Monday, November 30, 2020

Top 10 risk and compliance related news stories and world events that (for better or for worse) shaped the week's agenda, and what is next

Dear members and friends,

Aesop, a great fabulist and storyteller, believed that *affairs are easier of entrance than of exit; and it is but common prudence to see our way out before we venture in*. Well, neither the EU nor the UK did that when they initiated their romantic relationship.

Before Brexit, some EU legislation was directly applicable to the United Kingdom. To be clear, it applied automatically in UK law, without any action required by the UK. Other EU legislation required domestic implementing legislation before it became national law in UK.

After Brexit, some EU legislation will not be part of UK law. Many experts are not sure which directives and regulations will continue to apply, or to what extend the spirit of the EU law will be present at the UK law. We are always looking for information to understand better what will happen after Brexit.

I have just read a new presentation from Sam Woods, Deputy Governor for Prudential Regulation of the Bank of England, and Chief Executive of the Prudential Regulation Authority (PRA), with title *"Strong and simple"*. We read:

"I should say first that, despite the fears sometimes articulated by politicians in the EU, we have absolutely no intention of weakening prudential regulation in the UK.

It would be mad for us to do any such thing only a decade or so on from a crisis in which the British taxpayer footed the bill for one of the biggest banking disasters in history, with a financial sector around ten times the

size of our economy, and with clear evidence in front of us that the post-2008 reforms have allowed the banking system to support the economy through the Covid crisis so far.

You only have to ask yourself the question "How would the financial system have fared if Covid had hit in 2007?" to appreciate this point.

As the host of a very large international financial centre, we also have a global responsibility to maintain high prudential standards in the UK.

This is important for the Bank of England's objective of financial stability, but it also makes sense for industrial policy for the UK financial services industry: we want people to bring their money to the City for the right reasons, not the wrong ones, and we have no interest whatsoever in a race-to-the-bottom approach to financial regulation. And it was very good to see the Chancellor making this same point clearly in his wide-ranging address to the House of Commons on Monday.

None of that is to say that nothing will change as we leave the EU. Financial regulation is constantly developing as financial services change, and it is clear that neither the EU nor the UK wishes to be shackled in lockstep with the other as these developments occur in both jurisdictions."

Michelangelo believed that *genius is eternal patience*. In Brexit we cannot have eternal patience, we must soon understand the new reality for UK and the EU.

Best regards,

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Number 1

Risk Dashboard: European insurers slightly less exposed to risks compared to the beginning of COVID-19 outbreak but concerns remain

Risks	Level	Trend (Past 3 months)	Outlook[2] (Next 12 months)
1. Macro risks	Very high	↑	↗
2. Credit risks	Medium	↓	↗
3. Market risks	Medium	↓	↗
4. Liquidity and funding risks	Medium	→	→
5. Profitability and solvency	Medium	↓	→
6. Interlinkages and imbalances	Medium	→	→
7. Insurance (underwriting) risks	Medium	→	→
8. Market perceptions	Medium	↓	→

The European Insurance and Occupational Pensions Authority (EIOPA) published its updated Risk Dashboard based on the second quarter of 2020 Solvency II data.

The results show that the risk exposures of the European Union insurance sector slightly reduced, compared to July risk assessment. Insurers are particularly exposed to very high levels of macro risk, while market, credit, profitability and solvency risks decreased to medium level. However, the risk assessment does not account for the outbreak of the second wave of the pandemic.

With regard to macro risk, Gross Domestic Product (GDP) growth forecasts at the end of September show the strongest expected decline in the last quarter of 2020 and first recovery in the second quarter of 2021. The effects of the new wave of the pandemic might skew further downward GDP growth.

The unemployment rate remained at the very high level in July. The 10 year swap rates indicator decreased reaching new lows. Inflation remains at a low levels and a decrease is forecasted for the next three quarters.

The stabilization of the financial markets at the end of the third quarter 2020 partially eased the challenging situation for European insurers: market and credit risk indicators have stabilised at the end of September 2020.

The price gap between stocks and the economic outlook remain a concern, as it could result in sharp valuation adjustments.

The credit worthiness of the assets in insurers' portfolios is under close monitoring. The outlook of those risk categories reflects information available until the third quarter 2020.

Profitability and solvency risks, decreased to medium level. SCR ratio for groups slightly improved from the first to second quarter of 2020, amid remaining at lower levels than in the last quarter of 2019.

All half-year profitability indicators, which now include the first months of the COVID-19 crisis and their impact on financial returns, show the expected signs of deteriorations.

Insurance risks remain at medium level, driven by general concerns over decrease in premium growth, and in some Member States over reserve adequacy.

More specifically, year-on-year premium growth for life reported a significant deterioration for the second consecutive quarter, indicating already a negative impact from the COVID-19 outbreak.

While market perceptions exhibit a decreasing trend, they are still at medium level. Since June 2020, stocks of life and non-life insurance outperformed relative to the market.

The median price-to-earnings ratio of insurance groups in the sample slightly increased dispersing from the low levels reached in the first half of 2020.

Key observations:

- Risk exposures for the European insurance sector remain very high for macro, while it decreased from high to medium level for credit, market, profitability and solvency.

- Macro risks remain at very high level given the persistent global impact of the outbreak of Covid-19 on economic activities, intensified by the second wave already initiated in several EU countries. Whereas a recovery is

already observed for GDP growth forecasts, outlooks were revised upwards for all geographical areas. Moreover, the indicator on the 10 year swap rates decreased reaching new lows.

- Credit risks decreased to medium level. The CDS spread continue decreasing across all market segments in September, remaining above the levels before Covid-19 crisis.

- Market risks decreased to medium level. Financial markets have stabilized in the first half of 2020, while remaining concerns related to decoupling between financial market performance and economic outlook that could lead to potential market correction remain. The volatility in the equity and bond markets continue decreasing, reaching lower levels than before Covid-19 crisis for the bond markets.

