you see a significantly higher level of global indebtedness in France. So it was really important for the HCSF to take into consideration this high level of debt. That's why we have gradually raised the Countercyclical Capital Buffer (CCyB) to 1% to increase the resilience of banks to cyclical systemic risks.

Really the idea is 'learning by doing' because those tools are quite new and we have tried to tailor them to our situation.

Nathalie Aufauvre

Banque de France

In addition, we have also addressed these risks by implementing structural tools that act as a guardrails – namely, borrower-based measures for housing risks, since 2019, to address the deterioration of lending standards, and also a sectoral systemic risk buffer, since 2023, to address risks related to highly indebted non-financial corporations. I can enter in more details later on if you wish, but really the idea is 'learning by doing' because those tools are quite new and we have tried to tailor them to our situation.

For example, if you take the housing market in France, it has specific features because it is based on a guarantor scheme. It means that most loans are guaranteed through a guarantor scheme and the use of mortgages whereby the home is used as collateral is very limited in France. And this helps to mitigate the credit risk for banks in case of house price corrections.

Another characteristic is the fact that loans are at fixed rates for the entire duration of the loan. So this also limits default risk for households associated with a rise in interest rates. And the third characteristic is the fact that borrower solvency is assessed based on an analysis of income rather than on the value of the asset. So this also provides protection against the risk of a feedback loop between house prices and home lending. So you see we have characteristics, so it means that macroprudential tools have to be adjusted to the national local characteristics. And it's why we try to also use the countercyclical buffer because we thought it was a way to directly reinforce the resilience of banks, but not necessarily having an impact on the cycle.

Regarding our sectoral systemic risk buffer, it's really another structural tool that we have used and which is one of the tools that are granted by the European macroprudential framework. We have used it to target a very specific potential vulnerability that we had identified in the French financial system – that is, large exposure of systemic banks to highly indebted non-financial corporations. As we needed to target a very specific subset of non-financial corporations, we had to build on the capital requirement directive to go beyond the standard macroprudential tools. That is why the sectoral systemic risk buffer of 3% is applied if the exposures to highly indebted non-financial corporations exceed 5% of a bank's capital. And we think that this macroprudential tool acts as a deterrent for banks from increasing such riskier exposure. So it's a kind of preemptive tool which sends a signal, a clear signal, to the banking sector.

So just to conclude on this, I think we must continue our efforts. The macroprudential framework for banks is up and running now. It's really new, but it's up and running. But I think it's now important to collectively reflect also on the macroprudential approach to further address the risk stemming from the non-bank financial sector because it has developed a lot. So we have now the microprudential for banks, the macroprudential approach for the financial sector – banks also, but also we need now to look at the issue of NBFI (non-bank financial industry) because of course there are also many financial stability risks related with their development. I'll stop there for the moment.

Babak Abbaszadeh:

That's great. Nathalie, thank you so much. I think it's very impressive to see the vigilance that you are bringing to bear. And also it kind of ties back to what Bill said, standards and principles are essentially a starting point and they do not replace judgment. So you are bringing judgment to bear based on the alphabet soup of organizations you talked about and the specific examples. So that's actually very useful for all of us.

Let's move to the second round. We're going to talk about Basel Core Principles, compliance challenges. So Bill, based on your experience, what are the key challenges in implementing macroprudential policies in emerging market economies and how can these challenges be overcome? Thank you.

Bill Coen:

Good question, Babak. Thank you. Nathalie, a moment ago, Nathalie mentioned macroprudential tools, interest rates, the CCyB, the countercyclical capital buffer, borrower-based measures like value ratios, debt-to-income analyses, things like that. These are things that have been in place, except for the CCyB – macroprudential considerations have been around for a while, they just have never really been formally adopted as part of the bank regulatory framework. And that's why I think the CCyB is so important, because now it just formalizes that discipline, that way of thinking about how to keep a financial system safe and sound and stable.

Nathalie said something really important: learning by doing. And that's exactly what's happening with the countercyclical capital buffer and other parts of the framework. You asked a moment ago, Babak, about some of the challenges, particularly in an emerging market context.

