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Financial Stability Board Should Rethink Its Agenda on Non-Bank Financial Intermediation

By Eric J. Pan

Non-bank financial intermediation (NFBI)—encompassing a broad range of capital sources, including broker-dealers, private funds, and open-end funds (OEFs)—is vital for the financing of the real economy, serving as a critical complement to the traditional banking sector. NBFI is generally most active in jurisdictions, like the United States, with robust capital markets that power investment in large and small-and-medium sized enterprises and which have high levels of retail and institutional investor participation. Given the importance of NBFI, the Financial Stability Board (FSB)—an international body composed of the world's most important finance ministries, central banks and regulators—has made it a priority to analyze and propose policies related to the impact of NBFI activities on financial stability.

Regretfully, the FSB's work on NBFI has disproportionately focused on the activities of OEFs—the most transparent and regulated segment of NBFI—and has neglected serious examination of less regulated NBFI segments as well as the critical challenges relating to the supply of liquidity. The FSB's December 2022 report about liquidity mismatch in OEFs[1] shows this blind spot. The FSB should reconsider its work agenda with respect to NBFI and avoid policy proposals that will have the effect of weakening market-based financing.

There is a significant NBFI agenda outside OEFs

The points which the FSB attributes to OEFs represent only a minority of the issues that need to be addressed in the context of ensuring the effective functioning and resilience of NBFI. In its November 2022 update to the G20, the FSB itself has noted:

> [T]he structure of core wholesale funding markets continues to be characterized by limited standardization, low levels of automated trading and turnover even in normal times, and heavy reliance on dealer intermediation. While there are historical reasons why these markets developed in this way, it is possible that their underlying structure contributes to amplifying stress as it may impede efficient use of liquidity that is potentially available to the market.[2]

It is also clear that major structural changes have negatively impacted liquidity in key markets over recent years.

The FSB's own work on government bond markets, for example, says liquidity has become scarcer at times of stress over the past decade because: (i) the stock of gross debt has grown; (ii) government bonds are being used more for hedging and liquidity management; (iii) dealers have a lower risk warehousing capacity; and (iv) non-bank liquidity providers do not increase their market making enough in times of stress.[3]

There is further a recognition that the lack of adequate dealer intermediation capacity is a significant problem. Banks are now committing less of their balance sheets to market-making activities than they used to, further shrinking available liquidity.

Yet the FSB has dismissed too quickly the need to review whether the prudential rules that apply to banks are adversely affecting their market intermediation activities. In US Treasury markets, for example, the supplementary leverage ratio (SLR) is a real problem.[4] It has become a binding regulatory constraint on the allocation of capital by most of the banks who, in their dealer capacity, are major providers of liquidity to the Treasury and Treasury repurchase agreement (repo) markets.

While the FSB seems to acknowledge there are real issues with *liquidity supply*,[5] its actual work program is aimed almost

exclusively on *liquidity demand* and, even within that, has a myopic focus on the role of OEFs. The FSB agenda, outside of OEFs, is unfortunately far less developed and is not being pursued by the FSB with anything like the zeal it shows for OEFs.

Analysis of OEFs is flawed

OEFs provide an accessible and efficient tool for investors. Retail investors in particular need these vehicles to access markets and to save. As such, OEFs offer an important way to channel retail investor savings into the capital markets, which in turn support long-term economic investment. The FSB says that its latest proposals would not "unduly" reduce OEFs' ability to perform their core economic functions because its assessment has recognized the diversity of the OEF sector and the economic benefits the sector brings.[6] The FSB, however, has not made any such recognition in its work agenda.

Instead, the FSB has made policy recommendations about OEFs—with little supporting evidence—that could have an adverse impact on financial intermediation. The FSB should avoid penalizing OEF investors, especially when broader markets benefit from OEFs bringing together those who otherwise may not be able to invest in those markets. It would not be beneficial to push OEF investors toward investing individually or not investing at all due to a perception, absent empirical support, by the FSB that there will be an appropriate reduction in financial stability risk.