- Profitability and solvency risks decreased to medium level. SCR ratio for groups slightly improved from Q1-2020 to Q2-2020 amid remaining at lower levels than Q4-2019. All half-year profitability indicators, which now include the first month of the Covid-19 crisis and their impact on financial returns, show the expected signs of deteriorations.

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- While market perceptions exhibit a decreasing trend, they are still at medium level. The median price-to-earnings ratio of insurance groups in the sample slightly increased dispersing from the low levels reached in the first half of 2020.

To read more:
https://www.eiopa.europa.eu/tools-and-data/risk-dashboard_en

Number 2

Strong and simple

Sam Woods, Deputy Governor for Prudential Regulation of the Bank of England and Chief Executive of the Prudential Regulation Authority (PRA), at the Prudential Regulation Authority Mansion House.

Introduction

I am reliably informed that following my last Mansion House speech the chair of one of our banks was so enraged that I had spent ten minutes talking about credit unions that they nearly choked on their beef fillet.

This, arguably, did not advance the PRA's objective of safety and soundness. So it's a very good thing that this year the Lord Mayor has introduced new safety measures by removing all food from this event.

You will, however, still need a strong dose of caffeine in order to make it to the end of my speech.

I'm also delighted to join the Lord Mayor in welcoming Nikhil to this event. Nikhil and I have known each other for a long time.

I'm sure he will be a great leader of the FCA and I'm confident that with him at the helm the two regulators will continue to work well together.

Now, coming back to those credit unions – the reason for the chair's anger was that I announced that we would bring in a radical simplification of capital requirements for credit unions, but didn't announce anything on banks.

Since then, we have motored ahead and put in place that new regime for credit unions.

But we have not forgotten about banks. In fact, despite the huge pressures of the Covid crisis we have taken care to preserve one vital part of our work programme: our plans to bring in a simpler prudential regime for small banks and building societies.

A new style of regulation

The reason we have kept up work on this topic is that our exit from the EU provides us with the first opportunity we have had in a long time to make real progress on it.

But before coming to that, let me make a few brief points about the broader regulatory scene as we exit the EU.

I should say first that, despite the fears sometimes articulated by politicians in the EU, we have absolutely no intention of weakening prudential regulation in the UK.

It would be mad for us to do any such thing only a decade or so on from a crisis in which the British taxpayer footed the bill for one of the biggest banking disasters in history, with a financial sector around ten times the size of our economy, and with clear evidence in front of us that the post-2008 reforms have allowed the banking system to support the economy through the Covid crisis so far.

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As the host of a very large international financial centre, we also have a global responsibility to maintain high prudential standards in the UK.

This is important for the Bank of England's objective of financial stability, but it also makes sense for industrial policy for the UK financial services industry: we want people to bring their money to the City for the right reasons, not the wrong ones, and we have no interest whatsoever in a race-to-the-bottom approach to financial regulation.

And it was very good to see the Chancellor making this same point clearly in his wide-ranging address to the House of Commons on Monday.

None of that is to say that nothing will change as we leave the EU.

Financial regulation is constantly developing as financial services change, and it is clear that neither the EU nor the UK wishes to be shackled in lockstep with the other as these developments occur in both jurisdictions.

But of course financial regulators tend to be interested in similar things, we coordinate with each other across borders constantly, and we hammer out international agreements at the Financial Stability Board, the Basel Committee, and the International Association of Insurance Supervisors in

order to keep us moving forward together as we tackle issues like climate change, cyber and operational resilience.

Indeed, the Lord Mayor's Green Horizon Summit in London this week is a great example of this sort of activity.

Our commitment to those mechanisms of international coordination, including working closely and cooperatively with our European colleagues, will not waver with Brexit – indeed we will double down on them.

To read more:
https://www.bis.org/review/r201113b.pdf

Number 3

SP 800-53B, Control Baselines for Information Systems and Organizations

NIST
National Institute of Standards and Technology
U.S. Department of Commerce

This publication provides security and privacy control baselines for the Federal Government.

There are three security control baselines (one for each system impact level—low-impact, moderate-impact, and high-impact), as well as a privacy baseline that is applied to systems irrespective of impact level.

In addition to the control baselines, this publication provides tailoring guidance and a set of working assumptions that help guide and inform the control selection process.

Finally, this publication provides guidance on the development of overlays to facilitate control baseline customization for specific communities of interest, technologies, and environments of operation.

Executive Summary

As we push computers to "the edge," building an increasingly complex world of connected information systems and devices, security and privacy will continue to dominate the national dialogue.

In its 2017 report entitled, Task Force on Cyber Deterrence [DSB 2017], the Defense Science Board provides a sobering assessment of the current vulnerabilities in the U.S. critical infrastructure and the information systems that support mission-essential operations and assets in the public and private sectors.

"…The Task Force notes that the cyber threat to U.S. critical infrastructure is outpacing efforts to reduce pervasive vulnerabilities, so that for the next decade at least the United States must lean significantly on deterrence to address the cyber threat posed by the most capable U.S. adversaries.

It is clear that a more proactive and systematic approach to U.S. cyber deterrence is urgently needed…"

There is an urgent need to further strengthen the underlying information systems, component products, and services that the Nation depends on in every sector of the critical infrastructure— ensuring that those systems,

components, and services are sufficiently trustworthy and provide the necessary resilience to support the economic and national security interests of the United States.

NIST SP 800-53B responds to the call of the Defense Science Board by providing a proactive and systemic approach to developing and making available to federal agencies and private sector organizations a comprehensive set of security and privacy control baselines for all types of computing platforms, including general-purpose computing systems, cyber-physical systems, cloud-based systems, mobile devices, and industrial and process control systems.

The control baselines provide a starting point for organizations in the security and privacy control selection process.

