IMMFA

INSTITUTIONAL MONEY MARKET FUNDS ASSOCIATION

IMMFA Response to EBA consultation paper on draft RTS on criteria for the identification of shadow banking entities

21 October 2021

Dear Sir or Madam,

The Institutional Money Market Funds Association (IMMFA) welcomes the opportunity of responding to this consultation. As a trade association representing the European money market fund (MMF) industry we are committed to promoting and supporting the development and integrity of the MMF industry. We do this by providing a single point of contact and by engaging with and informing policy makers.

IMMFA currently has 27 members, consisting primarily of asset managers, but also custodial banks and other firms. Of the 27, 19 are asset managers offering MMFs. IMMFA MMFs are overwhelmingly institutional, and all have AAA MMF ratings by one or more authorised credit rating agency.[1]

IMMFA MMFs currently have EUR826bn Euro equivalent[2] in assets under management (AUM). Assets have increased 32% since the implementation of EU Money Market Fund Regulation in March 2019, reflecting investor confidence in the regulatory framework and the continued utility value of MMFs.[3] Within the IMMFA universe there are 3 main currencies: USD, GBP and EUR. USD is the largest currency (currently USD494bn), followed by GBP (GBP233bn) and EUR (EUR124bn).[4]

As a share of total European MMF AUM, IMMFA represents approximately 58%.[5] IMMFA MMFs are domiciled in Ireland and Luxembourg.[6] Although 96% of IMMFA MMFs are stable Net Asset Value (NAV) in the form of Low Volatility NAV (LVNAV) or Public Debt Constant NAV (PDCNAV) funds, IMMFA represents all money market fund types and many of our members offer a range of funds including Variable NAV (VNAV) MMFs. The majority of other European MMFs are domiciled in France and consist predominantly of standard VNAV MMFs.

The economic fall-out from the COVID-19 pandemic created a systemic liquidity event impacting not only MMFs, but all asset classes. The unprecedented 'dash for cash' meant that MMFs also experienced challenging conditions. Despite this, MMFs continued to serve their purpose in preserving capital and providing liquidity, with no MMFs imposing gates or fees, and all MMFs staying within their collars.[7] IMMFA AUM fell a net 5 % during the peak of the March 2020 crisis but had fully recovered by early April and thereafter climbed swiftly to a new high, demonstrating continued investor confidence in their operation.

The COVID-19 crisis was the first true stress test of the reforms introduced in response to the global financial crisis of 2008, including, in Europe, the EU Money Market Fund Regulation (MMFR). As a trade association which represents, promotes, and supports the development of the European money market fund industry, we engaged extensively and contributed to the co-legislators' efforts during the

[1] AAAmmf/Aaa mf/AAAm money market fund ratings by one or more of Fitch Ratings, Moody's Investors Services and S&P Global Ratings.
[2] Sources iMoneyNet and IMMFA as of 15 October 2021.
[3] Regulation EU 2017/1131 of the European Parliament and of the Council of 14 June 2017.
[4] As of 24 September 2021, sources iMoneyNet and IMMFA. The split remains fairly constant.
[5] ECB Statistical warehouse 30 June 2021, total MMF AUM in Europe were EUR1,376bn. As of 24 June 2021, IMMFA AUM were EUR804bn equivalent.
[6] With one exception, a GBP fund in the UK.
[7] In Europe collars apply in the case of LVNAV and PDCNAV MMFs, the vast majority of which are IMMFA MMFs. No IMMFA MMFs broke their collars and IMMFA is not aware of any non IMMFA funds doing so.

establishment of the regulation. Those reforms proved instrumental in providing MMFs with increased resilience in the challenging circumstances of last March. However, as identified by the industry and the regulators, the crisis demonstrated that there are areas of money market regulation which could be improved upon, and we expect future reforms to refine any such areas.

MMFs are a vital cash management tool for many investors and provide an invaluable source of funding to a wide range of issuers, thereby contributing to the real economy. We have serious concerns about the designation of MMFs as shadow banks. Whilst the term shadow banking is embedded in the CRD framework, it is misleading in the wider debate on MMFs to characterise the role of MMFs as shadow banking. MMFs do not meet the general criteria for the designation 'shadow banking'. European MMFs operate within a highly prescriptive, robust regulatory framework, the effectiveness of which was demonstrated during the crisis. Given this background, the fact that existing regulation is under review with a view to enhancing resilience further, is no reason to designate MMFs as shadow banking entities prior to the review's conclusions. Furthermore, MMFs are low risk funds which are highly transparent. MMFs do not employ leverage, and their maturity gap is the narrowest of any investment fund. For these reasons the activities performed by MMFs cannot in our view be considered comparable to the banking sector. We therefore urge the EBA to reconsider its characterisation of MMFs as shadow banks as the term is a misrepresentation of the important function which they continue to perform successfully.

