

# The European Commission issues a 'Roadmap' for tackling the risks in Shadow Banking

The European Commission has issued a 'Roadmap' for tackling the risks inherent in shadow banking. In a Communication issued on 4 September 2013, it unveiled its proposed new rules for Money Market Funds, summarised the regulatory reforms already undertaken in order to reduce shadow banking risks and set out possible further actions in five priority areas. The Communication, which came less than a week after the Financial Stability Board issued its Final Policy Recommendations, is described as being 'fully in line with the recommendations issued so far at international level'.

Improving the regulation and monitoring of shadow banking has been a priority for the Commission in the wake of the financial crisis and the Communication builds upon previous work, notably the Green Paper published in March 2012. While acknowledging the important role of shadow banks in providing alternative financing that is essential to the real economy, the Commission believes that the shadow banking sector should be better monitored because of its size, its interconnectedness with the traditional banking sector and the systemic risks it may pose to financial stability.

## Existing Reforms

Shadow banking risks are being addressed in the EU, not in a single regulation, but in several. Some of the regulations have already been

implemented and the Communication provides an overview of these.

In general terms, the EU has sought to reduce shadow banking risk in two main ways:

- at a 'micro-level' by imposing additional requirements on certain 'financial entities' e.g. managers of alternative investments under the AIFMD
- at a 'macro level' by introducing regulations designed to strengthen the integrity of the market as a whole e.g. EMIR in the OTC derivatives market

An overview of the main European regulatory measures intended to mitigate shadow banking risk is shown Appendix 1.

## The EU Shadow Banking Roadmap

- Summarises existing EU regulatory reforms that address shadow banking risks
- Proposes new rules for Money Market Funds
- States that additional regulatory measures might be introduced in the future in five priority areas
  - To increase transparency
  - To enhance the regulatory framework for investment funds
  - To reduce risks in securities financing transactions
  - To strengthen the prudential banking framework to limit contagion and arbitrage risks
  - To improve supervision of the shadow banking sector

## Proposed Rules on Money Market Funds

The Commission has proposed new rules for Money Market Funds (MMFs), which are perceived by the Commission (and the FSB) as a major source of shadow banking risk.

The proposed MMF Regulation requires:

- set levels of daily/weekly liquidity in order for the MMF to be able to satisfy investor redemptions (MMFs are obliged to hold at least 10% of their assets in instruments that mature on a daily basis and an additional 20% of assets that mature within a week)
- clear labelling on whether the fund is a short-term MMF or a standard one (short term MMFs hold assets with a residual maturity not exceeding 397 days while the corresponding maturity limit for standard MMFs is 2 years)
- a capital cushion (the 3% buffer) for constant NAV funds that can be activated to support stable redemptions in times of decreasing value of the MMFs' investment assets
- customer profiling policies to help anticipate large redemptions
- internal credit risk assessment by the MMF manager to avoid overreliance on external ratings

A summary of the MMF proposal is shown in Appendix 2.

## Additional Measures

Five priority areas have been identified by the Commission where additional regulatory measures might be necessary to mitigate shadow banking risk. The priority areas generally align with those of the FSB.

### Transparency

To increase transparency in shadow banking the Commission propose:

- supplementing existing initiatives on collection and exchange of data
- developing central repositories for derivatives which have been developed within the framework of EMIR and the revision of MiFID
- implementing the Legal Entity Identifier
- increasing the transparency of securities financing transactions

### Enhancing the regulatory framework for certain investment funds

In addition to the specific legislative measures for MMFs, as described above, the Commission plans to strengthen the UCITS framework. Work in this area has been on-going since 2012 in the context of the general review of the UCITS Directive. A key feature of the review, commonly known as UCITS VI, is to examine how investment funds use securities financing transactions.

### Reducing the risks associated with securities financing transactions

Like the FSB, the Commission singles out securities lending and repo markets as an area for reform. As

well as concerns over transparency, the Commission is concerned about the re-use or re-hypothecation of collateral. The Commission note that they are 'considering a legislative proposal regarding securities law', which will include elements of property rights and transparency. Aside from noting that the indicative date for the Securities Law proposal is '2014 and beyond", no further details are given in the Communication.

