association of the luxembourg fund industry

Luxembourg, 26 October 2021

Response to the EBA consultation on Draft Regulatory Technical Standards on criteria for the identification of shadow banking entities under Article 394(4) of Regulation (EU) No 575/2013

Introduction

The Association of the Luxembourg Fund Industry (ALFI) represents the face and voice of the Luxembourg asset management and investment fund community. The Association is committed to the development of the Luxembourg fund industry by striving to create new business opportunities, and through the exchange of information and knowledge.

Created in 1988, the Association today represents over 1,500 Luxembourg domiciled investment funds, asset management companies and a wide range of business that serve the sector. These include depositary banks, fund administrators, transfer agents, distributors, legal firms, consultants, tax advisory firms, auditors and accountants, specialised IT and communication companies. Luxembourg is the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds. Luxembourg domiciled investment funds are distributed in more than 70 countries around the world.

We thank the European Banking Authority (EBA) for the opportunity to participate in this consultation on Draft Regulatory Technical Standards on criteria for the identification of shadow banking entities under Article 394(4) of Regulation (EU) No 575/2013.

Response to the consultation

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.

ALFI response:

We do not agree with the approach to identify non-shadow banking entities. We would like to refer to our answers under questions 5, 7, 8 and 9 in this regard.

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?

ALFI response:

We would like to refer to our answers under questions 5, 6, 7, 8 and 9.

Association of the Luxembourg Fund Industry a.s.b.l.
12, rue Erasme L-1468 Luxembourg B.P. 206 L - 2012 Luxembourg
Tel: +352 22 30 26 - 1 Fax: +352 22 30 93 info@alfi.lu www.alfi.lu
TVA LU 23710105 R.C.S. F4428

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.

ALFI response:

We would like to refer to our answers under questions 5, 6, 7, 8 and 9.

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?

ALFI response:

We would like to refer to our answers under questions 5, 6, 7, 8 and 9.

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?

ALFI response:

In ALFI's view, funds should not be considered as shadow banking entities due to manifold reasons:

- Being investment products, funds, generally speaking, operate with a completely different business model compared to banks.
- There is a different set of regulatory requirements to mitigate risks that may be faced by investment funds.
- Funds do not collect repayable funds from the public and accordingly their failure does not pose a systemic risk towards the public in the same way as banks. To the contrary, funds conduct an investment activity and investors in funds are made aware that they may lose their entire investment, which means that the fund is generally not liable to repay invested amounts to its investors, unlike banks that are required to repay deposits to their clients.

Keeping in mind the organic differences between banks and funds and between their respective regulations, investment funds should in general not be considered as comparable to banks and therefore not as shadow banking entities.

Furthermore, we do not share EBA's view as per the definition of shadow banking entities that money market funds (MMFs) (both UCITS and AIFs) and certain AIFs carry out banking activities outside the regulated framework.

The MMF Regulation (MMFR), the UCITS and AIFMD directives (as well as their implementing acts) and related ESMA Guidelines have introduced a robust regulatory framework, ensuring prudential supervision in a manner adapted to the specificities of investment funds. This framework contains aspects discussed in the consultation such as risk management, including credit, liquidity and leverage risk.

For further details regarding the classification MMFs and certain AIFs as shadow banking entities, we would like to refer to our responses under questions 6, 7, 8 and 9.

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?

ALFI response:

As outlined in our responses to questions 5, 7, 8 and 9, the broad approach proposed by EBA potentially gives the impression that the regulatory framework for funds is not appropriate. Funds play an important role in financing the economy (especially SMEs). Taking a too broad approach may be detrimental to the activities of such funds and hence to the economy as a whole.

From an operational point of view, we would like to give to consideration that a broader approach could lead to higher administrative burdens in terms of reporting while the purpose for this reporting (e.g. monitoring of certain risks) may already be covered within the regulatory framework for funds.

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

ALFI response:

Recital 5 of the draft RTS states that institutions' exposures to MMFs should be seen as exposures to shadow banking entities, because MMFs have faced severe liquidity issues during the COVID-19 crisis and the related risks have not been fully addressed by prudential requirements in the Union. In this context, EBA references in particular the ongoing work of ESMA and the FSB aiming at improving MMFs' resilience based on the experiences during the Covid-19 crisis to ensure that MMFs can operate without negative impact on financial stability and to avoid (implicit) interventions of central banks (point 86). EBA further outlines that "in view of the ongoing review of the MMFR to tackle the vulnerabilities identified with MMFs, it is considered 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" (point 89).