We look forward to our continuing engagement with the EBA on this consultation and remain at your disposal should you have any questions on our response or wish to discuss it in more detail.

Yours faithfully,

Veronica Iommi
Secretary General
IMMFA

Our response addresses questions 5 to 7 which concern MMFs.

Q5. 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?

Whilst the term shadow banking is embedded in the CRD framework (Article 394) it is misleading in the wider debate on MMFs to characterise MMFs' role as shadow banking. In the CRD this refers to banking activities that are 'outside a regulated framework'. It cannot be said in Europe that MMFs are unregulated. Since the reforms introduced after the 2007-08 global financial crisis, MMFs are subject to an extensive and robust regulatory framework, namely the EU Money Market Fund Regulation (MMFR), in addition to pre-existing UCITS legislation. As the EBA notes in paragraph 84, this dual approach ensures that the framework is more robust and safer. It also means MMFs are one of the most regulated of any investment fund type.

As a general principle we think that the term 'shadow banking' should be replaced with 'non-bank financial institutions' to be consistent with FSB and ESRB terminology. In categorising funds as shadow banking entities, funds should be clearly differentiated based on the risks which they represent. In the case of money market funds (MMFs), these funds are low-risk, highly transparent and regulated, and are not leveraged. The term was intended to designate entities which 'carry out bank-like activities outside a regulated framework'[8], which is not the case for MMFs. On the contrary, MMFs operate within a highly prescriptive regulatory environment tailored to the specific risks which they represent. The maturity and liquidity transformation conducted by MMFs is minimal and the lowest of any investment fund. MMFs should therefore not be defined as shadow banks.

With regard to interconnectivity with the banking sector, in the case of European MMFs, the MMFR specifically prohibits sponsor support, limiting risk contagion between a fund and the sponsor bank. The interconnectedness between MMFs and banks is primarily in the form of the short-term funding which MMFs provide to the financial sector through their holdings of financial paper or other bank assets such as deposits and (reverse) repo, as indicated in paragraph 19 of the consultation. However, prudential reforms introduced after the global financial crisis of 2007-2008 mitigated the risk of banks being too reliant on short-term funding from MMFs or other sources. Consequently, banks are now much less reliant on short-term funding from MMFs to finance long-term assets. Banks now set strict limits on the amount of short-term debt they will issue, typically limiting issuance to periods longer than 90 days as only the longer dated funding contributes to LCR requirements. As stated above, MMFs are highly transparent, engage in minimal maturity transformation and are not leveraged. Therefore, they only resemble banks in so far as they are highly regulated, which is a positive.

One of the primary reasons the EBA cite for designating MMFs as shadow banking entities is that the global liquidity crisis has prompted a review of the existing money market fund regulation (paragraph 86). In our view, the EBA should not pre-empt the outcome of such review before conclusions have been reached. The intention of reform is plainly to enhance resilience further and should not in and of itself be a reason to undermine the status of MMFs. The review should also be seen in the context of what has been a much broader consideration of fund liquidity and how this operated in general in open ended funds, not just the MMF sector. As noted in paragraph 84, a review to assess the adequacy of the regulation after three years of operation was due to take place in 2022 under Article 46 of the

[8] EBA/GL/2015/20: Limits on exposures to shadow banking entities which carry out banking activities outside a regulatory framework under Article 395(2) of Regulation (EU) No 575/2013.

MMFR. It was therefore timely to consider what lessons could be learnt the events of March 2020 and if regulation should be reconsidered. Further reforms can be expected to enhance the existing regulations by strengthening those areas which did not operate as intended.

Q6. What would be the advantages and disadvantages of taking a broader approach with respect to the scope of funds included as shadow banking entities?

Using the designation 'shadow-banking' to include investment funds which do not represent bank-like risk is not an effective means of monitoring financial stability risk more accurately. Some long-term funds, through their leverage, risk taking or interconnectedness, may be considered to represent a threat to financial stability. This is not the case for MMFs.