Using the tailoring guidance and assumptions provided, organizations can customize their security and privacy control baselines to ensure that they have the capability to protect their critical and essential operations and assets.

To read more:
https://nvlpubs.nist.gov/nistpubs/SpecialPublications/NIST.SP.800-53B.pdf

Number 4

The euro area financial sector in the pandemic crisis

Luis de Guindos, Vice-President of the European Central Bank, at the 23rd Euro Finance Week, Frankfurt am Main.

I am honoured to open the 23rd Euro Finance Week. My remarks today will focus on two main issues.

First, I will provide an overview of the current economic situation in the euro area, and focus on how the pandemic has amplified existing vulnerabilities in the financial system.

And second, I will highlight the important role that financial regulation and prudential policy have played in response to the pandemic so far, and argue that further policy measures are needed.

An uneven recovery across sectors and countries increases the risks of fragmentation

The pandemic crisis has put great pressure on economic activity, with euro area growth expected to fall by slightly less than 8% in 2020.

While the gradual relaxation of social distancing measures created a strong yet incomplete rebound in economic activity in the third quarter, that recovery started losing momentum.

The tighter containment measures recently adopted across Europe are weighing on current growth.

With the future path of the pandemic highly unclear, risks are clearly tilted to the downside. Economic uncertainty is being augmented by geopolitical risks, such as the possibility of a no-deal Brexit.

While its impact on the euro area economy should be contained, such an outcome could amplify the macro-financial risks to the euro area economic outlook.

On the upside, news about a potential vaccine fosters hope of a faster return to pre-pandemic growth levels.

The severity of the pandemic shock has varied greatly across euro area countries and sectors, which is leading to uneven economic developments and recovery speeds.

Countries more heavily affected by the coronavirus crisis and the associated containment measures suffered the sharpest falls in economic activity in the first half of 2020.

And growth forecasts for 2020 also point towards increasing divergence within the euro area.

The recent European initiatives, such as the Next Generation EU package, should help ensure a more broad-based economic recovery across various jurisdictions and avoid the kind of economic and financial fragmentation that we observed during the euro area sovereign debt crisis.

The economic impact of the pandemic is highly skewed at the sector level. Consumers have adopted more cautious behaviour, and the recent tightening of restrictions has notably targeted the services sector, including hotels and restaurants, arts and entertainment, and tourism and travel.

Output losses and the expected recovery will be significantly more uneven across sectors than in previous crises, as a result.

The pandemic has amplified existing vulnerabilities in the euro area financial system

Fiscal support has played a key role in mitigating the impact of the pandemic on the economy and preserving productive capacity. This is very welcome, notwithstanding the sizeable budget deficits anticipated for 2020 and 2021 and the rising levels of sovereign debt.

While policy support will eventually need to be withdrawn, abrupt and premature termination of the ongoing schemes could give rise to cliff-edge effects and cool the already tepid economic recovery.

Loan guarantees, tax deferrals and direct transfers have alleviated immediate liquidity constraints for many firms, thus keeping a lid on insolvencies during the acute phase of the crisis.

However, corporate bankruptcies are projected to increase in 2021.

Credit risk has risen for SMEs in particular, as they are more dependent on bank financing than large firms.

A premature withdrawal of loan guarantee schemes may induce banks to tighten credit standards. This would result in a credit crunch for non-financial corporations and translate into a sharp rise in company defaults.

The pandemic has also weighed on the long-term profitability outlook for banks in the euro area, depressing their valuations.

From around 6% in February of this year, the euro area median banks' return on equity had declined to slightly above 2% by June.

The decline in profitability is being driven mainly by higher loan loss provisions and weaker income-generation capacity linked to the ongoing compression of interest margins.

Looking ahead, bank profitability is expected to remain weak and not to recover to pre-pandemic levels before 2022.

This profitability outlook is reflected in rock-bottom bank valuations, with the stock prices of euro area banks recovering less than the overall market over the summer.

Non-performing loans (NPL) are likely to present a further challenge to bank profitability.

But there is typically a lag between a contraction in economic activity and the formation of new NPLs.

The policy support provided to borrowers through moratoria and public guarantees may imply that this lag will be longer than in past downturns, and NPLs may start to materialise in the course of next year.

Banks have already anticipated some future credit losses by increasing their provisions.

This is in response to a doubling in the value of loans where credit risk has significantly increased since origination, also known as Stage 2 assets.

And despite these efforts, loan loss provisions of euro area banks, could still be below needs suggested by fundamentals.

Newly originated loans have also tended to have greater credit risk, with banks reporting a higher probability of default according to their internal ratings-based portfolios in the second quarter of the year.

This is in line with results of the ECB's vulnerability analysis.

Under the baseline scenario, credit losses would continue increasing and the solvency position of the significant euro area banks would deteriorate by mid 2022.

Moving on, the non-bank financial sector continued to be an important source of financing for companies and thereby helped support the economic recovery.

Non-banks have absorbed the vast majority of the new debt securities issued by non-financial corporates in the euro area this year - notably also from sectors more sensitive to the economic fallout from the pandemic.

At the same time, non-banks also played a more negative role in amplifying the market turmoil this spring.

Investment funds, including money market funds, experienced outflows of a magnitude last seen during the global financial crisis.

This only stopped once the ECB launched its pandemic emergency purchase programme (PEPP). The PEPP indeed proved to be a turning point in financial markets.

Flows into investment funds turned positive again in the subsequent months, quickly compensating for all the redemptions experienced in February and March.

However, these flow dynamics imply that investment funds shed large volumes of assets procyclically, in the first quarter of the year, before becoming a net buyer again once market valuations started to recover.

One major reason why investment funds are particularly liable to amplify adverse market dynamics is their structurally low liquidity buffers.

Low cash holdings force investment funds to sell relatively illiquid assets in the event of outflows, which serves to depress asset prices.

