INVESTMENT COMPANY INSTITUTE

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FSB Publishes Documents on Strengthening Oversight and Regulation of Shadow Banking

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TO: ICI GLOBAL SHADOW BANKING TASK FORCE
INTERNATIONAL MEMBERS No. 47-13
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 26-13 RE: FSB PUBLISHES DOCUMENTS ON STRENGTHENING OVERSIGHT AND REGULATION OF SHADOW BANKING

On August 29, 2013, the Financial Stability Board ("FSB") published three final policy documents on Strengthening Oversight and Regulation of Shadow Banking. The published documents are:

1. An Overview of Policy Recommendations [1] - This paper sets out the FSB's approach to addressing financial stability concerns associated with shadow banking, actions taken to date, and next steps.
2. Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities [2] - This paper sets out the high-level policy framework to assess and address risks posed by "other shadow banking" entities and activities.
3. Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos [3] - This paper sets out recommendations for addressing financial stability risks in this area, including enhanced transparency, regulation of securities financing and improvements to market structure. It also includes a consultation on minimum standards for methodologies to calculate haircuts on non-centrally cleared securities financing transactions and a framework of numerical haircut floors.

An Overview of Policy Recommendations

The FSB's relatively short paper on An Overview of Policy Recommendations describes its approach to addressing financial stability concerns associated with shadow banking, actions taken to date, and next steps. It explains that the FSB has focused on the five specific areas described below in which it believes policies are needed to mitigate the potential systemic risks associated with shadow banking. The FSB will report on overall progress to the G20 in November 2014.

1. Mitigate the spill-over effect between the regular banking system and the shadow banking system. Among other things, the Basel Committee on Banking Supervision ("BCBS") will finalize its proposed supervisory framework for banks' large exposures and its proposed capital treatment for banks' investments in the equity of funds by the end of 2013.

2. Reduce the susceptibility of money market funds ("MMFs") to "runs." Final policy recommendations have been developed by IOSCO that provide the basis for common standards of regulation and management of MMF's across jurisdictions, and a peer review process of national implementation will be launched in 2014.

3. Assess and align the incentives associated with securitization. Final policy recommendations on reforms in this area were issued by IOSCO in November 2012 and a peer review on the national approaches will be undertaken by IOSCO in 2014. Regulatory impediments to a resumption of orderly and sustainable securitization markets will continue to be reviewed.

4. Dampen financial stability risks and pro-cyclical incentives associated with securities financing transactions such as repos and securities lending that may exacerbate funding strains in times of market stress. As mentioned above, the FSB issued a paper on this issue, including a consultation. The FSB will complete its work on proposed recommendations on minimum haircuts for securities financing transactions by spring 2014 and will develop standards and processes for data collection and aggregation at the global level on securities financing markets by the end of 2014.

5. Assess and mitigate systemic risks posed by other shadow banking entities and activities. As mentioned above, the FSB issued a paper on the policy framework for strengthening oversight and regulation of shadow banking entities. In addition, an information sharing process to activate the high-level policy framework for strengthening oversight and regulation of shadow banking entities will be developed by March 2014.

Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities

The Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities sets out the final policy framework to address risks posed by non-bank financial entities other than money market funds (e.g., "other shadow banking entities"). It follows a November 2012 consultation on which ICI and ICI Global commented. [4]

In the paper, the FSB describes its high-level policy framework for other shadow banking entities as consisting of three elements:

1. First: The framework of five economic functions (or activities) to which authorities should refer in determining whether non-bank financial entities other than MMFs in their jurisdictions are involved in non-bank credit intermediation that may pose systemic risks or in regulatory arbitrage.

2. Second: The framework of policy toolkits, which consists of overarching principles that authorities should apply for all economic functions and a toolkit for each economic function to mitigate shadow banking risks (that pose systemic risks) associated with that function.

3. Third: Information sharing among authorities through the FSB process, in order to maintain consistency across jurisdictions in applying the policy framework, and also to

minimize “gaps” in regulation or new regulatory arbitrage opportunities.

With respect to the first element, the FSB expects authorities to refer to the five economic functions set out below in assessing their non-bank financial entities’ involvement in shadow banking, which will allow authorities to categorize not by legal forms or names but by economic function or activities. The five economic functions are: (i) management of collective investment vehicles with features that make them susceptible to runs, [5] (ii) loan provision that is dependent on short-term funding, (iii) intermediation of market activities that is dependent on short-term funding or on secured funding of client assets, (iv) facilitation of credit intermediation, and (v) securitization-based credit intermediation and funding of financial entities.

For the second element, the FSB developed a set of overarching principles and a policy toolkit for each economic function. The FSB states that, when implementing the policy tools, authorities should ensure that the tools are proportionate to the degree of risks posed by the non-bank financial entities, and should take into account the adequacy of the existing regulatory framework as well as the relative costs and benefits of applying the tools. The overarching principles are: (i) authorities should define, and keep up to date, the regulatory perimeter, (ii) authorities should collect information needed to assess the extent of risks posed by shadow banking, (iii) 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 (iv) authorities should assess their non-bank financial entities based on the economic functions and take necessary actions drawing on tools from the policy toolkit.

With respect to the management of collective investment vehicles with features that make them susceptible to runs, the following tools are outlined for managing redemption pressures in stressed market conditions: redemption gates, suspensions of redemptions, imposition of redemption fees or other redemption restrictions, and side pockets. For dealing with liquidity risk, the tools outlined are: limits on investments in illiquid assets, liquidity buffers, limits on asset concentration, limits on leverage, and restrictions on maturity of portfolio assets.

The FSB believes that it is important to apply the policy framework consistently, and intends to develop detailed procedures for information sharing by March 2014.

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endnotes

[1] http://www.financialstabilityboard.org/publications/r_130829a.pdf.

[2] http://www.financialstabilityboard.org/publications/r_130829c.pdf.

[3] http://www.financialstabilityboard.org/publications/r_130829b.pdf. The contents of this paper will be addressed in a separate memorandum.

[4] The ICI and ICI Global letter, dated January 14, 2013, is available at http://www.ici.org/pdf/26882.pdf.

[5] The FSB provides as an example the management of CIVs with a very low risk investment objective or relatively illiquid portfolio because they can face “run” risk in time of market stress from flights to quality or liquidity.