Shadow Banking and Money Market Funds

Since the financial crisis, policy makers worldwide have been grappling with how to ensure that saver-taxpayers and the financial system as a whole are protected from future crises. To this end, policy makers are assessing the entities and activities that constitute the financial ecosystem and the potential risks they could pose. In Europe, and elsewhere, the focus has extended beyond banks, brokers, and exchanges to a wide range of entities and activities that have been broadly labelled 'shadow banking'. The broad application and, according to some, negative connotation, of this term create a degree of controversy since many activities often included under this umbrella play important roles in the provision of savings and retirement, in the 'real economy', ensuring companies can obtain the financing they need to operate and grow their businesses and preserving the efficient functioning of capital markets. As part of tackling 'shadow banking', regulators are considering imposing a variety of 'bank-like' rules on market finance activities.

The following paper provides the background to the 'shadow banking' policy debate. The risks and benefits to end-investors, the 'real economy' and financial stability arising from the European Commission's proposal for Money Market Funds Regulation (MMFR) – delivery of which forms a key pillar of the EU's 'shadow banking' agenda – is the focus of this paper.

Shadow Banking

What's in a name?

Shadow banking' refers to the system of credit intermediation that involves entities and activities that are outside the banking system. According to the European Commission, "shadow banks are not regulated like banks yet engage in bank-like activities". Whilst the term 'shadow banking' has been broadly adopted by policy makers the terminology applied to these activities could be misleading, according to some. 'Shadow banking' has also been more narrowly used to refer to certain off-balance sheet activities sponsored by banks and/or activities, where non-banks engage in financing transactions in order to obtain leverage, with very limited visibility for regulators. 'Market finance', on the other hand, might describe the capital market activities that serve end-investor needs and provide funding for companies, contributing to investment and economic growth. Reform of Money Market Funds (MMF) is at the heart of the 'shadow banking' / market finance debate. Securities lending, securities financing through repo and securitisation are other themes discussed under this umbrella term.

European regulatory approach – combining tools from banking and markets supervision

On 4 September 2013, the European Commission released a "Communication on Shadow Banking" together with a proposal for Money Market Fund Regulation. At the global level the Financial Stability Board's (FSB) "Recommendations for Shadow Banking" were published a week earlier. These publications were the latest in a multi-year series of consultations and policy statements from global and European policy makers on 'shadow banking'.

The European Commission has already adopted, or undertaken to adopt, a range of proposals to address 'shadow banking' risk. The approach focuses at the micro-level by imposing additional requirements on certain financial entities e.g. managers of alternative investments under the AIFMD and at the macro-level by introducing regulations designed to strengthen the integrity of the market as a whole, such as central clearing in the OTC derivatives market. To achieve this dual approach to regulating 'shadow banking', the Commission proposes to combine tools most commonly associated with regulating securities markets – disclosure, conduct of business standards, liquidity rules, etc. – with prudential regulation such as capital buffers for CNAV MMFs, and potentially regulating 'collateral chains' by imposing haircuts on individual transactions to curb the perceived risks associated with collateral re-use in a sub-set of securities finance transactions.

Regulating non-banks as banks

The relationship between non-bank financial institutions such as asset managers (which typically provide MMFs and a source of securities that could be eligible for lending) and the overall financial stability has not been fully articulated, a point which the Commission itself recognised in the 2012 Public Consultation on a possible framework for the recovery and resolution of non-bank financial institutions.

The Commission suggests that this link cannot be forcefully made because of the differences in scope and quality of the data regulators hold on bank finance compared to market finance. The industry would contend that there is already a significant amount of data on market finance but it may be that this data still has to be collated in a way which is meaningful for regulators and then collected.

It is perhaps more difficult to make the link because of the very nature of the non-bank business models, which differ significantly from that of banks, as non-banks represent dramatically different risks for the financial system. Therefore, a number of commentators have highlighted the scope for unintended consequences for end-investors, corporate and bank funding arising from adopting a functional "same risk, same rules" approach to regulating 'shadow banking'.

Money Market Funds Regulation

What are Money Market Funds?

MMFs are a 'socially useful' investment vehicle. According to the European Commission, corporate treasurers who need to hold large amounts of cash on a short-term basis and who do not want to put all of their cash in one single bank deposit account mostly invest in MMFs, attracted by their high degree of liquidity and diversification. It is worth noting that pension funds, local governments, public services and charities also invest in MMF to reduce their exposure to bank deposits. MMFs play a critical role in the financial markets and broader economy since they bring together investors and issuers of short-term financial instruments and, via Asset Backed Commercial Paper (ABCP)1, in improving the working capital of European companies, particularly those that have limited access to bank loans and capital markets.