Although ALFI would in general welcome a re-assessment of the classification of MMFs as shadow banking entities, we do not agree with the underlying reasoning that MMFs' resilience needs to be enhanced via respective reforms to the MMFR as proposed by ESMA and the FSB. Notwithstanding that certain improvements to the MMFR would generally be beneficial (such as a decoupling the automatic link between a specific level of liquidity and the consideration of suspensions/gates), we would like to stress that in our view, the crisis rather proved that MMFs are resilient. Therefore, we believe that the developments during the crisis do not per se justify any amendments to the MMFR. We base our reflections on the following (reference is also made to the ALFI response to the respective ESMA consultation on the EU Money Market Fund Regulation – legislative review and the ALFI response to the respective FSB consultation on policy proposals to enhance Money Market Fund resilience earlier this year):

Setting the scene, it should be highlighted that the beginning of COVID-19 pandemic lead to liquidity pressures within a broad range of market segments. The outlook of a potential economic crisis triggered significant risk aversion and the demand for cash started to increase (ESMA report on Trends, Risks and Vulnerabilities, September 2020, p. 29). Consequently market liquidity came under pressure and fell sharply, not only for riskier assets, but briefly also in high-quality markets, such as the US Treasury and money markets, as both financial and non-financial sectors demanded cash (ECB Financial

Stability Review, May 2020 p. 7). As a result, like other European investment fund types, some segments of the EU short-term MMF industry faced liquidity challenges, in particular low-volatility net asset value (LVNAV) MMFs (here and the following ESMA report on Trends, Risks and Vulnerabilities, September 2020, p. 32). At the same time, constant net asset value (CNAV) MMFs recorded high inflows. VNAVs experienced overall limited outflows although individual VNAV funds may have been subject to large outflows. Among the outflows, the ones from both euro and USD-denominated funds were significant, especially USD-denominated LVNAV funds, while preliminary USD-dominated public debt CNAV funds received net inflows (ECB Financial Stability Review, May 2020, p. 86 f. and IOSCO Thematic Note, Money Market Funds during the March-April Episode, November 2020, p. 7 f). Subsequent measures by the US Federal Reserve and the ECB (in particular the Pandemic Emergency Purchase Program "PEPP") helped to maintain investor confidence in the market and thereby limited the impact by investor behaviour. However, European USD MMFs were not eligible for the support by the US Federal Reserve and the PEPP only provided limited support to MMFs as it covered only debt issued by non-financial companies and denominated in euro whereas European MMFs invest predominantly in commercial paper and certificates of deposits issued by financial institutions and denominated for the most part in non-euro currencies (EFAMA Market In-sights October 2020 – Money Market funds in Europe – State of Play, p. 6). At the end of the first quarter 2020, the situation relaxed and inflows into MMFs were observed. It should be noted in addition that despite the liquidity challenges faced by European MMFs, none of them had to introduce redemption fees or gates or suspend redemptions during the market turmoil in March 2020 (ESMA report on Trends, Risks and Vulnerabilities, September 2020, p. 34). This as well as the quick recovery show that the systems as foreseen by the MMFR operated well.

We would like to highlight in particular that the portfolio construction of MMFs organically has high levels of liquidity as it holds at least 30% of weekly liquid assets (WLA). Assets within the WLA will generate cash due to a natural maturity schedule without the sale of any position. Therefore, the need to sell to meet redemptions from investors is in general very limited due to the nature of the instrument. Moreover, it should be noted that short-term European MMFs entered March 2020 already with weekly liquidity levels well above their regulatory minima and that the average liquidity levels for the whole first half of 2020 remained at around 50% (EFAMA, European MMFs in the Covid-19 market turmoil, November 2020 p. 17).

Further to the above, we believe that the framework in place already leaves MMFs in a very good position to mitigate possible (liquidity) risks and to avoid the necessity of central bank intervention. In our view, a re-assessment of the classification of MMFs as shadow banking entities does therefore not necessarily have to be based on possible reforms. Rather a re-assessment may already be based on the current, robust framework as it stands.

