FSB FINANCIAL STABILITY BOARD

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Thematic peer review on the implementation of the FSB policy framework for other shadow banking entities

Summarized Terms of Reference

1. Introduction

Transforming shadow banking into resilient market-based finance is one of the core elements of the FSB's regulatory reform agenda to address the fault lines that contributed to the global financial crisis and to build safer, more sustainable sources of financing for the real economy. The FSB has adopted a two-pronged strategy to deal with these fault lines.[1] First, it has created a system-wide monitoring framework to track financial sector developments outside the banking system with a view to identifying the build-up of systemic risks and initiating corrective actions where necessary. Second, it is coordinating and contributing to the development of policy measures in five areas where oversight and regulation need to be strengthened to reduce excessive build-up of leverage, as well as maturity and liquidity mismatch, in the system.[2]

One of these five areas is assessing and mitigating financial stability risks posed by non-bank financial entities other than money market funds ("other shadow banking entities"). The November 2014 G20 Roadmap toward strengthened oversight and regulation of shadow banking calls on the FSB to launch a peer review in 2015 regarding member jurisdictions' implementation of the FSB policy framework for other shadow banking entities. This document describes the background, objectives, scope and process for carrying out the work.

2. Background

Based on the G20 Roadmap agreed at the St Petersburg Summit, the FSB developed a high-level policy framework for other shadow banking entities in August 2013 (see Annex). By focusing on the underlying economic functions (i.e. activities) rather than legal forms, this framework allows authorities to assess shadow banking activity in non-bank financial entities in a consistent manner and be forward-looking in capturing new structures and innovations. The framework sets forth key overarching principles that authorities will adhere to in their oversight of non-bank financial entities that are identified as posing shadow banking risks that threaten financial stability. These four principles call on authorities to: (1) have the ability to define, and keep up to date, the regulatory perimeter if necessary to ensure financial stability;

[1] For details, see http://www.financialstabilityboard.org/wp-content/uploads/Progress-Report-on-Transforming-Shadow-Banking-into-Resilient-Market-Based-Financing.pdf.

[2] Shadow banking has been identified by the FSB as a priority area under the Coordination Framework for Implementation Monitoring (CFIM). As a result, the implementation of policy measures in this area by FSB member jurisdictions will undergo intensive monitoring and detailed reporting.

(2) collect information needed to assess shadow banking risks for entities identified as having the potential to pose risks to the financial system; (3) enhance disclosure of shadow bank entities' risks; and (4) assess shadow bank entities based on economic functions and apply policy tools if necessary to mitigate identified financial stability risks.

The framework comprises three pillars: (i) an assessment of non-bank financial entities based on five economic functions;[3] (ii) the adoption of appropriate policy tools from a menu of optional policies (policy toolkit) where necessary to mitigate financial stability risks; and (iii) information-sharing among member authorities through the FSB process to maintain international consistency in applying the framework, minimise gaps in regulation and detect new shadow banking adaptations.

3. Objectives of peer review

The peer review will evaluate the progress made by jurisdictions to implement the FSB's high-level policy framework on other shadow banking entities across its three pillars. In particular, the review will evaluate jurisdictions' adherence to the overarching principles set out in the policy framework and their efforts to assess shadow banking entities based on the five economic functions, to adopt policy tools if necessary to mitigate any identified financial stability risks, and to participate in the FSB information-sharing process. As part of this work, the review will examine the structures and processes established by national authorities to implement the framework as well as the findings collected through the information-sharing process. The review will also take stock of the measures and initiatives that are ongoing or have been planned by jurisdictions but are yet to be implemented. Given the early stage of implementation, the review will seek to identify gaps and recommend improvements to the way in which the framework is applied by FSB jurisdictions. The review will not, however, assess or make recommendations on the appropriateness of policy tools to address identified financial stability risks, since this issue will be covered separately by the FSB.

The peer review will therefore have the following objectives:

- take stock of how authorities define, assess and update their regulatory perimeter to capture new forms of shadow banking if necessary to ensure financial stability;
- examine the process by which authorities engage in data collection on entities that have been identified as having the potential to pose risks to the financial system through their involvement in shadow banking and identify obstacles associated with this data collection and analysis;
- examine authorities' efforts to enhance public disclosure of shadow banking risks posed by these entities;
- review authorities' adoption of policy tools to deal with any identified financial stability risks emanating from shadow banking, based in part on authorities' risk mapping exercises where available;

[3] Each of the five economic functions involves non-bank credit intermediation that poses bank-like risks (e.g. maturity/liquidity transformation and leverage).

