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FSB Publishes Regulatory Framework for Haircuts on Non-Centrally Cleared Securities Financing Transactions

Financial Stability Board (FSB)

Press Release - FSB Publishes Regulatory Framework for Haircuts on Non-centrally Cleared Securities Financing Transactions

The Financial Stability Board (FSB) is publishing today a *Regulatory Framework for Haircuts on Non-centrally Cleared Securities Financing Transactions* . This Framework is a key part of the FSB's policy recommendations to address shadow banking risks in relation to securities financing transactions, and takes into account public responses received on the consultative proposals issued on 29 August 2013 as well as the results of a two-stage quantitative impact study (QIS).

The Framework aims to limit the build-up of excessive leverage outside the banking system and to help reduce the procyclicality of that leverage. It consists of: (i) qualitative standards for methodologies used by market participants that provide securities financing to calculate haircuts on the collateral received; and (ii) numerical haircut floors that will apply to non-centrally cleared securities financing transactions in which financing against collateral other than government securities is provided to entities other than banks and broker-dealers (referred to for simplicity as "non-banks").

In revising the Framework, the FSB has decided to raise the levels of numerical haircut floors based on the QIS results, existing market and central bank haircuts, and data on historical price volatility of different asset classes. It has also decided to propose applying the numerical haircut floors to non-bank-to-non-bank transactions so as to ensure shadow banking activities are fully covered, to reduce the risk of regulatory arbitrage, and to maintain a level-playing field. The consultative proposal in this regard is set out in Annex 4 of the Framework document. Comments on that proposal should be submitted by **15 December 2014** by email to fsb@bis.org or by post (Secretariat of the Financial Stability Board, c/o Bank for International Settlements, CH-4002, Basel, Switzerland). All comments will be published on the FSB website unless a commenter specifically requests confidential treatment.

The FSB will complete its work on the application of numerical haircut floors to non-bank-to-non-bank transactions and set out details of how it will monitor implementation by the second quarter of 2015. FSB member authorities will implement the Framework, including the numerical haircut floors, by the end of 2017.

In addition to the Framework document, the FSB is also publishing today a background document entitled *Procyclicality of Haircuts: Evidence from the QIS1*. This background document examines the procyclicality of haircuts on non-centrally cleared securities financing transactions and their role during the global financial crisis based on the first stage QIS (QIS1) data. The FSB hopes this will provide additional insights to the discussions on procyclicality of haircuts that take place in the academic literature and elsewhere.

Mark Carney, Chairman of the FSB, stated that "The regulatory framework for haircuts on securities financing transactions issued by the FSB today addresses important sources of leverage and the level of risk-taking in the

Full text

- PDF 3 pages, 128 kb

Related information

- Regulatory framework for haircuts on non-centrally cleared securities financing transactions
- Background Document - Procyclicality of haircuts: Evidence from the QIS1

core funding markets. It has been carefully developed, finalised after rounds of public consultation and impact studies, and marks a big step forward in the FSB's overall work programme to transform shadow banking into resilient market-based financing conducted on a sound basis".

Daniel Tarullo, Chairman of the FSB Standing Committee on Supervisory and Regulatory Cooperation stated that "Securities financing transactions such as repos are important funding tools for a wide range of market participants, including non-bank financial firms. The implementation of the numerical haircut floors on securities financing transactions will reduce the build-up of excessive leverage and liquidity risk by non-banks during peaks in the credit and economic cycle. It will be important for the FSB to monitor the impact of the framework following the implementation to help ensure that it achieves these objectives".

Notes to editors

At the Cannes Summit in November 2011, the G20 Leaders endorsed the FSB's report *Shadow Banking: Strengthening Oversight and Regulation* which set out initial recommendations with a work plan to further develop them. Five workstreams were launched to develop these policy recommendations. The FSB published on 29 August 2013 an *Overview of Policy Recommendations*, setting out the FSB's overall approach to addressing financial stability concerns associated with shadow banking, actions taken to date, and next steps. At the same time the FSB published its *Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos*, which contained the consultative proposals on haircuts that are being issued in finalised form today.

In addition, the FSB has been conducting annual global shadow banking monitoring exercises through its Standing Committee on Assessment of Vulnerabilities to assess the global trends and risks in the shadow banking system, and to enable early detection of any rapidly growing new non-bank financial activities or entities that pose bank-like risks. These annual monitoring reports are available on the FSB website (the 2013 Report was published in November 2013 and the 2014 report will be published later this month).

The "shadow banking system" can broadly be described as "credit intermediation involving entities and activities (fully or partially) outside the regular banking system" or non-bank credit intermediation in short. Such intermediation, appropriately conducted, provides a valuable alternative to bank funding that supports real economic activity. But experience from the crisis demonstrates the capacity for some non-bank entities and transactions to operate on a large scale in ways that create bank-like risks to financial stability (longer-term credit extension based on short-term funding and leverage). Such risk creation may take place at an entity level but it can also form part of a chain of transactions, in which leverage and maturity transformation occur in stages, and in ways that create multiple forms of feedback into the regular banking system.

Like banks, a leveraged and maturity-transforming shadow banking system can be vulnerable to "runs" and generate contagion risk, thereby amplifying systemic risk. Such activity, if unattended, can also heighten procyclicality by accelerating credit supply and asset price increases during surges in confidence, while making precipitate falls in asset prices and credit more likely by creating credit channels vulnerable to sudden loss of confidence. These effects were powerfully revealed in 2007-09 in the dislocation of asset-backed commercial paper (ABCP) markets, the failure of an originate-to-distribute model employing structured investment vehicles (SIVs) and conduits, "runs" on MMFs and a sudden reappraisal of the terms on which securities lending and repos were conducted. But whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is typically subject to less stringent, or no, oversight arrangements.

The objective of the FSB's work is to ensure that shadow banking is subject to appropriate oversight and regulation to address bank-like risks to financial stability emerging outside the regular banking system while not inhibiting sustainable non-bank financing models that do not pose such risks. The approach is designed to be proportionate to financial stability risks, focusing on those activities that are material to the system, using as a starting point those that were a source of problems during the crisis. It also provides a process for monitoring the shadow banking system so that any rapidly growing new activities that pose bank-like risks can be identified early and, where needed, those risks addressed. At the same time, given the interconnectedness of markets and the strong adaptive capacity of the shadow banking system, the FSB believes that policies in this area necessarily have to be comprehensive.

The FSB has been established to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies in the interest of financial stability. It brings together national authorities responsible for financial stability in 24 countries and jurisdictions, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts.

The FSB is chaired by Mark Carney, Governor of the Bank of England. Its Secretariat is located in Basel, Switzerland, and hosted by the Bank for International Settlements. For further information on the FSB, visit the FSB website, www.financialstabilityboard.org.