26 October 2021

Response to the European Banking Authority's Consultation on Identifying "Shadow Banking Entities" for the Purpose of Large Exposure Reporting Under the Capital Requirements Regulation

ICI Global[1] appreciates the opportunity to provide feedback on the European Banking Authority's (EBA's) consultation paper on draft Regulatory Technical Standards (RTS) on criteria for the identification of shadow banking entities under Article 394(4) of Regulation (EU) No 575/2013, the Capital Requirements Regulation (CRR).[2]

Article 394(2) of the CRR requires an institution to report to supervisory authorities its ten largest exposures to "shadow banking entities which carry out banking activities outside the regulated framework." The draft RTS define the term "banking services and activities" and describe the entities that shall or shall not be considered "shadow banking entities" for purposes of this reporting requirement. The consultation paper explains that the "main basis" for the draft RTS are guidelines published by the EBA in 2015 with "the objective of setting specific [large exposure] limits to shadow banking entities under Pillar 2 in view of the risks that such entities pose to the financial system" (2015 Guidelines).

In the sections below, we explain why the EBA should not base the RTS on its 2015 Guidelines and instead should adopt a more accurate definition of "banking activities outside the regulated framework" consistent with the mandate outlined in Article 394(4). We then explain why all regulated funds—including regulated money market funds—should not be considered "shadow banking entities" under the RTS.[3]

<u>The EBA Should Adopt a More Accurate Definition of "Banking Activities Outside the Regulated Framework"</u>

As noted in the consultation paper, the CRR does not define the terms 'shadow banking entities,' 'banking activities' and 'regulated framework.' In developing definitions of these terms for purposes of the 2015 Guidelines, the EBA looked to the Financial Stability Board (FSB), which at that time viewed much of the financial activity occurring outside the banking system as being insufficiently regulated and taking place "in the shadows." In its 2011 Recommendations on Strengthening the Oversight and Regulation of Shadow Banking, for example, the FSB broadly defined shadow banking as "credit intermediation involving entities and activities outside the regular banking system," calling for authorities to focus on "credit intermediation activities that pose systemic risks" and to monitor the "key risk factors" of maturity transformation, liquidity transformation, credit risk transfer and leverage.

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[1] ICI Global carries out the international work of the Investment Company Institute, the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US$42.5 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

[2] The consultation is available at https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Consultations/2021/Consultation%20on%20draft%20RTS%20on%20criteria%20for%20the%20identification%20of%20shadow%20banking%20entities/1017738/CP%20on%20draft%20RTS%20on%20Shadow%20Banking%20Entities.pdf.

[3] Our comments generally respond to questions 1, 5, 6 and 7.

Following the FSB's lead, the EBA incorporated these four factors into the 2015 Guidelines, stating that "*any* service or activity involving maturity transformation, liquidity transformation, leverage, or credit risk transfer" would be included within "banking services and activities."

ICI/ICI Global and other stakeholders consistently have impressed upon the FSB and other policymakers that it is not productive to view the whole of market-based finance as risky and a potential threat to financial stability merely because nonbank financial intermediaries are regulated differently from banks. In a June 2011 letter to the FSB,[4] ICI:

- Strongly objected to the use of the terms "shadow banks" and "shadow banking" because they are inherently inaccurate and misleading, connoting that all activities so labeled lack both transparency and any regular or official status;

- Urged the FSB to use more precise and neutral terminology when discussing the various roles of non-bank financial intermediaries, noting that while these roles may share some similarities with the role that banks play, there are also critical differences that should be respected;

- Expressed deep concerns with the lengthy discussion in the FSB's April 2011 Note of the perceived deficiencies or laxity of regulation to which "shadow banks" are subject. ICI opined that simply characterizing capital market activities as "shadow banking" is unhelpful and evaluating the regulation of nonbank financial intermediaries solely through a banking lens distorts and ignores the very substantive regulation and oversight to which these entities are subject through the securities laws. In an appendix, ICI detailed how capital markets and entities that operate in them provide credit intermediation in a manner that is different from banks; and

- Called upon the FSB to acknowledge and respect the differences that exist between banking and securities-related activities and their respective regulatory frameworks, and to ensure that its recommendations are closely informed by, and tailored to take account of, the unique features of existing regulatory regimes and the experiences of different financial markets.

To its credit, the FSB has since adopted a more constructive approach to nonbank financial intermediation. This can be seen not just in the FSB's decision in 2018 to drop the pejorative "shadow banking" terminology.[5] Substantively, the FSB has engaged more collaboratively with capital markets regulators through the International Organization of Securities Commissions (IOSCO) and, together with IOSCO, is pursuing a workplan on nonbank

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[4] Letter to FSB from Paul Schott Stevens, President & CEO, ICI, dated June 3, 2011 (responding to a FSB background note entitled Shadow Banking: Scoping the Issues), available at https://www.ici.org/system/files/attachments/comment_11_shadow_bank.pdf.