- highlight lessons of experience (e.g., in terms of the range of approaches in adopting the overarching principles), including any challenges arising from implementation of the framework;
- evaluate the functioning of the information-sharing process, including the identification of any potential gaps in national/regional reporting; and
- make recommendations to improve implementation of the policy framework by addressing identified material weaknesses, challenges or inconsistencies that are common across jurisdictions.

The aforementioned objectives are consistent with the objectives set out in the [*Handbook for FSB Peer Reviews*] (*Handbook*), with one exception: the peer review will not assess the effectiveness of the policy framework in realising its intended results, given the early stage of implementation of the reforms.

The main findings and recommendations of the peer review will be included in G20 progress reporting and will contribute to the broader effort by the FSB and its members to strengthen the identification of shadow banking risks and improve the design of appropriate policy responses.

4. Scope

The peer review will evaluate the implementation by FSB jurisdictions of the overarching principles set out in the FSB policy framework for other shadow banking entities.

The **first overarching principle** is that authorities should define, and keep up to date, the regulatory perimeter. In this regard, as a key prerequisite to addressing the systemic risks of other shadow banking entities through policy tools, authorities should have a regime to define, expand, and keep up to date the regulatory perimeter where necessary to ensure financial stability. The peer review will examine the approaches used by FSB jurisdictions in defining regulatory and supervisory perimeters with regard to entities identified as posing shadow banking risks that may threaten financial stability. As part of this work, it will analyse the processes and institutional arrangements used to identify new entities/activities for each economic function that pose shadow banking risks that may threaten financial stability and to bring such entities within the regulatory perimeter in the jurisdiction. It will review the extent to which entity types or activities are captured within the regulatory perimeter, the range of procedural and analytical approaches to assess and update the regulatory perimeter, and the various possible forms of extension of regulatory perimeters.[4] Where the information indicates gaps in the regulatory/supervisory perimeter and associated processes, the review team would seek to identify the reasons for those gaps and the efforts made to address them.

The **second overarching principle** is that authorities should collect information from non-bank financial entities identified as having the potential to pose risks to the financial system. Such information should be collected to be able to assess the extent of shadow banking risks

[4] This includes, for example, designation of entities as systemically important, extension to industries or markets that have not previously been regulated, or upgrading the type of regulation through enhanced data collection and policy measures.

posed by those entities, so that authorities can decide on appropriate rectification measures. The peer review will examine the institutional arrangements, systems, processes and resources of authorities to collect and analyse information about these risks. It will review the breadth and quality of data collection efforts across jurisdictions and entity types within a particular jurisdiction, and identify data gaps and obstacles to data collection efforts (e.g., lack of legal mandate or authority to collect data from certain entities, budget or resource constraints etc.) as well as the efforts underway to mitigate the challenges.

The **third overarching principle** is that authorities should enhance public disclosure by other shadow banking entities as necessary so as to help market participants understand the extent of risks posed by such entities. The peer review will examine the existing arrangements and ongoing initiatives by FSB jurisdictions to enhance public disclosures of risks posed by shadow banking entities at two levels: reporting of risks by entities themselves, and reporting of aggregate risks for particular types of entities or functions by the authorities. It will seek to identify gaps, the reasons for their existence, and ongoing/planned initiatives to address them.

The **fourth overarching principle** is that authorities should assess their non-bank financial entities based on the economic functions and take necessary actions drawing on tools from their policy toolkit if necessary to mitigate the financial stability risks identified. The peer review will analyse the extent to which FSB jurisdictions are regularly assessing the shadow banking risks that may threaten financial stability of non-bank financial entities and the framework in place as well as review the range of tools adopted to address those risks. The review team will also assess the functioning of the FSB process (information-sharing exercise) via which authorities share information on: (a) which non-bank financial entities (or entity types) are identified as being involved in which economic function and its rationale explained by each of the shadow banking risk factors; (b) what the identified financial stability risk was; and (c) which policy tool(s) the relevant authorities adopted and how.

In carrying out this work, the peer review will seek to identify: lessons of experience and good practices in the implementation of the high-level policy framework; key challenges faced by jurisdictions in implementing the framework and their plans to overcome them; and material weaknesses, inconsistencies and gaps in implementation that are common across jurisdictions and that, where necessary, should be the focus of peer review recommendations.

5. Process

The primary source of information for the peer review will be the responses to a questionnaire that will be prepared by the peer review team and agreed by the SCSI. The questionnaire will cover information not already available to the review team through other FSB work (e.g. FSB information-sharing exercise). The questionnaire, which will be sent to FSB jurisdictions for completion, will cover the following issues:

- **Definition, assessment and update of the regulatory perimeter** –the approaches, processes and institutional arrangements used by FSB jurisdictions to define, assess and keep up to date their regulatory and supervisory perimeters to capture new non-bank financial entities that may pose risks to financial stability;
- **Collection of information needed to assess shadow banking risks** –the systems and processes by which national authorities engage in data collection to assess shadow

banking risks, identify the challenges associated with this data collection and analysis and the efforts underway to mitigate these challenges;

- **Public disclosure of information needed to assess shadow banking risks posed by non-bank financial entities**–national authorities' efforts to enhance public disclosure of information to help market participants understand the risks posed by non-bank financial entities; and
- **Assessment of shadow banking risks and adoption of policy tools** –the extent to which FSB jurisdictions are assessing the risks posed by non-bank financial entities, adopting policy tools to address identified risks, and sharing information with other authorities, in particular via the FSB information-sharing exercise.

