Session IV. (b) Overview on leverage and maturity mismatches in the non bank financial sector (shadow banking) (re DGI #4)

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FSB FINANCIAL STABILITY BOARD

FSB Initiative on Shadow Banking

- Outline
  A. Context and purposes of the initiative
  B. Process and scope for potential policy recommendations
  C. Implications for data needs

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A. Why focus on shadow banking?

(i) Experience of the Financial Crisis

- Large build-up of maturity transformation and leverage in shadow banking ahead of crisis (ABCP conduits, SIVs, CDOs) – misperceived, underestimated
- Collateral-based financing (especially repo and other secured financing markets) and funding from MMFs (stable NAV) proved susceptible to “runs” – produced market seizures
- Collapse of credit supply from shadow banks and large tracts of the securitisation market – underscored pro-cyclicality of both.

(ii) Guard against re-creation of systemic risks and regulatory arbitrage

(iii) But preserve good parts of “non-bank credit intermediation”

- Much “non-bank credit intermediation” provides a valuable alternative to bank funding
- FSB definition of “shadow banking” - “non-bank credit intermediation” that pose “bank-like risks to financial stability (maturity transformation and leverage)”

A. What is “Shadow Banking”?

FSB Report “*Shadow Banking: Strengthening Oversight and Regulation*” (27 Oct. 2011)

Shadow banking system can be broadly defined as the system of credit intermediation that involves entities and activities outside the regular banking system.

Monitoring and policy responses be guided by a practical two-step approach:

- Firstly, authorities should cast the net wide, looking at all non-bank credit intermediation to ensure that data gathering and surveillance cover all areas where shadow banking-related risks might potentially arise.
- Secondly, authorities should then narrow the focus for policy purposes to the subset of nonbank credit intermediation where there are:
  - developments that increase systemic risk (in particular maturity/liquidity transformation, imperfect credit risk transfer and/or leverage); and/or
  - indications of regulatory arbitrage that is undermining the benefits of financial regulation.

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

A. Five general principles for developing regulatory measures related to shadow banking

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(i) *Focus*: Regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates;

(ii) *Proportionality*: Regulatory measures should be proportionate to the risks shadow banking poses to the financial system;

(iii) *Forward-looking and adaptable*: Regulatory measures should be forward-looking and adaptable to emerging risks;

(iv) *Effectiveness*: Regulatory measures should be designed and implemented in an effective manner, balancing the need for international consistency to address common risks and to avoid creating cross-border arbitrage opportunities against the need to take due account of differences between financial structures and systems across jurisdictions; and

(v) *Assessment and review*: Regulators should regularly assess the effectiveness of their regulatory measures after implementation and make adjustments to improve them as necessary in the light of experience.

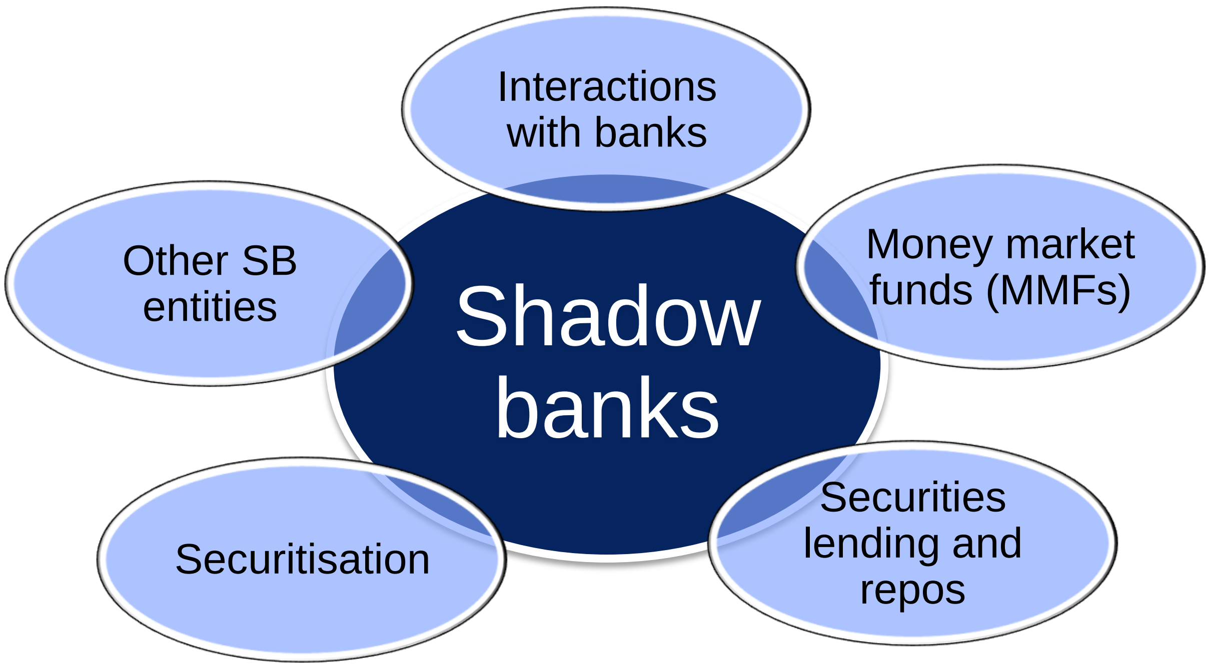
Source: http://www.financialstabilityboard.org/publications/r_111027a.pdf

