FINANCIAL STABILITY BOARD

Consultative Document

Strengthening Oversight and Regulation of Shadow Banking

An Integrated Overview of Policy Recommendations

18 November 2012

Preface

Strengthening Oversight and Regulation of Shadow Banking

Consultative documents

The Financial Stability Board (FSB) is seeking comments on consultative documents on Strengthening Oversight and Regulation of Shadow Banking.

The FSB has focused on five specific areas in which the FSB believes policies are needed to mitigate the potential systemic risks associated with shadow banking:

(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 (MMFs)* 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*; 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 consultative documents published on 18 November 2012 comprise[1]:

- **An integrated overview of policy recommendations**, setting out the concerns that have motivated this work, the FSB's approach to addressing these concerns, as well as the recommendations made.

- **A policy framework for oversight and regulation of shadow banking entities**.[2] This document sets out recommendations to assess and address risks posed by "Other Shadow Banking" entities (ref. (iii) above).

- **A policy framework for addressing shadow banking risks in securities lending and repos**.[3] This document sets out recommendations for addressing financial

[1] As for area (i) above, the Basel Committee on Banking Supervision (BCBS) will develop policy recommendations by mid-2013. As for areas (ii) and (iv) above, the International Organization of Securities Commissions (IOSCO) has developed final policy recommendations in its reports *Policy Recommendations for Money Market Funds* (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD392.pdf) and *Global Developments in Securitisation Markets* (http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf).

[2] http://www.financialstabilityboard.org/publications/r_121118a.pdf

[3] http://www.financialstabilityboard.org/publications/r_121118b.pdf

stability risks in this area, including enhanced transparency, regulation of securities financing, and improvements to market structure (ref. (v) above).

The FSB welcomes comments on these documents. Comments should be submitted by **14 January 2013** by email to fsb@bis.org or post (Secretariat of the Financial Stability Board, c/o Bank for International Settlements, CH-4002, Basel, Switzerland). All comments will be published on the FSB website unless a commenter specifically requests confidential treatment. The FSB expects to publish final recommendations in September 2013.

Table of Contents

Page

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 initial recommendations of the Financial Stability Board (FSB) and its work plan to further develop policy recommendations during 2012. At the Los Cabos Summit in June 2012, the G20 Leaders reiterated their support for the shadow banking work and asked the FSB to submit its recommendations for review at the G20 Finance Ministers and Central Bank Governors meeting in November 2012.

This note contains an integrated view of the FSB's recommendations for strengthened oversight and regulation of shadow banking. The analyses and data underpinning these recommendations are set out more fully in separate underlying reports some of which are issued for public consultation alongside this note.

The "shadow banking system" can broadly be described as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system" or non-bank credit intermediation in short. Such intermediation, appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity. But experience from the crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability (longer-term credit extension based on short-term funding and leverage). Such risk creation may take place at an entity level but it can also form part of a complex chain of transactions, in which leverage and maturity transformation occur in stages, and in ways that create multiple forms of feedback into the regulated banking system.

Like banks, a leveraged and maturity-transforming shadow banking system can be vulnerable to "runs" and generate contagion risk, thereby amplifying systemic risk. Such activity, if unattended, can also heighten procyclicality by accelerating credit supply and asset price increases during surges in confidence, while making precipitate falls in asset prices and credit more likely by creating credit channels vulnerable to sudden losses of confidence. These effects were powerfully revealed in 2007-09 in the dislocation of asset-backed commercial paper (ABCP) markets, the failure of an originate-to-distribute model employing structured investment vehicles (SIVs) and conduits, "runs" on money market funds (MMFs) and a sudden reappraisal of the terms on which securities lending and repos were conducted. But whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is typically subject to less stringent, or no, oversight arrangements.

The FSB is of the view that the authorities' approach to shadow banking has to be a targeted one. The objective is to ensure that shadow banking is subject to appropriate oversight and regulation to address bank-like risks to financial stability emerging outside the regular banking system while not inhibiting sustainable non-bank financing models that do not pose such risks. Indeed, a resilient system of non-bank credit intermediation would be welcomed. The approach is designed to be proportionate to financial stability risks, focusing on those activities that are material to the system, using as a starting point those that were a source of problems during the crisis. It also provides a process for monitoring the shadow banking system so that any rapidly growing new activities that pose bank-like risks can be identified early and, where needed, those risks addressed.

