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Towards a more resilient NBFI sector

The resilience of European investment funds, including money market funds (MMFs), was tested by the large and widespread imbalances in the demand and supply of liquidity and the repricing of risk caused by the economic impact of the COVID-19 pandemic. Between 20 February and 20 March 2020, several funds investing in illiquid assets experienced severe outflows, sometimes in excess of liquidity buffers; cumulative redemptions from euro-area high-yield corporate bond funds reached 10 per cent of their assets under management (AUM). Outflows from MMFs in the central week of March reached 5 per cent of their AUM. Redemptions stabilised only after unprecedented central bank interventions that alleviated market stress.

Outflows from open-ended funds and MMFs were driven primarily by institutional investors. Insurance corporations and pension funds invest largely in MMFs primarily for liquidity management purposes. Distress in other parts of the non-bank financial intermediation (NBFI) sector spilled over to the investment funds' sector, amplifying liquidity strains. Recent research shows that institutional funds tend to act procyclically, by actively investing in higher yielding, longer-duration and lower-rated assets as spreads compress, ultimately affecting asset price volatility. In some cases, redemptions from institutional investors occurred due to the need to cover exceptionally high margin calls resulting from heightened market volatility. In other cases, liquidity pressures on institutional investors were associated with a significant mismatch between assets and liabilities; this is the case, for instance, of some unit-linked policies, where insurance companies hold assets whose liquidity profile does not necessarily match with the daily redemptions frequency offered to policyholders. An increased need for cash amplified both intermediaries' demand for highly liquid assets and the potential for forced asset sales by investment funds. Interconnections among non-bank financial intermediaries' balance sheets also contributed to propagating and amplifying the stress.

Non-bank financial institutions experienced broadly similar episodes of stress. In general, liquidity risks in the NBFI sector contributed to the international transmission of the financial shock induced by the pandemic. The "dash for cash" episode in March 2020, for instance, led to severe strains in the dollar funding market, thus affecting entities that borrow in US dollars worldwide.

The increasing role of the NBFI sector in financing the economy and the vulnerabilities seen last year renewed a policy debate on the adequacy of the regulatory and supervisory framework for these intermediaries. Given the global dimension of the issues, the multilateral setting provided by the Financial Stability Board (FSB) and the global Standard Setting Bodies is most suited to adopt a common approach aimed at increasing the effectiveness of the framework and preventing fragmentation.

Last December, Italy assumed the Presidency of the G20, with a commitment to the full implementation of the FSB workplan on NBFI. Building upon the FSB "holistic review", the work program includes a number of key deliverables to be submitted to the G20 later this year, including a report on policy options to enhance MMFs' resilience, as well as analytical work on vulnerabilities in open-ended funds that invest in illiquid assets and on potential procyclicality issues on margin calls.

The G20 Italian Presidency will lay out the stepping stones of a macroprudential approach to NBFI regulation, with the aim of contrasting the build-up of risk in periods of market exuberance and reducing the probability of central bank interventions.