B. Strengthening financial systems by monitoring and regulating shadow banking risks

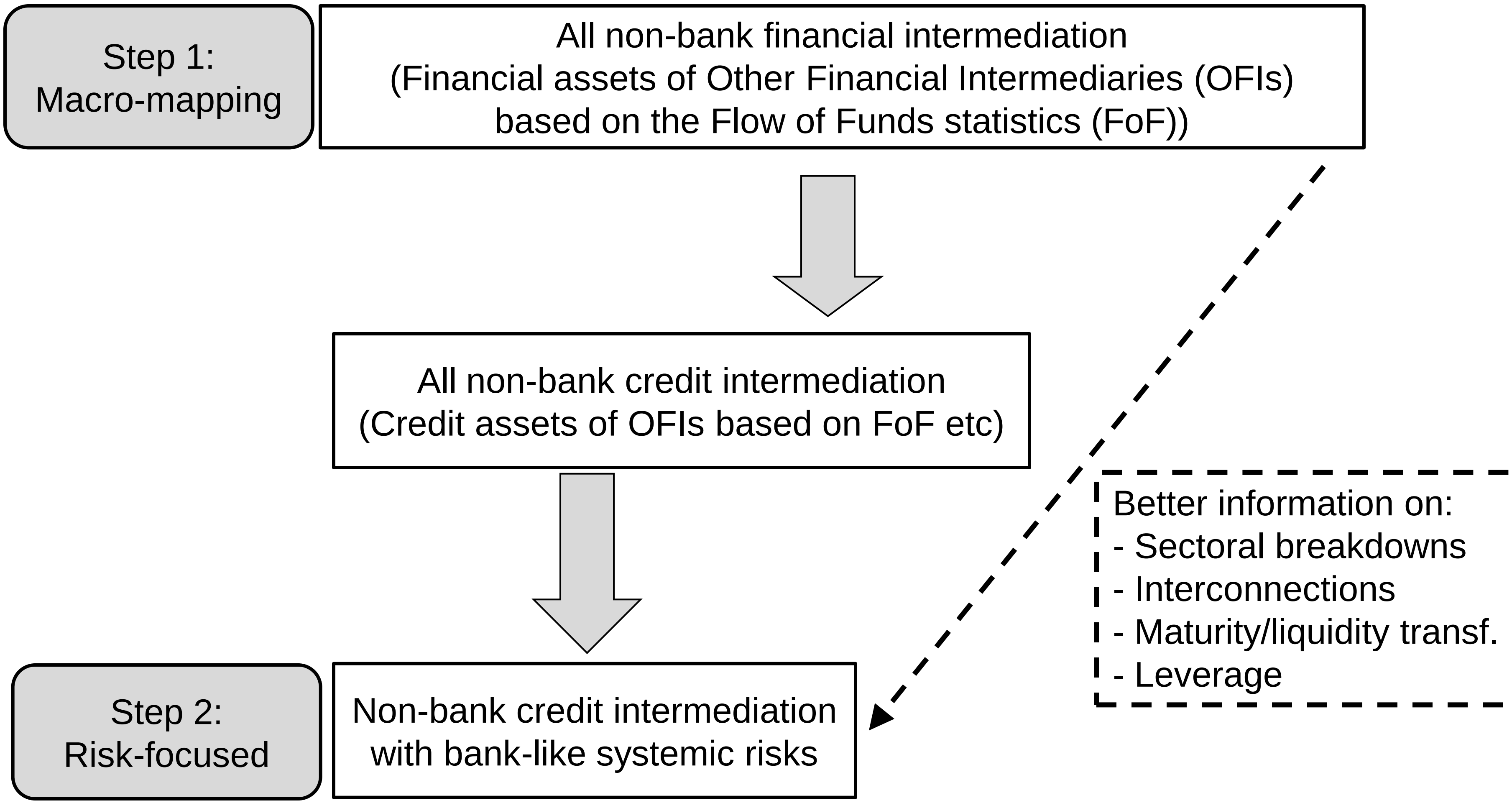
The FSB has adopted a two-pronged approach to address risks posed by the shadow banking system.

