BANK FOR INTERNATIONAL SETTLEMENTS

International cooperation to address shadow banking risks

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Disclaimer

Not the views of the BIS or FSB.

Source of policy concerns

- The 2007-09 crisis:
  - Bad loans distributed throughout the financial system
  - Maturity and liquidity mismatches (SIVs, broker-dealers …)
  - Safe assets (e.g. CDO tranches) become risky assets
  - Safe entities (e.g. MMFs) become risky entities
  - Wholesale funding dried up, throughout the system
  - Private obligations become public obligations
- Since the crisis
  - How do we set risk weights?
  - How do we regulate MMFs?
  - How do we regulate securitisation?

→ Making sure banks are healthy is not enough.

The FSB workplan and the G20 mandate

- G20 mandate, Seoul summit, November 2010:
  - "With the completion of the new standards for banks, there is a potential that regulatory gaps may emerge in the shadow banking system. Therefore, we called on the FSB to work in collaboration with other international standard setting bodies to develop recommendations to strengthen the regulation and oversight of the shadow banking system by mid-2011."
- Financial Stability Board taskforce set up in January 2011
  - Data and monitoring
  - Regulatory recommendations

Scope

- Instead of a formal definition, a two-step approach to delineate the scope of the analysis
  - Step 1: "Cast the net wide": Look at all financial intermediation outside the traditional banking system
  - Step 2: "Narrow the focus": Focus on entities and activities that pose potential systemic risks, or create avenues for regulatory arbitrage

Data and monitoring

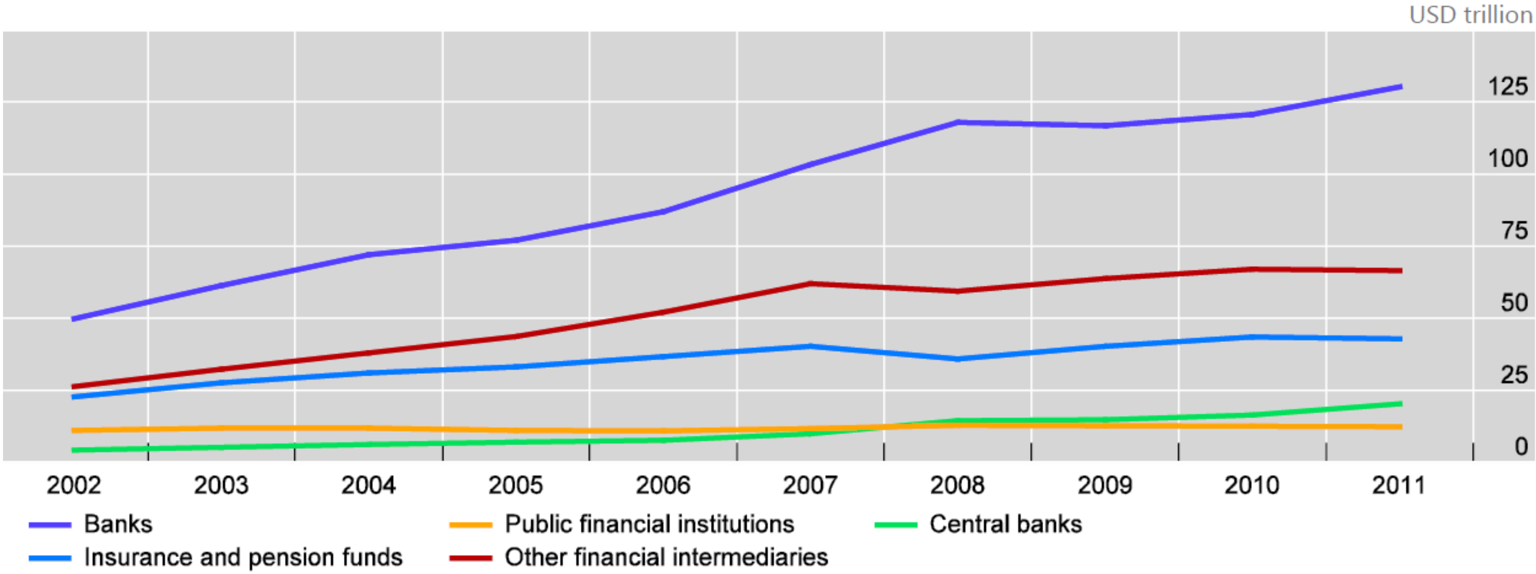
- In line with the "non-definition," the monitoring exercise has two elements:
  - Trends in broad categories of financial activity
  - Developments in specific sectors that potentially raise concerns
- Thanks to differences in definitions and availability, it is challenging to formulate global aggregates and make cross-national comparisons

