



THE CURRENT REGULATORY AND SUPERVISORY LANDSCAPE

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Prepared for the course
**Prudential Regulation and Supervision:
Challenges in an Era of Financial Disruption**

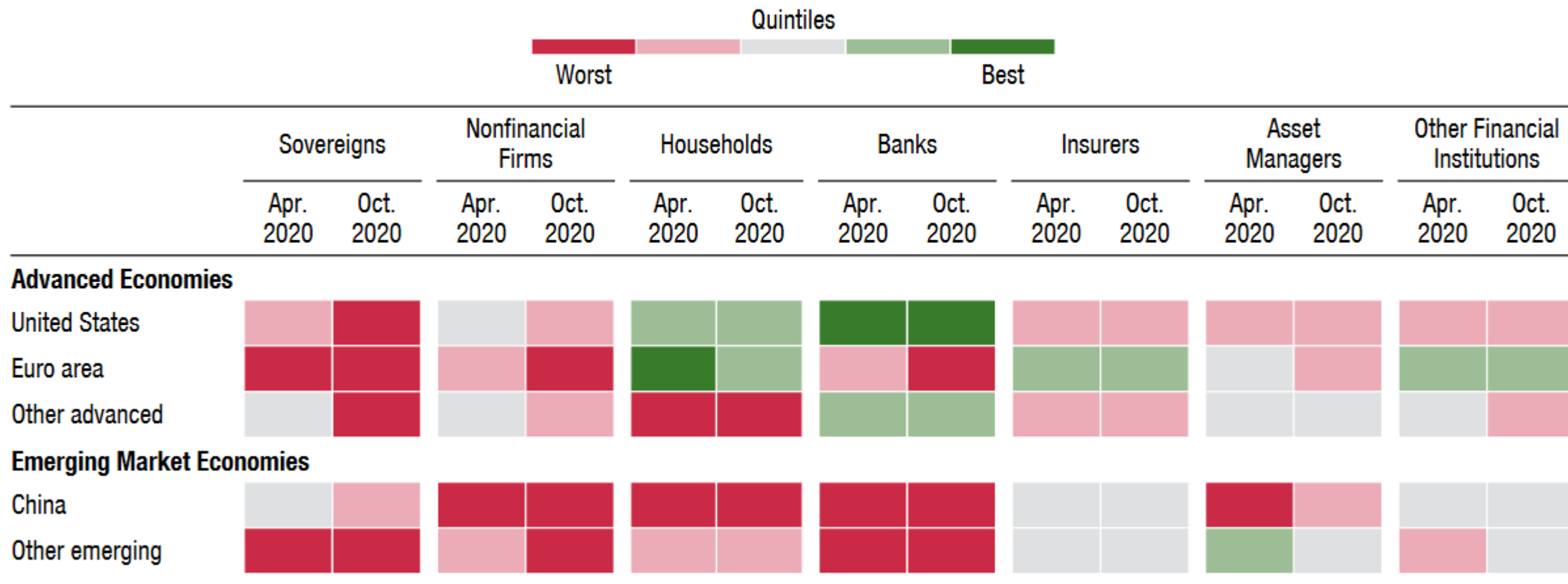
CENTRAL BANKING

15 March 2021

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THE CURRENT REGULATORY AND SUPERVISORY LANDSCAPE

2. Financial Vulnerabilities by Sector and Region



Source: Global Financial Stability Report, IMF, October 2020

- 1 An overview of the regulatory agenda

- 2 The reinforced role of supervision: key focus points

- 3 The main challenges for the financial sector

1. AN OVERVIEW OF THE REGULATORY AGENDA

Priority areas of work and new initiatives

- Supporting international cooperation and coordination of the COVID-19 response
- Enhancing the resilience of the non-bank financial intermediation sector
- Enhancing central counterparty resilience, recovery and resolvability
- Enhancing cross-border payments
- Climate change and sustainable finance

