

Transforming Shadow Banking into Resilient Market-based Finance

An Overview of Progress

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Executive Summary

Non-bank financing provides a valuable alternative to bank funding and helps support real economic activity. It is also a welcome source of diversification of credit supply from the banking system, and it provides healthy competition for banks. As demonstrated by the 2007-09 global financial crisis, however, if non-bank financing is involved in bank-like activities, transforming maturity/liquidity and creating leverage like banks, it can become a source of systemic risk, both directly and through its interconnectedness with the banking system. To address these risks, and to build safer, more sustainable sources of non-bank financing for the real economy, the FSB has been working on transforming shadow banking into resilient market-based finance as a core element of regulatory reforms.

The FSB has defined shadow banking as “credit intermediation involving entities and activities (fully or partly) outside the regular banking system”, or non-bank credit intermediation in short.¹ It has also stated that if such non-bank credit intermediation is involved in transforming maturity/liquidity and a build-up of leverage, it may pose a risk to the financial system and deserves policy responses by authorities that are proportionate to the financial stability risk posed.

In response to the G20 Leaders’ request at the Seoul Summit in 2010 and subsequently, the FSB has adopted a two-pronged strategy to address the financial stability risks in shadow banking and transform it into resilient market-based finance. First, the FSB has created a system-wide monitoring framework to track developments in the shadow banking system with a view to identifying the build-up of systemic risks and initiating corrective actions where necessary. Second, the FSB has been coordinating and contributing to the development of policies to strengthen oversight and regulation of shadow banking, with a focus on measures that seek:

- (i) to mitigate *risks in banks’ interactions with shadow banking entities*;
- (ii) to reduce the susceptibility of *money market funds (MMFs)* to “runs”;
- (iii) to improve transparency and align the incentives in *securitisation*;
- (iv) to dampen procyclicality and other financial stability risks in *securities financing transactions such as repos and securities lending*; and
- (v) to assess and mitigate financial stability risks posed by *other shadow banking entities and activities*.

In accordance with the actions and deadlines set out in the updated Roadmap endorsed by the G20 Leaders at the Brisbane Summit in November 2014,² the FSB has progressed its two-pronged strategy.

¹ Some authorities or market participants prefer to use other terms such as “market-based financing” instead of “shadow banking”. The use of the term “shadow banking” is not intended to cast a pejorative tone on this system of credit intermediation. However, the FSB is using the term “shadow banking” as this is the most commonly employed and, in particular, has been used in the earlier G20 communications.

² For the roadmap, see annex to <http://www.financialstabilityboard.org/wp-content/uploads/Progress-Report-on-Transforming-Shadow-Banking-into-Resilient-Market-Based-Financing.pdf>.

First, with regard to **system-wide monitoring** to track developments in the shadow banking system, **the FSB has this year introduced a new activity-based “economic function” approach in its annual monitoring.** This activity-based approach is intended to help authorities detect and assess the sources of financial stability risks from shadow banking in the non-bank financial space, and apply appropriate policy measures where necessary to mitigate these risks. The approach is still at an early stage and will be further refined through increased data availability, more consistency in the national assessments and a deeper understanding of each other’s shadow banking systems through more structured information-sharing. As further refinement takes place over time, it should allow authorities to detect and respond to new sources of risk or potential shifts of risky activities across sectors as tighter regulations on banks and other traditional market participants come into effect.

Second, with regard to **policies to strengthen oversight and regulation of shadow banking, there has been further progress this year, particularly in the area of securities financing,** which amplified maturity mismatching and the build-up of excessive leverage prior to the global financial crisis (see Section 2.4). The regulatory framework for haircuts on non-centrally cleared securities financing transactions is now completed with the scope extended to cover securities financing between non-banks. Standards and processes for global securities financing data collection have also been finalised, which will increase transparency about these important financing markets. FSB members will adopt these policy measures in an internationally-coordinated manner, acting within their domestic policy processes. The Basel Committee on Banking Supervision (BCBS) and the International Organization of Securities Commissions (IOSCO) have also set out criteria for identifying simple, transparent and comparable securitisations.

The implementation of previously agreed policies is progressing. It is essential for the agreed policies to be implemented in a timely manner. The FSB, in coordination with the relevant standard-setting bodies (SSBs), will monitor the national implementation of the agreed policies to ensure they achieve the intended objectives. Since shadow banking activities take a variety of forms and continue to evolve, FSB members are also mindful of the need to periodically review the agreed policies.