Designating MMFs as shadow banking entities can have a negative and misleading impact on their perception. By providing disintermediated and diversified funding, MMFs represent a key part of the capital market financing which Europe is seeking to develop and strengthen to avoid all risks being channelled through the banking system. In our view, if the role of MMFs is diminished, their function in providing funding and a vital cash management tool is likely to be replaced by less regulated and transparent alternatives.

The consultation suggests that MMFs be included on the basis that the risks associated with MMFs have not been fully addressed and that they faced severe liquidity issues (recital number 5). As stated above in response to question 5, the events of last year demonstrated that the MMFR has improved fund resilience and future reforms can be expected to address the issues raised. MMFs were not alone in experiencing liquidity challenges which affected large parts of the market, including other fund types. In relation to how MMFs performed during the crisis, see IMMFA's responses to the ESMA consultation on the EU Money Market Fund Regulation and the FSB consultation on policy proposals to enhance Money Market Fund resilience earlier this year.

Q7. What are your views with regard to the consideration of money market funds as shadow banking entities?

In our view money market funds should not be considered as shadow banking entities for the following reasons.

European MMFs are highly regulated.
The EBA guidelines of 2015 qualified MMFs as shadow banking entities based on their size and the systemic risks posed by their interconnectedness to the banking sector which it was deemed had not been addressed by existing regulatory measures, 'pending the agreement of the European Commission's proposal for a regulation on MMFs' (p.9 and p.44 of 2015 EBA Guidelines). However, since the publication of the 2015 EBA guidelines, the regulatory framework has been significantly reinforced by the introduction of the MMFR in 2017 followed by its implementation in 2019.
The draft RTS fails to acknowledge the highly regulated nature of MMFs which are subject not only to long-standing harmonized EU rules (UCITS) but also the dedicated regime of the MMFR, which mitigates against the specific risks to which MMFs are exposed. MMFs are also subject to related ESMA guidelines, for instance with regard to stress testing where they set out detailed, stringent

requirements. In addition, MMFs are also supervised by their national competent authorities. In the case of IMMFA EU domiciled MMFs, this is the Central Bank of Ireland (CBI) or the Commission de Surveillance du Secteur Financier (CSSF) Luxembourg. This robust framework contains aspects discussed in the consultation, such as risk management, including credit, liquidity and leverage risk.

All IMMFA MMFs have a AAA money market fund rating from one or more European credit rating agencies (CRA). The CRAs provide an independent overview of fund health and additional oversight which compliments the regulatory framework. The criteria for the AAA money market fund rating are closely aligned with the regulations and serve to reinforce the conservative regulatory requirements. Further layers of oversight are provided by management companies who are themselves subject to significant levels of regulation, by custodial functions and also by internal controls.

MMFs are low risk

MMFs have the lowest risk profile of any investment fund. This is reflected in the Synthetic Risk and Reward Indicator used to indicate the level of risk in a UCITS fund which rates MMFs as 1 out of 7, where 1 is the lowest risk. Their key objectives are the preservation of capital and the provision of liquidity. To achieve this, they adhere to very conservative parameters. The regulatory framework in the EU, the MMFR, is designed to ensure that they are robust and resilient, even at times of stress. As noted in paragraph 83 of the consultation, the MMFR aims to ensure the low risk and high liquidity of MMFs. It does so by imposing stringent limits on portfolio composition, including credit quality and diversification and limits on the maturity profile. It also ensures that high levels of transparency are maintained.

MMFs are not leveraged

Unlike banks, MMFs do not employ leverage which is a key amplifier of risk. Shares in the fund are effectively 100% capitalized by the fund assets which are a diverse pool of high quality, short-term investments.

MMFR limits the interconnectedness of funds and sponsor banks

Article 35 of the MMFR explicitly prohibits sponsor support. This appropriately demarcates the fund sector from the banking system for systemic risk purposes, thereby limiting the 'contagion channel' arising from linkage between an asset manager and a financial firm.