The FSB's approach to OEFs relies on propositions which are contestable in some key respects. The FSB is seeking to apply some tools to OEFs that may be neither appropriate for their business model nor their broader purpose and benefits. Recommended new tools are assessed by the FSB largely in theoretical terms rather than how they would operate in practice, while the effectiveness of existing tools is underplayed—even though they act to ameliorate many of the risks outlined by the FSB.

At the outset, there is a definitional issue regarding how the FSB measures those NBFI activities that it believes will be more likely to give rise to vulnerabilities. This subset of NBFI activities, which is subject to extra scrutiny, is described by the FSB in its December 2022 report as a "narrow measure" of non-bank credit intermediation. This narrow measure is composed of NBFI entities that authorities have assessed as being involved in credit intermediation that involves maturity or liquidity transformation, or leverage or imperfect credit risk transfer "… that may pose bank-like financial stability risks."[7] OEFs are assessed as accounting for *three-quarters* of this narrow measure.

While the FSB acknowledges that its chosen narrow measure is "cautiously defined," its approach still has several critical limitations that impair any cohesive risk identification, measurement, and/or assessment.

First, the measure assesses potential vulnerabilities *before* considering any existing policy measures or risk management tools that may ameliorate some, if not all, of the purported financial stability risk captured by the five predetermined economic functions. In other words, by definition, OEFs *always* will be captured within the FSB's narrow measure, irrespective of whether risks relating to them are already recognized by regulators and appropriately mitigated by existing policy measures. Such an approach must surely be flawed as it only captures hypothetical, not actual, risk.

Second, with the narrow measure defined on this basis, new FSB recommendations will have no measurable or measured impact. OEFs will continue to be in the narrow measure no matter what.

Third, by focusing on only five predetermined economic functions, the narrow measure also limits the FSB's ability to address other activities. Any unmitigated risks outside the narrow measure—even if quantitatively more severe—are not captured at all.

"Structural mismatch" in OEFs needs to be set in wider context

The FSB may argue that it has based its work around the notion that OEFs embody a structural liquidity mismatch due to the difference between the daily redemption offered and the amount of time needed to liquidate holdings to satisfy such redemption requests. In the FSB's view, this mismatch can amplify shocks as it creates a first mover advantage for redemptions during crises.

The FSB rightly acknowledges in its report that *OEFs are only one part of a broader market ecosystem*, and the impact of their activities on the functioning of core markets will depend on factors such as their scale, size of trading, and, most importantly, the footprint, behavior, and interaction of other investors in those same markets. However, the FSB does not follow through on the implications of this insight.

Deep, transparent, and competitive capital markets help to reduce transaction costs by narrowing bid-ask spreads for securities and reducing brokerage commissions, thereby enhancing liquidity transformation. It is important to note that OEFs, unlike banks and some other parts of the financial ecosystem, do not have large balance sheets and do not employ significant leverage.

OEFs engage in liquidity transformation, but the FSB exaggerates the significance of this because OEFs are very liquid in comparison with other financial intermediaries such as banks, hedge funds, and private equity funds. Moreover, it would be wrong to make OEFs the sole focus of policy thinking about "structural mismatch" because *liquidity transformation is a characteristic of*

financial intermediation more generally.

Investment Company Institute (ICI) economic research, for example, has demonstrated that assets held through OEFs are no more susceptible to first-mover dynamics than assets held directly by investors.[8] Indeed, in its latest paper on OEFs, the FSB goes so far as to acknowledge that "competition for finite asset liquidity among different types of investors that hold overlapping portfolios has the potential to produce first mover advantage at a market-wide level."[9] That acknowledgement, however, is relegated by the FSB to a mere footnote and dismissed as not being the focus of the assessment. *Should this important aspect of market functioning not be a higher priority for the FSB*? It seems logical that, if any first-mover advantage at the market-wide level damages market resilience, the remedy would be to develop policies that address all market participants, not solely OEFs. Yet the FSB's policy recommendations seem to ignore this important point.

In short, the FSB should follow through on its stated approach of adopting a holistic view to financial markets.