### Strengthening the prudential banking framework

The Commission intends to reduce the risk of contagion and regulatory arbitrage between the banking and shadow banking sectors in two main ways:

- tightening the prudential rules applied to banks in their dealings with unregulated financial entities in order to reduce contagion risks
- considering extending the scope of prudential rules in order to reduce arbitrage risks

Measures intended to tighten the prudential rules applied to banks in their operations with unregulated financial entities in order to reduce contagion risks are already in progress (e.g. The Capital Requirements Regulation (CRR) and Directive (CRD IV) which will implement Basel III in the EU).

In addition, the Commission is considering extending the scope of prudential rules in order to reduce arbitrage risks between banks and shadow banks, noting: 'by extending the scope, it would be possible to respond to the concerns notably expressed in the [European] Parliament's initiative report which suggests the application of prudential

rules to entities performing activities similar to those of banks without a banking licence'.

In this context, the Commission will also consider FSB recommendations on the other entities from the shadow banking system which are not currently subject to a suitable supervision framework and will

propose, if necessary, legislative measures to remedy this.

### **Greater supervision of the shadow banking sector**

The Commission urges greater supervision in the shadow banking sector which it considers has 'yet to be clearly defined or lacks depth'.

Improving supervision will be included in the review of the European System

of Financial Supervisors (ESFS), to be performed by the Commission later in 2013, which will, in particular, assess the existence of effective procedures to collect and exchange information on shadow banking.

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Appendix 1 - An overview of the main measures intended to mitigate shadow banking risks

## Shadow Banking – main EU regulatory measures

Indirect regulation through Banking Regulation	Specific initiatives in the banking sector / Shadow Banking	Indirect approach/ Insurance sector	Asset Management Sector	Risk Transfers Framework	Reducing risks associated with securities financing transactions	Enhancing Transparency of Shadow Banking	EU Supervisory framework	Rating agencies	Resolution tools for non-banks
<b>2014 and beyond</b>									
<ul style="list-style-type: none"> <li>CRD 4 implementation to begin</li> </ul>	<ul style="list-style-type: none"> <li>EBA report on limits to unregulated counterparties exposures expected</li> </ul>	<ul style="list-style-type: none"> <li>Delegated Acts for Solvency II (including capital requirements and risk management requirements)</li> </ul>	<ul style="list-style-type: none"> <li>UCITS VI review including investment techniques and strategies of the funds</li> </ul>	<ul style="list-style-type: none"> <li>Rules on contracts subject to mandatory clearing obligation to be adopted (Q2) and to enter into force (Q3)</li> </ul>	<ul style="list-style-type: none"> <li>Securities Law Legislative Proposal</li> </ul>	<ul style="list-style-type: none"> <li>Entry into force of the reporting requirements for derivatives transactions to trade repo (EMIR) (Q1)</li> <li>Monitoring framework to be developed by authorities (eg. ESRB working group)</li> <li>Securities law proposals / Specific actions for securities financing transactions</li> <li>Legal identifier (LEI) implementation phase</li> </ul>	<ul style="list-style-type: none"> <li>Determine if further actions are needed to enhanced shadow banking oversight in the EU</li> </ul>		<ul style="list-style-type: none"> <li>Legislative proposal on recovery and resolution of CCPs and Communication on the policy orientation in relation to other non-financial institutions</li> </ul>
<b>2013</b>									
<ul style="list-style-type: none"> <li>EU Bank structural reform</li> <li>Proposal on structural reform Q3</li> </ul>	<ul style="list-style-type: none"> <li>EBA assessment on the scope of banking prudential regulation to start (final report in 2014)</li> </ul>	<ul style="list-style-type: none"> <li>EIOPA Reports for Omnibus II trilogue</li> <li>Omnibus II trilogues to be concluded</li> </ul>	<ul style="list-style-type: none"> <li>AIFMD implemented</li> <li>Money Market Funds regulation proposal – issued September 2013</li> </ul>	<ul style="list-style-type: none"> <li>EMIR technical standards adopted</li> </ul>	<ul style="list-style-type: none"> <li>FSB policy recommendations related to repo and securities lending transactions</li> </ul>	<ul style="list-style-type: none"> <li>Establishment of LEI Regulatory Oversight Committee</li> <li>Shortselling regulation implemented</li> <li>MIFID revision / increase the scope of transparency</li> </ul>	<ul style="list-style-type: none"> <li>EFSF review by the Commission</li> </ul>	<ul style="list-style-type: none"> <li>CRA 3 force since 20 June 2013</li> </ul>	<ul style="list-style-type: none"> <li>Internal assessment / works at international level (FSB on resolution and CPSS-IOSCO on recovery of FMI)</li> </ul>
<b>2009-2012</b>									
<ul style="list-style-type: none"> <li>CRD 2 implemented in 2010</li> <li>CRD 3 implemented in 2011</li> </ul>			<ul style="list-style-type: none"> <li>Policy recommendations for Money Market Funds – IOSCO/ESRB</li> </ul>	<ul style="list-style-type: none"> <li>EMIR in force since 2012</li> </ul>				<ul style="list-style-type: none"> <li>CRA 1 into force in 2009</li> <li>CRA 2 into force in 2011</li> </ul>	<ul style="list-style-type: none"> <li>Consultation on nonbank resolution</li> </ul>