Private non-bank, non-insurance, non-pension assets grew rapidly before the crisis, more slowly since …

Total assets of financial intermediaries

20 jurisdictions and euro area

Exhibit 2-1



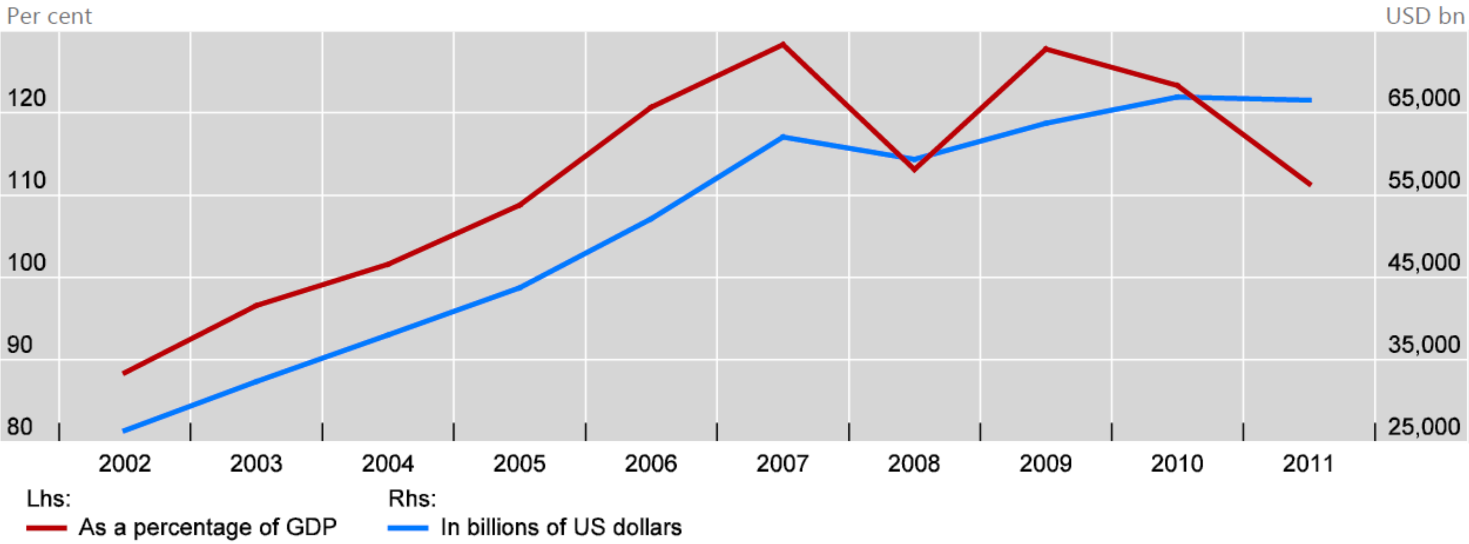
Source: National flow of funds data.