Continuation and completion of ongoing financial stability work

- Benchmark transition
- Digital innovation, and cyber and operational resilience
- Financial stability surveillance framework
- Market fragmentation
- Completing post-crisis financial reforms

Source: FSB Work Programme for 2021, Financial Stability Board, 20 January 2021

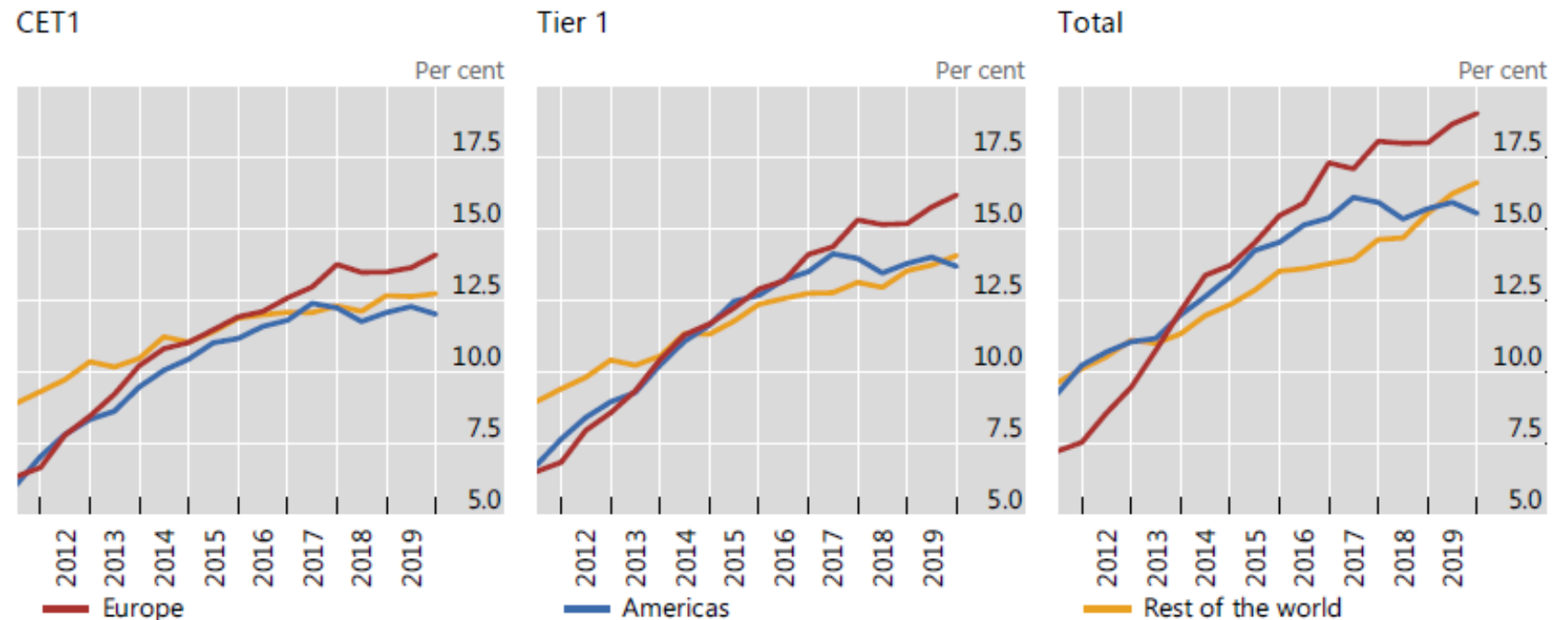
1. AN OVERVIEW OF THE REGULATORY AGENDA

Basel III implementation

Initial Basel III CET1, Tier 1 and total capital ratios,¹ by region

Consistent sample of Group 1 banks

Graph 15



¹ The graph shows the fully phased-in initial Basel III framework for the data points up to and including the end of 2018 and the actual framework in place at the reporting date for all data points thereafter.