<sup>1</sup> All dates are indicative.

Source: Based on information contained in the European Commission Communication on Shadow Banking - September 2013.

## Appendix 2 - A summary of the proposal for a regulation on Money Market Funds

<b>Chapter I – General provisions (Articles 1-6)</b>	
<i>Chapter I deals with general rules, such as the subject matter and scope of the proposed rules, definitions, the authorisation of MMFs and the interplay of the proposed Regulation with existing rules contained in the UCITS Directives and AIFMD.</i>	
Article 1: Subject Matter and Scope	<ul style="list-style-type: none"> <li>■ Scope - applies to all MMFs established, managed and/or marketed in the Union.</li> <li>■ The requirements contained in the Regulation are intended to be exhaustive, i.e. no scope for additional 'gold-plating' at national level.</li> <li>■ MMFs are either UCITS or AIFs that invest in short-term financial instruments and have specific objectives.</li> </ul>
Article 2: Definitions	<ul style="list-style-type: none"> <li>■ Definitions.</li> </ul>
Article 3: Authorisation of MMFs	<ul style="list-style-type: none"> <li>■ Requires that collective investment undertakings be authorised explicitly as MMFs either as part of the harmonised authorisation procedure of UCITS or following the new harmonised procedure laid down in Article 4 for AIFs.</li> </ul>
Article 5: Use of designation as MMF	<ul style="list-style-type: none"> <li>■ Reserves the designation 'MMF' only to funds that comply with the Regulation.</li> </ul>
Article 6: Applicable Rules	<ul style="list-style-type: none"> <li>■ Describes the interaction between the existing UCITS and AIFMD rules and the new MMF Regulation, essentially specifying that compliance with the Regulation shall be incumbent on the manager of the MMF.</li> </ul>
<b>Chapter II – Obligations concerning the investment policies of MMFs (Articles 7-20)</b>	
<i>Chapter II contains the rules on permissible investment policies to be pursued by an MMF, such as eligible assets, diversification, concentration and credit quality of investment assets.</i>	
Article 7: General Principles	<ul style="list-style-type: none"> <li>■ Describes the relationship with the UCITS rules on investment policies and the proposed rules on investment policies of MMF; the UCITS rules as set out in Article 7 do not apply to MMFs.</li> </ul>
Article 8: Eligible assets	<ul style="list-style-type: none"> <li>■ Describes four categories of financial assets that an MMF can invest in: money market instruments, deposits with credit institutions, financial derivatives and reverse repurchase agreements.</li> <li>■ MMFs may not invest in any other assets, engage in short selling of money market instruments, gain exposure to equities or commodities, enter into securities lending or securities borrowing agreements, enter into repurchase agreements or borrow or lend cash, as these asset classes and practices would undermine the liquidity profile of an MMF.</li> </ul>