Well, I guess first of all, anything new, right, anything new takes time to get accustomed to the framework and what that framework seeks to address. So just the newness and okay, it's been a couple of years, but there's got to be experience with imposing the CCyB, withdrawing it, putting it back in place depending on macro conditions in your particular environment. The newness of course is the starting point, is the challenge.

Another one is bandwidth. I mean there is so much going on, right? There's new risks and Babak, in your opening comments, you mentioned climate-related financial risk, the digitalization of finance, there's the ever-present cyber risk or cyber resilience, crypto assets, this whole digital evolution that both supervisors and the banking industry are undergoing. There's a lot going on.

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> **Bill Coen**
> Toronto Centre

And of course, on top of the other more traditional functions and responsibilities of supervisors, there's credit risk – Nathalie talked about housing finance. Every jurisdiction that I've been exposed to, and I guess I've been exposed to most of them, housing finance will always be one of the biggest risks – credit risks, but particularly housing-related finance. So there's credit risk, there's AML, there's sanctions. So the landscape for supervisors is ever changing and it's ever busier. We've got Basel III, the new Basel III, most of it is in place, but parts of it are still coming online. Revised standardized approach for credit risk, a new op-risk framework for those jurisdictions that use the Fundamental Review of the Trading Book, and have market risk rules. There's a lot there and there's a lot to learn to put the new frameworks in place.

And then of course the whole function of this panel is to talk about the Basel Core Principles for effective banking supervision. Why is this important? Well, I mean just to state the obvious, it's important that you have a well-run, robust supervisory apparatus in your country.

It's also important from the context of the FSAP, the Financial Sector Assessment Programs. For people who think that doesn't matter, I can tell you different. I can tell you different. I've spoken to large institutional investors, credit-rating agencies, counterparties who do business in a country – it is something that's very closely watched, how a country is rated when it comes to compliance with the BCPs, the Basel Core Principles.

So, Babak, that's a long way of saying – the challenges that you mentioned, there's the newness, there's bandwidth because there's so much going on. And I guess as a corollary to that or an extension of that, there's resources. Does a supervisory authority have the necessary human resources? Does it have the necessary financial resources? In other words, budget.

Most would say it doesn't matter. An emerging market economy, a developed economy – everyone has budget issues, particularly these days when it comes to human resources. And so many jurisdictions are having problems attracting, hiring, and retaining staff. And this is not just a public-sector thing, it's a private-sector thing as well. And so how do we attract, hire, and retain staff is a big issue. So what are the solutions? Are there solutions?

First of all: technology, without a doubt. Supervisors rightfully ask banks, how are you taking full advantage of FinTech? That's important. RegTech is important. Banks, a lot of banks, are saving enormous amounts of money by improving their regulatory reporting through the use of regulatory technology, RegTech. But what about SupTech? It's just as important for supervisors to take full advantage of technology.

One of the things I did once I left Basel, and that was a couple of years ago, I edited a book called *RegTech, SupTech and Beyond: Innovation in financial services*. I spoke with a number of central banks and supervisory authorities about their digital transformation, their digital journey as some people like to say. And there's a good story to tell, but things are changing so quickly. And the big question for everyone, public and private sector, is how to take full advantage of technology and SupTech, particularly with the promise of artificial intelligence. AI is such a huge opportunity, but it's also quite challenging.

So I would say technology is one of the ways to address these challenges that I mentioned. Staff training: this is a huge one, really a critical dimension. Taking full advantage of resources and – this is an ad for the Toronto Centre, I didn't mean for it to be – but training is so important and it's a tremendous opportunity to have an organization like the Toronto Centre that offers cutting-edge training on topical issues, things that we've been discussing so far during this panel, taking full advantage of that.

Finally – Babak, you said earlier in your career you worked with elected officials – the importance of, underscoring the importance of, a really strong supervisory apparatus, supervisory framework.