The FSB will:

- **Enhance the monitoring framework** through its annual monitoring exercise.
- **Develop recommendations to strengthen the regulation** of shadow banking to mitigate potential systemic risks, with specific focus on five areas:

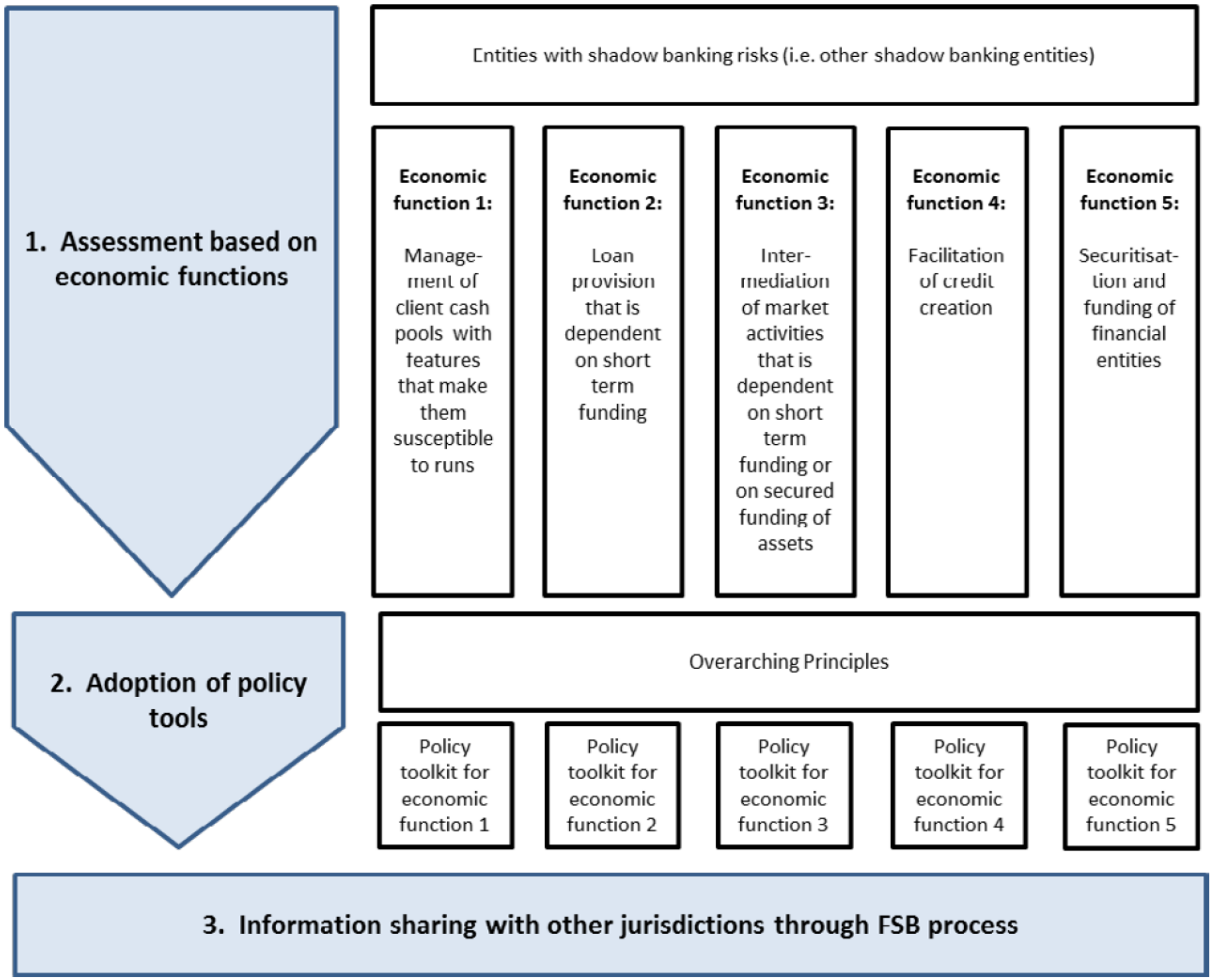


B. Monitoring the Shadow Banking System
(Simplified conceptual image)



Source: http://www.financialstabilityboard.org/publications/r_121118c.pdf

B. Function-based policy framework for oversight and regulation of shadow banking entities



Source: http://www.financialstabilityboard.org/publications/r_121118a.pdf

C. Implications for data needs: Global Shadow Banking Monitoring Exercise

FSB's Standing Committee on Assessment of Vulnerabilities (SCAV) conducts the annual monitoring exercise.

