

Strengthening the Oversight and Regulation of Shadow Banking

Progress Report to G20 Ministers and Governors

I. Introduction

At the Cannes Summit in November 2011, the G20 Leaders agreed to strengthen the oversight and regulation of the shadow banking system, and endorsed the Financial Stability Board (FSB)'s initial recommendations with a work plan to further develop them in the course of 2012.¹ The G20 Leaders also asked the FSB to report its progress for review at the G20 Finance Ministers and Central Bank Governors meeting in April 2012.

The “shadow banking system” can broadly be described as “credit intermediation involving entities and activities outside the regular banking system”.² It has become an integral part of the modern financial system that has an important role in supporting the real economy. For example, the shadow banking system provides market participants and firms with an alternative source of funding and liquidity. Furthermore, some non-bank entities may have specialised expertise to assess risks of borrowers and hence can spur competition in the allocation of credit in the economy.

However, the shadow banking system can also pose risks to the financial system, on its own and through its links with the regular banking system. These risks can become acute especially when it transforms maturity/liquidity and creates leverage like banks. For example, short-term deposit-like funding of non-bank entities can easily lead to “runs” in the market if confidence is lost. The use of collateralised funding (secured financing) techniques such as repos (repurchase agreements) and securities lending can exacerbate such “runs” and boost leverage, especially when asset prices are buoyant and margins/haircuts on secured financing are low. Moreover, the risks in the shadow banking system can easily spill over into the regular banking system as banks often comprise part of the shadow banking credit intermediation chain or provide support to non-bank entities.

The shadow banking system can also be used to avoid financial regulation and lead to build-up of leverage and risks in the system. For example, securitisation was widely used by banks during the pre-crisis period to take on more risks and facilitate the build-up of leverage in the system, while avoiding the regulatory capital requirements (Basel I).

¹ Paragraph 30 of the G20 Leaders Summit Communiqué at Cannes (<http://www.g20.org/en/>)

² It is important to note the use of the term “shadow banking” is not intended to cast a pejorative tone on this system of credit intermediation. The FSB has chosen to use the term “shadow banking” as this is most commonly employed and, in particular, has been used in the earlier G20 communications. Alternative terms used by some authorities or market participants include “market-based financing” or “market-based credit intermediation”.

The FSB issued initial recommendations in its report “Shadow Banking: Strengthening Oversight and Regulation” (hereafter October 2011 Report)³ to address such risks posed by the shadow banking system. It has adopted a two-pronged approach. First, the FSB will enhance the monitoring framework through continuing its annual monitoring exercise to assess global trends and risks, with more jurisdictions participating in the exercise. Second, the FSB will develop recommendations to strengthen the regulation of the shadow banking system, where necessary, to mitigate the potential systemic risks with specific focus on five areas: (i) to mitigate the spill-over effect between the regular banking system and the shadow banking system; (ii) to reduce the susceptibility of *money market funds* to “runs”; (iii) to assess and mitigate systemic risks posed by *other shadow banking entities*; (iv) to assess and align the incentives associated with *securitisation* to prevent a repeat of the creation of excessive leverage in the financial system; and (v) to dampen risks and pro-cyclical incentives associated with *secured financing contracts such as repos, and securities lending* that may exacerbate funding strains in times of “runs”. The proposed policy recommendations in all five areas will be developed by the end of 2012.

The rest of this report details the FSB’s progress to-date in response to the request from the G20.

II. Strengthening Oversight

The FSB has set out recommendations for effective monitoring of shadow banking in its October 2011 Report. The recommendations consist of seven high-level principles for the relevant authorities and a stylised 3-step monitoring process. The FSB also committed to continue conducting annual monitoring exercises to assess global trends and risks of the shadow banking system through its Standing Committee on Assessment of Vulnerabilities (SCAV). The global monitoring exercise conducted last year covered eleven FSB member jurisdictions⁴ and the euro area, and some of its results are published in the October 2011 Report.

Based on this commitment, the FSB will conduct a monitoring exercise based on the end-2011 data during 2012. The SCAV plans to finalise the template for data collection in April and ask members to submit end-2011 data, a short analysis of national trends in shadow banking and, on a voluntary basis, case studies for discussion by June/July. The results will be reviewed by the SCAV in September and will be reported to the Plenary as well as to the G20 in the autumn. The monitoring exercise by the SCAV is expected to facilitate the national authorities’ assessment of shadow banking risks based on the FSB recommendations, and the sharing of experiences among authorities in order to highlight trends in shadow banking that are of relevance to the stability of the global financial system.

³ http://www.financialstabilityboard.org/publications/r_111027a.pdf

⁴ They are Australia, Canada, France, Germany, Italy, Japan, Korea, Netherlands, Spain, UK, and US.