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[1] ABCP should not be confused with the securitisation structures which experienced problems during the 2007-2008 financial crisis (such structure investment vehicles (SIVs) and some mortgage-backed (MBS) and asset-backed (ABS) securities). These securitisation structures had features (leverage, limited liquidity facilities and market triggers) that meant that, during the financial crisis, conduits had to sell underlying assets in the pools to pay investors on maturity dates exacerbating the market distress. In contrast, ABCP conduits are not leveraged and are secured by diversified pools of short maturity, very high quality assets, in fact the best quality asset in which 'prime' MMFs can invest.

MMFs have long been considered a 'safe haven' by investors – a MMF is simply an investment fund, typically a UCITS in Europe, that invests in short-term debt such as money market instruments issued by banks, governments or corporations. However, this perception was challenged in September 2008 when The Reserve Primary Fund "broke the buck" (that is, the market price of the MMF fell below $99.50).

The rationale for MMF reform? 'Made in America'

In the run up to the banking crisis, financial markets had become increasingly illiquid over the summer of 2008 as the crisis deepened and finally froze with the Lehman Brothers bankruptcy on 15 September 2008. Credit-worthy issuers could not issue commercial paper, outstanding short-term liabilities for high quality issuers were being priced at a deep discount, and secondary markets were generally frozen.

The Reserve had made a decision to own a significant amount of Lehman's commercial paper. This company-specific decision was not shared by many others in the industry, and in fact, highlights the idiosyncratic risk associated with credit or maturity structure decisions made by an individual manager. Unfortunately, this fund-specific decision had wider ramifications for the broader industry and ultimately MMF investors.

When investors began to focus on The Reserve Primary Fund's holdings of Lehman paper on September 15 and 16, 2008, they began to redeem en masse. This behaviour quickly spread from The Reserve Primary Fund to all prime institutional MMFs as doubts spread over the solvency of a number of significant banks. Clients had very little transparency into the underlying holdings hence couldn't discriminate between the few MMFs that had issues and those that had not. The redemptions effectively eliminated much of the liquidity within the MMFs requiring many MMF managers to sell 'money good' assets at a discount in order to meet investor redemptions. Finally, MMFs could no longer reinvest maturing securities for most issuers other than US Government entities, eliminating a critical funding source for many banks and important sectors of the economy.

A similar but more muted scenario played out in Europe, reflecting investors differing perceptions of the credit risk of the banking industry in the US, continental Europe and the UK, which in turn depended in part on the actions taken by regulators in the different areas. For example, sterling denominated MMFs saw few outflows in the weeks following the Lehman's bankruptcy; part of the reason was that the British Government quickly "nationalised" RBS and Lloyds so that their debt had the same risk profile as sterling sovereign debt. Euro denominated MMFs experienced modest levels of redemptions (see charts below) reflecting the troubles experienced by Dexia and Fortis. However, the number of European banks in the headlines was small and the European Central Bank very quickly put in place more liquidity lines for banks. This reassured investors about the liquidity of the bank exposure held within Euro denominated MMFs and redemptions ceased.

In contrast, significant parts of the US banking industry were considered insolvent. Consequently, investors switched more challenging levels of assets from US Dollar Prime MMFs into US Dollar Government Liquidity MMFs. Fortunately, the US Government responded quickly to stabilise the situation since at the time US regulation did not provide for gates and fees which the MMF managers could use to stem client redemptions. In particular, the US Treasury's "Temporary Guarantee Program for MMFs" guaranteed money market fund balances as of 19 September 2008 and rapidly returned MMFs to normal functioning.

European MMFs today

European end-investors can currently invest in Constant Net Asset Value (CNAV) MMF and Variable Net Asset Value (VNAV) MMFs. CNAV MMFs seek to maintain a stable €1 per share when investors redeem or purchase shares, whereas VNAV MMFs offer redemptions and subscriptions at a price equal to the fund's NAV per share. Accounting practices, domestic taxation, tradition and familiarity with the products influence the end-investor's decision into which MMF structure they will invest. According to the European Fund and Asset Management Association (EFAMA), the split between both MMF models in Europe is "roughly 50/50". According to the Institutional Money Market Funds Association (IMMFA), MMFs in total represent approximately 6% of the Euro short term funding market and 8% of the sterling short term funding market. These figures shrink to 2% and 6% respectively when taking into account CNAV MMFs only. However, MMFs represent a greater source of short term funding to some banks than others. This is illustrated by the data for CNAV MMFs shown below.