1. AN OVERVIEW OF THE REGULATORY AGENDA

Basel III implementation

Changes in Tier 1 MRC at the target level due to the final Basel III standards

Conservative estimation, in per cent of overall basis MRC

Table 7

	Number of banks	Total	Risk-based requirements							Leverage ratio
			Total	Of which:						
				Credit risk ¹	CVA	Market risk	Op risk ²	Output floor ³	Other Pillar 1	
Group 1 banks	82	2.1	3.6	-1.7	1.4	1.9	-0.8	2.9	-0.1	-1.5
Of which: Europe	34	18.1	21.2	3.2	3.2	2.7	3.7	8.7	-0.3	-3.2
Of which: AM	13	-0.3	-0.3	2.5	1.7	4.7	-6.0	-3.2	0.0	-0.1
Of which: RW	35	-6.7	-5.4	-6.8	0.3	0.0	-1.1	2.2	0.0	-1.2
Of which: G-SIBs	28	2.2	2.9	-1.4	1.3	2.2	-1.4	2.3	-0.1	-0.6
Group 2 banks	60	8.4	14.2	6.2	1.1	0.2	2.6	4.1	0.0	-5.8

¹ Change in MRC due to the revised standardised and IRB approaches, including securitisation. ² Change in MRC due to revised operational risk framework. Figures may not show supervisor-imposed capital add-ons. Therefore, increases in MRC may be overstated and reductions may be understated. ³ Net of existing Basel I-based floor according to national implementation of the Basel II framework.

1. AN OVERVIEW OF THE REGULATORY AGENDA

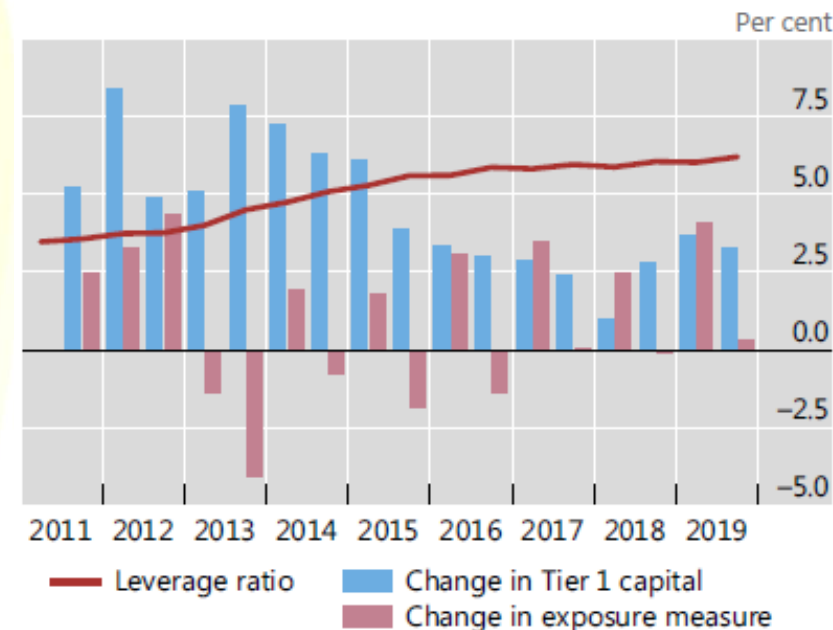
Basel III implementation

Fully phased-in Basel III leverage ratios¹ increased in H2 2019 except in the Americas

