EFAMA

European Fund and Asset Management Association

EFAMA's RESPONSE TO EBA's CONSULTATION PAPER ON DRAFT RTS ON CRITERIA FOR THE IDENTIFICATION OF SHADOW BANKING ENTITIES

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EBA CONSULTATION PAPER ON DRAFT RTS ON CRITERIA FOR THE IDENTIFICATION OF SHADOW BANKING ENTITIES

PRELIMINARY REMARKS

As the European trade association representing asset management companies and their funds, EFAMA welcomes the opportunity to respond to this important open consultation.

Ever since the term "shadow banking" has emerged from the FSB's working circles in the immediate aftermath of the 2008 global financial crisis[1], our association has consistently argued that its use as a reference to regulated asset management companies and their funds is inaccurate and mis-leading. We consider that the explicit references to "shadow banking entities" introduced more recently through CRR II into the wording of Article 394(2), of the amended CRR is unfortunate, as it only perpetuates a negative bias and improper understanding of market-based financing when compared to that of credit institutions. Moreover, it continuously blurs the otherwise clear distinction between banking *versus* non-banking activities, where we remind the latter are by nature very different from the former. For instance, an investor in funds (whether an institution or an individual) deliberately takes an equity-stake in an investment exposed to market risk, unlike a bank deposit account holder whose priority is principal protection instead. Naturally, the distinction between securities and prudential (bank) regulations must reflect these critical differences in terms of nature and risk of underlying activities. We would therefore call on the EBA to reconsider defining "banking services outside the regulated framework" for the purposes of its future RTS away from the early "shadow bank" label of the FSB and fully recognise the distinctive body of EU securities regulations that apply to non-bank actors, including asset managers and their regulated funds.

We find that a more appropriate and neutral reference, as well as one fortunately gaining greater currency within both European and global standard-setting circles, is that of "non-bank financial institutions" (NBFI). Furthermore, while understanding that the EBA's present mandate to draw up RTS intended to identify "shadow banking entities" derives formally from Article 394(4) of the CRR, we care to observe that the prolonged use of the term "shadow banking" – especially when inserted into EU legal texts – risks undermining the core objectives of the CMU Action Plan, which in good substance aims to diversify funding and savings channels away from banks through the development of deeper and more integrated EU capital markets.

Our second preliminary remark is that we support the EBA's approach in that the mandate of the CRR is "microprudential" by nature, marking an important difference with that of the very broad monitoring exercises of the ESRB and FSB. It is therefore in the EBA's remit that the regulatory regime for each non-bank financial institution must be carefully assessed in light of the legislation in force and complemented by fact-based evidence on the impacts of their underlying economic activities and on the latter's potential impact on banks (from a solvency and liquidity perspective).

While broadly concurring with the categorisation of the different non-bank entities assessed in the consultation paper, we have important reservations around the inclusion of MMFs in particular. In sum, the inclusion of MMFs within the scope of the future RTS must be reconsidered in light of the fact that the MMFR final text has been finalised in 2017 and is effective since January 2019. Moreover, we deem that ESMA's preliminary (i.e. and thereby non-conclusive) views expressed in the margins of its March 2021 public consultation should not decide whether MMFs should continue to be treated as "shadow banking entities" for the purpose of Article 394(2) of the CRR[2].

[1] See for instance the October 2011 *Recommendations of the FSB on Strengthening the Oversight and Regulation of Shadow Banking*; available at the following hyperlink.
[2] For further details, please refer to EFAMA's response to the ESMA Consultation on the legislative review of the MMFR of 30 June 2021; available at the following hyperlink.

Question 1: Do you agree with the conditions of Article 1 paragraph 2 for identifying an entity as a non-shadow banking entity? Please provide reasons if you do not agree with any of the conditions or have comments with regard to any of them.

Question 2: Have you got any comments regarding the list of entities that, being exempted or optionally excluded from those four legal acts in Annex I, should not be considered as shadow banking entities?

According to the consultation paper, there are two fundamental criteria which must concomitantly be met in order to identify a "shadow banking entity": (i) the conduct of a "banking activity"; and (ii) that this activity occur outside an existing EU or equivalent regulatory (prudential and supervisory) framework. While concurring with the EBA's exclusionary approach to identify "shadow banking entities" based on the above criteria, we believe that the list of legal acts under Annex I - referred to under Article 1(2) of the draft RTS - should be amended to necessarily include references to the EU Money Market Fund Regulation (MMFR)[3], thereby scoping out money market funds from the definition of "shadow banks".