… and have fallen relative to GDP …

Assets of non-bank financial intermediaries

20 jurisdictions and the euro area

Exhibit 2-3



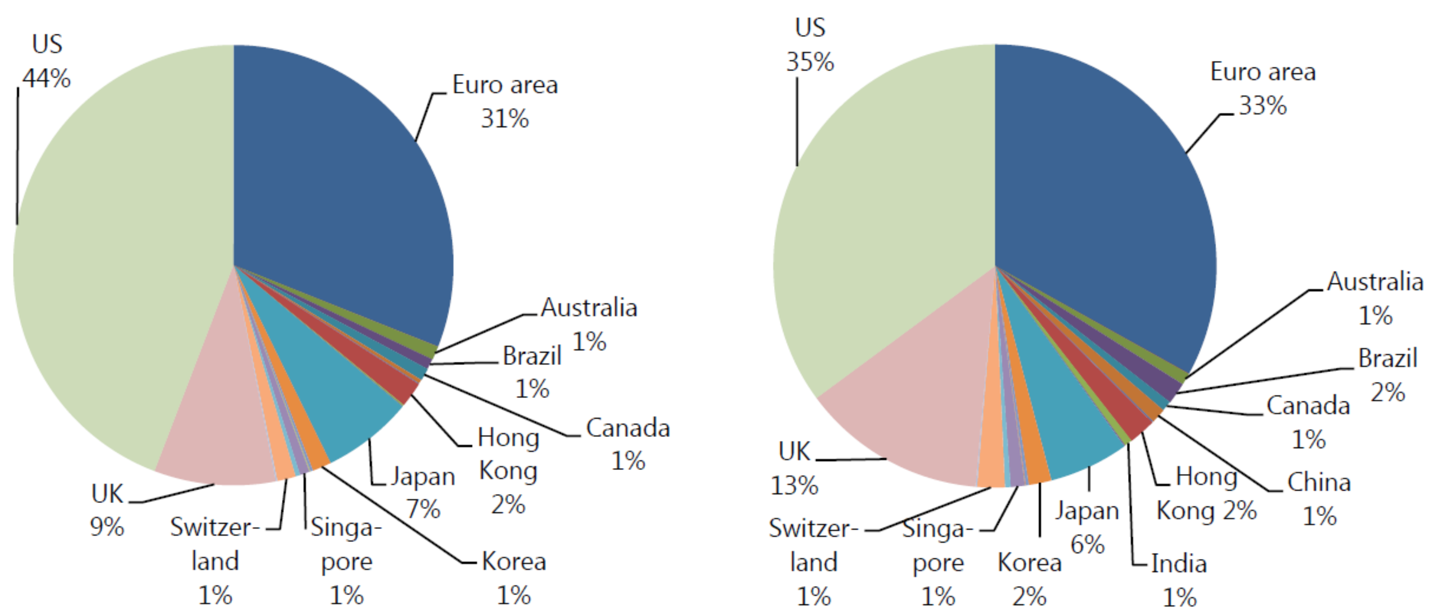
Source: National Flow of Funds data.

… but have grown outside the US.

Share of assets of non-bank financial intermediaries

20 jurisdictions and euro area — Exhibit 2-4

At end-2005 — At end-2011



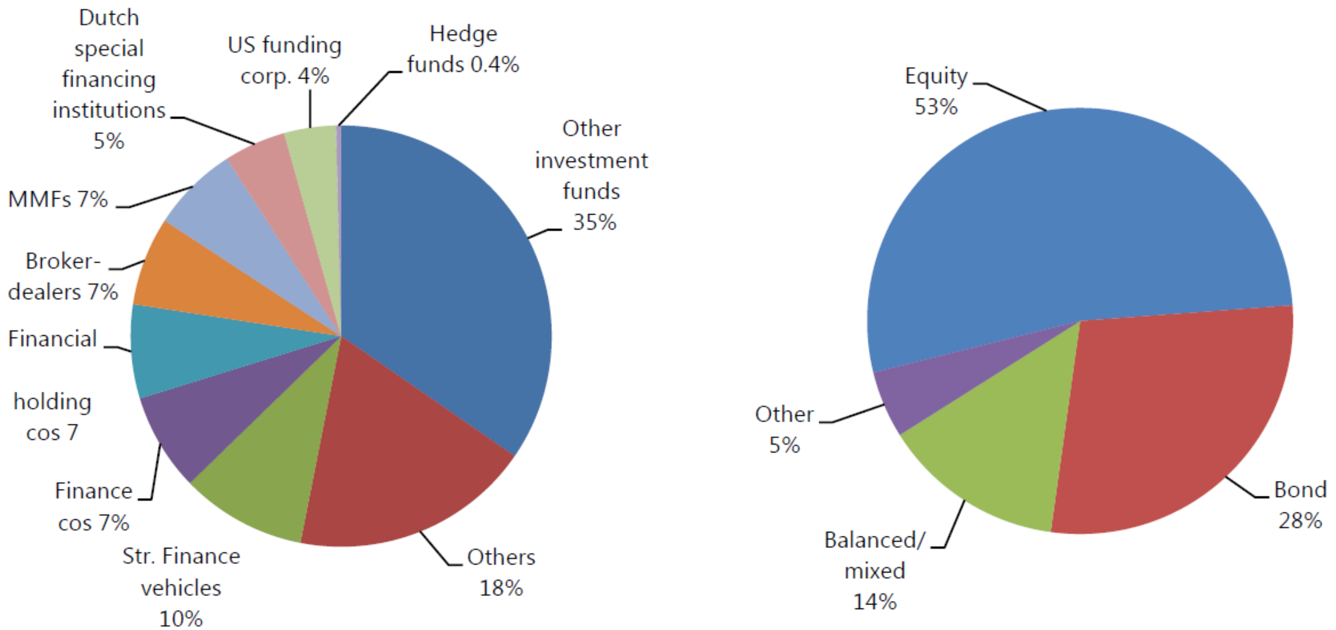
Source: National flow of funds data.