There are many countries around the world who do have that recognition and their budgets are such that they can pay supervisors and central bankers a salary that approaches, maybe it's not exactly on par with the private sector, but it's approaching that. So there's a clear recognition in some jurisdictions of the importance of supervision. And that really starts with elected officials. And I think people recognize the importance of a strong supervisory structure. They recognize the importance when there's a failure or when there's some kind of a major disruption or even a crisis in a jurisdiction. It's hard to identify, though, during good times. So you need good supervisors in bad times and their good work goes unnoticed in good times. But it is important to underscore the importance of a strong supervisory structure. Babak, back to you.

Babak Abbaszadeh:

Thank you, Bill. This was a very, very thorough response and I think the one observation I want to put on the table – I see a lot of supervisors around the world, talk to a lot of them, and the reality at the end of the day is, and this is a kudos to all those supervisors who are watching, you guys, you women, never, ever get a positive press release when you do something right. But when there's a financial failure, politicians, everybody else ducks out, going to the washroom or wherever. It's the supervisors that – their neck is on the line. And in some jurisdictions, they don't even have legal protection. So everything, Bill, you said is something we take very, very seriously to equip them and argue for, advocate for, strong, independent mandates. And we learn from all these various issues.

So let's just carry on and we have, I see some questions beginning to trickle in, so hopefully we'll have some time left. So I'll ask Bill and Nathalie in the next segments that we are talking, if you could limit your responses to five minutes, that would be great. It's really a shame that I'm asking that because your responses are amazing. This should have been a much longer webinar.

Nathalie let's go to you. What considerations have informed your calibration, implementation, of the countercyclical buffer tools in your jurisdiction? Now the next question is very important. What have been the biggest challenges when communicating with stakeholders? Because when I say countercyclical, I bet you a lot of people are getting frightened, like how do you communicate all this to stakeholders who need to really understand it? Thank you.

Nathalie Aufauvre:

Yes, you're right. It's a most difficult question and the most challenging one. Actually, at the HCSF in France, the governor of the Banque de France submits proposals and the committee discusses, and in the end, the chair, who is the Minister of Finance, decides. So let's imagine, even if all the people within the committee understand very well the aim of macroprudential tools and the need to adopt them, sometimes – if you take the countercyclical buffer, the idea could be that its impact would be to reduce the lending capacity of banks, so it could reduce growth in the end.

So it's not easy for a Minister of Finance to press a button, saying, "I deliberately decide to reduce potential growth." So you see, it's rather complicated. And that's why we really work on this communication or issue and say, look, if you look at the impact of increasing the CCyB from zero to 0.5% and then 1%, the impact on growth is absolutely very, very limited.

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> Banque de France

But in the end, you have increased banks' resilience – capacity to resist in case of a crisis. And so what we did, we tried to change a little bit our communication by saying, "It is a tool in order to protect credit in the future in case of crisis, and to avoid a credit crunch in the event of a crisis by releasing this buffer." So the idea is not slowing down the credit cycle by this measure, but, on the contrary, to avoid a credit crunch if we have a crisis. And that's why the HCSF decided to refer to the CCyB as a "Credit Protection Reserve." First, because CCyB is not understandable by people, the general public can't understand that. But Credit Protection Reserve is something much more positive, you see? And it shows, the major effect which is looked at, is the effect of what happens in case you release the buffer in a period of crisis.

Also, another thing we try to do is to increase the CCyB progressively. We increased it in France from 0% to 0.5% in March 2022, and then to 1% in December 2022. This gradual approach was justified also by the highly uncertain macroeconomic environment in 2022. Because we had inflation, we had the start of interest rate increases and the strong increase of interest rates leads to a forecast of a clear – not a recession, but a reduction in growth. So it was also a way to accommodate fears, concerns, that we could have procyclical effects in a negative way in the sense that it would intervene, the increase in the CCyB would intervene, at a moment where the macroeconomic would be completely different. So it was a way also to accommodate those concerns.

And maybe also there are different views on the way CCyB can be used. On our side, the fact that the current CCyB rate is at still 1% should not be interpreted as a positive neutral CCyB. Some countries have decided that the CCyB should be at a positive level, for example, 1% in its neutral position in order to always have the possibility to release it, so to have the power to release the CCyB in case it’s needed.