At the same time, given the interconnectedness of markets and the strong adaptive capacity of the shadow banking system, it is apparent that any proposals in this area necessarily have to be comprehensive. A piecemeal or incomplete approach would be quickly arbitraged. The FSB, working with the Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO), has therefore examined and developed recommendations in five areas where financial stability risks from shadow banking have arisen.

FSB members believe that the recommendations developed across these areas represent a major step forward and present the G20 with concrete proposals. If taken forward, these will provide a significant measure of additional protection against "runs" in the shadow banking sector of a type that exacerbated procyclicality and added to systemic risk in the years leading to 2007/8. As with work on the Basel III framework for banks, the FSB believes that it is important to put forward proposals that are suitable for long-term application while treating separately the timetable for "switching on" such requirements.

In advancing these proposals, the FSB is conscious that shadow banking activities take a variety of forms. These have evolved in the past in response to changing market and regulatory conditions, and they will continue to evolve. So looking ahead, authorities must be mindful that, by strengthening the capital and liquidity requirements applying to banks (an essential pillar of the G20's financial reform programme), the Basel III framework may increase the incentives for some bank-like activities to migrate to the non-bank financial space. Other forms of regulatory reform may have similar effects. The FSB therefore believes that oversight and regulation for shadow banking must incorporate a system of "embedded vigilance" through on-going review and be capable of evolving in response to market changes.

In addition, while the authorities' approach to shadow banking should be comprehensive, it should not be blunt. Banks play a crucial role in the economy by providing businesses and households with long-term as well as short-term credit. Non-bank financial entities can also be sources of long-term and short-term credit to businesses and households. Where non-bank financial entities have specialised expertise in assessing risks, they may provide these functions in a cost-efficient manner, and provide competition, innovation and lower borrowing costs. And where non-bank credit intermediation takes forms which do not involve maturity transformation or leverage - for instance through direct investment in long-term credit instruments by institutions such as insurance companies or pension funds - it can increase the resilience of the financial system.

The rest of this note sets out recommendations for strengthening the oversight and regulation of the shadow banking system, as well as the next steps in taking the work forward.

The FSB welcomes comments on this document. Comments should be submitted by **14 January 2013** by email to fsb@bis.org or post (Secretariat of the Financial Stability Board, c/o Bank for International Settlements, CH-4002, Basel, Switzerland). All comments will be published on the FSB website unless a commenter specifically requests confidential treatment.

1. FSB's approach to shadow banking

In response to the request from the G20 at the Seoul Summit in November 2010, the FSB issued initial recommendations in its report "Shadow Banking: Strengthening Oversight and Regulation" (hereafter October 2011 Report).[4] The October 2011 Report confirmed the definition of the shadow banking system broadly as "the system of credit intermediation that involves entities and activities outside or potentially outside the regular banking system" and emphasised the importance of taking a practical two-step process in approaching the shadow banking system:

- First, for monitoring purposes, 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.
- Second, authorities should narrow the focus for policy purposes to the subset of non-bank credit intermediation involving maturity/liquidity transformation, imperfect credit risk transfer, leverage, and/or regulatory arbitrage concerns.

The two-step approach places the authorities' policy focus on forms of non-bank credit intermediation with a demonstrated potential to pose ban-like systemic risks, while maintaining monitoring sufficiently broad to capture adaptations at the boundary of bank regulation. It also recognises that many non-bank financial activities are not bank-like by filtering out those that have no relation to credit intermediation, such as pure equity trading and foreign exchange transactions.

The October 2011 Report identified five specific areas in which the FSB believed policies were needed to mitigate the potential systemic risks associated with shadow banking:

(i) to mitigate *the spill-over effect between the regular banking system and the shadow banking system*;

(ii) to reduce the susceptibility of *MMFs* 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".