Although funds temporarily increased their holdings of liquid assets in response to this year's market stress, their cash positions have already returned to pre-pandemic levels.

This again leaves the sector vulnerable to large redemptions in the event of any renewed stress in the financial markets.

Moreover, financial vulnerabilities were aggravated by investment funds continuing to increase their exposure to credit risk.

More than three-quarters of the bonds purchased by funds after March 2020 were rated BBB or below.

Policy considerations for the banking sector

Starting in March 2020, European and national prudential authorities took swift and extraordinary policy measures to address the impact of the pandemic on the euro area banking sector.

Thanks to this prompt policy reaction, coupled with the forceful fiscal and monetary support measures that have been put in place and the stronger capital positions that banks have built since the global financial crisis, banks have contributed to absorb the shock of the pandemic by meeting increased demand for credit.

Looking ahead, it will be essential for banks to be willing to make use of the available capital buffers to absorb losses without excessive deleveraging. Over the medium term, a rebalancing between structural and cyclical capital requirements is desirable to create macroprudential policy space.

A greater share of releasable buffers would enhance macroprudential authorities' ability to act countercyclically.

But we must not lose sight of key structural weaknesses in the European banking sector that were evident even before the crisis hit.

For quite some time now, European bank valuations have been depressed by very low profitability caused by excess capacity, limited revenue diversification and low cost efficiency.

The need to tackle these structural issues is now more urgent than ever.

Although banks have stepped up cost-cutting efforts in the wake of the pandemic, they need to push even harder for greater cost efficiency.

Consolidation via mergers and acquisitions is another potential avenue for reducing overcapacity in the sector. The planned domestic mergers in some countries are an encouraging sign in this regard.

Furthermore, a comprehensive approach at national and EU level will be needed if distressed assets on bank balance sheets increase significantly.

Market-based solutions should take a leading role, and actions at the European level to make secondary markets for NPLs more efficient and transparent would be desirable.

Further actions might include guidance on best practices for government-sponsored securitisation schemes, or new solutions that would help troubled but viable firms to restructure outstanding debts and raise new equity.

Finally, we also need to make progress on the banking union, which unfortunately remains unfinished. Renewed efforts are urgently required to improve its crisis management framework.

This includes finalising the agreement on the European Stability Mechanism as a backstop to the Single Resolution Fund and ensuring an orderly and efficient exit of small and medium-sized banks in particular, by harmonising the powers to transfer assets and liabilities in liquidation with the support of deposit guarantee funds.

We also need to facilitate the flow of capital and liquidity within banking groups, subject to adequate financial stability safeguards and establish the third pillar of banking union - the European deposit insurance scheme.

Policy considerations for the non-bank sector

The developments in the investment fund sector highlight the fact that the current policy framework relies to a large extent on ex post liquidity management tools such as suspensions or gating, which asset managers can use at their discretion.

However, we saw that these tools were not enough to alleviate the liquidity strains from a system-wide perspective and can have adverse effects on investors scrambling for liquidity.

Only the decisive policy action by central banks helped stabilise financial markets and improve liquidity conditions across a broad range of markets and institutions.

This suggests that a comprehensive macroprudential approach for non-banks needs to be devised. Policies should address system-wide risk and reflect the fact that the sector comprises a diverse set of entities and activities.

This would ensure that the non-bank sector is better able to absorb shocks in the future. Authorities should be equipped with a range of policies to effectively mitigate the build-up of risks during periods of exuberance.

In particular, the liquidity of investment funds' assets should be closely aligned with redemption terms.

Funds should also be required to hold a sufficiently large share of cash and highly liquid assets to manage increased liquidity needs stemming from outflows or margin calls in periods of stress.

During the spring turmoil, increasing margin calls helped to ensure that the extraordinary market volatility did not result in concerns about counterparty risk.

At the same time, it contributed to amplify the liquidity pressures in the system for non-bank financial intermediaries in particular.

This warrants further analysis to assess whether adjustments to margining practices and the related regulatory approaches are needed to reduce excessive procyclicality in initial margins.

As money market funds also demonstrated significant vulnerabilities during the recent market turmoil further work should focus on enhancing liquidity requirements and reconsidering the share of their liquid assets.

Conclusion

Let me conclude.

As I've outlined, the banking sector has weathered the crisis to date fairly well, despite a number of risks and vulnerabilities. It has helped to absorb the shock and avoided a credit crunch that would have been detrimental to the economy.

Going forward, it is urgent to tackle structural weaknesses in the European banking sector, by reducing overcapacity and enhancing cost-efficiency to address its persistently low profitability.

Furthermore, it will be important for banks to be willing to use their capital buffers to absorb losses and continue to support lending.

On the non-bank side, investment funds continue to be vulnerable to sudden outflows during periods of market stress due to their relatively small liquidity buffers.

A review of the liquidity requirements for money market funds and their portfolio composition is also necessary.

This calls for the timely roll-out of a comprehensive macroprudential framework for non-banks.

Number 5

The Federal Reserve's New Framework: Context and Consequences

Richard H. Clarida, Vice Chair of the Board of Governors of the Federal Reserve System, at the "The Economy and Monetary Policy" event hosted by the Hutchins Center on Fiscal and Monetary Policy at the Brookings Institution, Washington, D.C.

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

The new framework has important implications for the way the FOMC going forward will conduct monetary policy in support of its efforts to achieve its dual-mandate goals in a world of low neutral policy rates and persistent global disinflationary pressures.

At the September 16 FOMC meeting, the Committee made material changes to its forward guidance for the future path of the federal funds rate to bring the guidance into line with the new policy framework and, in so doing, provided transparent outcome-based guidance linked to the macroeconomic conditions that must prevail before the Committee expects to lift off from the effective lower bound (ELB).