But in the case of France, we believe that such an approach would go against the very philosophy of this buffer, which is intended to address cyclical systemic risks and not structural ones. And we think that we can implement, use another tool – it’s quite complicated, all these macroprudential tools – but we think it’s much more appropriate to use another systemic, structural risk buffer in Europe, which exists in the European framework, and which is the systemic risk buffer. So it depends, as we said earlier, it is learning by doing. You have to adjust it to your country, to your local situation and see which instrument is the best. And we are still in the period of developing these instruments, but communication is absolutely key in that.

Babak Abbaszadeh:

And also in terms of – first of all, thank you for that response – in terms of communication, for those who may not be so up on the various abbreviations and acronyms, CCyB, countercyclical capital buffer. So communication is absolutely key. I totally agree with you sometimes it’s best to do and then plan, especially when things are beginning to shift. It may sound contradictory, but that’s where we are. Communication is really key. Let’s move to the final part of the structured questions and then we open it up to Q&A, we’re already seeing a number of questions there, so I’d like to be able to get to as many of them as we can.

This one is Basel Core Principles and climate risk. Bill, why do you think the Basel Committee incorporated climate as an important risk at this time? Thank you.

Bill Coen:

This isn’t a new risk. It’s not a new consideration. I chaired a group with the Basel Committee called the Policy Development Group and we were talking about somehow addressing climate risk through the Basel framework as far back as 2015, 2016.

It’s not a regulatory issue at this point, it’s more of a supervisory issue. It’s more of a risk management issue. And that was the conclusion, I think, of the Basel Committee back then. I think people acknowledge or recognize that this is a risk. It’s different: think about the time horizon, the time horizon could be 10, 20, 30 years or longer. So it’s a very different time horizon. But the main issue, or I guess what’s really lacking, is data. Everyone knows it’s a risk that will have an impact on banks, particularly banks’ borrowers, but there’s not good data to help inform setting a regulation. But that doesn’t diminish the importance of the risk.

And I think that’s why it’s in the Basel Core Principles. It is a material risk that banks have to be addressing. And it shows up in several of the different Core Principles – particularly, there’s one Core Principle on the supervisory approach. So you as the supervisor, does your approach recognize the importance of climate risk? Are you talking to your banks about, have they developed policies? How about their methodologies? Are they trying to measure, manage, mitigate climate risks? So it’s really just part of the supervisory discussion with banks.

This is very similar to the trajectory for operational risk. I worked on Basel II, and so 25 years ago, the Basel Committee had proposals on operational risk. And similarly, back then there wasn't much data, there wasn't commonly accepted methodologies for managing operational risk. There certainly wasn't clear-cut definitions, but everyone knew it was a material risk, probably after credit risk is the second biggest risk of losses coming from operational risk. But that was then, that was 25 years ago. Now the methodologies for operational risk are far better. There are commonly accepted definitions. And so we've come a long way when it comes to operational risk. I suspect the same will be true for climate risk. I think it's moving even faster for climate risk.

Again, going back to my point earlier, don't think about this in terms of regulation. Think of it in terms of supervision – risk, risk management, governance, those three things really matter. I think they matter more than regulation. And that's why climate risk really is a particularly important new addition to the BCPs, to the Basel Core Principles, because of its materiality.

Babak Abbaszadeh:

Well, thank you Bill. And I think I'm going to take a bit of a jumping off point from what you said about governance. So when we talk about ESG, it is firmly our view that the G is probably the most important letter there. Without good governance, the environmental and social is just something bopping along and how can you possibly have a way of trying to deal with it? And I think many organizations probably don't get that right. They focus more on the E and then maybe S. The other thing is I really would like to take this opportunity to congratulate the Basel Committee for finally putting climate into the risk aspect of their work. And when Toronto Centre deals with climate risk, we also deal with it from risk-based supervision. So very much along the line that you talked about.