Our argument in this regard is essentially two-fold:

1. According to EFAMA's industry-wide statistics, the overwhelming majority of European MMFs abiding by the MMFR are at the same time UCITS authorised and supervised funds (and to a far lesser extent AIFs)[4]. In fact, as the consultation paper also accurately recognises (par. 82), the MMFR is built upon and complementary to the UCITS/AIFMD frameworks, where the MMFR-specific requirements apply in addition to the core UCITS/AIFMD ones. Therefore, despite the specific characteristics of MMFs that the MMFR regime recognises as *offering returns in line with money market rates or preserving the value of the investment*[5], MMFs in Europe are authorised and supervised either under the UCITS, or to a far lesser extent the AIFM, framework directives. The fact that a large majority of MMFs in Europe are thus comprehensively regulated under the UCITS regime would therefore formally justify an explicit reference under Annex I of the draft RTS for these to be excluded from the definition of "shadow banking entities" altogether;

2. The inclusion of MMFs within the "shadow banking" definition at the time the EBA's Guidelines were finalised in 2015 was reasonably warranted by caution, recognising that the final text of the MMFR was at the time still being negotiated by the EU co-Legislators[6]. With the final text having been published in the EU Official Journal on 30 June 2017, no previous attempt has been made until now by the EBA to review the status of European MMFs for CRR purposes. While this consultation is certainly a very welcome occasion to review the EBA's 2015 conclusions, such review must necessarily account for the fact that a) a final MMFR text now exists and has been effective since 1 January 2019, complete with additional requirements (as the annual ESMA stress-testing Guidelines' update); and b) the effective resilience demonstrated by the EU regime throughout the course of the pandemic-induced financial market shock in March 2020 has proven that the MMFR regime is ultimately "fit for purpose". We turn to discuss this second aspect in greater depth in our response to Question 7 below.

Another ancillary consideration relates to reporting, whereby Article 37 of the MMFR requires MMFs to periodically and extensively report data to their national competent authorities and in turn to ESMA.

[3] Regulation (EU) 2017/1131 of 14 June 2017 and effective since January 2019.
[4] Please refer to EFAMA *Quarterly Statistical Release* for Q2-2021; available at the following hyperlink.
[5] Please refer to Article 1, par. 1, letter a) and c) of the MMFR.
[6] In this regard, please refer specifically to paragraph 14 of the EBA's final *Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013.*

Such data is further transmitted to the ECB for monitoring and statistical purposes, as more generally eurozone UCITS have to provide ongoing statistical reporting on fund holdings and liabilities to the ECB. All this data is a counterfactual to the EBA's assumption of poor transparency over MMFs and must instead be credited as another major regulatory advance since the EBA's 2015 Guidelines.

On the basis of these observations, we deem that MMFs deserve to be excluded from the scope of the RTS by virtue of their comprehensive regulatory framework.

Our view is that the decision to also include AIFs that are "leveraged on a substantial basis" within the scope of the RTS should also be reviewed. This is true especially in light of the additional work on leverage in investment funds led by IOSCO as an intentional standard-setter, followed by ESMA's own *Guidelines* on Article 25 of the AIFMD published in December 2020 and prompted by the ESRB's own specific Recommendations. We include further details to argue for the exclusion of specific types of AIFs in our response to Question 8 below.

Question 3: Conversely, what are your views concerning other entities exempted or optionally excluded from the other legal acts in Annex I and that would be identified as shadow banking entities? Please provide reasons in case you view that any of those entities should fall under the exemption in Article 1 paragraph 3 and therefore not be treated as shadow banking entities.

N/A

Question 4: Have you got any other comments with regard to the content of Article 1 of the draft RTS? In your view, is it clear and easy to implement for the purposes of the reporting obligation of Article 394(2) of Regulation (EU) No 575/2013?

N/A

Question 5: In general, what are your views on the treatment of funds in these draft RTS? Do you agree with the approach adopted in these draft RTS, that follows the approach in the EBA Guidelines on limits on exposures to shadow banking entities, or alternatively should it be extended to capture those funds as shadow banking entities?

Please refer to our response to Questions 1 and 2 above, as well as to Question 8 further below.

Question 6: What would be the advantages and disadvantages of taking a broader approach with respect to the scope of funds included as shadow banking entities?

N/A

Question 7: What are your views with regard to the consideration of money market funds as shadow banking entities?