In the coming year, the FSB and its members will take forward the following work to transform shadow banking into resilient market-based financing:

- *Development of the guidance on the scope of consolidation for bank prudential regulation:* The BCBS will publish guidance for public consultation on the scope of consolidation for bank prudential regulation, in particular to capture step-in risk, around the end of 2015.
- *Findings on the possible harmonisation of regulatory approaches to re-hypothecation:* The FSB will prepare its final findings on the possible harmonisation of regulatory approaches to re-hypothecation of client assets and review possible financial stability issues related to collateral re-use by March 2016.
- *Implementation monitoring for the policy framework for shadow banking entities:* The FSB will publish the results of peer review of its policy framework for shadow banking entities in the first half of 2016.

- *Evaluation of the case for developing further policy recommendations:* Based on the findings from the peer review and information-sharing exercise, the FSB will evaluate the case for developing further policy recommendations for the relevant shadow banking entities and report the results to the G20 in the first half of 2016.
- *Implementation monitoring for MMFs and securitisation:* IOSCO will start updated “level one” peer reviews on the implementation of its recommendations on MMFs and securitisation in 2016. It will also consider developing a plan for regular monitoring and reporting on the consistency and effectiveness of these reforms.
- *Monitoring of the global trends and risks in the shadow banking system:* The FSB will continue to conduct its annual monitoring exercise and publish the next results in the fourth quarter of 2016.

1. Establishing a system-wide monitoring framework

A first step for authorities towards addressing risks in shadow banking activities is the establishment of system-wide monitoring arrangements that assess sources of systemic risks within and beyond the bounds of prudential regulation. To this end, the FSB has been conducting annual monitoring exercises since 2011 to assess **global trends and risks in the shadow banking system** and **published the results of its fifth exercise** in November 2015 (reflecting data as of end-2014).³ This year’s monitoring covers 26 jurisdictions,⁴ representing about 80% of global GDP and 90% of global financial system assets.

This year, the FSB published for the first time a narrow measure of shadow banking based on economic functions where non-bank financial entities and activities are assessed by authorities to be involved in shadow banking risks (e.g. maturity/liquidity transformation and leverage). The measure is based on authorities’ classification of non-bank financial entities in their jurisdictions into the five economic functions identified in the FSB Policy Framework published in August 2013 (see Section 2.5). The narrowing-down approach is an important step towards a better understanding of the shadow banking system and toward risk-based monitoring by helping authorities detect and assess the sources of financial stability risks from shadow banking in the non-bank financial space, and apply appropriate policy measures where necessary to mitigate these risks. Given the differences across national financial systems and that the approach allows for some degree of supervisory judgement, this approach remains a work in progress and additional guidance will have to be developed on how to implement it consistently across jurisdictions and to fill gaps in data. To ensure a level of consistency in reporting this year, participating jurisdictions were asked to conservatively classify activities into the narrow measure where doubts remained about whether or not the activities contained shadow banking risks, and this will be assessed further in future exercises. Refinements will take place over time as more structured information-sharing increases data availability and promotes more consistency in the national assessments and a deeper

³ http://www.fsb.org/wp-content/uploads/global_shadow_banking_monitoring_report_2015.pdf

⁴ The exercise covered all 24 FSB member jurisdictions, Chile and (for the first time this year) Ireland.

understanding of national/regional shadow banking systems (including applicable regulatory frameworks and policy measures).

The key findings from this year's annual monitoring exercise are as follows:

- In 2014, the wider aggregates comprising “Other Financial Intermediaries (OFIs)”⁵ in 20 jurisdictions and the euro area grew to reach \$80 trillion, from \$78 trillion in 2013. This broad measure outpaced growth in other categories of financial intermediation and the overall economy. Growth in overall credit intermediation, where it occurred, was largely a result of the growth of fixed income and mixed funds.
- The new, economic function-based, narrow measure of shadow banking that may pose financial stability risks was \$36 trillion in 2014, versus \$35 trillion in 2013. This measure amounted to about 30% of the overall non-bank financial sector⁶ assets and 60% of the GDP of the 26 participating jurisdictions. This activity largely occurred in advanced economies, although growth was rapid in a number of emerging market economies. Credit intermediation associated with collective investment vehicles (e.g. certain fixed income funds, MMFs, credit hedge funds) comprised more than 60% of the total narrow measure and has grown by nearly 10% on average annually over the past four years.
- At the aggregate level, interconnectedness between the banking and the non-bank financial sectors⁷ continues to decline from its pre-crisis peak, although in some jurisdictions OFIs' credit and funding exposures to banking systems are quite elevated.

In addition to providing insight into global trends and risks in the global shadow banking system, the FSB's annual monitoring exercises have prompted an increasing number of national and regional authorities to regularly assess the risks of shadow banking.⁸ In addition to the participation of Chile and Ireland in the FSB annual monitoring exercise, the FSB's Regional Consultative Group (RCG) for the Americas, for example, has been conducting its own monitoring based on the annual FSB monitoring exercises and recently published its second results (reflecting data as of end-2013),⁹ with expanded coverage of international financial centres where shadow banking entities are often domiciled helping to deepen authorities' understanding. The FSB is encouraging other RCGs to conduct similar monitoring exercises.