These aggregates represent a wide range of entities …

Sub-sectors of non-bank financial intermediaries (OFIs)

25 jurisdictions; at end-2011 — Exhibit 4-1

Decomposition by sub-sector — Other investment funds by type from ICI statistics[1]



[1] Sample: 25 jurisdictions minus Indonesia, Saudi Arabia, Hong Kong, Singapore, for which data is not available.

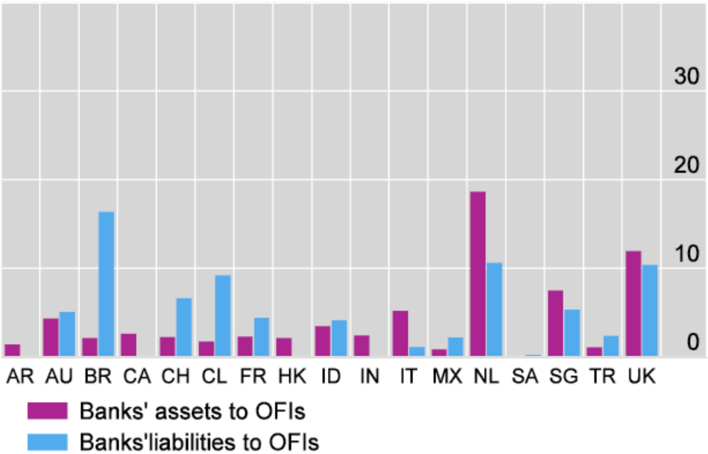
Sources: National Flow of Funds data; Investment Company Institute (ICI).

… and are closely intertwined with the banking system

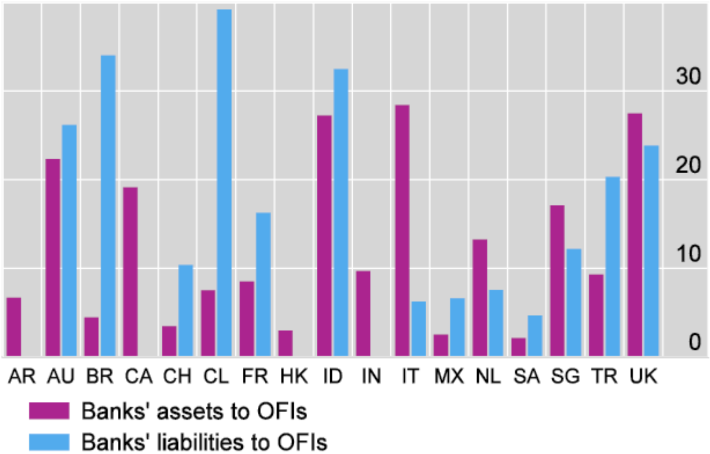
Banks' assets and liabilities to non-bank financial intermediaries

At end-2011 Exhibit 5-2

As a percentage of banks' assets



As a percentage of OFIs assets



AR = Argentina; AU = Australia; BR = Brazil; CA = Canada; CH = Switzerland; CL = Chile; FR = France; HK = Hong Kong; ID = Indonesia; IN = India; IT = Italy; MX = Mexico; NL = Netherlands; SA = Saudi Arabia; SG = Singapore; TR = Turkey; UK = United Kingdom..