Events of March 2020 have been misread

The FSB's agenda has been further skewed by the fact that it has mischaracterized important aspects of OEF behavior during March 2020. The FSB's view is that many OEFs—particularly corporate bonds funds—experienced liquidity pressure and valuation challenges, facing large redemption requests and deteriorating market liquidity triggered by the flight to safety and "dash for cash."

This does not accord with the data.

In relation to corporate bonds, for example, US core bond mutual funds sold only $11 billion, net, of US investment grade corporate bonds in the first three weeks of March 2020.[10] Indeed, some fund managers, motivated by favorable prices, wanted to *buy* investment grade corporate bonds but were unable to locate sellers. Further, ICI estimates that these funds' very small net sales accounted for only a tiny fraction (7 basis points) of the sharp (313 basis points) increase in yield spreads on US investment grade corporate bonds that month.[11] These results contradict contentions that bond mutual funds amplified stresses in the investment grade corporate bond market during March 2020.

The FSB should look closely at this research, or it risks developing misguided policy prescriptions.

Swing pricing is not the panacea

An example of where the FSB is heading the wrong direction appears in its recent Assessment of the 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds. In this report, the FSB considers the imposition of liquidity management tools (LMTs), especially swing pricing.

The FSB asserts that swing pricing, by allocating explicit and implicit liquidity costs to redeeming investors, would address first-mover advantage dynamics at the source. No empirical evidence has been presented to back this assertion about first-mover advantage dynamics.

At the same time, there is plenty of evidence showing that applying swing pricing to US-regulated OEFs would be extremely difficult to carry out from an operational standpoint and require very costly changes to funds. ICI has done an intensive analysis of these challenges in its recent letter to the US Securities and Exchange Commission.[12] Mandating swing pricing could result in funds becoming more expensive to retail investors who access them or cause funds to become unavailable.

Instead, existing tools need to be refined

With swing pricing being unproven as helpful to financial stability, as well as operationally challenging, we need to look to other tools to appropriately manage OEF risks. Given the variety of funds and circumstances, funds need to be able to calibrate how to address the costs of exiting and entering investors in a way which balances the interests of all investors. In that context, the FSB appears to dismiss too quickly the effectiveness of existing liquidity buffer provisions, including their interaction with fund investment strategies and redemption terms.[13]

As the FSB notes, the International Organization of Securities Commissions (IOSCO)'s Recommendations for Liquidity Risk Management for Collective Investment Schemes (February 2018)[14] already expect managers to determine appropriate liquidity thresholds which are proportionate to an OEF's redemption obligations and liabilities. Most jurisdictions already have specific requirements, such as limits, on investing in illiquid assets, and many jurisdictions provide detailed asset eligibility requirements or identify permissible assets to ensure OEFs invest in liquid assets. This is a point supported by previous IOSCO work.[15]

Many jurisdictions already require OEFs to maintain sufficient liquidity and/or determine an internal liquidity threshold corresponding to the fund's characteristics such as investment strategy, investor profile and redemption terms. Some jurisdictions have put in place specific measures to address consistency between asset liquidity and redemption terms, including requirements for dealing

frequencies that depend on the composition of an OEF's portfolio, or for the use of notice periods.

Given this extensive base of work, it would be more effective and proportionate to consider appropriate adjustments of existing liquidity requirements. This would include removing any "threshold"-type linkages to the application of other tools, which could have perverse effects on investor behavior. For example, if breaching regulatory liquidity thresholds triggers restrictions on ability to redeem shares, this may prompt investors to pre-empt the crossing of the threshold.

Final Observation

The FSB agenda on NBFI is currently anchored in only a subset of the relevant analytical points, which the FSB had earlier identified. And, even then, several of these points have been applied in ways that lead to unsupported conclusions. The FSB should take into account fully the role OEFs play in markets and their value to investors, especially retail investors. To this end, the FSB should seek to address market-based finance holistically and focus on tackling crucial *liquidity supply issues*. Disregarding these points will undermine any reform efforts focused on liquidity demand.

Notes

[1] Financial Stability Board, *Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds* (Dec. 2022), available at https://www.fsb.org/wp-content/uploads/P141222.pdf.