⁵ OFIs are financial intermediaries that are not deposit-taking institutions, insurers, pension funds, public financial institutions, and financial auxiliaries. For details, see http://www.fsb.org/wp-content/uploads/global_shadow_banking_monitoring_report_2015.pdf.

⁶ The non-bank financial sector excludes public financial institutions.

⁷ Excluding those OFIs that are prudentially consolidated into banking groups.

⁸ Several jurisdictions (e.g. Australia, Canada, Germany, Ireland and the Netherlands) and the European Central Bank (ECB) have also published analyses of their respective shadow banking system, leveraging on the FSB annual monitoring exercises. The International Monetary Fund has conducted some analysis including data collected in the FSB annual monitoring exercise in its October 2014 Global Financial Stability Report (<http://www.imf.org/external/pubs/ft/gfsr/2014/02/pdf/c2.pdf>).

⁹ <http://www.financialstabilityboard.org/wp-content/uploads/Working-Group-on-Shadow-Banking-Second-Report.pdf>

Going forward, the global monitoring exercise is expected to benefit from further improvements in data gathering and additional follow-up by jurisdictions of identified gaps and data inconsistencies. Further refinement to authorities' assessment based on five economic functions may improve the activity-based narrow measure of shadow banking. Implementation of policy recommendations to address financial stability risks in securities financing transactions, in particular the global securities financing data collection initiative by the FSB (see Section 2.4), is expected to improve the coverage and granularity of the monitoring exercise, and may also help expand activity- and risk-based monitoring.

2. Strengthening the oversight and regulation of shadow banking

The policy work to address the systemic risks from shadow banking has focused on the following five areas.

2.1. Mitigating risks in banks' interactions with shadow banking entities

The financial crisis revealed how the regular banking system was both intertwined with, and exposed to, risks in the shadow banking system. The FSB asked the BCBS to develop policy recommendations to ensure the spillovers of risks from the shadow banking system to the banking system are prudentially mitigated.

The BCBS is continuing its review of the scope of consolidation for prudential regulatory purposes with a view to developing guidance to ensure all banking activities, including banks' on- and off-balance sheet interactions with the shadow banking system, are appropriately captured in prudential regimes. In particular, it is assessing the risk of banks stepping in to support shadow banking entities (i.e. step-in risk) and is considering possible ways to capture such risk in the regulatory perimeter. It plans to issue proposals for public consultation around the end of 2015.

Meanwhile, **BCBS members are currently in the process of implementing the following finalised policy measures:**¹⁰ **(i) risk-sensitive capital requirements for banks' investments in the equity of funds;**¹¹ **and (ii) the supervisory framework for measuring and controlling banks' large exposures.**¹² The first of these requirements establishes a more consistent and risk-sensitive approach for computing regulatory capital requirements for banks' investments in the equity of funds that are not held for trading purposes, by appropriately reflecting both the risk of the fund's underlying investments and its leverage. BCBS members are still at an early stage of implementing the new requirement, which should come into force by 1 January 2017.¹³

¹⁰ In addition to these policies, BCBS members have implemented or are in the process of implementing a number of measures that should strengthen the resilience of the regular banking system against risks posed by shadow banking entities. For example, the BCBS increased the capital requirements applied to banks' re-securitisation exposures and for liquidity facilities (under one year) provided to securitisation vehicles.

¹¹ <http://www.bis.org/publ/bcbs266.pdf>

¹² <http://www.bis.org/publ/bcbs283.pdf>

¹³ According to the BCBS monitoring results, most jurisdictions are currently in the process of drafting the relevant regulation and expect to publish it in 2016. See <http://www.bis.org/bcbs/publ/d338.pdf>.

The supervisory framework for limiting banks' large exposures to single counterparties seeks to protect the banking sector from the risk of the default of single private sector counterparties, including shadow banking entities. To achieve this, the definition of a large exposure is strengthened to limit carve outs and exemptions (which shadow banks may have previously been able to take advantage of), and to more clearly and consistently capture exposures to funds, securitisation structures and other vehicles. Banks will also be subject to a hard limit on large exposures of 25% of Tier 1 capital (15% for exposures of a global systemically important bank (G-SIB) to another G-SIB), which is more prudent than the 25% of total capital currently applied in most jurisdictions. BCBS members are currently in the process of implementing the framework fully by 1 January 2019.¹⁴

2.2. Reducing the susceptibility of MMFs to “runs”

MMFs are important non-bank credit intermediaries as well as a source of wholesale funding for the banking system. When offering stable Net Asset Value (NAV), MMFs can provide investors with a deposit-like instrument redeemable at short notice and at par. During the crisis, some MMFs proved susceptible to contagious investor runs. To reduce the risk of such runs, IOSCO issued policy recommendations in October 2012 that provide the basis for common standards of regulation and management of MMFs across jurisdictions, including a recommendation that regulators should require, where workable, a conversion of MMFs with stable NAV to floating NAV.