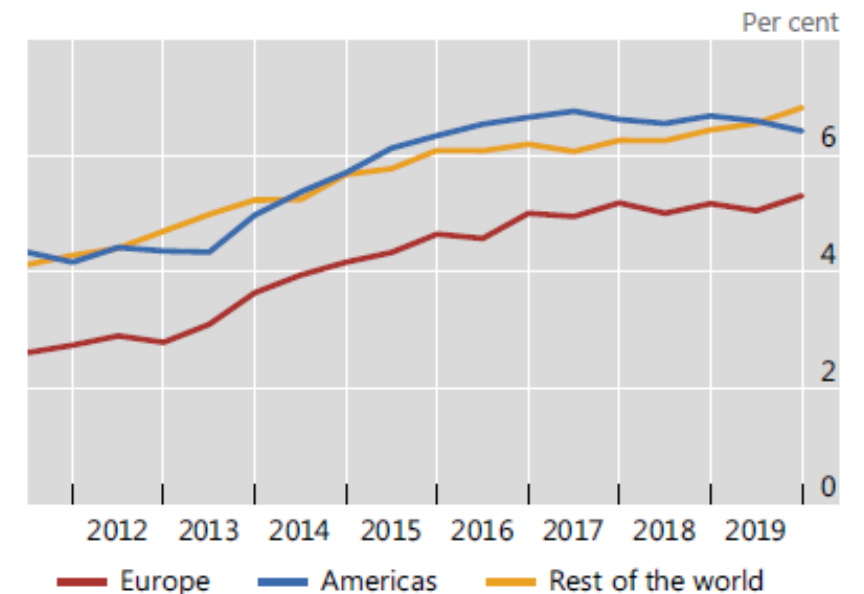
Consistent sample of Group 1 banks, exchange rates as of the current reporting date

Graph 3

Leverage ratios and their determinants



Leverage ratios by region



¹ Data points from H1 2011 to H2 2012 use the original definition of the leverage ratio. Data points from H1 2013 to H1 2017 use the definition of the leverage ratio set out in the 2014 version of the framework. Note that the data points for H1 2013 use an approximation for the initial definition of the Basel III leverage ratio exposure where gross instead of adjusted gross securities financing transaction values are used. Data points from H2 2017 onwards use the final definition of the leverage ratio to the extent data are available.

1. AN OVERVIEW OF THE REGULATORY AGENDA

Basel III implementation

CAPITAL METRICS (Pros and Cons)

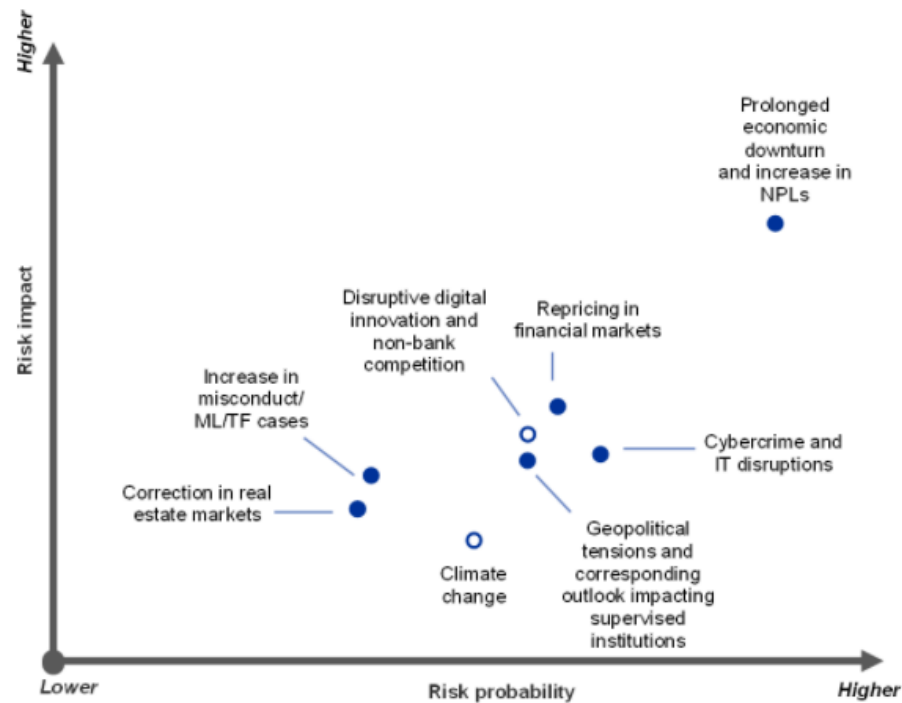
	Risk-weighted CET1	Output Floor	Leverage ratio
Considers risk of individual assets	✓✓	✓✓	xx
Mitigates risk for excessive risk-taking (low incentives to riskier, higher-yield assets)	✓✓	✓✓	xx
Promotes risk management practices	✓✓	✓✓	xx
RWAs dispersion and inconsistency	xx	✓✓	x
Low levels of model based RWAs	xx	✓✓	x
Horizontal inequality in RWAs requirements	xx	✓✓	x
Risk of building-up of excessive leverage	xx	x	✓✓
Risks of gaming (non comparability)	xx	x	✓✓
Lack of market confidence in RWAs	xx	x	✓✓
Pro-cyclicality	xx	xx	✓✓
Model risk	xx	x	✓✓
Treatment of zero RWAs	xx	xx	✓✓
Simplicity (versus complexity)	xx	xx	✓✓