Since the publication of the EBA Guidelines (Guidelines EBA/GL/2015/20 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) the regulatory framework was very much enlarged. Not only the MMFR was introduced in 2017, but also complementing regulation which aims to mitigate liquidity risks and limit the impact of redemptions on the market, such as the IOSCO Recommendations for Liquidity Risk Management for Collective Investment Schemes (e.g. implemented by the CSSF via their Circular 19/733), the ESMA Guidelines on Stress Test Scenarios under the MMFR (e.g. implemented by the CSSF via their Circular 20/735) or the ESMA Guidelines on Liquidity Stress Testing in UCITS and AIFs (e.g. implemented by the CSSF via their Circular 20/752).

In parts, the current regulation is even more extensive and stringent compared to other types of funds. Considering e.g. the ESMA Guidelines on stress test scenarios under the MMFR, no other area/asset class/fund type faces as detailed requirements. Furthermore, it should be noted that the liquidity risk management requirements and the broad range of available liquidity management tools, such as liquidity fees, gating or suspension of redemptions, do not apply to the banking sector.

In addition, systemic risks that MMFs may pose are not comparable with those that banks may inherit. Since the financial crisis in 2008, regulation supports certain arrangements between private banks and national banks in order to avoid systemic risks such as spill over effects in case of bank failure. Therefore, the enhanced scrutiny in view of shadow banking entities and the risks they may pose is very much justified. MMFs in contrast are prohibited from receiving sponsor support by the MMFR. The preliminary responsibility in case of liquidity issues remains with the shareholders of the fund. As a consequence, it appears not justified to qualify MMFs as shadow banking entities from a systemic risk perspective. It should be added, that MMFs, unlike banks, do not underwrite loans and the liquidity transfer remains limited. Finally, in contrast to banks, they do not apply leverage. Therefore, the activities performed by MMFs and associated risks can in our view not be considered as comparable to the banking sector. By investing in short-term deposits of banks, MMFs rather support banking activities and thereby contribute to the banking sector.

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

ALFI response:

Further to our response under question 5, we would like to stress again that the term “shadow banking entity” has a negative connotation that is inappropriate for AIFs. The AIFMD is a bespoke regulatory framework for the operation of investment funds that do not qualify as UCITS. Considering them as operating “in the shadow” creates the impression that the AIFMD rules (in particular its reporting and investor protection elements) are to a certain extend of lesser quality as the regulation of credit institution that uses this term.

The activities of AIFs carried out in accordance with such framework, cannot be considered as being carried out “in the shadow” as they are subject to reporting to national competent authorities (NCAs) (including reporting for NCAs to be able to assess leverage risks and implement leverage limits as per art. 25 AIFMD and respective ESMA Guidelines), rules of conduct etc. This undermines the reputation of AIFMD regulated investment funds (including those that operate duly under the applicable exemptions).

Already under the EBA Guidelines of 2015 AIFs applying substantial leverage as well as AIFs granting loans or purchasing third parties’ lending exposures onto their balance sheet were classified as shadow banking entity as in EBA’s view, the risks arising directly from the funds themselves are not mitigated in a satisfactory way from a prudential point of view (p. 9). However, since the publication of the EBA Guidelines, as outlined also in our response to question 7, the regulatory framework was very much enlarged including complementing regulation which aims to mitigate liquidity risks and limit the impact of redemptions on the market, such as the IOSCO Recommendations for Liquidity Risk Management for Collective Investment Schemes (e.g. implemented by the CSSF via their Circular 19/733), the ESMA Guidelines on Liquidity Stress Testing in UCITS and AIFs (e.g. implemented by the CSSF via their Circular 20/752) or in particular for MMFs, the ESMA Guidelines on Stress Test scenarios under the MMFR (e.g. implemented by the CSSF via their Circular 20/735).

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?

ALFI response:

In addition to what is set-out under our response to question 5, 6, 7 and 8, ALFI would like to underline the following.

The term "shadow" implies a higher risk of default of the counterparty of the reporting credit institution.

AIFs using leverage on a substantial basis as referred to article 1(5) (b) of the draft RTS are indeed generally considered as more risky, but this assessment is rather made from the investors' perspective as the term "leverage" used under AIFMD refers to an increase of exposure on the assets of the AIF. It should further be noted that there are circumstances where instruments or transactions that create leverage under AIFMD which are actually used to reduce the level of operational or credit risk at the level of that AIF.