As per our answer to Question 1 and 2 above, we further explain why we believe European MMFs – as UCITS or AIF regulated funds and additionally meeting the MMFR requirements - should not be treated as "shadow banking entities" for the purposes of Article 394, par. 2 of CRR. While appreciating the EBA's openness to review this categorisation in light of ESMA's ongoing work to prepare the review of the MMFR over the coming years, as well as of the broader parallel mandates of the global standard-

setters (FSB/IOSCO), we argue that:

- The “vulnerabilities" identified by ESMA through the means of its March 2021 consultation paper are by no means conclusive. Far from constituting a policy-document, the consultation paper encapsulates ESMA’s very preliminary views on the March 2020 money market stresses. Absent market participants’ views and additional data, it would be extremely premature for the EBA to rely on ESMA’s early and uncorroborated views to determine that MMFs meet the definition of “shadow banking entities”;

- Instead, we resolutely believe that the EBA – for the purpose of its RTS - should base its analysis on the final letter of the MMFR, further supported by the following evidence-based facts in light of the March 2020 market correction[7]:

  i. The events of March 2020 have become in many ways the MMFR framework’s first general “stress test”. The fact that no European MMF had to introduce liquidity fees, gates or even suspend redemptions as a result, bears testimony to the quality of the regulations put in place following the 2008 global financial crisis in Europe. Moreover, we note that the most recent market correction was provoked by an exogenous shock prompted by a global pandemic, rather than by inherent weaknesses in the EU regulatory and supervisory framework. Consequently, any regulatory response should be cognisant of the non-financial nature of such shocks;

  ii. Whereas liquidity management proved challenging for all market participants, European MMFs – whatever their formal denomination under the MMFR and irrespective of their base currency denominations – met all redemption demands. Moreover, they continued to provide a high-quality, well-diversified and liquid investment option at a time when markets underwent considerable stress, all while offering both investors and regulators complete transparency around funds’ portfolio holdings and liquidity levels;

  iii. Provisions in the MMFR mandating high levels of daily and weekly liquidity for each type of EU MMF, prudently supplemented in practice with even higher amounts of liquidity based on investor profiling and in light of gradually deteriorating market conditions at the start of 2020, ensured that European managers entered the pandemic with sufficient liquidity able to meet all consequent redemption demands;

  iv. Greater caution is warranted when considering the extent of official sector interventions in the course of March 2020, as no case can be made to suggest that the European MMF industry benefitted from the direct support of the ECB. Rather, the ECB’s Pandemic Emergency Purchase Programme (PEPP), unveiled on 18 March, was limited both in nature and scope to support the recovery of the Eurozone real economy as national government lockdown measures began curtailing essential (non-financial) economic activities. In addition, its actual implementation through the six Eurosystem central banks participating in the programme only began several weeks later, by which most MMFs had already recorded their largest outflows. In terms of limited scope, the Bank of England and HM Treasury’s Covid-19 Corporate Financing Facility (CCFF) was in many ways similar to that the of the ECB. On the other hand, the accompanying measures of the ECB in the form of refinancing operations and waivers for dealer bank operations proved essential for the resumption of the bidding process in underlying money markets.

[7] For more details, please refer to EFAMA’s November 2019 study on “European MMFs in the Covid-19 market turmoil: Evidence, experience and tentative considerations around eventual future reforms”; available at the following hyperlink.

Based on the comprehensiveness of the MMFR regime in force, as well as on our evidence-based findings covering the March 2020 market events, we would therefore call on the EBA to exclude European MMFs from its list of "shadow banking entities" by amending Annex I to the proposed RTS accordingly.

Question 8: Do you face any difficulties identifying whether an alternative investment fund (AIF) should be considered as a shadow banking entity?

EFAMA appreciates that the consultation paper excludes most non-MMF AIFs from the definition of "shadow banking entities", with the exception of AIFs that a) employ leverage on a "substantial basis" as per the definition under Article 111(1) of Commission Delegated Regulation (EU) 231/2013, b) grant loans or c) purchase third parties' lending exposures onto their balance sheet.

In relation to those under a) above, we would invite the EBA to review its decision to include these specific AIFs within the scope of its RTS, considering that, in addition to the extensive reporting requirements and intervention powers of the competent supervisory authorities (respectively under Article 24 and 25 of the AIFM Directive), ESMA has more recently (December 2020) issued specific Guidelines on common criteria for national supervisors to promote greater convergence when assessing the extent to which the use of leverage within the AIF sector contributes to the build-up of systemic risk in the financial system, as well as when designing, calibrating and implementing leverage limits[8]. We recall that such Guidelines translate IOSCO's "2 step-approach"[9] into the European risk management framework for investment funds, as well as follow the explicit recommendations of the European Systemic Risk Board (ESRB) published in April 2018[10]. We believe that these recent evolutions constitute important specifications of existing supervisory powers to monitor and regulate leverage levels for a limited category of AIFs, enough to no longer justify their inclusion withing the original "shadow banking entities" definition.