III. Strengthening Regulations

Based on the initial recommendations and work-plans set out in the October 2011 Report, five workstreams have been launched to advance the work to develop proposed policy recommendations in the following five areas:

- (i) **Banks' interactions with shadow banking entities;**
- (ii) **Money market funds (MMFs);**
- (iii) **Other shadow banking entities;**
- (iv) **Securitisation; and**
- (v) **Securities lending and repos.**

The first, second and fourth of these workstreams will prepare their recommendations by July 2012. The recommendations from the other shadow banking entities workstream are expected by September 2012, while the securities lending/repo workstream is to prepare recommendations by the end of 2012. All workstreams will be reviewed by the FSB through its Standing Committee on Regulatory and Supervisory Cooperation (SRC) as well as its Task Force on Shadow Banking (Task Force). The detailed status of each workstream is described in the following sections.

In its final report to the G20, the FSB will provide a holistic and integrated view of the proposed policy recommendations from the five workstreams. A properly structured and regulated shadow banking sector can make the financial system more robust, efficient and diversified; hence, our reforms in this area seek to mitigate systemic risks while preserving the scope for realizing these benefits.

1. Banks' interactions with shadow banking entities

The Basel Committee on Banking Supervision (BCBS) is undertaking its work to propose, where needed, further action on regulation of banks' interactions with shadow banking entities by July 2012. It has assigned tasks to various working groups to develop policy recommendations in the following four areas that were requested in the October 2011 Report:

- (i) *Consolidation rules for prudential purposes* – The BCBS is carrying out work to identify which non-bank entities are sponsored by banks; to consider whether the identified non-bank entities are consolidated for accounting purposes and risk-based purposes; and to clarify the extent to which there are differences in regulatory consolidation practices across jurisdictions.
- (ii) *Limits on the size and nature of a bank's exposures to shadow banking entities* – The BCBS is taking the work forward as part of its existing review of large exposure limits to entities individually or in aggregate. In particular, it is assessing:
 - whether the large exposure regime captures exposures to all entities, including shadow banking entities; and
 - to the extent that certain shadow banking exposures are excluded from the large exposure regime (whether intra-group or with respect to third parties),

what are the reasons for those exclusions and the implication for the comprehensiveness of concentration risk measurement and management.

- (iii) *Risk-based capital requirements for banks' exposures to shadow banking entities* – The BCBS is examining: (i) the capital treatments for investments in funds (e.g. hedge funds); and (ii) whether the treatment for short-term liquidity facilities for securitisation vehicles should be extended to all non-bank entities including shadow banking entities, respectively.
- (iv) *Treatment of reputational risk and implicit support* – The BCBS is reviewing the implementation of the enhancements to the treatment for reputational risk and implicit support under the Basel II.5 framework within the BCBS member jurisdictions. A survey on the implementation of the Pillar 2 treatment for implicit support has been conducted and the BCBS is now assessing its results.

All the above are closely coordinated to ensure consistency and timeliness. An integrated proposal will be developed during the second quarter 2012 with interim reports to be presented to the FSB. The integrated proposal will include what has already changed in the capital regulatory framework in relation to shadow banking.

2. Money market funds

The International Organization of Securities Commissions (IOSCO) is developing policy recommendations related to money market funds (MMFs) by July 2012 through its Standing Committee on Investment Management (SC5). IOSCO aims to publish a consultation report shortly.

The consultation report provides an analysis of the systemic importance of MMFs and their key vulnerabilities, including their susceptibility to runs. It also highlights some of the issues which have to be considered, such as the impact on short-term funding and effects on investor behaviour, implementation challenges as well as other potential disruptive effects. It also clarifies the role of MMFs during the crisis and describes the changes introduced in MMF regulation following the crisis. The report then analyses the characteristics and benefits of MMFs in various jurisdictions (with a focus on Europe and the US, but also including Australia, Brazil, Canada, China, India and Japan) and the particular regulatory arrangements which have influenced their role and risks.

Based on such analysis, the draft consultation report sets out possible policy options that could reinforce the soundness of money market funds and address the identified systemic vulnerabilities such as the following:

- (i) *Mandatory move from constant to variable net asset value (NAV)* – this may include other structural arrangements that may reduce susceptibility to runs caused by sudden fluctuations in the “true” price of MMFs, such as introduction of “NAV buffer” if constant NAV is maintained.
- (ii) *Enhancement of MMF valuation and pricing framework* – this may include restricting the use of amortised cost accounting by MMFs.

- (iii) *Enhancement of liquidity risk management* – policy measures such as liquidity buffer, redemption restrictions and establishment of private liquidity facilities will be considered as tools to improve MMFs’ management of redemption pressures.
- (iv) *Reduction in the importance of ratings in the MMF industry*– policy measures such as removal of references to ratings from MMF regulations and improvement of MMF ratings would be considered to reduce the herding and “cliff-effects” associated with the use of ratings in relation to MMFs.

These options are not mutually exclusive and some may be considered in combination. Pursuant to IOSCO Technical Committee approval, the consultation report will be published to obtain inputs from the stakeholders in assessing the different policy options. IOSCO envisages using the outcomes of the consultation to narrow down the policy options into policy recommendations by July 2012. FSB will separately provide its members’ views on the consultation report to IOSCO to facilitate its preparation of policy recommendations.