In my remarks today, I would like to look ahead and offer my individual perspective on the consequences of our new framework for the conduct of monetary policy over the business cycle, and I also want to provide some context that connects key elements of our new framework to the literature on optimal monetary policy subject to an ELB constraint that binds in economic downturns.

Let me say at the outset that when I am not quoting directly from the consensus statement and the September FOMC statement, the views expressed are my own and do not necessarily express the views of other Federal Reserve Board members or FOMC participants.

The plan of my talk is as follows. I will first highlight and discuss the five elements of the new framework that define how the Committee will seek to achieve its price-stability mandate over time and how, in September, it revised its forward guidance on the federal funds rate to bring the FOMC's policy communications into line with the new framework.

I will then provide my perspective on how these key elements of the new framework and the related forward guidance connect to the literature on conducting optimal monetary policy at—and after lifting off from—the ELB.

I will next discuss how the Committee's conception of its maximum - employment mandate, a sixth element of the new framework, has evolved since 2012, what this evolution implies for the conduct of monetary policy, and how I plan to factor in this information as I think about the appropriate path for setting the federal funds rate once the conditions for liftoff have been met.

I will conclude with a brief recap of my thesis before joining David Wessel, Seth Carpenter, and Annette Vissing-Jørgensen in what I am sure will be an engaging virtual conversation.

The New Framework and Price Stability

In my remarks today, I will focus on six key elements of our new framework and the forward guidance provided by our September FOMC statement.

Five of these elements define how the Committee will seek to achieve its price-stability mandate over time, while the sixth pertains to the Committee's conception of its maximum-employment mandate.

Of course, the Committee's price-stability and maximum-employment mandates are generally complementary, and, indeed, this complementarity is recognized and respected in the forward-guidance language introduced in the September FOMC statement.

However, for ease of exposition, I will begin by focusing on the five elements of the new framework that define how the Committee will seek to achieve over time its price-stability mandate, before discussing how maximum employment is defined in the new framework and what this definition implies for the conduct and communication of monetary policy under the new framework.

Five features of the new framework and September FOMC statement define how the Committee will seek to achieve its price-stability mandate over time:

- The Committee expects to delay liftoff from the ELB until PCE (personal consumption expenditures) inflation has risen to 2 percent on an annual basis and other complementary conditions, consistent with achieving this goal on a sustained basis and to be discussed later, are met.

- With inflation having run persistently below 2 percent, the Committee will aim to achieve inflation moderately above 2 percent for some time in the service of having inflation average 2 percent over time and keeping longer-term inflation expectations well anchored at the 2 percent longer-run goal.

- The Committee expects that appropriate monetary policy will remain accommodative for some time after the conditions to commence policy normalization have been met.

- Policy will aim over time to return inflation to its longer-run goal, which remains 2 percent, but not below, once the conditions to commence policy normalization have been met.

- Inflation that averages 2 percent over time represents an ex ante aspiration of the FOMC, but not a time-inconsistent ex post commitment.

To read more:
https://www.federalreserve.gov/newsevents/speech/clarida20201116a.htm

Number 6

Audit Committee Resource

New PCAOB Requirements Regarding Auditing Estimates and Use of Specialists

The Public Company Accounting Oversight Board's (PCAOB) new requirements related to:

(1) auditing accounting estimates, including fair value measurements, and

(2) using the work of specialists will take effect for audits of fiscal years ending on or after December 15, 2020.

This document aims to provide audit committees with key takeaways about these new requirements and includes some possible questions audit committees may consider asking their auditors.

Auditing Accounting
Estimates, Including Fair Value Measurements
Background

Between 1988 and 2003, the auditing profession adopted three different standards related to auditing accounting estimates.

Although these three standards used a common approach for the substantive testing of estimates, they varied in their level of detail in describing the auditor's responsibilities.

The result was inconsistency in the auditing of estimates.

The three standards also predated the Board's risk assessment standards and therefore did not fully integrate requirements related to identifying, assessing, and responding to risks of material misstatement in accounting estimates.

The New Requirements

In December 2018, the Board adopted a single standard for auditing accounting estimates.

The new standard is risk-based and scalable. It does not prescribe detailed procedures for the auditor to perform nor the extent of those procedures in

each circumstance. Rather, it requires that the auditor respond to assessed risks and provides direction for testing estimates based on those risks.

The new standard builds on our existing risk assessment requirements and focuses the auditors' efforts on those estimates with greater risk of material misstatement.

It also reinforces the importance of auditors applying professional skepticism, including by addressing potential management bias.

Additionally, the new standard reminds auditors to take into account relevant audit evidence—regardless of whether it corroborates or contradicts the company's assertions.

To read more:
https://pcaobus.org/Documents/Audit-Committee-Resource-Estimates-Specialists.pdf

Number 7

EIOPA's Supervisory Statement on the sound practices within the registration or authorisation process of IORPs, including as regards suitability for cross-border activity

The European Insurance and Occupational Pensions Authority (EIOPA) published a supervisory statement on the sound supervisory practices for registering or authorising Institutions for Occupational Retirement Provision (IORPs), including the assessment of suitability for cross-border activities.

The main aim of the supervisory statement is to ensure that IORPs operating cross-border do it under prudent conditions, regardless of the different authorisation or registration regimes.

This will foster a level-playing field across the European Union conducive to an internal market for IORPs and ensure adequate protection of the members and beneficiaries.

This objective is achieved through supervisory convergence of currently divergent practices and avoiding risks of supervisory arbitrage after the implementation of IORP II Directive.

The supervisory statement is issued based on Article 29(2) of the EIOPA Regulation and aims to promote common supervisory practices.

It is addressed to national competent authorities.

Home national competent authorities are expected to carry out a prudential assessment, which ensures that any registered or authorised IORPs meet all the requirements of the IORP II Directive to operate domestically or across borders.