Regarding those other specific types of AIFs that either b) grant loans or c) purchase third parties' lending exposures onto their balance sheet, we would recall that such fund categories often take the form of closed-end structures (i.e. thus neutralising risks from liquidity mismatches) and are typically available only to sophisticated institutional investors. Lastly, while these types of funds are not presently covered by a dedicated EU legal regime, they do benefit from more specific and stringent domestic regulations in the Member States where they are authorised and domiciled. We invite the EBA to please refer to the individual submissions of EFAMA's national association Members for further details in this respect.

Question 9: Have you got any specific comments with regard to AIFs and in particular, with points (b) and (c) of Article 1 paragraph 5?

In line with our response to Questions 1, 2 and 7 above and for the reasons explained, we deem that MMFs – whether authorised as UCITS or AIFs - should not fall within the scope of the present RTS.

If AIFs were to be retained in scope of the RTS, Article 1(5) letter c) of the draft RTS would need to be further specified. We note in fact that the EBA's reference to AIFs that originate "exposures in the ordinary course of business" or purchase third-party exposures for their own account is too broad, with

[8] Please refer to the ESMA *Guidelines on Article 25 of Directive 2011/61/EU*; available at the following hyperlink.
[9] Please refer to IOSCO's *Recommendations for a Framework Assessing Leverage in Investment Funds*, published in December 2019; available at the following hyperlink.
[10] Please refer to the *Recommendations of the ESRB on liquidity and leverage risks in investment funds*; available at the following hyperlink.

the potential to unintendedly capture AIFs which do not undertake activities consistent with the EBA's stated policy intention as set out in Recital 4. Where for instance, an AIF's incorporating documentation does not explicitly prevent it from originating or purchasing third-party exposures, it is not necessarily the case that said AIF is indeed originating or purchasing third-party exposures. Moreover, there is need to better qualify what is meant under the term "exposures" under Article 1(5) letter c). As defined under the CRR - Regulation (EU) No 575/2013- the term designates "any asset or off-balance sheet item", which in our view would range far beyond the narrower references to loans and third-party lending exposures which are proper of the EBA's 2015 Guidelines.

For the wording of Article 1(5) letter c), the EBA could alternatively revert to the wording under paragraph 75 of the consultation paper, i.e. to a positive inclusion of AIFs only to the extent these are (…) *entitled to grant loans or purchase third parties` lending exposures onto their balance sheet (…)* pursuant to the AIF's rules or instruments of incorporation.

Question 10: Do you agree with the description of banking services and activities as included in Article 2 of the draft RTS? Have you got any specific comments regarding any of the points included?

N/A

Question 11: Do you agree with the possibility granted under paragraph 1 of Article 3 to prevent the identification of a bank in a third country as a shadow banking entity in the absence of an equivalence decision under Article 391 of the CRR?

N/A

Question 12: Have you got any comments regarding the approach set out in paragraph 2 of Article 3 for other entities established in third countries to prevent their identification as shadow banking entities?

N/A

Question 13: Do you agree with the list of legal acts included in Annex I?

From a general perspective, we agree with the list of legal acts referenced under Annex I. As explained, we advocate for the inclusion of the reference to the MMFR, so as to exclude European MMFs from the broad definition of "shadow banking entities", as well as for a narrower requalification of the term "exposure" referred to specific types of AIF under Article 1(5) letter c) thereof.

Question 14: Is there any other legal act that should be included in Annex I? If yes, please mention the act and legal reference, and provide reasons to support it based on the criteria included in Article 394(4) of Regulation (EU) No 575/2013.

For the reasons explained above, please include references to the MMFR – Regulation (EU) 2017/1131 of the European Parliament and of the Council of 14 June 2017 on money market funds – into Annex I.

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About EFAMA

EFAMA is the voice of the European investment management industry, which manages over EUR 27 trillion of assets on behalf of its clients in Europe and around the world. We advocate for a regulatory environment that supports our industry's crucial role in steering capital towards investments for a sustainable future and providing long-term value for investors.

Besides fostering a Capital Markets Union, consumer empowerment and sustainable finance in Europe, we also support open and well-functioning global capital markets and engage with international standard setters and relevant third-country authorities.

EFAMA is a primary source of industry statistical data and issues regular publications, including Market Insights and the authoritative EFAMA Fact Book.

More information is available at www.efama.org.

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