[5] *See, e.g.*, FSB, Global Monitoring Report on Non-Bank Financial Intermediation 2018 (4 Feb. 2019) at 4, available at https://www.fsb.org/wp-content/uploads/P040219.pdf. *See also* "Shadow Banking," Federal Reserve Bank of New York, Staff report no. 458 (July 2010) ("the label 'shadow banking system'. . . is an incorrect and perhaps pejorative name for such a large and important part of the financial system.").

financial intermediation that brings more rigor to the FSB's consideration of potential vulnerabilities outside the banking space.[6]

Article 394(4) requires the EBA to "take into account international developments and internationally agreed standards on shadow banking" in developing the RTS. On this basis, we would expect the EBA to look afresh at how to define "banking activities outside the regulated framework" given the evolution since 2011 in the FSB's approach to nonbank financial intermediation. Instead, the EBA proposes to adhere to the approach it outlined in the 2015 Guidelines, wherein it stated:

> Shadow banking entities are generally unregulated or not subject to the same standards of prudential regulation as core regulated entities such as institutions [as defined in CRR], do not provide protection to investors' investment from these entities' failures, and do not have access to central banks' liquidity facilities.[7]

We recommend that the EBA depart from this outdated "shadow banking" narrative based on the FSB's position from a decade ago and instead adopt a more accurate definition of "banking activities outside the regulated framework" consistent with the mandate outlined in Article 394(4).

UCITS and Other Regulated Funds Neither Carry Out "Banking Activities" Nor Operate "Outside the Regulated Framework"

The consultation paper states:

> The UCITS Directive prescribes rules under which UCITS and their managers operate. These include requirements on the asset manager (initial capital, own funds, and internal controls 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 and should not be regarded as shadow banking entities. Equally, entities established in non-EU countries and authorized under laws and regulations that subject them to supervision considered to be equivalent to that of the UCITS Directive should be subject to the same treatment.

We agree that UCITS and regulated funds in other jurisdictions should not be treated as "shadow banking entities" under the RTS. Regulated funds do not carry out "banking activities"—they are investment products, purchased by investors who are given full

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[6] *See, e.g.*, FSB, Holistic Review of the March Market Turmoil (17 Nov 2020) at 3, available at https://www.fsb.org/wp-content/uploads/P171120-2.pdf; IOSCO Board Priorities – Work Programme 2021-2022 at 3, available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD673.pdf.

[7] EBA, Guidelines: 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 (14 Dec. 2015) at 12, available at https://www.eba.europa.eu/sites/default/documents/files/documents/10180/1310259/f7e7ce6b-7075-44b5-9547-5534c8c39a37/EBA-GL-2015-20%20Final%20report%20on%20GL%20on%20Shadow%20Banking%20Entities.pdf.

disclosure of the fact that they bear any gains or losses associated with their investment.[8] And regulated funds do not operate "outside the regulated framework"—in fact, they and their managers are subject to comprehensive regulation under securities laws.

In response to other regulatory consultations, ICI/ICI Global have described in great detail why regulated funds do not present the sorts of weaknesses or risk of failure that justifiably concern policymakers considering the exposures of banking institutions to non-bank entities. In its first of two letters to the Basel Committee on Banking Supervision regarding "step-in risk," for example, ICI Global explained:

> Regulated investment funds serve as the vehicle through which millions of people save and invest to meet their most important financial goals. The substantial advantages that these funds provide to investors—including professional money management, diversification, and reasonable cost—are consistent across international borders. They include the benefit of substantive government regulation and oversight, as befits an investment product eligible for sale to the retail public. All regulated funds typically are subject to substantive regulation in areas such as disclosure (e.g., form, delivery, and timing), form of organization, separate custody of fund assets, mark-to-market valuation, and investment restrictions (e.g., leverage, types of investments or "eligible assets," concentration limits and/or diversification standards). Although the governing rules in different jurisdictions are not identical, they are very similar. Indeed, such rules reflect common principles developed by [IOSCO] for regulated funds (which IOSCO refers to as "collective investment schemes" or "CIS") as well as IOSCO's more detailed work on core areas of CIS regulation.[9]

Quite plainly, the regulatory and structural characteristics of regulated funds are more than sufficient to warrant their exclusion from the RTS.

<u>Regulated Money Market Funds Likewise Should Not Be Considered "Shadow Banking Entities" Under the RTS</u>

Having concluded that UCITS and similarly regulated funds in other jurisdictions are not shadow banking entities for purposes of the draft RTS, we fail to understand how the EBA can reach a different conclusion with respect to regulated money market funds (MMFs).

Like their non-MMF counterparts, regulated MMFs are highly regulated investment products. In the EU, for example, regulated money market funds adhere to the UCITS Directive *as well as to additional requirements* set forth in the 2017 Money Market Fund Regulation (MMFR). In the United States, regulated MMFs are similarly regulated under the Investment Company Act of 1940 *and* Rule 2a-7 under that Act, a scheme of regulation that the US Securities and Exchange Commission enhanced through two rounds of reform since the 2008 global financial crisis.

The consultation paper recognizes the scope of regulation applicable to EU regulated MMFs. It notes such funds may be authorized as UCITS and highlights several aspects of the

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[8] It also is worth noting that an investor in a regulated fund owns an equity stake and is exposed to equity-like risk. This is very different from a deposit holder or a bond holder toward a bank, where the holder is a *creditor* of the bank.

