Monetary and Capital Markets Department

Investment Funds and Financial Stability

Policy Considerations

Prepared by an IMF staff team led by Antonio Garcia Pascual, Ranjit Singh, and Jay Surti

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Executive Summary

The marked growth of investment funds—particularly of money-market and open-end funds over the last two decades and especially after the global financial crisis (GFC)—has been a significant driver of the rising prominence of nonbank financial intermediation. These funds are critical to intermediation in core financial markets such as the United States Treasuries and corporate bonds and are a crucial driver of global capital flows to emerging market and developing economies.

A key feature of most investment funds' business models is to offer daily liquidity to investors, similar to that offered by banks on their demand deposits.[1] As these funds have ventured beyond large-cap equity and advanced economy sovereign bonds into corporate debt (including speculative-grade), real estate, and emerging market securities, their ability to make good on their promise of daily liquidity has come under increasing scrutiny and has repeatedly been under pressure in the face of occasional exogenous shocks. Unlike banks, investment funds generally do not benefit from public backstops in the form of discount window access or deposit insurance and an extensive literature has documented that they can be subject to fire sale externalities, illiquidity spirals, and, occasionally, even run risk.

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[1]There are some exceptions, such as certain mutual funds that offer monthly or quarterly liquidity. However, such funds represent a small fraction of total assets under management. We are generally excluding private funds including private equity, hedge funds, and family offices from this paper, which tend to feature lock ups.

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These adverse feedback loops became evident during the turmoil triggered by the onset of the global COVID-19 pandemic that started in January 2020 and accelerated markedly in March 2020. As risk asset prices dropped rapidly in response to the pandemic shock, investors' risk assessment grew sharply and triggered portfolio reallocation in favor of relatively safe assets, leading to a dramatic sell-off of risky assets. As emphasized in the April 2020 and October 2020 Global Financial Stability Reports (GFSR) and our previous analyses, the selloff amplified the initial shock as the rise of risk aversion, market illiquidity, and adverse feedback loops amplified the initial fall of asset prices. Under such stressful conditions, the liquidity mismatch between these funds' assets and liabilities contributed to shock amplification, with investor outflows and the associated asset fire-sales by fund managers combining to eventually threaten broader financial stability. This motivated central banks to step in aggressively via repurchase agreements and outright asset purchases that were large, quickly scaled up, and broadly spread across asset classes. Arguably, these adverse feedback loops in the investment funds sector complemented selling pressures from other banks and nonbank financial institutions.

Policy makers were alarmed by the speed and magnitude of the amplification of asset price declines across markets and by the sudden illiquidity, including in the most liquid asset market of all—the US Treasury market. Selling pressures were amplified across a diverse set of institutions, including investment funds. While longer-term yields fell sharply throughout February and early March, in mid-March longer duration Treasuries sold off aggressively, leading to a sudden rise in yields, indicating that longer-term Treasury securities were no longer traded as a hedge asset.

All of these developments raised questions about the effectiveness of post-GFC financial sector reforms, and specifically, whether the reforms went far enough, to enhance financial market resilience to shocks. Concerning investment funds reforms, the focus has been on the adequacy of existing risk management and supervisory tools.

In this context, we identify four key policy objectives. First, we propose to address incentives of investors to front run others when adverse shocks occur. Second, we analyze the inherent tension between daily liquidity and exposure to illiquid assets. Third, we argue that frictions in some important asset markets need to be addressed. Fourth, we advocate for mitigating cross-border spillovers to emerging market and developing economies.

The paper identifies specific tools targeted to address these objectives. Investors' early exit incentives can be best addressed by increasing the value of waiting to sell fund shares. And the risks inherent to the sector's liquidity and maturity transformation can be reduced through a combination of liquid-

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ity management tools of increasing intensity to be deployed sequentially. In terms of liquidity backstops, market-based solutions, such as dealer pre-commitments or more robust trading arrangements, should be the first line of defense, buttressed in the event of tail episodes, by central bank emergency liquidity support. When combined with appropriate domestic macroeconomic and macroprudential policies, these measures can also lessen cross-border contagion, a risk increasingly material to financial stability in emerging markets and developing economies. The overall benefits of our policy recommendations, especially the reduced risk of market turmoil and financial instability, would carry significant welfare gains for issuers and investors that would more than offset any adjustment costs borne by them.

The paper's analysis underscores the importance of the ongoing Financial Stability Board-led process of identifying policy options, involving national authorities and the International Organization of Securities Commissions and other standard setters. In this context, the global nature of the investment fund business and fungibility of financial flows makes it vital to ensure consistency of global policy choices that can secure financial stability by precluding regulatory arbitrage.

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