Legend: ✓✓ means *pros*; xx means *cons*; x means mitigated *cons*.

2. THE REINFORCED ROLE OF SUPERVISION: KEY FOCUS POINTS

SSM Risk Map and table of vulnerabilities for 2021

The risk picture shaped by the COVID-19 pandemic and the high uncertainty about the macroeconomic outlook...



Internal to banks	Weaknesses in management and coverage of credit risk	Structurally low income levels and profitability	IT deficiencies
	Weak governance, including weak strategic steering	Lingering cost inefficiencies	
External to banks	High public and private debt levels in the euro area	Overcapacities in banking	Fragmentation in the regulatory and legal framework

... will affect banks through existing vulnerabilities requiring supervisory action

2. THE REINFORCED ROLE OF SUPERVISION: KEY FOCUS POINTS

SSM supervisory priorities:

- Credit risk management
- Capital strength
- Business model sustainability
- Governance

Bank of England (PRA) supervisory priorities:

- Financial resilience
- Operational risk and resilience
- Transition from LIBOR to alternative Risk Free Rates
- Financial risks arising from climate change

- Credit risk
- Competition and future regulatory frameworks

2. THE REINFORCED ROLE OF SUPERVISION: KEY FOCUS POINTS

EIOPA supervisory priorities:

- Business model sustainability
- Adequate product design, including via a close monitoring of product oversight and governance

Bank of England (PRA) supervisory priorities:

- Financial resilience
- LIBOR transition
- Operational resilience
- Financial risks arising from climate change
- Changes in PRS responsibilities following the EU withdrawal transition period