Note: Liabilities of banks to OFIs are not available for Argentina, Canada, Hong Kong and India. Countries with no data on assets and liabilities of banks to OFIs include China, Germany, Japan, Korea, Russia, South Africa, Spain and the United States.

Source: National Flow of Funds data.

Regulatory recommendations

- Targeted approach
- Focus on externalities, esp potential sources of systemic risk:
  - Hidden leverage
  - Maturity and liquidity mismatches
  - Regulatory arbitrage
- Focus on entities/activities not (fully) covered by existing regulatory frameworks
- Areas where there is a role for consistent, harmonised global rules or standards
- Proportional, forward-looking, adaptable

FSB workstreams (established summer 2011)

1. Banks’ interactions with shadow banking entities (Basel Committee on Banking Supervision [BCBS])
2. Money market funds (International Organisation of Securities Commissions [IOSCO])
3. Other shadow banking entities (FSB)
4. Securitisation (IOSCO)
5. Securities lending and repo (FSB)

WS1. Banks and shadow banking

- Many of the key changes are already in Basel II.5 and Basel III
- Higher capital requirements (Pillar 1) for:
  - Credit exposures in the trading book
  - Re-securitisation exposures
  - Liquidity facilities
  - Exposures to unregulated firms
- Stronger supervisory oversight (Pillar 2) of:
  - Securitisation risk
  - Reputational risk
  - Implicit support
- Enhanced disclosure (Pillar 3) of securitisation risks

WS1. Banks and shadow banking

- Further work underway:
  - International consistency on consolidation for supervisory purposes
  - Large exposure regime
  - Risk-based capital rules for banks’ holdings of equity in investment funds
- Policy recommendations by mid-2013

WS2: Money market funds

- IOSCO, *Policy recommendations for money market funds,* October 2012
- Explicit regulatory definition (not just another investment fund)
- Fair value whenever possible
- Sound liquidity management, including stress-testing
- Constant NAV funds
  - Convert to floating NAV, or
  - Introduce safeguards: capital, redemption gates, …
- Avoid mechanistic reliance on external credit ratings
- Disclose risks to investors
- Guidelines on use of repos (cf WS 5).

WS3. Other shadow banking entities

- FSB, *A Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities*, November 2012
- Regulatory responses should be based on economic functions or activities, with particular attention to:
  - Pooled credit investment vehicles that could face runs (stable NAV, leverage …)
  - Loan provision financed at short maturities (finance companies …)
  - Market activity financed at short maturities (securities brokers …)
  - Facilitators of credit provision (guarantors, insurers …)
  - Vehicles funded by securitisation
- Identified policy toolkits appropriate to each of these
- International standards should focus on information-sharing, international consistency

WS4. Securitisation

- IOSCO, *Global developments in securitisation regulation*, November 2012
- Convergence of implementation of retention requirements, monitoring of impact
- Improved disclosure of stress-testing, scenario analysis
- Standardisation of securitisation products, e.g. disclosure templates

WS5. Securities lending and repo

- FSB, *A policy framework for addressing shadow banking risks in securities lending and repos*, November 2012
- Recommendations:
  - Improved transparency:
    - regulatory reporting
    - market data
    - corporate disclosures
    - From fund managers to investors
  - Minimum standards for haircut practices
    - Methodologies
    - Floors?
  - Reduced risks in cash collateral reinvestment
  - Reduced risks in rehypothecation

WS5. Securities lending and repo

- Recommendations (cont.)
  - Strengthened collateral valuation and management
  - Wider use of central clearing
  - Bankruptcy law treatmnet
- Coordinate with BCBS-IOSCO work on margin requirements for non-centrally-cleared derivatives
- Final recommendations by September 2013

Concluding thoughts

- Goals of policy: Risk reduction vs risk containment vs risk shifting
- Need to keep an eye on both high-level principles and specific risks
- The innovation cycle:
  1. An exotic curiosity
  2. The next big thing
  3. The heart of the system
- Regulatory arbitrage: across sectors, across borders
- Regulation: intended consequences vs unintended consequences