Liquidity transformation gap in an MMF is very narrow

The liquidity transformation gap in an MMF is the narrowest of any investment fund. One of the options being considered as part of reforms to enhance resilience is removal of the tie between liquidity buffers and regulatory thresholds. Commonly referred to as 'delinking' or 'decoupling', this proposed reform would narrow the liquidity gap further. Low Volatility Net Asset Value (LVNAV) or Public Debt Constant Net Asset Value (PDCNAV) MMFs hold a minimum of 10% of their assets in daily liquid assets and 30% in weekly liquid assets (WLA).[9] The fact that MMFs hold structurally high levels of liquidity which organically generate cash means that the need to sell assets to meet redemptions is in general very limited. Removal of the tie would enable MMFs to use these substantial liquidity buffers for their intended purpose, namely, to meet redemptions, including during stressed periods. Due to investor concerns over the link between regulatory thresholds and the possible imposition of gates and fees, MMFs were effectively unable to use their buffers during the crisis. Despite this, MMFs continued to fulfil their regulatory requirements and met all redemptions in full, without suspensions or the imposition of gates and fees. MMFs are adequately structured to provide liquidity, but the

[9] As noted in the above letter, 96% of IMMFA MMFs are LVNAV or PDCNAV. Weekly liquid assets are weekly maturing assets, reverse repo able to be terminated without prior notice or cash which is able to be withdrawn within 5 working days (Article 24 MMFR).

linking of buffers and thresholds impaired their ability to do so. IMMFA has recommended that this be addressed in forthcoming reforms by delinking, and other stakeholders have also supported this view.

Maturity transformation in an MMF is very limited

The consultation states that MMFs 'engage in some maturity and liquidity transformation since a large portion of MMFs' assets consists of bank debt securities and deposits' (p.10). Maturity transformation in an MMF is subject to stringent limits on the weighted average maturity (WAM) and the weighted average life (WAL) of the portfolio. In the case of the overwhelming majority[10] of IMMFA MMFs, which are LVNAV or PDCNAV MMFs, the WAM is limited to 60 days and the WAL 120 days. Maturity and liquidity transformation are not a function of holding bank debt securities and deposits, as the consultation appears to imply. Maturity transformation on such a limited scale bears no comparison to a bank like activity.

High levels of transparency

The MMFR introduced additional reporting requirements which make MMFs one of the most transparent investment funds from the perspective of both regulators and investors. If MMFs become less attractive or are suppressed by regulation which reduces their utility value to investors, it is likely that other types of investment will replace their function. Any such replacements are likely to be significantly less transparent and regulated, or indeed unregulated.

Intervention

The term shadow banking implies an interconnectedness to the banking sector which can result in implicit access to official support. As outlined above, this interconnectedness is addressed and eliminated by the prohibition of sponsor support under Article 35 of the MMFR. The interconnectedness of MMFs with the banking sector comes on the asset side through MMFs' holdings of bank assets such as bank issued commercial paper or deposits and repo. This aspect does not give rise to increased risk of central bank intervention. Indeed, holding primarily financial paper meant that European MMFs were unable to avail themselves of support since those financial assets were not eligible. In Europe, the asset purchase programmes targeted non-financial paper.

We note that central bank intervention conducted to support short-term markets in March 2020 was part of a series of measures to support the markets and restore confidence **far more broadly**. Whilst the Federal Reserve's Money Market Mutual Fund Liquidity Facility (MMLF) was specifically targeted at MMFs and was highly effective in enabling dealers to provide liquidity, intervention in Europe, in the form of various asset purchase programmes, including those targeted at corporate issuance, provided minimal help to European MMFs. The European Central Bank's (ECB) Corporate Sector Purchase Programme (CSPP) and the Bank of England's Covid Corporate Financing Facility (CCFF) were successful in providing funding to corporates and thereby to the real economy but contributed little or no direct benefit to private debt MMFs since the majority of MMF assets are in financial paper. The operational integrity of IMMFA MMFs was maintained without recourse to asset purchase facilities as the fund assets were ineligible.[11] Refinancing operations, on the other hand, which were not related to MMFs but were aimed at restoring liquidity to the banking sector, were effective in providing liquidity to banks and unlocking their ability to resume intermediation in the wider markets.

[10] 96% of IMMFA MMFs.

[11] Low Volatility NAV (LVNAV) MMFs held less than 3% in corporate paper on 29 February 2020 (Source, Crane Data).