3. THE MAIN CHALLENGES FOR THE FINANCIAL SECTOR IN AN ERA OF INNOVATION AND CLIMATE CHANGE TRANSITION

The key economic trends: THE GREAT REALLOCATION

Growth

Dispersion

Asymmetry

Ageing

Automation

Sustainability

Digital demand

Global power

3. THE MAIN CHALLENGES FOR THE FINANCIAL SECTOR IN AN ERA OF INNOVATION AND CLIMATE CHANGE TRANSITION

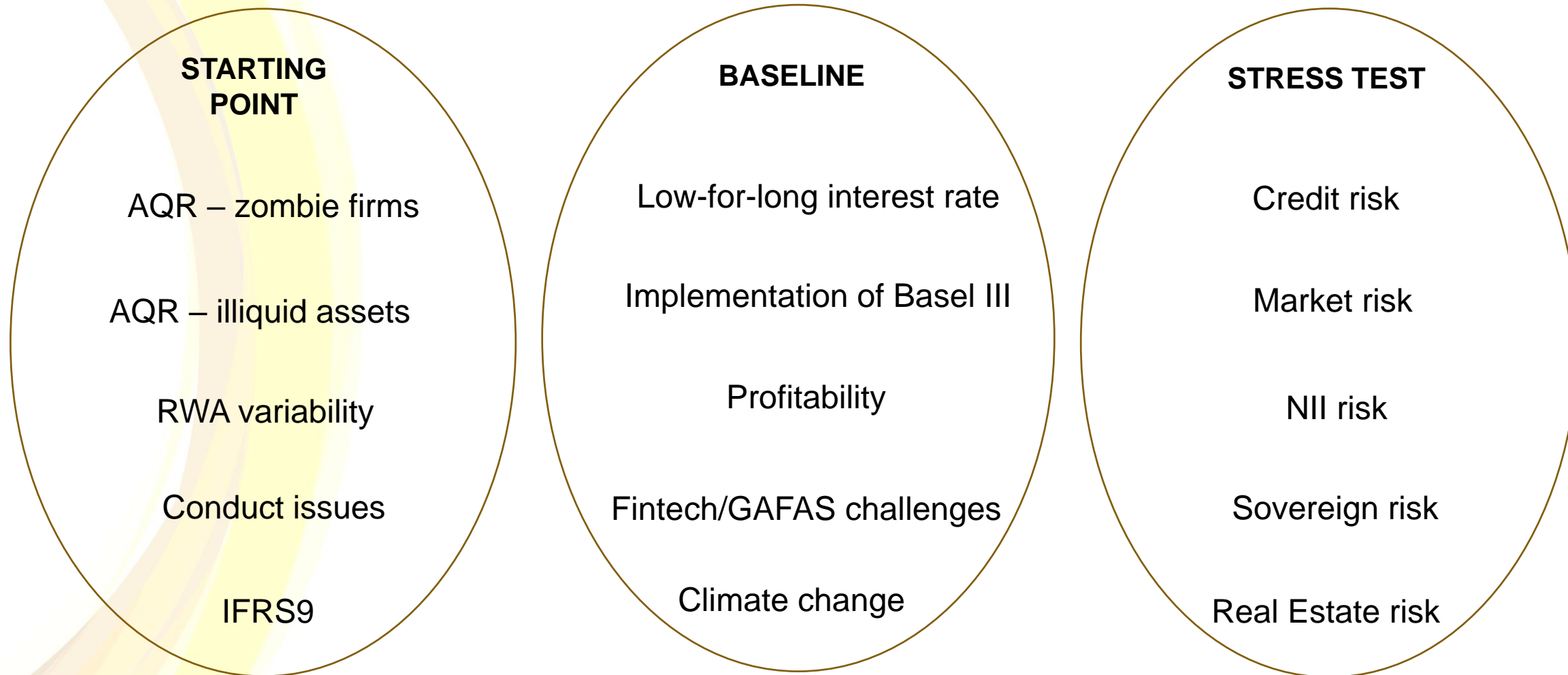
The key economic trends: THE GREAT REALLOCATION

	<u>Growth</u>	<u>Dispersion</u>	<u>Asymmetry</u>
<u>Ageing</u>	--		
<u>Automation</u>	+	+++	+++
<u>Sustainability</u>		++	
<u>Digital demand</u>		++	+
<u>Global power</u>	+	++	

Interpretation: (+) means a positive impact on the column variable, measured in a scale from (+) to (+++); the same applies to a negative impact on the column variable.

3. THE MAIN CHALLENGES FOR THE FINANCIAL SECTOR IN AN ERA OF INNOVATION AND CLIMATE CHANGE TRANSITION

DISCUSSION ON THE FUTURE CHANGES OF THE EU-WIDE STRESS TESTS



3. THE MAIN CHALLENGES FOR THE FINANCIAL SECTOR IN AN ERA OF INNOVATION AND CLIMATE CHANGE TRANSITION

1. Overview of the paper.....*Bank's (baseline) projections*

	Dynamic BS	Static BS	ICAAP	Top-down	Sensitivity
Realism	H	L	H	M	M-H
Forward-looking	H	L	H	H	H
Accountability	H	L	H	H	M-H
Comparability	M	H	L	H	M
Supervisory use					
Capital adequacy	H	M	H	H	H
Business model	H	L	H	M	H

