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

Quadrilateral meeting (Webex) 9 September 2021

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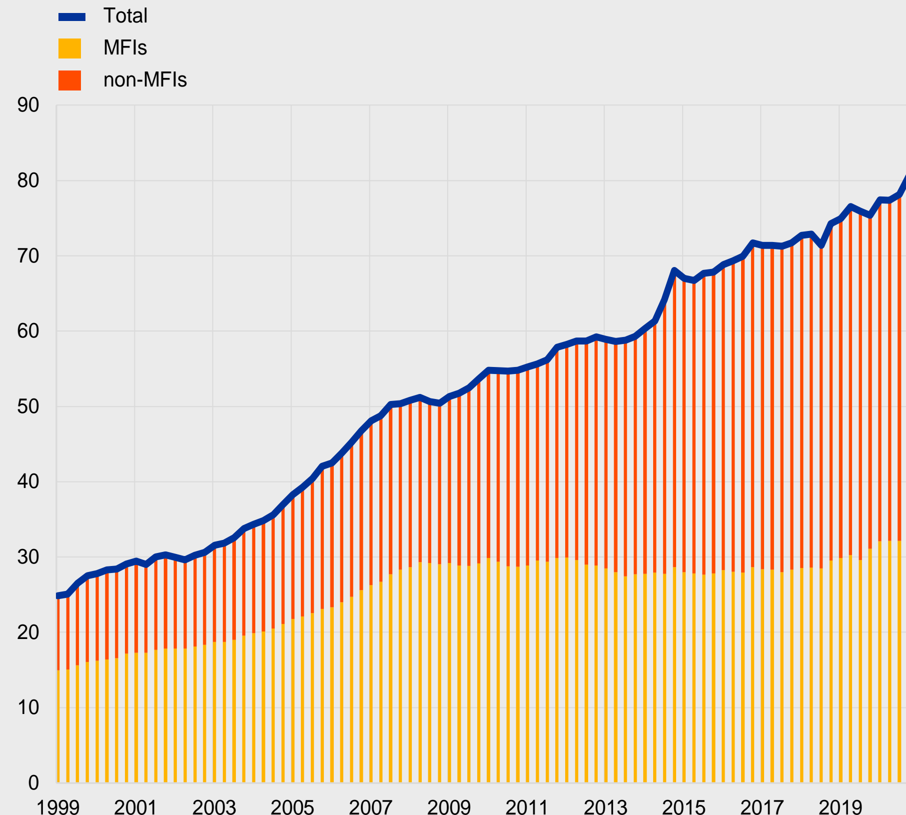
Non-bank financial intermediaries:

- 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)

Evolution of bank and non-bank finance



Source: Euro area accounts

Notes: Non-MFIs include ICPFs, 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

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- 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

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- **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)

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- **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?**