Workstreams in these five areas have since developed specific recommendations that are summarised in this report.

1.1 Enhancing monitoring of the shadow banking system

One of the lessons of this crisis is the need for authorities to establish system-wide monitoring arrangements capable of assessing sources of systemic risks outside the banking system. The FSB conducted its second annual monitoring exercise over the summer of 2012 using end-

[4] http://www.financialstabilityboard.org/publications/r_111027a.pdf

2011 data through its Standing Committee on Assessment of Vulnerabilities (SCAV).[5] In the 2012 exercise, coverage was broadened to include 25 jurisdictions (all 24 FSB member jurisdictions and Chile), compared with 11 jurisdictions in 2011, and therefore captures jurisdictions representing 83% of global GDP and 90% of global financial system assets.[6] The primary focus of the exercise is on a "macro-mapping" based on national Flow of Funds and Sector Balance Sheet data, that looks at all non-bank financial entities and activities to ensure the information set is sufficiently broad to cover the areas where shadow banking-related risks may arise.

The macro-mapping suggests the following pattern:

- Non-bank financial intermediation grew rapidly before the crisis (in parallel with the regular banking system), and is still increasing, although at a much slower pace.
- There is considerable diversity in the relative size and composition of the non-bank financial intermediaries across jurisdictions. For example, the size of the shadow banking system continues to be large relative to the regular banking system in the US and in a number of other jurisdictions.
- Data granularity is improving, with the share of unidentified non-bank financial intermediaries within overall non-bank financial intermediation falling from 36% last year to 18% this year. Further improvements are needed in a few jurisdictions with a large non-bank financial sector (e.g. the euro area and the UK) that still lack granular data.
- Understanding of the risks created by different types of institutions and activities, and comparability across jurisdictions is impaired by the fact that institutional descriptions (e.g. "Finance Companies" or "Other Investment Funds") can encompass a wide range of different specific business models and activities. It is clear that more granular national analysis, based on categories of activity as much as on institutions, will be essential to deepen our understanding of the present situation and of trends.

The 2012 monitoring exercise added new insights on interconnectedness between banks and non-bank financial entities as well as on a specific non-bank financial subsector, namely finance companies. While progress is being made, the exercise underscored the need for significant improvements in data availability and granularity to adequately capture the magnitude and nature of risks in the shadow banking system. The use of additional analytical methods based on market, supervisory and other data to conduct deeper assessment of risks, for example, leverage and interconnectedness, would also provide significant value-added to the monitoring. The SCAV plans to complement the monitoring exercise next year by obtaining more granular data on assets/liabilities as well as expanding activity-based and risk-based monitoring. Over time, implementation of enhanced data reporting and disclosure requirements for shadow banking as recommended by the FSB (see next section) will be essential to provide the necessary data for such an enriched monitoring.

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5 For details, please see http://www.financialstabilityboard.org/publications/r_121118c.pdf.

6 In addition to national jurisdiction data, euro-area wide data was collected and integrated into the results.

1.2 Strengthening regulation of the shadow banking system

Based on the initial recommendations and work plans set out in the October 2011 Report, the FSB, working with the BCBS and IOSCO, have developed policy recommendations the detailed design and implementation of which have been guided by the following five general principles for regulatory measures:

(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.

1.2.1 WS1: Banks' interactions with shadow banking entities

Since the crisis, BCBS members have implemented or are in the process of implementing a number of measures (through Basel II.5 and Basel III) that should strengthen the resilience of the banking sector against some risks posed by shadow banks. In particular, the BCBS has:

- increased the capital requirements applied to banks' re-securitisation exposures and for liquidity facilities (under one year) provided to securitisation vehicles;
- increased the capital requirements under the internal ratings-based approach (IRB) for exposures to regulated financial institutions whose total assets are greater than or equal to US $100 billion, and to unregulated financial institutions, regardless of size;
- enhanced the banks' internal capital adequacy assessment process under Pillar 2 for securitisation risk, reputational risk and implicit support; and
- enhanced the Pillar 3 disclosure requirements related to securitisation.