Note: H means High, M means Medium; L means Low

3. THE MAIN CHALLENGES FOR THE FINANCIAL SECTOR IN AN ERA OF INNOVATION AND CLIMATE CHANGE TRANSITION

DISCUSSION ON THE FUTURE CHANGES OF THE EU-WIDE STRESS TESTS

- # Move to dynamic balance sheets
- # Move to a reinforced holistic approach to measure capital adequacy (CET1 ratio, output floor, leverage ratio) in line with the Basel III finalization
- # Move to top-down stress tests and full ownership of the exercise by the supervisor
- # Consider more than one adverse scenario; Develop sensitivity scenarios; Incorporate ICAAP in the stress testing procedure
- # Reintroduce binding hurdles

3. THE MAIN CHALLENGES FOR THE FINANCIAL SECTOR IN AN ERA OF INNOVATION AND CLIMATE CHANGE TRANSITION

Supervisory expectations relating to business model and strategy

Expectation 1: Institutions are expected to understand the impact of climate-related and environmental risks on the business environment in which they operate, in the short, medium and long term, in order to be able to make informed strategic and business decisions

Expectation 2: When determining and implementing their business strategy, institutions are expected to integrate climate-related and environmental risks that impact their business environment in the short, medium or long term

Supervisory expectations relating to governance and risk appetite

Expectation 3: The management body is expected to consider climate-related and environmental risks when developing the institution's overall business strategy, business objectives and risk management framework and to exercise effective oversight of climate-related and environmental risks

Expectation 4: Institutions are expected to explicitly include climate-related and environmental risks in their risk appetite framework

Expectation 5: Institutions are expected to assign responsibility for the management of climate-related and environmental risks within the organizational structure in accordance with the three lines of defence model.

Expectation 6: For the purposes of internal reporting, institutions are expected to report aggregated risk data that reflect their exposures to climate-related and environmental risks with a view to enabling the management body and relevant sub-committees to make informed decisions

3. THE MAIN CHALLENGES FOR THE FINANCIAL SECTOR IN AN ERA OF INNOVATION AND CLIMATE CHANGE TRANSITION

Supervisory expectations relating to risk management

Expectation 7: Institutions are expected to incorporate climate-related and environmental risks as drivers of existing risk categories into their risk management framework, with a view to managing, monitoring and mitigating these over a sufficiently long-term horizon, and to review their arrangements on a regular basis. Institutions are expected to identify and quantify these risks within their overall process of ensuring capital adequacy.

Expectation 8: In their credit risk management, institutions are expected to consider climate-related and environmental risks at all relevant stages of the credit-granting process and to monitor the risks in their portfolios.

Expectation 9: Institutions are expected to consider how climate-related and environmental events could have an adverse impact on business continuity and the extent to which the nature on their activities could increase reputational and/or liability risks.

Expectation 10: Institutions are expected to monitor on an ongoing basis the effect of climate-related and environmental factors on their current market risks positions and future investments, and to develop stress tests that incorporate climate-related and environmental risks.

Expectation 11: Institutions with material climate-related and environmental risks are expected to evaluate the appropriateness of their stress testing, with a view to incorporating them into their baseline and adverse scenarios.

Expectation 12: Institutions are expected to assess whether material climate-related and environmental risks could cause net cash outflows or depletion of liquidity buffers and, if so, incorporate these factors into their liquidity risk management and liquidity buffer calibration.

Supervisory expectations relating to disclosures

Expectation 13: For the purposes of their regulatory disclosures, institutions are expected to publish meaningful information and key metrics on climate-related and environmental risks that they deem to be material, with due regard to the European Commission's Guidelines on non-financial reporting: Supplement on reporting climate-related information.

3. THE MAIN CHALLENGES FOR THE FINANCIAL SECTOR IN AN ERA OF INNOVATION AND CLIMATE CHANGE TRANSITION

THE MAIN CHALLENGES OF DIGITALIZATION AND FINANCIAL INNOVATION

Fintech and Insurtech

Digital Responsibility

Business Model Sustainability

Market Integrity

BIG TECHS

SupTech and RegTech



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