The responses to the questionnaire will be supplemented by the results and analysis (prepared by the Secretariat) of the FSB information-sharing exercise as well as information from existing publications and input from other market participants and interested parties. As with past peer reviews, a request for public feedback will be posted on the FSB website, asking for comments and suggestions on the topics covered by the peer review.

6. Peer review report

The peer review report will include qualitative and, wherever possible, quantitative summaries of the information provided by authorities, and evaluate the progress made by FSB jurisdictions in implementing the policy framework. Progress in implementation will be illustrated with examples of good practices and lessons learned from experience to date, in terms of authorities' assessment of shadow banking risks that may threaten financial stability, disclosures of risks in relevant shadow banking entities and adoption of policy tools to address those risks.

As stated in the *Handbook*, the report "will give particular attention to weaknesses common across a number of jurisdictions, problems caused by a lack of cross-country consistency in implementation… and lessons from implementation experience." The findings will be used to provide recommendations for improvements and follow-up actions in areas where challenges and obstacles to the implementation of the policy framework remain.

Annex: Excerpt from "Strengthening Oversight and Regulation of Shadow Banking – Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities" (August 2013)

Introduction and Summary

This document sets out the final policy framework to address shadow banking risks posed by non-bank financial entities other than money market funds (MMFs) ("other shadow banking entities"). It is based on a careful consideration of more than 50 responses received on the Consultative Document published on 18 November, which set out the high-level policy framework that would allow authorities to: detect and assess the sources of shadow banking risks in the non-bank financial space from a financial stability perspective; and apply appropriate policy measures if necessary to mitigate any financial stability risks identified. In general, the respondents supported the FSB's efforts to address the potential risks posed by other shadow banking entities based on the five economic functions, but asked for closer coordination among the different shadow banking workstreams as well as with other regulatory initiatives, and for clearer definitions and more precision for the policy toolkits for the five economic functions before they could be applied.

In developing the policy framework, the FSB, through its workstream on other shadow banking entities (hereafter WS3), assessed the extent to which non-bank financial entities other than MMFs are involved in shadow banking. WS3 first completed a categorisation and data collection exercise for a wide range of non-bank financial entities. After casting the net wide, 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 their shadow banking risk factors (e.g. maturity/liquidity transformation and leverage). As part of the process, WS3 met with industry representatives to exchange views and obtain additional information. It also commissioned a separate study providing a detailed assessment of commodities traders.

The filtered entities that WS3 identified were: (i) credit investment funds; (ii) exchange- traded funds (ETFs); (iii) credit hedge funds; (iv) private equity funds; (v) securities broker- dealers; (vi) securitisation entities; (vii) credit insurance providers/financial guarantors; (viii) finance companies; and (ix) trust companies. From its detailed assessment of these 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 sector (or entity-type). This diversity is exacerbated by the different legal and regulatory frameworks across jurisdictions as well as the constant innovation and the dynamic nature of the non-bank financial sectors. Together, these factors tend to obscure the economic functions conducted by these entities, and hence to complicate the evaluation of the regulations that do or should apply to them. WS3 therefore developed an economic function- based (i.e. activities-based) perspective for assessing shadow banking activity in non-bank entities.

The economic function-based 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. Furthermore, this approach is forward-looking in that it will be able to capture additional types of entities that conduct these economic functions generating shadow banking risks. Over time, the FSB may revise the economic functions and add new ones if deemed appropriate.

This document also presents a menu of policy tools from which authorities can draw if necessary to mitigate the shadow banking risks inherent in each of the economic functions. The advantage of setting a menu of policy tools is to provide a certain degree of consistency across jurisdictions, while allowing national authorities to adopt policy tools if necessary that in their view are more appropriate for the non-bank financial entities concerned, the structure of the markets in which they operate, and the degree of financial stability risks posed by such entities in their jurisdictions. It should be noted that some of these policy tools may be already in place. Moreover, policy recommendations from the other FSB shadow banking workstreams will have priority if they address the same shadow banking risks.

In order to maintain consistency across jurisdictions in applying the policy framework and to detect new adaptations and innovations in financial markets, authorities will set up an information-sharing process under the FSB.