Separately, the BCBS has examined the need for further measures to (i) improve the scope of consolidation for prudential purposes and (ii) make further refinements to the regulatory treatment of banks' exposures to shadow banking entities.

In July 2012, the BCBS reported its findings to the FSB and set out its plans to develop detailed policy recommendations in the following three areas by mid-2013:

(i) ***Scope of consolidation*** – The BCBS will develop additional guidance to improve the international consistency of the scope of consolidation for prudential regulatory purposes. It will provide additional clarity on the boundary of consolidation which should help to limit regulatory arbitrage opportunities, particularly in a cross-border context.

(ii) ***Large exposures*** – The BCBS is developing a large exposure regime that takes into account the risks typically (but not exclusively) arising from the shadow banking system, such as interconnectedness and opacity.

(iii) ***Banks' investment in funds*** – The BCBS will introduce a more internationally consistent and risk sensitive capital treatment for banks' investment in the equity of funds, which will reflect both the risk of the fund's underlying investments and its leverage.

The BCBS will continue its existing work to aid the full implementation of its July 2009 guidance on the treatment of reputational risk and implicit support under Pillar 2.

Although the measures listed above will be designed in general terms to ensure an appropriately risk sensitive and consistently applied risk-based capital regime, all are expected to have a positive effect in protecting banks against the risks posed by the shadow banking system.

As requested in the October 2011 Report, the BCBS has furthermore examined the capital requirements relating to banks' short term liquidity facilities to shadow banking entities that are outside the scope of the Basel III securitisation framework (e.g. MMFs). In this area, the BCBS decided not to make further policy changes as it could potentially have an adverse effects (such as making the capital regime less risk sensitive), and may be unnecessary in light of other changes, such as the introduction of the liquidity coverage ratio (LCR).

The FSB reviewed the BCBS proposals in October 2012 and agreed that the specific measures will strengthen the banking system's resilience to shocks, or other negative effects, arising from the shadow banking system. The FSB also asked the BCBS to ensure that banks' support to MMFs and other sponsored vehicles are adequately captured by its work on the scope of consolidation and/or its treatment of reputational risks and implicit support.

1.2.2 WS2: Money market funds

Money market funds (MMFs) form a large element within the shadow banking system: they provide short-term non-deposit funds to the regular banking system, and also fund separate non-bank chains of credit intermediation. During the crisis, moreover, certain types of MMFs experienced investor runs, some of which necessitated large scale support from sponsors or the official sector to maintain stability in the MMF sector. The MMFs that faced runs typically offered stable or constant net asset value (NAV) to their investors, fostering an expectation that their claims were similar to bank deposits. Thus, when a large loss due to holdings of asset-backed securities (ABSs) and other financial instruments caused some MMFs' net asset values to drop below their promised par value (i.e. they "broke the buck"), this prompted investor redemptions across MMFs, destabilising the sector as well as the borrowers that rely on funding from MMFs.

Given the demonstrated potential for systemic run risk among MMFs, the FSB requested IOSCO in October 2011 to develop policy recommendations for MMFs. IOSCO issued a consultation report in April 2012 that provided a preliminary analysis of the systemic importance of MMFs and their key vulnerabilities, including their susceptibility to runs.[7] Based on this analysis, the consultation report set out policy options that could reinforce the soundness of MMFs and address the identified systemic vulnerabilities. These possible policy options included: a mandatory move from stable NAV to floating (or variable) NAV[8]; enhancements to MMF valuation and pricing frameworks; enhancement of MMF liquidity risk management; and reduction in the reliance on ratings in the MMF industry.

