

MEMO# 33830

October 19, 2021

Draft Response to EBA Explaining That Regulated Funds are Not "Shadow Banking Entities;" Your Comments to ICI Global Due by Monday October 25

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TO: Global Regulated Funds Committee RE: Draft Response to EBA Explaining That Regulated Funds are Not "Shadow Banking Entities;" Your Comments to ICI Global Due by Monday October 25

Under the EU Capital Requirements Regulation (CRR), a banking organization must report to supervisory authorities its ten largest exposures to "shadow banking entities"—defined as entities that carry out banking activities outside an adequate prudential framework. The European Banking Authority (EBA) issued a consultation paper on draft regulatory technical standards (RTS) to specify criteria for identifying shadow banking entities for purposes of this reporting requirement. The draft RTS identify money market funds (MMFs) as shadow banking entities, and EBA asks whether the RTS should consider more types of funds (e.g., UCITS that are not MMFs) to be shadow banking entities. Background information and brief highlights from the consultation paper are provided below.

ICI Global has prepared the attached response, which explains why EBA should not look to guidelines it issued in 2015 for purposes of specifying criteria for identifying "shadow banking entities." The response states that the 2015 guidelines reflect an antiquated regulatory view of "shadow banking" and that EBA instead should adopt a more accurate definition of "banking services outside the regulated framework" consistent with the mandate outlined in Article 394(4) of the CRR. ICI Global then explains why all regulated funds—including regulated money market funds—should not be considered "shadow banking entities" under the RTS.

Please provide any comments on the draft response to Rachel Graham (rgraham@ici.org) on or before Monday, October 25. ICI Global will file the response with EBA on Tuesday, October 26.

Background - 2015 EBA guidelines

The CRR, adopted in 2013, is intended to decrease the likelihood of individual banks becoming insolvent. Pursuant to Article 395(2) of the CRR, the EBA issued guidelines in 2015 for banks to follow in setting internal limits on their exposures to "shadow banking entities," defined as entities that carry out banking activities outside the regulated framework. The CRR defines "exposure" as "any asset or off-balance sheet item."

The 2015 guidelines state that funds *prima facie* should be considered shadow banking entities because they "tend to engage in maturity and liquidity transformation and are generally regarded as outside the traditional banking sector." The guidelines indicate that some funds, however, are sufficiently regulated such that they need not be treated as shadow banking entities. In particular, the guidelines state that the UCITS Directive "prescribes a robust set of requirements under which undertakings for collective investment in transferable securities, and their managers, operate. These include requirements on the asset manager (initial capital, own funds, and internal control requirements) and the managed funds (e.g., limits to leverage and concentration). Therefore, such funds do not pose the same level of risk to institutions in terms of credit and step-in/bail-out risk (e.g., due to reputational, franchise and other risks) as unregulated funds."

Notwithstanding this exclusion, the 2015 guidelines treat all MMFs, including those that adhere to the UCITS Directive, as shadow banking entities. According to the guidelines, this treatment is appropriate "because, as acknowledged by the European Commission in its proposal for a regulation on MMFs (under negotiation), the average size of an MMF far exceeds the average size of a UCITS fund and, as acknowledged by the [Financial Stability Board (FSB)] and other institutions such as the International Organisation of Securities Commissions and the [European Systemic Risk Board (ESRB)], the systemic risks posed by such funds (in particular having regard to their interconnectedness with the banking sector) have not been addressed to an adequate degree through existing regulatory measures. Therefore, at this stage (in particular, pending agreement on the Commission's legislative proposal) the EBA includes all MMFs within the scope of the definition of shadow banking entity."

Current consultation paper

A separate provision of the CRR—Article 394(4)—requires a bank to report to supervisory authorities its ten largest exposures to "shadow banking entities" and calls on EBA to develop RTS to specify the criteria for the identification of shadow banking entities.

The consultation paper talks at length about shadow banking and the shadow banking risks identified to date by the FSB and the ESRB. The paper proceeds to note that the FSB/ESRB analysis is not compatible with the purpose of the CRR, which is to decrease the risk of individual banks becoming insolvent.

EBA states that its intention is to base the RTS as much as possible on its 2015 guidelines. The draft RTS identify MMFs as shadow banking entities, noting that MMF vulnerabilities identified during the Covid-19 crisis are "still to be addressed" and that stress within that market segment could cause severe liquidity issues for banks and institutional investors. EBA acknowledges that the EU Money Market Fund Regulation, adopted in 2017, has made MMFs "more robust." It then points to the "ongoing review" of the MMFR and concludes that it is "appropriate to follow the EBA guidelines and consider MMFs as shadow banking entities until such reforms are in place before re-assessing the current policy stance."

As with the 2015 guidelines, the draft RTS would exclude non-MMF UCITS based on EBA's conclusion that such funds do not present the same level of credit risk as "unregulated" funds.

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