Its results are published in the *Global Shadow Banking Monitoring Report 2012*.

<u>Coverage:</u> 25 national jurisdictions + the euro area as a whole

<u>Data/information collected from participating jurisdictions:</u>

1) Macro-mapping data for 2002-2011 (based on Flow of Funds data)

- Common data template used in summer 2011 (Annex 1 of the *Report*)

2) A brief note analysing recent trends and potential risks in the domestic shadow banking system

3) Survey on finance companies based on a questionnaire (Annex 3 of the *Report*)

4) Case studies (on a voluntary basis)

Source: http://www.financialstabilityboard.org/publications/r_121118c.pdf

C. Implications for data needs: quantitative calibration of regulatory measures

The remedial measures aim at:

- A more resilient system of market-based finance, with stable funding structures and restrained leverage;
- Better risk management and collateral valuation practices especially at non-bank financial institutions; and
- More transparent markets with better understanding of risks by authorities as well as market participants.

However, we are cognizant of the potential impact and unintended consequences on the economy, for example:

- Numerical haircut floors for securities financing transactions may raise costs of such financing and increase calls on collateral assets; and
- Strengthened regulation on re-hypothecation of client assets may impact the funding of certain non-bank financial entities.

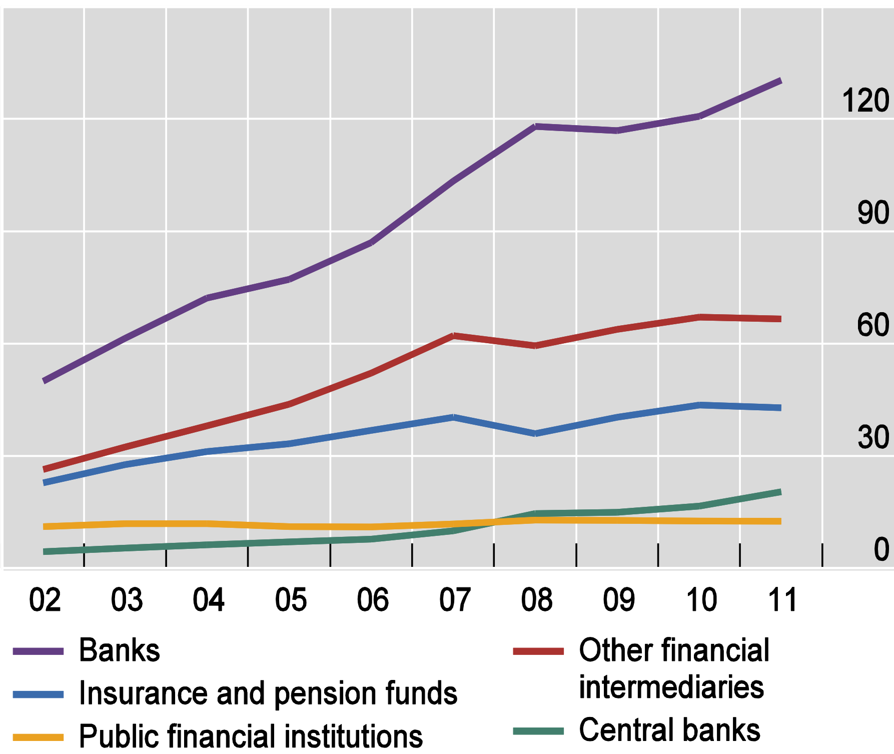
Thus, the FSB has conducted several rounds of public consultations and is launching a quantitative impact assessment on its key recommendations (e.g. numerical haircut floors).

Thank you!

