Risks associated with non-bank financial intermediation: case-study on MMFs

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Non-bank financial intermediaries:

- Increasingly relevant in the euro area and represent most of the growth in financial assets since 2008
- Increasingly relevant for a monetary policy transmission by reinforcing impulse on long-term interest rates (I. Schnabel)
- Hit strongly both in 2008 (credit crisis) and 2020 (liquidity crisis)

Source: Euro area accounts

Notes: Non-MFIs include ICPF, IFs, and OFIs. MFIs exclude the Eurosystem. Calculations based on market values. Latest observations are for 2021 Q1
Major vulnerabilities of MMFs

• Important providers of **short term financing** for financial institutions, corporates and governments

• Active in **Commercial Paper (CP)** and **Certificates of Deposit (CD)** markets which are less liquid and tend to be illiquid in crisis times

• MMFs’ shares are **redeemable on demand** and hence they are used as cash-like product by investors

• This creates two main **self-reinforcing vulnerabilities**:  
  – Sudden disruptive redemptions (cash-like product)  
  – Challenges in selling their illiquid assets to meet redemptions (limited liquidity of assets)
Need for structural changes

- Large scale sale of assets during the March 2020 market turmoil - much larger than the outflows faced by some funds

- Central bank intervention was successful in stabilising the markets, preserving financial stability and monetary policy transmission

- The crisis nevertheless revealed structural vulnerabilities in MMFs and in short term financial markets

- The FSB has issued on 30 June a report setting out policy proposals to enhance MMF resilience & further work is expected on the matter from other sources
Proposals made by the FSB

- **Reduce destabilizing redemptions:**
  - **Swing pricing:** allow fund managers to reduce the fund’s NAV when outflows exceed a swing threshold and thus impose costs on redeemers.
  - **Absorb losses:** via *minimum balance at risk (MBR)* which cannot be redeemed immediately or *capital buffer* to absorb a material loss in stress situations.
  - **Reduce threshold effects:** by decoupling mandatory fees and gates from regulatory thresholds creating cliff effects or by removing the stable NAV requirement.
Proposals made by the FSB (cont’d)

- Mitigate the impact of large redemptions by reducing liquidity transformation: address the mis-match between the redemption terms of the shares (daily or intra-daily) with liquidity of assets held:
  - Create limits on eligible assets: require MMFs to invest more in shorter dated assets and/or more liquid instruments
  - Create additional liquidity requirements: require MMFs to hold minimum amounts of assets that can be swiftly converted to cash (2 weeks or less)
- Complementary measures on risk monitoring (stress testing) and short-term markets (transparency)
- Other ideas?