IOSCO members, acting within their domestic policy processes, are currently in the process of implementing the agreed policy recommendations in relation to MMFs, which cover eight reform areas.¹⁵ According to the results of a “level one” peer review (i.e. review on timeliness of adoption) by IOSCO on the progress of national/regional implementation of these recommendations for 31 IOSCO member jurisdictions (including the 24 FSB member jurisdictions), participating jurisdictions have made progress in introducing implementation measures across the reform areas.¹⁶ However, **implementation progress varies between jurisdictions and between reform areas**. Of jurisdictions with the largest MMF markets (i.e. the US, France, Luxembourg, Ireland and China, which together account for just under 90% of global assets under management in MMFs),¹⁷ the US reported having final implementation measures in all reform areas, France reported having final implementation measures in force in all but one areas, while China and the other EU members reported still being in the process

¹⁴ National/regional supervisors may request that banks begin reporting large exposures to them on the basis of the BCBS framework ahead of January 2019 to facilitate bank preparation and to identify any instances in which banks might have difficulties in transitioning to the new large exposures regulation.

¹⁵ They are: (i) scope of the regulatory reform (e.g. definition of MMFs in regulation); (ii) limitations to the types of assets of, and risks taken by, MMFs; (iii) valuation practices of MMFs; (iv) liquidity management for MMFs; (v) MMFs that offer a stable NAV; (vi) use of ratings by the MMF industry; (vii) disclosure to investors; and (viii) MMF practices in relation to repos.

¹⁶ <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD502.pdf>

¹⁷ While the value of assets under management in MMFs has declined or stagnated since 2009 in most jurisdictions, the MMF assets under management in China have significantly increased. See <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD502.pdf> and http://www.fsb.org/wp-content/uploads/global_shadow_banking_monitoring_report_2015.pdf.

of developing and finalising relevant reforms.¹⁸ For other jurisdictions, implementation progress was generally less advanced, although four jurisdictions (Brazil, India, Italy and Thailand) reported having final implementation measures in all reform areas.

In the US, which has the largest MMF market, the Securities and Exchange Commission (SEC) adopted amendments to the rules that govern MMFs in July 2014. The new rules required a floating NAV for prime MMFs with institutional investors, and provided the boards of directors of non-government MMFs solely owned by retail investors with new tools, including liquidity fees and redemption gates, to manage redemption pressures.¹⁹ The new rules also included enhanced diversification, disclosure and stress testing requirements, as well as updated reporting requirements for all MMFs. A two-year transition period for the principal reforms has been set to enable both funds and investors time to fully adjust their systems, operations and investing practices.

In the EU, the home to three of the five largest MMF markets, the European Commission issued a proposal for MMF regulatory reforms in September 2013.²⁰ The proposal included a 3% capital buffer for constant NAV funds, asset diversification requirements, daily and weekly liquidity requirements, as well as a number of other requirements relating to eligible assets, valuation methods, use of external credit ratings, transparency and reporting. However, the European Parliament has chosen not to retain the proposed capital buffer and instead indicated a preference to limit the use of the stable NAV either to funds that would be mainly invested in public debt instruments or to funds marketed to retail investors only, with retail investors defined narrowly to include charities, non-profit organisations, public authorities and public foundations.²¹ The European Parliament also proposed the creation of a new type of hybrid fund, the so-called Low-Volatility NAV MMF which may continue to use a stable NAV in more limited conditions. For funds that continue to use stable NAV, the European Parliament proposed the use of liquidity fees and redemption gates whenever the proportion of the funds' weekly maturing assets falls below a certain threshold. The European Council is still developing its own position on the Commission's proposal, which will be followed by the final legislative stage of trilogue negotiations between the Commission, Council, and Parliament.

Of the areas for reform identified by IOSCO, progress is most advanced in introducing express definitions of MMFs in regulation and least advanced with respect to introducing requirements related to liquidity management. IOSCO has also emphasised that further work is needed in relation to MMFs that offer a stable NAV. 12 jurisdictions reported that they continue to permit stable NAV MMFs, including four of the five jurisdictions with the largest MMF markets, and have generally chosen to introduce measures aimed at reinforcing a stable NAV MMF's resilience and ability to face significant redemptions.