So Basel has now joined IOSCO, IIS, NGFS, and ISSB, so now this is a very strong front for that. And you mentioned some things about the banking sector and looking at the trajectory of the risk. But if you look at the sister organizations in the insurance sector, there is literally a wildfire going on. There are companies that are going bankrupt in California of all places. So climate is very much front and center for them in the financial sector. And it is a supervisory issue, as you said, again, because policymakers, governments, are not making those tough decisions on carbon and other things. So it's all falling on the supervisors trying to manage that.

So, trying to set it up for Nathalie: How should supervisors and regulators integrate climate-related risks into their supervisory framework? Thank you.

Nathalie Aufauvre:

First of all, I concur with the idea that climate change should be first dealt with by microprudential supervision. As you said, I think supervision is the key. The microprudential supervision is key here.

At the ACPR, we started work on this in early 2020, we conducted the climate pilot stress test, which was the first exercise of that type. And we did it with both banking and insurance groups. And it was a very challenging exercise, but we learned a lot on how to conduct this kind of exercise and for banks and insurance groups, how to understand better the development of climate-related risk in the future. Because what is important is to see how it will develop. And so in the future, we are going to start to work to prepare for the integration of climate-related risk in our supervision work because in Europe we have the regulation which imposes banks to prepare a transition plan. And now we will have the mission as supervisors to check and to assess those transition plans.

> Systemic risks of climate change are becoming increasingly prominent and … we should collectively think how best to further develop macroprudential frameworks to address them.
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> **Nathalie Aufauvre**
> Banque de France

So we are really starting to work on this topic at the very individual level, micro level. And I think the work on our side is very new, and we will have to, of course, to build up skills and it is challenging for corporates, but for us too. But that being said, I think also that systemic risks of climate change are becoming increasingly prominent and that we should collectively think how best to further develop macroprudential frameworks to address them. So it's the second part of your question. And of course it's very new. As I said, macroprudential tools are just developed, have just been developed for more traditional risks, and for climate-related risk, it's even more new. I think it is worth considering and exploring the various options available.

We have a recent report by the ESRB, the European Systemic Risk Board, on this. The title of the report is *Towards macroprudential frameworks for managing climate risk*. It was released at the end of last year. And it provides a first detailed perspective on the options available and the goals to address this issue of climate risk, that existing macroprudential instruments are already relevant and appropriate to address climate risk because actually climate risk is not having a specific impact on banks and the financial sector because it can have an impact on operational risk, it can have an impact on market risk, it has an impact on governance as you've mentioned, because banks and insurers have to incorporate that dimension in their governance. So you can use all the different tools which are in the toolkit of supervisors to address this issue of climate risk because it can have different types of impact. And for the same reason, macroprudential tools can be used to address climate risks, with some adjustments of course. So those macroprudential tools can be very flexible and potentially useful instruments to increase the resilience of the financial system. For example, you can certainly use the systemic risk buffer that we have in Europe in order to address some climate risk.

I think also there are some specificities in climate risk, which is concentration, negative externalities, interaction between physical and transition risks. So we still have a lot of work to do in order to understand well how we can fine-tune those tools in order to have a macroprudential approach because we can have external shocks related to climate risk that would impact the whole sector. But I'll stop there.

Babak Abbaszadeh:

No, that's great. That's actually very important. And I'd like to say this is not a new issue for supervisors. Toronto Centre has been involved in teaching climate risk before even standard-setters looked at it, since 2016. So we have very practical information, knowledge, and techniques to talk about when it comes to risk-based supervision and incorporation of climate. So please take advantage of our resources. Some of them are available on our website, courses are available. Please take advantage.

I've never done this but let me ask the two speakers. There's a lot of questions. I'm wondering, are you able to stay an extra five minutes for us to be able to go through as many as we can? Okay. And then this is my appeal to you as the moderator. We are going to go into the CNN style, right? Which means you're supposed to answer the question in no more than 30 seconds. This is in fairness to the audience. So I know there's a lot to say, but please give your top-line views on things and we will move on. So I see a lot of questions here, including from the very courageous anonymous attendee, but let's go to some of the ones that are key here and not to exclude anything. So Bill, one question to you from Seynam: Challenges with regards to implementation. I want to know if political interference is a challenge in developing economies and how is this managed? Thirty seconds!