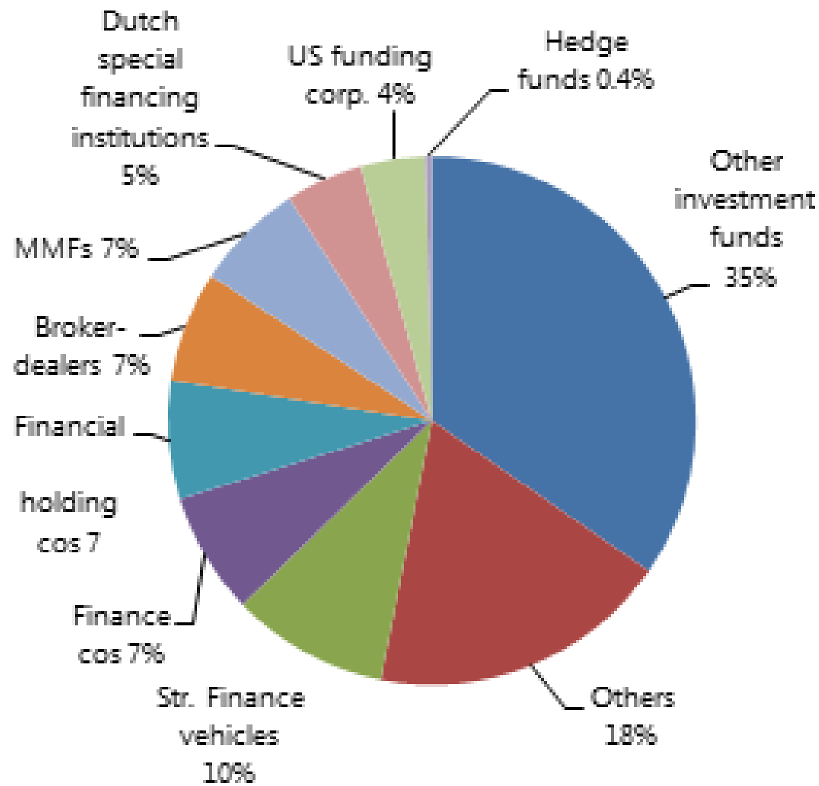
ANNEXES

Size of the Global Shadow Banking System

Total Assets of Financial intermediaries (in USD Trillion)



Composition of Other Financial Intermediaries (OFIs) at end-2011



Source: http://www.financialstabilityboard.org/publications/r_121118c.pdf

Proposed regulatory strengthening measures (1)

1) Mitigate the spill-over effect between the regular banking system and the shadow banking system
   - Clear and consistent scope of regulatory consolidation
   - Capturing shadow banking entities under the large exposure regime for banks
   - A more internationally consistent and risk sensitive capital treatment for banks' investment in funds

2) Reduce the susceptibility of MMFs to "runs"
   - Improved valuation and liquidity management
   - Conversion of stable NAV MMF to floating NAV, where workable, or additional safeguards functionally equivalent to prudential requirements on banks
   - Strengthened standards on the use of credit ratings and on disclosures to investors

Source: http://www.financialstabilityboard.org/publications/r_121118.pdf

Proposed regulatory strengthening measures (2)

3) Dampen risks and pro-cyclical incentives associated with secured financing such as repos and securities lending

- Improvements to market transparency and reporting to authorities
- Introduction of minimum standards for haircut practices (including possible numerical haircut floors on securities financing transactions)
- Possible restrictions on cash collateral reinvestment
- Strengthened regulation to address risks associated with re-hypothecation of client assets
- Minimum standards for collateral valuation and management practices for all market participants

Source: http://www.financialstabilityboard.org/publications/r_121118b.pdf

Proposed regulatory strengthening measures (3)

4) Better alignment of incentives in securitisation

- Consistent implementation of retention requirements
- Improved issuer disclosures (e.g. stress testing and scenario analysis undertaken on underlying assets)
- Standardisation of securitisation products (e.g. standard detailed disclosure templates)

5) A functional approach to oversight/regulation of shadow banking entities

- *Assessment based on 5 economic functions (activities)*: (i) management of client cash pools with features that make them susceptible to runs; (ii) loan provision that is dependent on short-term funding; (iii) intermediation of market activities that is dependent on short-term funding; (iv) facilitation of credit creation; and (v) securitisation and funding of financial entities.
- *Adoption of policy tools*: Authorities will adopt overarching principles and apply policy tools from a menu of policy options for each economic function.
- *Information-sharing*: Authorities will share information through the FSB to maintain consistency across jurisdictions and to minimise "gaps" in regulation or regulatory arbitrage opportunities.

Source: http://www.financialstabilityboard.org/publications/r_121118.pdf
http://www.financialstabilityboard.org/publications/r_121118a.pdf