¹⁸ In the absence of an EU-wide regulation, the current regulatory frameworks in place in different EU jurisdictions vary significantly. For example, whereas the existence of valuation and accounting restrictions in France have resulted in all MMFs having floating NAVs, the majority of MMFs are stable NAV funds in Luxembourg and Ireland.

¹⁹ <http://www.sec.gov/rules/final/2014/33-9616.pdf>

²⁰ http://ec.europa.eu/internal_market/investment/docs/money-market-funds/130904_mmfs-regulation_en.pdf

²¹ <http://www.europarl.europa.eu/news/en/news-room/content/20150424IPR45829/html/Making-money-market-funds-more-resilient-to-financial-crises>

IOSCO will undertake a second level one peer review starting in 2016 for 15 jurisdictions that have a significant MMF industry in which final implementation measures are still to come into force in one or more reform areas.²² Recommendations will be made to the IOSCO Board about a “level two” review (i.e. review of consistency with the IOSCO recommendations) at an appropriate time after completion of further level one reviews.

2.3. Improving transparency and aligning incentives in securitisation

Securitisation involves the pooling and selling of loans or contractual debt to investors as bonds, asset backed securities, or collateralised debt obligations. Securitisation, when well-structured, increases the availability of credit to the real economy while diversifying risks through converting non-tradable financial assets into securities that are traded by a wide range of investors. The structuring of payment rights into tranches and provision of credit enhancements also allow credit risks to be tailored to investor appetites. However, in the run-up to the crisis, misaligned incentives from securitisation weakened lending standards in the credit origination process, while securitisation structures grew increasingly opaque, hiding growing amounts of leverage and maturity mismatching in their funding.

A series of national and regional reforms were undertaken to address fault lines in securitisation in the aftermath of the crisis. Based on a stock-take of these national and regional reforms, IOSCO issued policy recommendations related to transparency, standardisation and incentive alignment in November 2012.²³ A level one peer review was recently undertaken by IOSCO on national/regional approaches to implementation of its recommendations with regard to incentive alignment in securitisation.²⁴ The review found **significant but mixed progress in implementing the two IOSCO incentive alignment recommendations included in the review.**²⁵ Among the 25 participating jurisdictions (including the 24 FSB member jurisdictions), five jurisdictions reported completing the implementation of the relevant IOSCO recommendations with respect to the whole securitisation market. The EU and the US, which have the largest securitisation markets, were generally further progressed in their implementation than many jurisdictions with smaller markets. IOSCO also observed differences in approaches in implementing its recommendations across jurisdictions. For example, some jurisdictions imposed incentive alignment requirements directly on issuers while other jurisdictions applied the requirements on investors. Some jurisdictions seemed to rely on a disclosure-based approach to incentive alignment. IOSCO plans to conduct a further level one peer review in 2016 for jurisdictions that had not yet fully implemented measures, and a level two peer review that should commence no earlier than mid-2016.

²² They are: US, France, Ireland, Luxembourg, China, Japan, Korea, Mexico, Brazil, Switzerland, India, Chinese Taipei, Canada, South Africa and Australia.

²³ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf>.

²⁴ <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD504.pdf>

²⁵ They are: evaluation, formulation and implementation deadline of approaches to align incentives, including risk retention requirements (Recommendation 1); and elements of the incentive alignment approach and risk retention requirements (Recommendation 2).

The resumption of sound securitisation is a goal of the wider financial reform programme, and the FSB and the SSBs will continue to review and address impediments in this regard as necessary. **The BCBS and IOSCO published criteria for identifying simple, transparent and comparable securitisations in July 2015.**²⁶ Their purpose is not to serve as a substitute for investors' due diligence but rather to assist in the financial industry's development of simple and transparent securitisation structures. They are non-exhaustive and non-binding. The criteria apply to term securitisations and the BCBS and IOSCO are considering the case for extending them to short-term securitisations. The BCBS has issued a consultative proposal on how to incorporate the criteria in the securitisation capital framework.²⁷

2.4. Dampening procyclicality and other financial stability risks in securities financing transactions

Securities financing transactions (SFTs), including lending and repurchase (repo) agreements, support price discovery and secondary market liquidity for a wide variety of securities. However, SFTs can also be used to build excessive leverage as well as maturity and liquidity mismatched exposures. As a result, some SFTs – for example, the repo market backed by asset-backed securities collateral – shrank dramatically during the crisis, with widening haircuts and shortening of maturities.