The consultation period ended in June 2012, after a one-month extension of the initial deadline. Based on the comments received, IOSCO issued 15 policy recommendations intended to provide the basis for common standards for the regulation and management of MMFs across jurisdictions in October 2012.[9] The recommendations cover a range of issues associated with MMFs including:

(i) ***General (regulatory framework)*** – MMFs should be explicitly defined in collective investment schemes (CIS) regulation as they present several unique features. Such regulation should include specific limitations on the types of assets MMFs may invest in and the risks they may take. Regulators should closely monitor the development and use of other vehicles similar to MMFs so as to reduce regulatory arbitrage. (recommendations 1-3)

(ii) ***Valuation*** – MMFs should comply with the general principle of fair value when valuing their assets. Amortised cost method should only be used in limited circumstances. Such MMF valuation practices should be reviewed by a third party as part of their periodic reviews of the funds accounts. (recommendations 4-5)

(iii) ***Liquidity management*** – MMFs should establish sound policies and procedures to know their investors (e.g. cash needs, sophistication, concentration). MMFs should hold a minimum amount of liquid assets to strengthen their ability to face redemptions and prevent fire sales. They should periodically conduct appropriate stress testing and have tools in place to deal with exceptional market conditions and substantial redemption pressures. (recommendations 6-9)

(iv) ***MMFs that offer a stable NAV*** – MMFs that offer a stable NAV should be subject to measures designed to reduce the specific risks associated with their stable NAV feature and internalise the costs arising from these risks. Regulators should require, where workable, a conversion to floating NAV. Alternatively, additional safeguards should be introduced to reinforce stable NAV MMFs' resilience and ability to face significant redemptions. (recommendation 10)

(v) ***Use of credit ratings*** – Regulatory obligations of the responsible entities regarding internal credit risk assessment practices should be strengthened and mechanistic reliance on external credit ratings should be avoided. Credit rating agencies should make more explicit their rating methodologies for MMFs. (recommendations 11-12)

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7 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf

8 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 a "NAV buffer" if stable NAV is maintained.

9 http://www.iosco.org/library/pubdocs/pdf/IOSCOPD392.pdf

(vi) ***Disclosure to investors*** – MMF documentation should include the absence of a capital guarantee and the possibility of principal loss. MMFs' disclosure to investors should include all necessary information regarding their practices in relation to valuation and the applicable procedures in time of stress. (recommendations 13-14)

(vii) ***MMFs' practices in relation to repos*** – When necessary, regulators should develop guidelines strengthening the framework applicable to the use of repos by MMFs, taking into account the outcome of current work on repos.[10] (recommendation 15)

The FSB has reviewed the IOSCO recommendations and endorsed them as an effective framework for strengthening the resilience of MMFs to risks in a comprehensive manner. In particular, the FSB endorses the Recommendation 10 requirement that stable NAV MMFs should be converted into floating NAV where workable. The FSB believes that the safeguards required to be introduced to reinforce stable NAV MMFs' resilience to runs where such conversion is not workable should be functionally equivalent in effect to the capital, liquidity, and other prudential requirements on banks that protect against runs on their deposits.

1.2.3 WS3: Other shadow banking entities

The third workstream (WS3) was set up by the FSB to examine the extent to which non-bank financial entities other than MMFs involved in shadow banking pose risks to the system and to develop policy recommendations as necessary. These policy recommendations should constitute a policy framework that would allow authorities to: detect the sources of shadow banking risks in the non-bank financial space; assess the risks posed from a financial stability perspective; and apply appropriate policy measures to mitigate the risks identified. Such a framework would also need to be sufficiently robust to capture innovations and adaptations that occur at the boundary of bank regulation.

In line with its mandate, WS3 completed a categorisation and data collection exercise for a wide range of non-bank financial entities. After casting the net wide through this exercise, WS3 conducted a two-step prioritisation process to narrow the scope to certain types of entities that may need policy responses: first looking at "size" and "national experience" (authorities' judgement) to derive a list of entity types ("filtered entities"); then assessing in detail their shadow banking risk factors (e.g. maturity/liquidity transformation and leverage). From its detailed assessment of the filtered entities, WS3 observed a high degree of heterogeneity and diversity in business models and risk profiles not only across the various sectors in the non-bank financial space, but also within the same entity-type. This is exacerbated by the different legal and regulatory frameworks across jurisdictions as well as by constant innovation and the dynamic nature of the non-bank financial sectors.