3. Other shadow banking entities

A workstream under the FSB Task Force (WS3) is examining the regulation of shadow banking entities other than MMFs by September 2012. The WS3 has completed a categorisation and data collection exercise for a wide range of non-bank financial institutions (or Other Financial Intermediaries (OFIs)). After casting the net wide through this exercise, the WS3 is adopting a two-step prioritisation process to narrow the scope to certain types of entities that may need policy responses. The first step is to develop a list of entity types (“filtered” list) based on national experience (i.e. authorities’ judgements) and size⁵; the second step entails the detailed assessment of the shadow banking risk factors (e.g. maturity transformation, liquidity transformation and leverage) with respect to each entity type in the filtered list.

This would allow WS3 to concentrate on a small number of entity types with significant shadow banking risks rather than conducting detailed assessments for all types of non-bank financial institutions, while preventing any entity types from falling outside the work’s initial coverage.

The WS3 plans to complete the prioritisation process by April/May and start developing policy recommendations for the prioritised entity types. It is now finalising the prioritisation process through a detailed assessment of shadow banking risks posed by entity types in the filtered list. In assessing the risks, the WS3 also held a meeting in April with the industry to exchange views and obtain additional information as necessary.

In addition to developing the policy recommendations for other shadow banking entities, WS3 is undertaking, following the G20 request⁶, the work to prepare methodologies for identifying systemically important global non-bank financial institutions (non-bank G-SIFIs) in consultation with IOSCO by the end of 2012. Such non-bank G-SIFIs exclude insurance

⁵ For size, the workstream is looking at both the gross size (i.e. total asset size of the relevant entities) as well as the net size (i.e. total asset size but excluding the assets of entities that are consolidated to the banking groups for prudential purposes).

⁶ Paragraph 29 of the G20 Leaders Summit Communiqué at Cannes (<http://www.g20.org/en/>)

companies and financial market infrastructures. While the shadow banking work focuses on systemic risks posed by bank-like activities (e.g. maturity transformation, liquidity transformation and leverage), the non-bank G-SIFIs work is aimed at developing methodologies to identify non-bank financial entities whose distress or disorderly failure would cause significant disruption to the wider financial system and economic activity at the global level.

4. Securitisation

IOSCO, in coordination with the BCBS, is examining the (i) retention requirements and (ii) measures that aimed at enhancing transparency and standardisation related to securitisation. It has structured the work into two phases where the European Commission and the US Securities and Exchange Commission (SEC) first work on a comparison of securitisation rules in the EU and US, and then its Task Force on Unregulated Markets and Products (TFUMP) take forward further work with wider focus on developments in other jurisdictions along with developing possible recommendations.

The first phase of the work is completed where both the European Commission and SEC staff analysed the EU and proposed US risk retention and disclosure rules for asset-backed securities (ABS), and concluded that no material incompatibilities were found between the two approaches. Even in areas they differ, they think such differences will not create material problems for cross-border ABS market participants. IOSCO has shared this result with the BCBS and the FSB in April.

Building on this work on EU and US rules, the TFUMP will conduct:

- (i) analysis of global regulatory and industry initiatives on risk retention, transparency and standardisation;
- (ii) identification and assessment of material differences in regulatory/industry approaches and their impact; and
- (iii) development of policy recommendations, if needed, to address material differences identified.

IOSCO will prepare an interim report for review by the FSB by May, with a view to publishing a consultation report in July 2012. Based on the comments on the consultation report, the IOSCO will prepare a final report during the second half of the year.

5. Securities lending and repos

A workstream under the FSB Task Force (WS5) is examining the regulation of secured financing contracts such as repos, and securities lending from a financial stability perspective by the end of 2012. As requested in the October 2011 Report, the WS5 has prepared its interim report for review by the March Plenary.⁷ The interim report covers:

⁷ The interim report will be published shortly.

- overview of the securities lending and repo markets – the four segments of the markets⁸;
- key drivers of the securities lending and repo markets;
- its location within the shadow banking system;
- overview of existing regulatory framework; and
- financial stability issues.

Financial stability issues include (i) lack of transparency, (ii) procyclicality of system leverage and interconnectedness through valuation, haircuts and collateral re-use, (iii) other issues associated with re-use of collaterals, (iv) potential risks arising from fire-sale of collateral assets; (v) potential risks arising from securities lending activities, (vi) shadow banking through cash collateral reinvestment, and (vii) insufficient rigour in collateral management and valuation.

To prepare the interim report, the WS5 conducted a regulatory mapping exercise in cooperation with IOSCO Standing Committee on Risk and Research (SCRR), surveyed academic literature, and held meetings with the European market participants and with the North American market participants in December 2011-January 2012. The WS5 members have also conducted detailed bilateral discussions with the market participants in their respective jurisdictions, some of the results of which are reflected in the interim report.

Based on the mapping of the markets and identification of financial stability issues, the WS5 has started work to develop policy recommendations as necessary by the end of 2012.

⁸ They are (i) securities lending segment, (ii) leveraged investment fund financing and securities borrowing segment, (iii) inter-dealer repo segment, and (iv) repo financing segment.