Shadow Banking: What Has Been Done (and Is It Enough)?

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Main Points

- To “monitor” shadow banking requires an understanding of the following:
  - Data collection is costly
  - Data may or may not allow one to see systemic implications of shadow banking
  - “Market intelligence” is essential
- To “regulate” or “supervise” shadow banking requires an understanding of the following:
  - Shadow banking constitutes institutions, markets, and instruments (and their interrelationships)
  - Shadow banks are a subset of non-banks
  - Shadow banking is not necessarily “bad” and does not necessarily “cause” systemic risk

Current FSB Approach to Monitoring

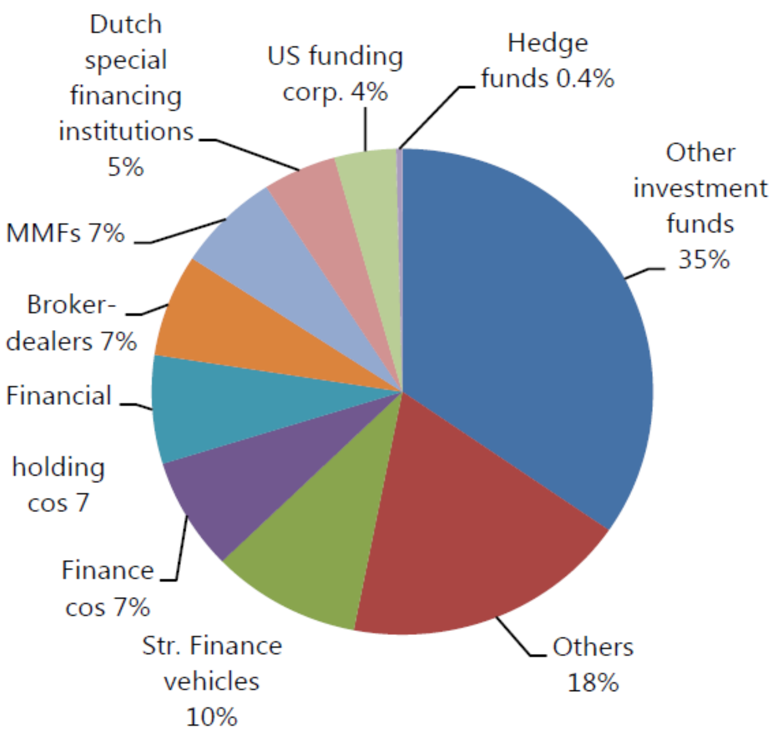
- Define and investigate what constitutes shadow banking
  - FSB definition with four key aspects: maturity transformation, liquidity transformation, leverage, and credit risk transfer.
- Collect data on scope and scale of non-bank financial intermediation (a "wide net")
  - "macro mapping exercise" from countries' flow of funds data, especially "other financial intermediaries" or "OFIs" (which exclude pensions funds and insurance companies)
  - Add supervisory knowledge
  - Add special studies of potentially problematic activities/entities (e.g., finance companies in last year's exercise)

2012 FSB Monitoring Exercise: OFIs

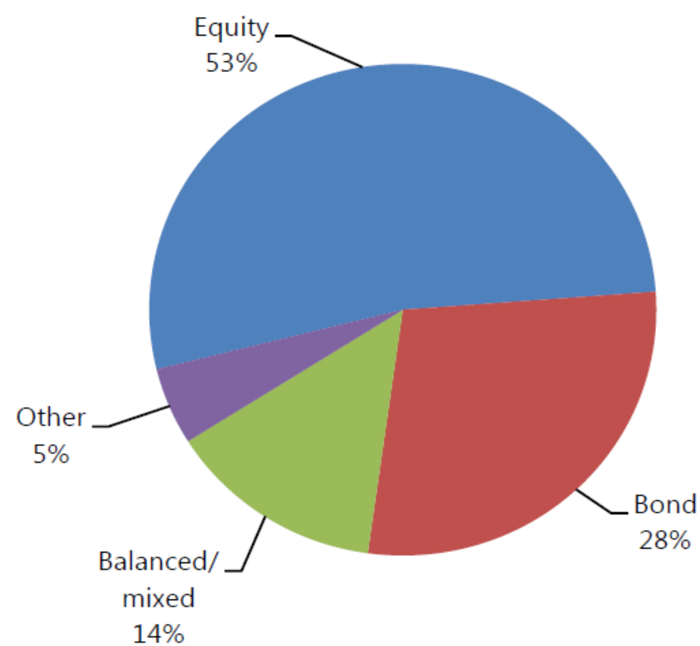
Sub-sectors of non-bank financial intermediaries (OFIs)

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).

Current FSB Approach to Regulating and Supervising

- Based on monitoring, decide which activities/entities have the potential to pose systemic risks or, due to regulatory arbitrage, undermine benefits of financial regulation
- Five regulatory work streams were deemed important
  - Mitigate spillover effects between regular banks and shadow banking entities
  - Reduce susceptibility of money market mutual funds to runs
  - Assess and mitigate systemic risks posed by other shadow banking entities
  - Assess and align incentives associated with securitization
  - Dampen risks and pro-cyclicality associated with securities lending and repos

FSB Suggested Four Overarching Principles

Authorities should:

- Be able to define the regulatory perimeter
- Collect information needed to assess extent of risks posed by shadow banking
- Enhance disclosure by other shadow banking entities as necessary to help market participants understand extent of risks posed
- Assess their non-bank financial entities based on economic functions and take necessary policy actions

Policy Tools Outlined

- Policy tools aimed at the four risks posed by shadow banks and generally include:
  - Restrictions on maturity of assets/liabilities and mismatches
  - Limits on leverage
  - Higher capital and liquidity buffers
  - Tools to manage other liquidity issues (e.g., redemptions pressures; eligible collateral)
  - Restrictions on cross-exposures, scale and scope of business
  - Enhanced risk management practices

Progress of Implementation Has Been Slow

- Even in areas of known problems:
  - Still little progress on banking risk of excessive reliance on short-term funding from shadow banks.
  - U.S. MMMF still maintain constant NAV (net asset value) with no effective backup plan for runs
  - Some countries cannot execute meaningful monitoring: not permitted to ask for data from unregulated entities to assess their need for regulation
  - Disclosure to market participants still inadequate for them to see risks
  - Tri-party repo markets have lowered time frames in which intra-day risks are most acute, but have not eliminated them
  - No agreement on how to mitigate procyclicality of margin in repo activities—proposed haircut floors not taken up

Progress Inhibited by Lack of Analysis

- Even if data were available, limited analysis of which tools work best to mitigate systemic risks
  - Would minimum haircuts work better than countercyclical ones?
  - Would limitation on the size of activities of the tri-party agents in the United States make them less systemic?
  - Would limitations on banks' acceptance of shadow banks' funds make the financial system safer or just push more risk into shadow banking activities?
  - How should the leverage embedded in securitizations be measured? Would a leverage ratio be meaningful?
  - What are the appropriate role(s) of finance companies? How can one gauge systemic risks originating through them?

Next Steps (A Personal View)

- On data
  - Move away from Flow of Funds
  - Collect exposure information (present and future)
  - Engage in more market intelligence (especially on OFIs and new products)
  - Change laws to allow data collection to proceed and allow more effective data sharing across borders
- On analysis
  - Conduct more analyses of tools, their calibration, and their effectiveness
  - Formulate frameworks for measuring systemic risks "caused" by shadow banks
- On regulation
  - Force all constant NAV MMMFs to either become regular mutual funds (variable NAV) or to become (narrow) banks
  - Decide the (global) legal structure for repo and margin transfers so that effective regulation can be imposed

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