Bill Coen:

This is a good question. It's a factor in EMDEs, in all countries. One of the important BCPs that's assessed by the IMF during the FSAP process is independence. And that's one of the most regularly recurring weaknesses of any country that gets an FSAP. So independence and political, well by extension, political interference, it's a huge factor. And that's why it's a Basel Core Principle, and that's why it's assessed by the IMF and the World Bank. It is a problem everywhere and people are aware of it.

Babak Abbaszadeh:

Thank you. And Nathalie, this other question for you again, 30 seconds. Is macroprudential – this is by Dwityapoetra – is macroprudential policy only aimed to mitigate systemic risks, or can they be also implemented for promoting growth for your Minister of Finance? Thanks.

Nathalie Aufauvre:

For me, it really, in order to reduce risks and increase resilience, banks' resilience, I mean, and to limit risk for financial stability. You have other types of instruments for supporting and enhancing growth. So I really think it's a question of risk management, but global risk management for the financial sector.

Babak Abbaszadeh:

Okay. Excellent. So Bill, I think I want to pass this one to you. Has the skillset required to be a supervisor changed given the need to understand climate risk and technology risk?

Bill Coen:

I don't think so. I think it's important to have, I always had a generalist background and I had a particular focus on credit risk, but I was curious and I learned, I learned a lot about market risk and operational risk. I think what's important for any supervisor, really, any financial-sector employee, be curious. You can learn. I think it's important to have people on staff who are experts. You can have one, two, you can have a small team, but from a supervisory perspective, it's important to know the basics. It's not that hard to learn the basics and what we as examiners, as supervisors assess – and that's really where things go wrong – is the basics. That's what trips up banks most of the time is failing to meet the basics. So I think it's good to have somebody on staff who has a little bit of, who could be an expert. But I think for the rest of the staff, I think just having a base knowledge of climate risk, how it affects banks, I think that's important. So thanks for the question.

Babak Abbaszadeh:

That's good, Bill. And also one of the things we find often is when you talk to supervisors, even experienced ones, sometimes they are not able to answer the question, what are you supervising? Right? They go right into these acronyms and everything else. But just trying to understand, that is very critical in building capacity where, you're right, it starts with that curiosity. So Nathalie, this is not necessarily so much a question, but I think it's bit of a compliment indirectly for you. We have a comment from Atul that says, "Very informative session. I have an engineering background, but learned a little about macro and micro prudential." I guess in his background. So he found it very interesting. So that's great.

So go with the question that Joseph has. Which of the macroprudential measures should be prioritized by a prudential authority to deal with climate and biodiversity risks, sustainable finance, capital buffers, risk weighting. Okay, 30 seconds. Let's see what you can do with that. Go ahead.

Nathalie Aufauvre:

I think it's very important to adjust to the local situation. I can't have, I think, a one-size-fits-all solution or reply. It's really dependent on the local situation because climate risk will affect countries in very different ways, depending on where you are. What are the type of your activities? Is it more physical risk or more transition risks? What are the risks in your financial system – is it more on the bank side, on the insurance side? So I think the first thing to do is to assess the risks and ask banks to identify the risks. Once you have identified the risk, you can decide how to take measures, macroprudential measures. If you think that the banking sector is very much at risk, you can use CCyB because it's a global measure, all banks will have to incorporate more capital. But it really depends on the assessment of risk. So the first step is really to assess the risk and to get the data, which is not always so easy.

Babak Abbaszadeh:

That's right. So assess the risk, understand the risk. And also it is very rare that a supervisor would know more about the risk than the financial institution itself. So you have to be a partner with them, ask them to ask those questions.