Articles 9 to 13: Eligibility conditions	<ul style="list-style-type: none"> <li>■ Further describe the eligibility conditions for the four categories of assets that an MMF can invest in.</li> <li>■ Article 13 contains rules aimed at ensuring that the collateral received in exchange of a reverse repurchase agreement is sufficiently liquid to permit its rapid sale when needed.</li> </ul>
Article 14: Diversification	<ul style="list-style-type: none"> <li>■ Detailed rules on the diversification of eligible investment assets that each MMF has to respect, such as upper limits on how much a single issuer can represent (as a percentage of the MMFs assets under management) and rules on maximum risk exposure that an MMF can have vis-à-vis a single counterparty.</li> </ul>
Article 15: Concentration	<ul style="list-style-type: none"> <li>■ Addresses the maximum limits that an MMF (as investor) can hold in a single issuer (concentration limits).</li> </ul>
Articles 16-19: Credit Quality provisions	<ul style="list-style-type: none"> <li>■ Contain detailed rules on an internal assessment of the credit quality of MMF investment instruments, in order to reduce reliance on external ratings.</li> </ul>
Article 20: Governance of credit quality assessment	<ul style="list-style-type: none"> <li>■ Describes the governance requirements governing the internal credit rating process, in particular the role of senior management.</li> </ul>
<b>Chapter III – Obligations concerning the risk management of MMFs (Articles 21-25)</b>	
<i>Chapter III deals with risk management aspects, such as the maturity and the liquidity profile of MMF's assets, soliciting of ratings, and so-called 'know-your-customer' policies and stress testing that an MMF is obliged to introduce. The new rules on weighted average maturity (WAM) and weighted average life (WAL), combined with the requirements on holdings of daily and weekly maturing assets are essential planks in increasing the liquidity profile of an MMF and thus its ability to satisfy investor redemptions.</i>	
Article 21: Portfolio rules for short-term MMFs	<ul style="list-style-type: none"> <li>■ Contains the important provisions on the maturity profile that short-term MMFs have to comply with.</li> </ul>
Article 22: Portfolio rules for standard MMFs	<ul style="list-style-type: none"> <li>■ Contains corresponding rules for standard MMFs which invest in longer term instruments than a short-term MMF. Standard MMFs have different maturity limits, such as WAL and WAM, and can use a lower diversification limit for the investments in money market instruments issued by the same entity. These features are coherent with the objectives of standard MMFs to offer slightly higher returns than money market rates. The characteristics of this MMF category are also coherent with the fact that standard MMFs cannot be managed as a constant NAV MMF (Article 22(5)) and are therefore less prone to massive outflows.</li> </ul>
Article 23: MMF credit ratings	<ul style="list-style-type: none"> <li>■ Prevents an MMF from soliciting or financing an external credit rating and thus complements the rules on internal ratings contained in Articles 16 to 19.</li> </ul>

Article 24: 'Know your customer' policy	<ul style="list-style-type: none"> <li>Introduces requirements on 'knowing-your-customer'. The aim of these rules is to allow MMFs to better anticipate redemption cycles.</li> </ul>
Article 25: Stress testing	<ul style="list-style-type: none"> <li>Contains rules on stress testing.</li> </ul>
<b>Chapter IV – Valuation rules (Articles 26-28)</b> <i>Chapter IV deals with the valuation of an MMF's investment assets and the calculation of the MMF's net asset value per unit or share.</i>	
Articles 26 to 28: Valuation of assets; calculation of NAV per share; issue and redemption price	<ul style="list-style-type: none"> <li>Contain rules on how an MMF has to value its individual investment assets, calculate the net asset value (NAV) per unit or share of the MMF, as well as the frequency of both sets of valuations.</li> </ul>
	<ul style="list-style-type: none"> <li>While there is a general rule favouring mark-to-market valuation, MMFs may also use marking to model, where marking to market is not possible or market data is not of sufficient quality.</li> <li>Only CNAV MMFs may also value assets at amortised cost.</li> <li>The method chosen for calculating the NAV is particularly important when issuing and redeeming shares or units in an MMF (Article 26).</li> </ul>
<b>Chapter V – Specific requirements for CNAV MMFs (Articles 29-34)</b> <i>Chapter V contains specific requirements for MMFs that value their assets at amortised cost or advertise a constant NAV per unit or share or round the constant NAV per unit or share to the nearest percentage point – so-called constant NAV or CNAV MMF.</i>	
Article 29: Additional requirements for CNAV MMFs	<ul style="list-style-type: none"> <li>Contains specific authorisation requirements that apply only to MMFs that use amortised cost to value their assets or advertise a constant NAV per unit or share or round the constant NAV per unit or share to the nearest percentage point.</li> <li>These CNAV MMFs must establish and maintain at all times a buffer amounting to at least 3% of the total value of their assets.</li> </ul>
Articles 30 and 31: NAV buffer	<ul style="list-style-type: none"> <li>Article 30 describes the constitution of the buffer (the 'NAV buffer').</li> <li>Article 31 describes its operation. Most importantly, Article 31 contains the rule that the NAV buffer can only be used to compensate the difference between the constant NAV per unit or share and the 'real' value of a unit or share.</li> <li>In addition, Article 31 contains rules on when the NAV buffer must be debited and when it can be credited.</li> </ul>