The prudential assessment needs to ensure that IORPs are prudentially sound and have suitable administrative and governing structures to protect the interests of their members and beneficiaries when operating domestically or cross-border.

To facilitate cross-border activities, the prudential assessment should also be proportionate to the additional risks linked to conducting cross-border operations in relation to the main objective of prudential supervision.

To read more:
https://www.eiopa.europa.eu/sites/default/files/publications/supervisory_statements/eiopa-bos-20-642-supervisory-statement-cross-border-iorps.pdf

Number 8

SPOTLIGHT - The PCAOB's Use of Economic Analysis and Stakeholder Input in Standard Setting

A core component of the Public Company Accounting Oversight Board's (PCAOB) oversight is setting standards for firms to follow as they prepare audit reports for public companies and other issuers, and broker dealers.

In setting standards, we follow an evidence-based approach which includes economic analysis.

This approach is responsive to the financial reporting and auditing environments, carefully weighs costs, benefits, and potential unintended consequences, and contemplates our mission to protect investors.

This Spotlight outlines how we conduct economic analysis and gather stakeholder input, both before and after our standards take effect.

We drafted this Spotlight in response to frequently asked questions we have received this year from audit committee chairs and others who have asked if we perform cost benefit analysis of our standards.

The PCAOB's Approach to Economic Analysis Our approach to analyzing economic considerations related to new or revised standards addresses four main elements.

1. Describing the Need for the Standard or Rule

When publishing a proposed or final standard, we describe, as clearly as possible, the need for standard setting and explain how the standard would meet that need.

2. Developing the Baseline and Measuring for Rule Impacts

To assess the potential economic effects of a new or revised standard, we first establish a baseline against which to measure the potential impacts of the new or revised standard.

In other words, we evaluate conditions without the new or revised standard—i.e., the state of the world today— including the economic attributes of the market being regulated.

The baseline analysis discusses the current standards that the new or revised standard will affect, as well as information available regarding the wider range of audit performance and market behavior found in practice.

3. Considering Reasonable Alternatives

We also consider alternative approaches to solving the stated problem, with the aim of answering three questions.

First, why is standard setting preferable to another regulatory approach, such as providing interpretive guidance or enhancing inspection or enforcement efforts?

Second, why is the chosen standard-setting approach preferable to other reasonable standard-setting approaches?

Third, what are the key policy choices made by the Board in determining the details of the standard?

4. Analyzing Economic Impacts of the Standard (and Alternatives)

Finally, we identify the likely economic benefits, costs, competitive effects, and potential unintended consequences of the new or revised standard (and alternatives).

To the extent we can, we quantify those variables. We also provide relevant qualitative analyses.

An example of a potential economic benefit could be a reduction in the likelihood of a highimpact event (such as a major audit failure) that could negatively impact investors and/or increase the cost of capital for public companies.

The costs of a standard can be either direct or indirect. Direct costs are those incurred by auditors to comply with the standard.

Indirect costs can be incurred by auditors or other affected entities.

To read more:
https://pcaobus.org/Documents/PCAOB-Use-Economic-Analysis-Stakeholder-Spotlight.pdf

PCAOB
PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

SPOTLIGHT

The PCAOB's Use of Economic Analysis and Stakeholder Input in Standard Setting

Number 9

The Impact of the Pandemic on Cultural Capital in the Finance Industry

Kevin Stiroh, Executive Vice President, Remarks at the Risk USA Conference

FEDERAL RESERVE BANK *of* NEW YORK

Good morning and thank you for the opportunity to participate today, the first day of what looks to be a very interesting four days featuring a range of important and timely discussion items for the financial sector. As I looked through the agenda, I was impressed with the diversity of topics the panels will be covering, including traditional banking risks, emerging risks like climate change, and the industry's response to the pandemic.

Today, I want to focus my time on the importance of a firm's culture in determining business outcomes and how that culture may be impacted by the Covid-19 pandemic. Through my remarks today, I will address two core sets of questions. One, what is cultural capital, why does it matter, and how does it evolve? Two, how is cultural capital impacted by the pandemic? I think we'll hear more about how the pandemic is impacting financial firms in a wide variety of ways throughout the conference.

Before proceeding, I will emphasize that I am speaking for myself and my views do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System.

What Is Cultural Capital?

First, what is cultural capital?

My colleagues and I introduced the concept of cultural capital for financial firms in a white paper in late 2017 as a type of intangible asset that impacts how a firm operates and ultimately performs.

Cultural capital is an input into a firm's production process that determines its ability to deliver the products and services that it offers. It is analogous to physical capital like the equipment, buildings and property a firm uses; to human capital, which is the accumulated knowledge and skills of its workers; and to reputational capital, which includes the franchise value or brand recognition of a firm.

More broadly, culture can be defined as the shared set of norms within a group that influences decision-making and is evidenced through behavior.

Cultural capital is a conceptual way to link a firm's culture, including its values, assumptions and behavioral norms, to its business outcomes. For financial firms, it is not loss-absorbing in a financial sense like equity capital, but it can be loss-preventing by influencing decisions, behaviors, and outcomes over time. As an intangible asset, we generally see the impact rather than the thing itself. But, its impact can be measured, assessed, and ultimately influenced.

In an organization with a low level of cultural capital, for example, behavioral risk is high. Behavioral risk refers to behaviors within an organization that could potentially lead to negative business outcomes.

In such organizations, behavioral risk is not effectively mitigated or even considered, and the stated values of the firm are not reflected in the actions and norms of the organization's members. Group think is prevalent and employees do not speak freely, or are ignored, when they have concerns about the way their group is doing business.

The letter of the law may be followed but not the spirit, with illegal activities only coming to light when discovered by authorities. "Conduct" is viewed as something that is only the responsibility of the compliance department through a set of rules and controls. The outcomes stemming from high behavioral risk reduce cultural capital, damage the firm and the trustworthiness of the industry over time.