[2] Financial Stability Board, *Enhancing the Resilience of Non-Bank Financial Intermediation: Progress Report* (Nov. 2022), available at https://www.fsb.org/wp-content/uploads/P101122.pdf at 16.

[3] Financial Stability Board, *Liquidity in Core Government Bond Markets* (Oct. 2022), available at https://www.fsb.org/wp-content/uploads/P201022.pdf.

[4] *See, e.g.*, Group of Thirty, *U.S. Treasury Markets: Steps Toward Increased Resilience* (June 2022), available at https://group30.org/images/uploads/publications/G30_Treasury-Mkts-UPDATE_Final_Report.pdf ("With leverage ratios, especially the SLR, currently the binding regulatory constraint on capital allocation at many of these banks, they are discouraged from allocating capital to market intermediation in the Treasury markets and especially in the Treasury repo markets, the liquidity of which is critical to all dealers in Treasury securities and other leveraged providers of Treasury market liquidity.").

[5] Financial Stability Board, *Enhancing the Resilience of Non-Bank Financial Intermediation: Progress Report* (Nov. 2022), available at https://www.fsb.org/wp-content/uploads/P101122.pdf at 26-27.

[6] *See* Financial Stability Board, *Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds* (Dec. 2022), available at https://www.fsb.org/wp-content/uploads/P141222.pdf.

[7] Financial Stability Board, *Global Monitoring Report on Non-Bank Financial Intermediation 2022* (Dec. 2022), available at https://www.fsb.org/wp-content/uploads/P201222.pdf.

[8] Direct investors and indirect investors via mutual funds compete for finite market liquidity when they or their funds sell assets, because, especially for less liquid assets, divesting large quantities can depress asset values below their fundamental values for some time before they recover. This competition for finite market liquidity generates an incentive for all types of investors to sell before others are selling to avoid holding assets with such temporarily depressed values. This market-level driven first-mover advantage leads to selling dynamics that are observationally equivalent to the behavior of mutual funds investors. However, instead of falsely attributing the behavior of fund investors to the structure of mutual funds, *the underlying motive for selling to avoid being affected by others selling in a market with limited liquidity is the same for all, direct and indirect, investors and drives this behavior*. Hence, any policy response to unilaterally constrain mutual funds and their investors rather than address the limited market liquidity that is the source for the behavior of all investors in the first place is ineffective. *See* Christof W. Stahel, *Strategic Complementarity Among Investors with Overlapping Portfolios*, ICI Working Paper (Sept. 2022), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3952125.

[9] *See* Financial Stability Board, *Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds*, (Dec. 2022), available at https://www.fsb.org/wp-content/uploads/P141222.pdf at 9.

[10] *See Core Bond Mutual Funds Had Little Impact on the Investment Grade Corporate Bond Market*, ICI Viewpoints (Aug. 2022), available at https://www.ici.org/viewpoints/22-view-bondfund-survey-5.

[11] *See Policymakers Need to Focus on Economic Fundamentals and Not Blame Bond Mutual Funds: Examining the Evidence of Investment Grade Corporate Bond Spreads in March 2020*, ICI Viewpoints (July 2022), available at https://www.ici.org/viewpoints/22-

view-bondfund-survey-4.

[12] Letter from Eric J. Pan, President and CEO, ICI, to Vanessa Countryman, Secretary, SEC (Feb. 14, 2023), available at https://www.ici.org/system/files/2023-02/23-cl-sec-liquidity-proposal.pdf.

[13] There is also theoretical support for the proposition that liquidity buffers are beneficial and can reduce the amplification of shocks. *See, e.g.*, Giovanni di Iasio, et al., *Macroprudential Regulation of Investment Funds*, ECB Working Paper 2695 (Aug. 2022), available at https://www.ecb.europa.eu/pub/pdf/scpwps/ecb.wp2695~22731e2f05.en.pdf.

[14] *See* IOSCO, *Recommendations for Liquidity Risk Management for Collective Investment Schemes*(Feb. 2018), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD590.pdf.

[15] IOSCO, *Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 Survey to Members* (Dec. 2015), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf.

Eric J. Pan is President and CEO of the Investment Company Institute.