Top six issuers funded by Prime CNAV MMFs [2]

Issuer	Total (€bn)
Crédit Agricole	13,8
FMS Wertmanagement	13,2
Société Générale	11,6
Rabobank	11,3
Sumitomo Mitsui	10,9
BNP Paribas	10,5

Top six issuers funded by Prime and Government Liquidity CNAV MMFs [3]

Issuer	Total (€bn)
US Treasury	24,6
Crédit Agricole	15,5
BNP Paribas	15,5
FMS Wertmanagement	13,6
Société Générale	13,6
Barclays	12,3

Source: Crane Data, October 2013

MMFR – Key issues of debate

Strengthening the product

The European Commission's proposal makes a number of requirements of MMF providers to ensure that the product is increasingly robust. The industry fully supports a number of aspects in the Commission proposal, in particular the introduction of minimum liquidity buffers to ensure MMFs can satisfy client redemptions in a timely manner, the transparency to inform investors about the key features of MMFs, and the implementation of prudent and rigorous internal risk assessment procedures. However, some of the proposed measures go too far and endanger the viability and attractiveness of both CNAV and VNAV MMFs.

Changing the structure of CNAV MMFs

The Commission proposal requires a capital cushion (the 3% buffer) for CNAV MMF that can be activated to support stable redemptions in times of decreasing value of the funds' investment assets. However, there is a consensus view within the industry that the cost of providing the 3% capital buffer effectively eliminates CNAV MMFs as an investment vehicle in Europe. Converting to VNAV MMFs, resorting to reverse Repo (collateralised lending) or concentrating investment in a small number of bank deposits, which would be concentrated in a small number of banking entities, would appear to be the options open to end-investors, absent CNAV MMF being available to end-investors in Europe. Alternative measures such as liquidity fees and gates would offer alternative safeguards to address the Commission's concern about financial stability.

Investment policies of MMFs

The Commission proposal significantly strengthens the rules on permissible investment policies to be pursued by an MMF, notably in the area of eligible assets, diversification and concentration. Whilst the industry can endorse the general orientation taken by the Commission, some of the proposed rules differ substantially from the UCITS rules and will have negative consequences for the financing of the economy, in general, and for credit institutions, in particular.

Use of ratings in MMFs

The European Commission refers to "some internal credit risk assessment by the MMF manager to avoid overreliance on external ratings" but the industry contends that internal credit ratings and prohibition on fund managers seeking fund level ratings will leave MMF investors without an external barometer of MMF performance.

Investments in SMEs and non-rated companies.

The current draft provisions on investment in ABCP impose maturity limits and quality criteria on the underlying assets. Instruments such as auto loans and leases, equipment leases, consumer loans, residential mortgage loans, credit card receivables or any other type of instrument linked to the acquisition or financing of services or goods by consumers are not eligible investments under MMFR. Companies and MMF providers contend that the ABCP provisions will reduce significantly non-bank funding to SMEs and non-rated companies in Europe and contrary to broader public policy goals focused on stimulating market finance and ensuring funding of Europe's SMEs.

[2] Prime MMFs invest primarily in bank debt.
[3] Government Liquidity MMFs invest in Government securities and reverse repo.

Conclusion

'Shadow banking' is a broad global topic and a multi-year agenda for policy makers. The agenda is challenged by a number of factors – differing understandings of the 'shadow banking' as a term, lack of consensus on the risks arising from 'shadow banking' and the rules that should be applied to mitigate 'shadow banking risk', together with a public policy tension between protecting the financial system without detriment to corporate funding or Europe's saver taxpayers. The proposed approach for reform of MMFs in Europe is similarly challenged. Fact driven analysis of the issue regulation is trying to solve for, and thorough consideration of consensus-oriented solutions, are now necessary to advance the agenda in a way that best protects the financial system and Europe's end-investors.

Briefing notes are prepared by the Financial Industry Committee to the European Parliamentary Financial Services Forum. For further information on the subjects raised in the briefs please contact the Secretariat or the Chair of the Financial Industry Committee.

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