[9] Letter to Basel Committee on Banking Supervision from Dan Waters, Managing Director, ICI Global, dated March 17, 2016, at 4-5, available at https://www.ici.org/system/files/attachments/29778.pdf.

MMFR, including that the MMFR: (i) subjects MMFs to specific authorization procedures by competent authorities; (ii) places limits on MMF investments that are "aimed at ensuring the low riskiness and high liquidity of such assets;" (iii) specifies requirements for MMFs, including in terms of liquidity, concentration, diversification, and risk management; and (iv) "introduces a set of rules for maximum harmonization that, in certain cases, are more stringent than those applied to UCITS."[10] The EBA concludes that "[t]hese requirements make the framework under which MMFs operate more robust and safer."[11]

Nevertheless, the EBA proposes to treat regulated MMFs as shadow banking entities under the draft RTS. The EBA points out that the current review of the MMFR by the European Securities and Markets Authority will consider the experience of MMFs during the March 2020 market turmoil associated with the start of the global COVID-19 pandemic. It also points to attention at the international level to "the situation faced by MMFs" during this timeframe and potential policy options "to address the issues which have been identified." Based on these workstreams, the EBA reasons that "[i]n view of the ongoing review of the MMFR to tackle the vulnerabilities identified with MMFs, it is considered appropriate to follow the [2015 Guidelines] and consider MMFs as shadow banking entities until such reforms are in place before re-assessing the current policy stance."[12]

Although we understand the EBA's interest in the outcome of these workstreams, it does not change the fact that regulated MMFs do not "carry out banking activities outside the regulated framework." By including regulated MMFs as shadow banking entities under the RTS, the EBA would go beyond its mandate in Article 394(4) of the CRR.

As to the experience of regulated MMFs in March 2020, we wish to take this opportunity to reiterate certain points that ICI/ICI Global have made to international, EU, and US policymakers.[13]

- In an effort to contain the spread of COVID-19 in February-March 2020, governments around the world contemporaneously shut down their economies. A health crisis forced an economic crisis, which, not surprisingly, disrupted the financial markets. By mid-March, after problems had already appeared in the US Treasury bond market, the short-term funding markets, including the markets for commercial paper and bank certificates of deposit, came under sharp stress as corporations and other investors "dashed for cash" to reduce risk and hoard cash in the face of great economic uncertainty (even fear) resulting from the health crisis. Liquidity dried up, short-and long-term credit markets ceased to function, and the flow of credit to the

[10] Consultation paper at paragraphs 82-83.

[11] *Id.* at paragraph 83.

[12] *Id*. at paragraphs 82-89.

[13] For a detailed discussion of ICI's research of the March 2020 events and the role of money market funds, *see Experiences of US Money Market Funds During the COVID-19 Crisis*, Report of the COVID-19 Market Impact Working Group (November 2020), available at www.ici.org/system/files/private/2021-04/20_rpt_covid3.pdf. *See also* Letter to FSB from Eric J. Pan, President & CEO, ICI, dated 13 Aug. 2021, available at https://www.ici.org/system/files/2021-08/21ltrfsbmmfs.pdf (containing a summary of ICI's April 2021 roundtable on the performance of MMFs and the short-term funding markets during March 2020); Keynote Address by ICI President & CEO Eric J. Pan, 2021 Mutual Funds and Investment Management Conference, March 15, 2021, available at https://www.ici.org/speeches/21_ejp_mfimc.

economy evaporated. These dynamics affected all market participants and each part of the financial system.

- Money market fund flows during the COVID-19 crisis were shaped by the efforts of businesses, households, and governments to preserve or build liquidity. During the March 2020 "dash for cash," all investors—not just those investing in certain MMFs—were scrambling for liquidity and were forced to navigate the resulting stress in the short-term funding markets.

- To prevent economic and financial collapse, governments and central banks around the world introduced a broad array of monetary policy measures and market liquidity programs to help virtually every sector of the economy. MMFs were neither the first nor the largest targets of the government and central bank intervention programs that helped a broad range of financial market participants during the COVID-19 crisis, and the relevant program should not be viewed as a "bail-out" of money market funds.[14]

- As policymakers continue to consider the March 2020 "dash for cash" episode, they should give high priority to examining the performance of all players in the market and their impact on market liquidity. Without understanding the role of other players, merely imposing new restrictions on MMFs would not address policymakers' concerns.

ICI/ICI Global and its members are committed to working with policymakers to strengthen MMFs, the financial markets, and the economy more generally against liquidity events like the one caused by the COVID-19 crisis.

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[14] *See* Investment Company Institute, "Experiences of European Markets, UCITS, and European ETFs During the COVID-19 Crisis," Report of the COVID-19 Market Impact Working Group (December 2020) (2020 ICI COVID-19 European Report) at 11, available at https://www.ici.org/system/files/private/2021-04/20_rpt_covid4.pdf (explaining that the programs put in place by the European Central Bank and the Bank of England provided little support for UCITS MMFs).