In an organization with a high level of cultural capital, on the other hand, behavioral risk is low. Employees refrain from taking excessive risks and they are unafraid of – and rewarded for – raising issues up the management chain. When they speak up, they believe the organization will take them seriously with meaningful responses.

The organization recognizes and rewards employees who understand and internalize the expectations of laws and regulations, and do not view compliance as a checklist. In organizations with a high level of cultural capital, an important factor in advancing to senior leadership is role-modeling behavior consistent with a firm's values, assumptions and behavioral norms. These actions all add to the firm's stock of cultural capital.

Like other forms of tangible and intangible capital, cultural capital grows and shrinks over time – purposeful investments and managerial focus can add to it, while neglect or misconduct can reduce it. Depletion of cultural capital can adversely impact the firm's productive capacity and value. This reflects, for example, changes to employees' attitudes and practices ("how we do things"), as well as their beliefs and values ("the way things should be

done"). In the Whitepaper, mthey need to recognize the importance of this critical asset, be able to measure it, and understand the types of investment needed to sustain it and the forces that may cause it to depreciate.

Since the New York Fed began to highlight the need for a focus on culture reform in financial services, measurement has consistently been raised as a challenge. While measuring culture may not be as straightforward as measurement approaches for more traditional assets and risks, it is possible to gain valuable insights through a multi-layered and patient approach.

Through the use of surveys, interviews, focus groups, behavioral analytics, network analyses, and board effectiveness assessments, firms can triangulate from multiple inputs and develop a view of how high or low their cultural capital is, both in an absolute and relative sense.

At a 2017 conference, hosted by the New York Fed, representatives from across the industry came together to discuss how boards of directors assess their firms' cultures, hold management accountable, the benefits of data and benchmarking, and finally, the role of performance management and incentives.

Since then, several firms have started to use big data to perform network analysis to understand how culture is transmitted through an organization. Others have further honed their ability to gather qualitative data and interpret it in new ways.

There is a greater recognition that there are no simple and straightforward metrics to tell them where they stand vis-à-vis cultural capital. Rather, these firms are regularly experimenting with new ways to identify patterns within complex systems that are continuously evolving.

A number of firms have recognized that the data they gather must be contextualized. Cultural capital is not a single statistic; one part of a firm could have generous stores of it, while another department or geography requires more focused investment and attention.

From the accumulation perspective, building cultural capital means investing in the way the organization approaches everything it does, including defining its purpose, setting its business strategy and risk appetite, training, communications, decision-making, prioritization, compensation practices, and how employees are incented to interact with colleagues, clients, and customers.

A critical part of sustained investment is that business leaders and boards of directors see it as their responsibility to set the tone from the top.

Modelling the desired behaviors sets a powerful example and serves as a form of behavioral risk mitigation. All of these actions reflect choices that a firm makes, either implicitly or explicitly, that can build cultural capital.

On the other hand, cultural capital can also decline or deteriorate as a result of internal choices. For example, overt incidences of misconduct such as a trading scandal or a legal issue, deviations between employees' actual experiences and a firms' stated values, or observations of inappropriate behavior that is tolerated or even rewarded can all contribute to the depreciation of a firm's cultural capital.

This decline can be self-reinforcing as certain behaviors are rewarded and individuals advance in an organization, or the composition of the workforce changes as employees choose to work at firms with higher cultural capital.

To read more:
https://www.newyorkfed.org/newsevents/speeches/2020/sti201116

Number 10

Cyberattacks targeting health care must stop

Tom Burt - Corporate Vice President, Customer Security & Trust

Two global issues will help shape people's memories of this time in history – Covid-19 and the increased use of the internet by malign actors to disrupt society.

It's disturbing that these challenges have now merged as cyberattacks are being used to disrupt health care organizations fighting the pandemic.

We think these attacks are unconscionable and should be condemned by all civilized society.

Today, we're sharing more about the attacks we've seen most recently and are urging governments to act.

In recent months, we've detected cyberattacks from three nation-state actors targeting seven prominent companies directly involved in researching vaccines and treatments for Covid-19.

The targets include leading pharmaceutical companies and vaccine researchers in Canada, France, India, South Korea and the United States.

The attacks came from Strontium, an actor originating from Russia, and two actors originating from North Korea that we call Zinc and Cerium.

Among the targets, the majority are vaccine makers that have Covid-19 vaccines in various stages of clinical trials.

One is a clinical research organization involved in trials, and one has developed a Covid-19 test.

Multiple organizations targeted have contracts with or investments from government agencies from various democratic countries for Covid-19 related work.

Strontium continues to use password spray and brute force login attempts to steal login credentials.

These are attacks that aim to break into people's accounts using thousands or millions of rapid attempts.

Zinc has primarily used spear-phishing lures for credential theft, sending messages with fabricated job descriptions pretending to be recruiters.

Cerium engaged in spear-phishing email lures using Covid-19 themes while masquerading as World Health Organization representatives.

The majority of these attacks were blocked by security protections built into our products.

We've notified all organizations targeted, and where attacks have been successful, we've offered help.

These are just among the most recent attacks on those combating Covid-19. Cyberattacks targeting the health care sector and taking advantage of the pandemic are not new.

Attackers recently used ransomware attacks to target hospitals and healthcare organizations across the United States.

Earlier in the pandemic, attacks targeted Brno University Hospital in the Czech Republic, Paris's hospital system, the computer systems of Spain's hospitals, hospitals in Thailand, medical clinics in the U.S. state of Texas, a health care agency in the U.S. state of Illinois and even international bodies such as the World Health Organization.

In Germany, we recently saw the resulting threat to human health become tragic reality when a woman in Dusseldorf reportedly became the first known death as a result of a cyberattack on a hospital.