To address such financial stability risks associated with SFTs, the FSB developed policy recommendations in August 2013, which include recommendations for enhanced transparency, regulation of securities financing, and improvement of market structure.²⁸ In addition, it issued a regulatory framework for haircuts on non-centrally cleared SFTs in October 2014, which included qualitative standards for methodologies used by market participants to calculate haircuts and a framework of numerical haircut floors in cases where banks provide financing to non-banks against collateral other than government securities (i.e. bank-to-non-bank transactions). FSB members are currently implementing these recommendations based on the agreed timelines. For example, the BCBS recently issued a consultative document to incorporate numerical haircut floors into the Basel capital framework for covering bank-to-non-bank transactions that may be used by jurisdictions that do not use market regulation in implementing the floors.²⁹

In November 2015, the FSB published a revised regulatory framework for haircuts on non-centrally cleared SFTs.³⁰ This revised framework enhances the framework document published in October 2014 by extending the scope of numerical haircut floors for SFTs for bank-to-non-bank transactions to also cover SFTs between non-banks (i.e. non-bank-to-non-bank transactions) based on the findings of a public consultation. By extending the scope of numerical haircut floors to cover non-bank-to-non-bank transactions, the revised framework aims to limit the build-up of excessive leverage outside the banking system, reduce the

²⁶ <http://www.bis.org/bcbs/publ/d332.pdf>

²⁷ <http://www.bis.org/bcbs/publ/d343.pdf>

²⁸ http://www.financialstabilityboard.org/wp-content/uploads/r_130829b.pdf

²⁹ <http://www.bis.org/bcbs/publ/d340.pdf>

³⁰ http://www.financialstabilityboard.org/wp-content/uploads/framework_for_SFTs.pdf

procyclicality of that leverage, reduce the risk of regulatory arbitrage, and maintain a level playing field.

The FSB recognises that the potential for non-bank-to-non-bank transactions to pose financial stability risks varies across jurisdictions. Thus, the implementation approach depends on the national/regional authorities' assessment of the scale of securities financing activities and the materiality of non-bank-to-non-bank transactions in their jurisdictions. To ensure consistent implementation, however, the FSB has provided detailed guidance for authorities and enhanced its implementation monitoring. Since jurisdictions may adopt market regulation to implement numerical haircut floors,³¹ which can take a few years to implement, the FSB decided to extend the implementation date to the end of 2018. This is a one-year extension compared to the date set in the October 2014 framework document.

In addition to this framework for haircuts, the FSB and its members have started to implement the policy recommendations that were finalised in August 2013. Based on the recommendations to improve transparency, the **FSB has developed, in cooperation with market participants, standards and processes for global securities financing data collection and aggregation that are relevant for financial stability monitoring and policy responses**. Such standards and processes would allow the FSB to collect from national/regional authorities aggregated data on repos, securities lending and margin lending, based on consistent definitions and minimal double-counting at the global level. The finalised standards will be published in November 2015 with an implementation timeline for launching the global data collection and aggregation in 2018.

Meanwhile, national/regional authorities are continuing to launch legislative and/or data collection initiatives to better understand their securities financing markets and improve market transparency. For example, in light of the FSB recommendations, the European Parliament adopted a Regulation on transparency of SFTs and of re-use on 29 October 2015,³² which will require SFTs to be reported to a trade repository. Depending on the category of the reporting entity, the reporting will start at different stages from 12 to 21 months after the entry into force of the relevant technical standards (i.e. between mid-2018 and mid-2019). In the US, the Office for Financial Research, in cooperation with other US authorities, has launched a pilot project to fill gaps in data with a focus on bilateral repo markets.³³

The FSB has **taken stock of the current regulatory approaches on re-hypothecation of client assets and started examining their possible harmonisation**.³⁴ It is also reviewing the financial stability issues regarding the re-use of collateral more generally. The re-hypothecation of client assets and re-use of collateral may create financial stability risks. For

³¹ Market regulation would be compulsory for jurisdictions with the largest securities financing activities, while other jurisdictions will be able to choose between market regulation and an entity-based approach. See footnote 31 for details.

³² The Regulation is expected to enter into force by the end of 2015 after its adoption by the European Council. (http://europa.eu/rapid/press-release_MEMO-15-5931_en.htm). The text follows the agreement reached between the European Parliament and the European Council on 17 June 2015. (http://europa.eu/rapid/press-release_MEMO-15-5931_en.htm)

³³ <http://financialresearch.gov/data/repo-data-project/>

³⁴ "Re-hypothecation" is defined narrowly as "any use of client assets by a financial intermediary". Meanwhile, "re-use of collateral" is not limited to the use of client assets. The re-use of collateral broadly includes "any use of assets delivered as collateral in a transaction by an intermediary or other collateral taker".

example, the re-hypothecation of client assets risks may pose risks if clients are not informed about the extent to which their assets have been re-hypothecated, or if there is uncertainty about the treatment in case of resolution or bankruptcy. Re-use of collateral may give rise to increased interconnectedness and contribute to the build-up of leverage. The expert group will prepare findings by early 2016.