Article 32 to 34: Escalation procedure; replenishment of the NAV buffer; powers of the competent authority concerning the NAV buffer	<ul style="list-style-type: none"> <li>■ Contain the obligation to replenish the buffer and the consequences of a failure to replenish the NAV buffer.</li> </ul>
<p><b>Chapter VI – External support (Articles 35-36)</b></p> <p><i>Chapter VI contains rules on external support. It lays down the rule that CNAV MMFs may receive external support only through the NAV buffer, whereas other MMFs are as a rule prohibited from receiving external support.</i></p>	
Articles 35 and 36: External support; exceptional circumstances	<ul style="list-style-type: none"> <li>■ Describes what needs to be understood by external support and contains a non-exhaustive enumeration of instances of external support.</li> <li>■ The aim of these Articles is twofold: to ensure that all 'sponsor' support is granted to CNAV MMFs via the transparent mechanism provided for in Article 31 by having recourse to a pre-established NAV buffer or, if sponsor support is granted to other MMFs, that the competent authorities allow such support only if exceptional circumstances linked to the maintenance of financial stability justify the ad hoc grant of sponsor support (Article 36).</li> </ul>
<p><b>Chapter VII – Transparency requirements (Articles 37-38)</b></p> <p><i>Chapter VII contains transparency rules applicable when MMFs are advertised to investors and reporting requirements to competent authorities.</i></p>	
Article 37: Transparency	<ul style="list-style-type: none"> <li>■ Contains special transparency requirements.</li> </ul>
Article 38: Reporting to competent authorities	<ul style="list-style-type: none"> <li>■ Establishes reporting requirements on all MMFs that apply in addition to the requirements under Directives 2009/65 and 2011/61.</li> </ul>
<p><b>Chapter VIII – Supervision (Articles 39-42)</b></p> <p><i>Chapter VIII contains the applicable rules on supervision of MMFs.</i></p>	
Article 39: Supervision by the competent authorities	<ul style="list-style-type: none"> <li>■ Explains the respective roles of the competent authorities of the MMF and of the manager of the MMF.</li> </ul>
Article 40: Powers of the competent authorities	<ul style="list-style-type: none"> <li>■ States that the powers of competent authorities under the UCITS and AIFM Directives should be exercised also by reference to the proposed Regulation.</li> </ul>
Article 41: Powers and competencies of ESMA	<ul style="list-style-type: none"> <li>■ Refers to ESMA's powers.</li> </ul>
Article 42: Co-operation between authorities	<ul style="list-style-type: none"> <li>■ Provides for the cooperation between authorities.</li> </ul>



**Chapter IX – Final provisions (Articles 43-46)**

*Chapter IX contains rules on the treatment of existing UCITS and AIFs acting as MMFs to ensure their compliance with the new rules on MMFs and a review clause for the application of NAV buffers to certain CNAV MMFs.*

Article 43 : Treatment of existing UCITS and AIFs	<ul style="list-style-type: none"> <li>■ States how existing UCITS and AIFs that meet the criteria of the definition of a CNAV MMF should build progressively the NAV buffer.</li> </ul>
Article 45: Review	<ul style="list-style-type: none"> <li>■ States that the application of NAV buffers to CNAV MMFs that concentrate their portfolios on debt issued or guaranteed by Member States should be reviewed by three years after the entry into force of this regulation.</li> </ul>

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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