UCITS Directive and MMFR

Paragraph 82 notes that MMFs are required to be authorised as UCITS under the UCITS Directive or as AIFS under the AIFMD and that MMFs under the MMFR are subject to the relevant rules of the UCITS and AIFM Directives, in addition to those of the MMFR. Paragraph 82 then appears to imply that the fact that in certain articles the MMFR overrides the UCITS Directive creates additional risks. We do not agree with this description. The MMFR is dedicated regulation designed to enhance fund resilience by providing a framework specific to MMFs. As such, it addresses the particular risks to which they are exposed. The overall effectiveness of the MMFR in improving resilience was demonstrated by the ability of MMFs to withstand the exceptional pressures of the March liquidity crisis. As noted in paragraphs 86 and 88, future reforms are intended to strengthen this resilience further by addressing certain areas where the MMFR did not function as intended. Paragraph 83 goes on to note that the MMFR provides specific requirements for MMFs based on liquidity, concentration and diversification and risk management and that in some cases these requirements are more stringent than UCITS. This is certainly correct and as such appears to contradict the more negative implications of paragraph 82.

MMFs demonstrated resilience during the COVID-19 crisis

Under paragraph 85, the EBA quote the ESMA consultation stating that the COVID-19 crisis was challenging for MMFs and that a number of MMFs faced significant liquidity challenges. The ESMA consultation and other international workstreams are cited as reasons to include MMFs in the designation of shadow banking (paragraph 86). The economic fall-out from the pandemic created a systemic liquidity event impacting not only MMFs, but all asset classes including some, such as the US treasury market, which are highly liquid under normal conditions. The unprecedented 'dash for cash' meant that MMFs also experienced challenging conditions. Nevertheless, MMFs continued to serve their purpose in preserving capital and providing liquidity, with no MMFs imposing suspensions or deploying gates or fees. Stable NAV MMFs, which are subject to collars, stayed within their permitted range.[12] We feel strongly that questions of how MMFs performed should be considered in the context of the broader ecosystem and should recognise that MMFs continued to function as intended.

Future Reforms

Recital 5 states that MMFs should be seen as shadow banking entities because they faced severe liquidity issues during the crisis and because the related risks have not been fully addressed by prudential requirements in the Union. As outlined above, the acute liquidity strains of March 2020 affected not only MMFs, but all sectors of the financial markets. One of the primary functions of an MMF is to provide liquidity, which the funds continued to do. Their role in the provision of liquidity and their exceptionally high levels of transparency have contributed to a focus on MMFs as a target for reforms. Overall, we believe the MMFR worked largely as intended and demonstrated increased fund resilience. However, the crisis also revealed an area (the link between liquidity buffers and regulatory thresholds) where the regulation did not work as intended, which can be redressed in future reforms. To this end, we have recommended the so called 'delinking' or 'decoupling' of liquidity buffers and regulatory thresholds. This is a matter of active debate as the various reform proposals are considered. The object of reform will be, as noted in paragraph 88, to build on the existing framework to increase MMF resilience further.

Whilst the global liquidity crisis of March 2020 has brought MMF regulation into the spotlight, it is important to note that the MMFR was due for review in 2022, as is the case generally for EU legislation.

[12] Applies to IMMFA LVNAV and PDCNAV MMFs which are stable NAV MMFs and operate within a 20bp 'collar'.

The focus on MMF liquidity should also be seen in the context of a much broader review of how liquidity operated in open ended funds, which was not limited to the MMF sector.

The increased regulatory scrutiny which has followed the events of March last year is not just focused on MMFs but on the wider ecosystem. In its role as an industry association representing the European money fund industry, IMMFA has responded to both the European and international consultations and is working with regulators and policy makers to ensure that future reforms are effective and proportionate.

Conclusion

In conclusion, we do not agree that MMFs should be categorised as shadow banking entities. We would have concerns over the impact on investor perception which could be detrimental to a sector of the market which plays a key role in capital markets disintermediated fund raising. MMFs are subject to a stringent regulatory framework which, whilst having proven to be largely effective, is subject to a review which will make it yet more robust; they are transparent, low risk, and conduct minimal liquidity and maturity transformation; they do not employ leverage; and their connection to the banking sector and the associated risk of contagion to the sponsors is specifically addressed in the current regulation which prohibits sponsor support. MMFs demonstrated high levels of resilience when challenged during the crisis and in Europe derived little or no direct benefit from central bank support. Support from the European Central Bank was targeted at providing real economy funding through corporate issuers and at easing broader market dysfunctionality. For all of these reasons, we do not believe that MMFs should be designated shadow banking entities. It is an inappropriate misrepresentation of the important purpose which MMFs continue to serve.