2.5. Assessing and mitigating systemic risks posed by other shadow banking entities and activities

The FSB has developed a forward-looking high-level policy framework for authorities to detect and assess the sources of financial stability risks from shadow banking, and apply appropriate policy measures where necessary to mitigate these risks (hereafter the Policy Framework). The Policy Framework comprises: (i) an assessment of non-bank financial entities based on five economic functions;³⁵ (ii) the adoption of policy tools to mitigate financial stability risks where necessary; and (iii) information-sharing by FSB members through the FSB process to maintain international consistency in applying the framework, minimise gaps in regulation and detect new adaptations.³⁶ By focusing on economic functions (or activities) rather than legal forms, this Framework is intended to help authorities to narrow down their focus to parts of credit intermediation that are involved in shadow banking, where policy responses may be needed. Such assessment (or the narrow measure of shadow banking based on economic functions) is based on both authorities' supervisory judgment (qualitative information from daily supervision and market intelligence) and quantitative risk metrics. Since supervisory judgement is taken into account, information-sharing among authorities through the FSB process was introduced aiming at ensuring consistency in applying the Framework and at further improving the assessment.

As part of implementing the Policy Framework, the FSB launched the comprehensive information-sharing exercise that covers for the first time all 24 FSB member jurisdictions, as well as Chile and Ireland, to exchange information on the status of national authorities' implementation of the Framework. The information exchanged includes: (i) the scale of non-bank financial entities that authorities assessed as being involved in five economic functions (hereafter "classified entities"); (ii) financial stability risks posed by the classified entities (in metrics and authorities' qualitative assessments (risk mapping)); (iii) detailed information on the policy tools applied to each type of classified entities; and (iv) case studies on new adaptations. Workshops were also held among the experts from participating jurisdictions to discuss the national/regional submissions and learn from each other's experiences. As noted in Section 1, since this is the first time for many jurisdictions to engage in this assessment, a number of challenges have been identified in conducting assessments in a consistent manner.³⁷ The FSB plans to make improvements to the information-sharing process and

³⁵ Each of the five economic functions involves non-bank credit intermediation that may pose shadow banking risks (e.g. maturity/liquidity transformation and leverage). They are: (i) management of collective investment vehicles 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 or on secured funding of client assets; (iv) facilitation of credit creation; and (v) securitisation-based credit intermediation and funding of financial entities.

³⁶ http://www.financialstabilityboard.org/wp-content/uploads/r_130829c.pdf

³⁷ Such challenges include differences in authorities' approaches in classifying non-bank financial entities into five economic functions and gaps in data that would help such classification.

assessments next year by leveraging on this year's experience as well as the findings and recommendations of the peer review explained below.

In parallel with the information-sharing exercise, the FSB launched a thematic peer review to evaluate progress in implementing the Policy Framework, as called for under the updated G20 Shadow Banking Roadmap. The main objective of the peer review is to evaluate jurisdictions' adherence to the overarching principles set out in the Policy Framework³⁸ and their efforts to assess non-bank financial entities based on the five economic functions, adopt policy tools if necessary to mitigate any identified shadow banking risks, and participate in the FSB information-sharing process.

The initial findings from the peer review indicate that implementation of the Policy Framework is ongoing and remains at a relatively early stage. In particular:

- ***Definition, assessment and update of the regulatory perimeter:*** In most cases, arrangements for monitoring and assessing the financial stability risks posed by non-bank financial entities form part of broader coordination mechanisms (e.g. inter-agency financial stability committees). A few jurisdictions have a systematic process to review the adequacy of the regulatory perimeter for such entities. In other cases, reviews tend to be *ad hoc* and undertaken in response to concerns about a particular activity or entity type.
- ***Collection of information needed to assess shadow banking risks:*** National authorities generally use data sourced from existing arrangements with regulated non-bank financial entities to assess shadow banking risks, with the assessment of such risks subsumed within broader financial stability analysis. The extent and frequency of monitoring of such risks varies significantly and many jurisdictions have identified a need to improve data availability and granularity. Several jurisdictions consider the assessment of risks from new and innovative shadow banking activities/entities as particularly challenging. Overall shadow banking risks associated with cross-border activities and exposures remain largely unassessed in the information-sharing exercise.
- ***Public disclosure of information about risks posed by shadow banking entities:*** Disclosure requirements focus on information for investors provided by individual entities, leaving it up to market participants to aggregate information in order to make a sector-wide assessment. National authorities rely on a combination of financial stability and other reports, public reporting requirements and survey results to disclose information. It is not clear to what extent such reporting enables market participants to gauge the financial stability risks posed by non-bank financial entities or activities on an ongoing and systematic basis.
- ***Assessment of shadow banking risks and adoption of policy tools:*** Most jurisdictions have set up informal arrangements to cooperate and share information among relevant domestic agencies in order to implement the Policy Framework. There are some gaps