Based on these observations, WS3 decided to approach the shadow banking issues through an economic function-based (i.e. activities-based) perspective, rather than solely through an entities-based perspective. Such a perspective allows the extent of non-bank financial entities' involvement in shadow banking to be judged by looking through to their underlying *economic functions* rather than *legal names* or *forms*. It also allows policy tools to be developed to mitigate shadow banking risks inherent in each of the economic functions so that they can be

[10] For example, the FSB workstream on securities lending and repos (WS5) as described in section 1.2.5.

applied across jurisdictions to all entities that conduct the same economic function. The approach is also forward-looking in that it is able to capture new structures or innovations that conduct the same economic function and thereby create shadow banking risks.

The WS3 high-level policy framework consists of the following three elements:[11]

(i) ***Assessment based on economic functions (or activities)*** – Authorities must identify the sources of shadow banking risks in non-bank financial entities in their jurisdictions by referring to "the framework of five economic functions" set by WS3. They are:

1) ***management of client cash pools with features that make them susceptible to runs*** (e.g. credit investment funds with stable NAV features, leveraged credit hedge funds);

2) ***loan provision that is dependent on short-term funding*** (e.g. finance companies with short-term funding structure or that take deposits);

3) ***intermediation of market activities that is dependent on short-term funding or on secured funding of client assets*** (e.g. securities brokers whose funding is heavily dependent on wholesale funding);

4) ***facilitation of credit creation*** (e.g. credit insurers, financial guarantee insurers); and

5) ***securitisation and funding of financial entities*** (e.g. securitisation vehicles).

(ii) ***Adoption of policy tools*** – Authorities should adopt overarching principles and apply policy tools from a menu of optional policies (policy toolkit) for each economic function as they think best fits the non-bank financial entities concerned, the structure of the markets in which they operate, and the degree of risks posed by such entities in their jurisdictions. The overarching principles are:

Principle 1: Authorities should have the ability to define the regulatory perimeter;

Principle 2: Authorities should collect information needed to assess the extent of risks posed by shadow banking;

Principle 3: Authorities should enhance disclosure by other shadow banking entities as necessary so as to help market participants understand the extent of shadow banking risks posed by such entities; and

Principle 4: Authorities should assess their non-bank financial entities based on the economic functions and take necessary actions drawing on tools from the policy toolkit.

Policy toolkits have been identified to address shadow banking risks arising from each of the "five economic functions". They do not include recommendations made by other FSB shadow banking workstreams to avoid duplications.

(iii) ***Information-sharing process*** – Authorities will share information through the FSB process, in order to maintain consistency across jurisdictions in applying the policy

[11] http://www.financialstabilityboard.org/publications/r_121118a.pdf

framework, and also to minimise “gaps” in regulation or new regulatory arbitrage opportunities.

The FSB members reviewed the policy framework and policy toolkits proposed by WS3, and endorsed the approach. The policy tools will need to be refined and prioritised so as to achieve consistent application across jurisdictions as necessary in the light of the public comments. The next step thereafter will be for each member jurisdiction to map relevant non-bank financial entities into the five economic functions and assess the viability of the existing policy tools applied to entities that are classified into one or more of the economic functions. The policy framework should eventually become an FSB membership commitment subject to peer reviews in the same way as the FSB Key Attributes for Effective Resolution Regimes for financial institutions. The framework will provide a structured process for focusing the annual monitoring exercise as well as for authorities to assess the need for extending the regulatory perimeter.

1.2.4 WS4: Securitisation

Securitisation allows long-term credit (e.g. loans) to be financed by short-term funds (e.g. ABCPs). Securitisation can have positive effects on the real economy when it transfers the risks of long-term credit to non-bank investors well placed to bear such risk. However, the forms of securitisation prevalent in the run-up to the crisis - entailing complex structuring devices and multi-step distribution chains - generated misaligned incentives while encouraging a rapid and largely undetected build-up of leverage and maturity mismatching. Many securitisation transactions created imperfect credit risk transfers, leading to risks being concentrated in, rather than dispersed from, the banking system. In many respects, securitisation was designed to circumvent the bank capital framework (Basel I) in place before the crisis.