Bill, a question from our friend Faizu from the Bank of Ghana. The FinTech and payment ecosystem, in my view (his view, not mine), may be a source of potential systemic risk to financial stability on account of interconnectedness and the systemically important nature of the payment and settlement systems. How do you incorporate the risk emerging from the FinTech and payment ecosystem into the overall, composite risk in macroprudential supervision? It's a very well written question. So what's your view on that? Thank you.

Bill Coen:

That's a really good question. I'm on the board of a payments platform and one of the big things that they're doing is – it's like the Core Principles. It's like the Basel Core Principles for effective banking supervision, but it's called the PFMI, the Principles for Financial Market Infrastructures. Nathalie mentioned earlier the importance of communication – the importance of bank supervisors communicating, cooperating with those on the payment system side is so important. I worked at the Federal Reserve for many years before I went to Basel, and there was so little cooperation. There was no communication between those on the prudential oversight side and those on the payment system side. So, internally, I think that has improved dramatically in the last 10 years. So I completely agree with his view. It is a source of risk. Nathalie talked about non-bank financial institutions. So just the awareness, and there's a much greater awareness of NBFI risk, but also taking it to the next step, communicating with those who've got some kind of insights into payment systems and non-bank financial institutions, is key here.

Babak Abbaszadeh:

Great, thank you. Nathalie, we have a question from Amalia. Do you have any input on how macroprudential supervision will evolve with the implementation of the CBDCs (central bank digital currencies)?

Nathalie Aufauvre:

We are still in the preparation phase in Europe on this project. And of course one aspect is the impact on bank deposits, which is a major concern for banks. That's why in the design of this project, it is expected to set a ceiling on the amount of CBDC – so digital euros, in our case – that would be held by individual people. It's a way to avoid the digital euro to become a kind of saving product. We want it to be only a payment instrument. So I can't say a lot up to now because studies are still going on.

If we have this kind of ceiling, we expect that the impact on banks and deposits and so on, on resilience and on the stability of the financial sector, will be quite limited. But now we enter into more details because it's a bit different to see the global picture, the average, and when you look at individual institutions where you might have differences depending on their business model. So now we are entering this in these details. We have many, many discussions. It's the

ECB who has conducted this work together with national central banks and also with the banking sector in order to assess the impact. I think that, of course, a key point is to have this ceiling on the holdings and it should really limit the impact on financial stability.

Babak Abbaszadeh:

That's great. I think we have time for one last question. Bill, I'm going to ask you to please touch upon operational resiliency, something you talked about, especially for cyber risk and AI, and how supervisors can stay ahead, given the speed of technology advancement. Thank you.

Bill Coen:

That's another good question because – I said earlier, Babak that it's always the basic things that trip up banks. I think of ICBC, the biggest bank in the world by assets. They had a cyber incident last October. What was the cause of that? It was something so basic. It was that they failed to install a patch from Citrix. Citrix provides remote connectivity solutions. There was a vulnerability identified. The bank failed to install a very basic patch that was distributed. The vulnerability was taken advantage of, and that caused a major incident. It even affected the U.S. Treasury market. So the point is, you have to make sure that banks, as a supervisor, you have to make sure that banks are taking care of the most rudimentary, the fundamental, the basic things. There are some really qualified people at all the banks, I've – particularly the big banks – there are some really qualified technologists who can thwart advanced, complex attempts to hack into their systems. It's very often the basic stuff. So really just make sure, try to make sure banks are addressing the nuts and bolts, the basics. The fundamentals.

Babak Abbaszadeh:

That's great. I mean, a testament to the importance of the comments you made, more than 98% of the people who signed on to this webinar are staying with us right now. And you've answered the questions extremely well. And I love the way you answered concisely, so don't be surprised if you get a call from Christiane Amanpour or Anderson Cooper of CNN to get on their programs because you passed the test at Toronto Centre. Thank you so much. We are so grateful for your participation. My apologies to the participants whose questions we couldn't get to. But as usual, we keep these questions, we incorporated them as part of our learning, as part of our future relevant webinars, so it's not wasted. And we really appreciate the goodwill of everybody. So thanks everyone. Take care and stay safe, especially during this hot climate weather as we talked about climate change. Take care.