Today, Microsoft's president Brad Smith is participating in the Paris Peace Forum where he will urge governments to do more.

Microsoft is calling on the world's leaders to affirm that international law protects health care facilities and to take action to enforce the law.

We believe the law should be enforced not just when attacks originate from government agencies but also when they originate from criminal groups that governments enable to operate – or even facilitate – within their borders. This is criminal activity that cannot be tolerated.

The good news is that we're not alone.

Our voice at Microsoft is just one of many speaking up from the multi-stakeholder coalition that will be needed to make progress.

In today's virtual Paris Peace Forum event addressing an audience of international leaders, Brad will discuss these issues with France's Minister for Foreign Affairs Jean-Yves le Drian, Ambassador Guilherme de Aguiar Patriota of Brazil and Ambassador Jürg Lauber of Switzerland.

Ambassador Patriota is chair of the UN's Group of Governmental Experts, and Ambassador Lauber is chair of the UN's Open-Ended Working Group – both important bodies in determining the future of cyberspace.

In the leadup to this year's Paris Peace Forum, more than 65 health care-related organizations have joined the Paris Call for Trust and Security in Cyberspace.

They include organizations like Merck working on vaccines, top hospitals like Hospital Metropolitano in Ecuador, and government health institutes like Poland's National Institute of Public Health.

There is no question the attacks we've seen in recent months are creating energy for action across the health sector. The Paris Call remains the largest multi-stakeholder coalition addressing these issues, and its first principle is the prevention of malicious cyber activities that threaten indiscriminate or systemic harm to people and critical infrastructure.

In May, a 136-strong group of the world's most prominent international law experts, in what has become known as the Oxford Process, issued a statement making it clear that international law protects medical facilities at all times.

In August, the Oxford Process issued a second statement emphasizing that organizations that research, manufacture and distribute of Covid-19 vaccines are also protected.

Earlier this year, the CyberPeace Institute and International Committee of the Red Cross led an effort by 40 international leaders calling on governments to stop the attacks on healthcare.

They included former secretary of state Madeline Albright, Archbishop Emeritus of Cape Town Desmond Tutu, former Member of the European Parliament Marietje Schaake and former Secretary-General of the United Nations Ban Ki-moon among many others.

Organizations are also taking steps to protect themselves. In April, we announced that we were making AccountGuard, our threat notification service, available to health care and human rights organizations working on Covid-19.

Since then 195 of these organizations have enrolled in the service and we now protect 1.7 million email accounts for health care-related groups. Any health care-related organizations that wish to enroll can do so here.

At a time when the world is united in wanting an end to the pandemic and anxiously awaiting the development of a safe and effective vaccine for Covid-19, it is essential for world leaders to unite around the security of our health care institutions and enforce the law against cyberattacks targeting those who endeavor to help us all.

You can learn more about what Microsoft is doing to advance cybersecurity at: https://www.microsoft.com/en-us/security

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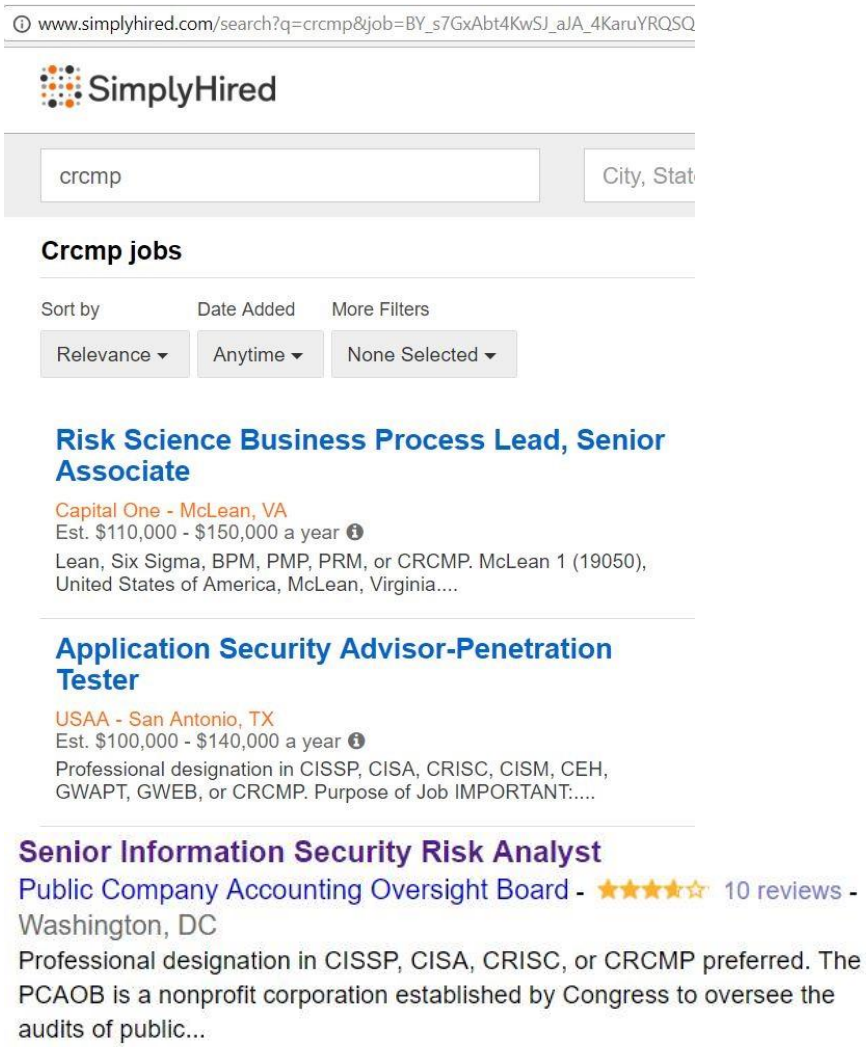

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