Many regulatory reforms designed to address the systemic vulnerabilities and incentive problems associated with securitisation have taken place since the crisis. The FSB asked IOSCO in the October 2011 Report to take stock of the implementation of reforms related to (i) retention requirements and (ii) measures that enhance transparency and standardisation of securitisation products, and examine the need for further policy action in these areas. Retention requirements are designed to align the incentives among originator (or issuer) and its investors, while enhancements of transparency and standardisation of securitisation products seek to reduce the opaqueness and complexity associated with such products. Improvements in transparency and standardisation will also enable market discipline to function properly.

In response to this request, IOSCO, in coordination with the BCBS, published its findings for public consultation in June 2012.[12] The consultation report proposed three possible policy actions to align the incentives associated with securitisation, and to support confidence in

[12] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD382.pdf

sustainable securitisation markets while avoiding impediments to cross-border activity in those markets[13]:

(i) enhancing monitoring of the implementation of retention requirements and its impact on the market (especially differences across jurisdictions in the approaches taken to adopt retention requirements such as the forms of retention and exemptions);

(ii) improving disclosures by issuers for example on stress testing or scenario analysis undertaken on underlying assets; and

(iii) encouraging standardisation of securitisation products through, for example, development of standard detailed disclosure templates on the basis of existing initiatives such as those developed by the industry.

Following exchanges with the industry at a roundtable and further analysis based on public comments received on its consultation report, IOSCO has finalised its final policy recommendations and published its final report on 16 November.[14] These recommendations cover a roadmap toward convergence and implementation of risk retention requirements, work to build on recent developments in terms of standardised templates for asset level disclosure, and other disclosure-related aspect to assist informed investment decisions, as well as further issues for consideration for the sound regulation of sustainable securitisation markets.

1.2.5 WS5: Securities lending and repos

Securities lending and repo markets support price discovery and secondary market liquidity for a variety of securities issued by both public and private market participants. They are central to financial intermediaries' abilities to make markets, and facilitate the implementation of various investment, risk management, and collateral management strategies. Repo markets are also core funding markets for some financial institutions and instrumental in monetary refinancing operations in many jurisdictions. Aside from these functions, however, securities lending and repos are also used to conduct "bank-like" activities, such as creating money-like liabilities, carrying out maturity/liquidity transformation, and obtaining leverage.

A workstream (WS5) was set up to assess financial stability risks and develop policy recommendations, where necessary, to strengthen regulation of securities lending and repos. In April 2012, WS5 published its interim report *Securities Lending and Repos: Market Overview and Financial Stability Issues* which provided an overview of the securities lending and repo markets, described their location in the shadow banking system, and discussed the financial stability issues arising from practices in these markets.[15] To address these financial stability issues, WS5 has now developed 13 policy recommendations[16] including:

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[13] In addition to these policy actions, IOSCO also noted in its consultation report a number of issues for further consideration, including work on definitions for securitisation; underlying asset selection and eligibility criteria; secondary market liquidity; or access to information provided to credit rating agencies.

[14] http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf

[15] http://www.financialstabilityboard.org/publications/r_120427.pdf

[16] For details, please see http://www.financialstabilityboard.org/publications/r_121118b.pdf. Application of the proposed policy recommendations may vary in details across jurisdictions, depending on existing regulatory frameworks. The

(i) ***Improving regulatory reporting –*** existing international initiatives to collect data on exposures amongst international financial institutions, such as the work of the FSB Data Gaps group, should be extended to capture more granular data on securities lending and repo exposures (recommendation 1);

(ii) ***Improving market transparency –*** WS5 has identified a list of data items to improve transparency of securities lending and repo markets and identified the establishment of trade repositories (TRs) as the most effective approach to data collection with market-wide surveys as an initial step (recommendations 2-3);

(iii) ***Improving corporate disclosures –*** public disclosure requirements for financial institutions' securities lending, repo and wider collateral management activities should be improved as needed through working with standard setting bodies internationally (recommendation 4);

(iv) ***Improving reporting by fund managers to end-investors –*** reporting requirements for fund managers to end-investors should be reviewed (recommendation 5);