With regard to the use of leverage by loan origination funds in particular, we would like to highlight that in contrast to banks, they either deploy no leverage or very modest leverage in their funds. As AIMA recently reminded in its letter to the European Commission, "there is typically no more than one unit of debt for one unit of equity in a credit fund. In other words, the leverage rarely exceeds 100% of the funds' net asset value (equivalent of equity). In the EU, banks hold, on average, only 5% of equity to support their balance sheet, and the remaining 95% being debt financing either in the form of deposits from the public or other forms of secured and unsecured debt. Banks therefore tend to use 24 units of debt for one unit of equity - more than 20 times more leverage than private credit funds".

In addition, the mere fact that an AIF is employing leverage on a substantial basis in accordance with the rules under AIFMD does in no way justify the qualification as a shadow banking entity. The underlying strategy of such AIF must not necessarily consist in the offering of a banking service or the carrying out of a banking activity, which we believe should be the prerequisite of being considered shadow banking entity. There is generally no link between the amount of leverage employed by an AIF and its investment strategy. Automatically considering such AIFs as shadow banking entities seems inappropriate.

In relation to loan origination or acquisition funds as referred to in article 1(5) (c) of the draft RTS (hereafter referred to as "Credit AIFs") the conclusion that these are counterparties subject to a specifically high risk of default seems inappropriate. The insolvency risk of Credit AIFs seems to be low due to various factors (such as):

- Credit AIFs invest normally with a (highly) diversified strategy. Exposures to a single borrower of more than 10% seem to be the exception which decreases significantly the risk of insolvency at the level of the Credit AIF. The balance sheet of a loan originating fund is not the same than the one of a bank. The balance sheet or assets under management controlled by a single manager is a collection of self-contained units of risks. This is in stark contrast to assets of a bank which form a single balance sheet that is identical with the bank as an institution. A bank, unlike a private credit manager, can therefore become insolvent if only a small portion of the assets on its balance sheet suffers from underperformance.
- Sophisticated investment due diligence is applied, in particular where the Credit AIF is operated within the full scope of AIFMD (i.e. outside of any exemptions). Institutional investors apply their own due diligence processes on those procedures, as do the Credit AIFs' (or their AIFM's) NCAs.
- Credit AIFs are subject to limited exposure to operational risks that are unrelated to their lending/acquisition activity. Their only activity is the lending/acquisition of loans and their administration (including work-out situations).
- Generally, loan funds are widely held, which decreases the risk of insolvency in case of an investor default. Investment funds originating loans are in a materially different position than banks: the latter will generally use public deposits to finance originated loans, which creates a risk for consumers and their savings. Whereas a fund will generally use non-redeemable funds invested by sophisticated investors, which should be aware that they may lose their entire investment in the fund.

- Furthermore, they are used for targeted investments during a pre-determined period, so the risk of sudden runs can be considered, generally speaking, as relatively low by nature.

The consultation paper sets out that loan originating funds perform activities outside of the regulated framework. This disregards in our view that the AIFMD already ensures that loan origination fund managers:

- are authorised and supervised by NCAs;
- match the liquidity arrangements of their funds with the liquidity profile of their lending activity;
- undertake rigorous borrower due diligence and credit underwriting procedures on any loans they originate;
- implement risk management systems, including stress testing, to identify, monitor and manage risk arising from their lending activity;
- are transparent in their use of leverage to their investors and NCAs; and
- provide detailed reporting to investors and NCAs.

Apart from that, the term “exposures” in the Draft RTS in article 1(5) (c) is vague and needs to be interpreted. Because the current Draft RTS’ wording includes all risk positions “exposures”, it contains the risk of an unintended expansion of the scope beyond the EBA Guidelines. Saying that, the wording in the Draft RTS should be aligned to that used in the EBA Guidelines, namely the wording “originate loans or purchase third party lending exposures” instead of the current draft RTS wording “originating exposures in the ordinary course of its business or from purchasing third-party exposures”. Such an approach would pick up the specific wording and the rationale of the Draft RTS, point 76 of section "3. Background and rationale", too.

Moreover, we do not agree with the inclusion of point (c) as it would entail including a negative statement in the constitutional documents in all funds, which would therefore have an impact on funds for which the principal activity is not loan origination. If so, to define positive criteria in point (c) would fit in better in the legal structure of article 1 (5) of the draft RTS since the alternatives (a) and point (b) describe positive criteria, too.

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?

ALFI response:

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?

ALFI response:

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?

ALFI response:

N/A

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

ALFI response:

We would like to refer to our responses under questions 5, 6, 7, 8 and 9.

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.

ALFI response:

We would like to refer to our responses under questions 5, 6, 7, 8 and 9.