³⁸ The four Principles are that authorities should: define, and keep up to date, the regulatory perimeter (Principle 1); collect information needed to assess the extent of risks posed by shadow banking (Principle 2); 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 (Principle 3); and assess their non-bank financial entities based on the economic functions and take necessary actions drawing on tools from the policy toolkit (Principle 4).

among jurisdictions in their data and risk mapping submissions to the information-sharing exercise and inconsistencies in their approach to classifying non-bank financial entities into economic functions, reflecting, to some extent, differences in interpretations and judgements about the risks associated with these entities. Some of these differences are being addressed via the process of mutual challenge that forms part of the information-sharing exercise. Jurisdictions report a broad range of tools available to address shadow banking risks posed by non-bank financial entities, drawing both on the policy toolkit in the Framework and other tools.

The peer review is ongoing. The FSB will publish the results of this peer review, including recommendations to address identified gaps or weakness in the implementation of the Policy Framework, in the first half of 2016. Based on the findings from the peer review as well as from the information-sharing exercise, the FSB will evaluate the case for developing further policy recommendations for relevant shadow banking entities and report the results to the G20 in the first half of 2016.³⁹

3. Next steps

Following the G20 Antalya Summit in November 2015, the FSB and its members will take forward work to transform shadow banking into resilient market-based financing in the following manner:

- *Development of the guidance on the scope of consolidation for bank prudential regulation:* The BCBS will publish guidance for public consultation on the scope of consolidation for bank prudential regulation, in particular to capture step-in risk, around the end of 2015.
- *Implementation of the regulatory framework for haircuts on non-centrally cleared SFTs at the international level:* The SSBs (e.g. the BCBS) will review existing regulatory requirements in line with the FSB's regulatory framework for haircuts on non-centrally cleared SFTs, in particular the qualitative standards for methodologies used by market participants by the end of 2015.
- *Implementation of policy recommendations related to structural aspects of the securities financing markets –* Authorities will evaluate the costs and benefits of proposals to introduce CCPs in their inter-dealer repo markets where CCPs do not exist, and consider pros and cons of broadening participation, in particular of important funding providers in the repo market, where CCPs exist by January 2016.
- *Operationalisation of the global securities financing data collection and aggregation:* The FSB will complete its work on the governance and technical issues to operationalise the global securities financing data collection and aggregation by 2016

³⁹ When evaluating the case for developing further policy recommendations for the relevant shadow banking entities, the FSB will take into account other ongoing policy initiatives, such as its work on structural vulnerabilities from asset management activities and assessment methodologies for identifying non-bank non-insurer global systemically financial institutions (NBNI G-SIFIs). See <http://www.financialstabilityboard.org/wp-content/uploads/NBNI-G-SIFI-Next-Steps-Press-Release.pdf>.

Q3. It will also prepare a timetable in 2016 for the start of reporting national aggregates to the global data aggregator.

- *Findings on the possible harmonisation of regulatory approaches to re-hypothecation:* The FSB will prepare its final findings on the possible harmonisation of regulatory approaches to re-hypothecation of client assets and review possible financial stability issues related to collateral re-use by March 2016.
- *Implementation monitoring for the policy framework for shadow banking entities:* The FSB will publish the results of peer review of its policy framework for shadow banking entities in the first half of 2016.
- *Evaluation of the case for developing further policy recommendations:* Based on the findings from the peer review and information-sharing exercise, the FSB will evaluate the case for developing further policy recommendations for the relevant shadow banking entities and report the results to the G20 in the first half of 2016.
- *Implementation monitoring for MMFs and securitisation:* IOSCO will start updated “level one” peer reviews on the implementation of its recommendations on MMFs and securitisation in 2016. It will also consider developing a plan for regular monitoring and reporting on the consistency and effectiveness of these reforms.
- *Monitoring of the global trends and risks in the shadow banking system:* The FSB will continue to conduct its annual monitoring exercise and publish the next results in the fourth quarter of 2016.
- *Monitoring the implementation of agreed policies:* Shadow banking is one of the priority areas highlighted by the FSB that, under the Coordination Framework for Implementation Monitoring (CFIM),⁴⁰ should undergo intensive monitoring and detailed reporting once implementation is underway. The FSB will continue to coordinate with the relevant SSBs to ensure that implementation monitoring in this area is effective and satisfies the G20 reporting requirements under the CFIM.

The FSB will report on the progress of the above work to the G20 in September 2016.

⁴⁰ http://www.financialstabilityboard.org/wp-content/uploads/r_111017.pdf