(v) ***Introducing minimum standards for haircut practices –*** minimum standards for methodologies used by market participants to calculate haircuts should be established in order to limit the extent to which haircuts are reduced in benign market environments, and there is a case in principle for introducing a framework of binding numerical haircut floors on securities financing transactions to limit the build-up of excessive leverage and procyclicality (recommendations 6-7);

(vi) ***Limiting risks associated with cash collateral reinvestment –*** minimum regulatory standards should be established to limit liquidity risk arising from maturity/liquidity transformation associated with cash collateral reinvestment activities (recommendation 8);

(vii) ***Addressing risks associated with re-hypothecation of client assets –*** authorities should ensure that regulations governing re-hypothecation of client assets address the following principles: financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets so that clients can understand their exposures in the event of a failure of the intermediary; in jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be re-hypothecated for the purpose of financing the own-account activities of the intermediary; and only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets (recommendations 9-10);

(viii) ***Strengthening collateral valuation and management practices –*** authorities should adopt minimum regulatory standards for collateral valuation and management for all market participants (recommendation 11);

implementation of recommendations and their consistency across jurisdictions will be monitored through FSB after they are finalised.

(ix) ***Evaluating the establishment or wider-use of central clearing where appropriate –*** authorities should evaluate the costs and benefits of central clearing in their securities lending and repo markets (recommendation 12); and

(x) ***Changing bankruptcy law treatment of repo and securities lending transactions –*** changes to bankruptcy law treatment and development of Repo Resolution Authorities (RRAs) may be viable theoretical options to reduce the excessive reliance on funding through repos and securities lending, and to mitigate market disruptions. However, they will not be pursued for now due to practical difficulties (recommendation 13).

The FSB members generally supported the above policy recommendations and endorsed them to be issued for public consultation. On Recommendation 7 (introducing minimum standards for haircut practices), FSB members believe there is a case in principle for introducing a framework of numerical haircut floors on securities financing transactions, especially for instruments with a potentially procyclical feature (e.g. corporate bonds and securitisation products). However, members also think such a framework would need to be carefully designed and calibrated, taking into account unintended consequences. It was also noted that detailed work on these issues needs to be coordinated with the separate BCBS-IOSCO work on margin requirements for non-centrally cleared derivatives transactions[17], given that some of the same principles apply, and that derivative contracts and secured funding contracts can be used to achieve similar economic objectives. The FSB believes that public consultation on the design of such numerical haircut floor framework will provide insights in assessing the most effective way to achieve the policy objectives.

Based on the public comments received, WS5 will develop final recommendations by September 2013. The final recommendations should also take into account results of a quantitative impact assessment and include an implementation timetable that take due consideration of current market conditions as well as the need for authorities and market participants to adjust their systems and controls. Some work, such as a feasibility study on TRs, may have to be conducted in a longer timeframe.

2. Next steps

Following the G20 Finance Ministers and Central Bank Governors meeting in November, the FSB will take forward the work in the following manner:

- *Development of the WS1 recommendations*: WS1 (BCBS) will continue its work to develop by mid-2013 policy recommendations on interactions between banks and shadow banking entities.
- *Refining and applying the WS3 recommendations*: WS3 will refine and prioritise their policy recommendations on other shadow banking entities, taking into account feedback from the public consultation.

[17] http://www.bis.org/publ/bcbs226.pdf

- *Refining and applying the WS5 recommendations*: WS5 will refine its recommendations on securities lending and repos, taking into account public consultation and the results of quantitative impact analysis, in particular in relation to Recommendation 7 on a framework of numerical haircut floors. The FSB will agree final recommendations by September 2013.
- *Activating the policy frameworks within the FSB process:* The FSB will decide on the implementation timetable for the policy recommendations from each workstream when they are finalised, taking into account market conditions as well as the need for authorities and market participants to adjust their systems and controls. It will also identify any implementation issues that would need to be addressed when turning the recommendations into an FSB membership commitment subject to a peer review process after policy recommendations are finalised.

FSB will review the progress of all workstreams and will prepare the final recommendations, including the detailed recommendations from each workstream in September 2013. It will thereafter work on the procedures to ensure policy recommendations are implemented appropriately.