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Shadow banking and financial stability: European money market funds in the global financial crisis

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ABSTRACT

When the troubles in the subprime markets began surfacing 2007, developments unfolded rapidly in the European MMF industry. The industry suffered from asset price drops and investor redemptions. But the difficulties of the MMF industry also spread to the banking sector and contributed to general financial instability that prevailed in 2007–2009. In this article, we describe the main events and developments of the European MMF industry during the global financial crisis. Based on these observations, we analyse the transmission channels through which financial instability may spread from the MMF sector to the wider financial system. Insofar, our article contributes to the understanding of how other financial intermediaries and shadow banking may affect financial stability. A number of policy conclusions on shadow banking and financial stability are also provided.

Abbreviations: ABCP, Asset backed commercial paper; ABS, Asset backed security; AMF, Autorité des marchés financier; CD, Certificate of deposit; CESR, Committee of European securities regulators; CNAV, Constant net asset value; CP, Commercial paper; CSSF, Commission de surveillance du secteur financier; EBA, European banking authority; EFAMA, European fund and asset management association; EONIA, Euro overnight index average; ESMA, European securities and markets authority; ESRB, European systemic risk board; EURIBOR, Euro interbank offered rate; FRN, Floating rate notes; ICI, Investment company institute; IMMFA, Institutional money market funds association; MMF, Money market fund; NAV, Net asset value; UCITS, Undertakings for collective investment in transferable securities; VNAV, Variable net asset value.

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1. Introduction

Money market funds (MMFs) have a long history of delivering cash management services with high levels of liquidity, stability in principal value and competitive market-based yields. They have been thought of as immune to runs and an important contributor to financial stability. Had not the subprime crisis occurred, this would perhaps still have been the prevailing belief. But when the troubles in the subprime markets began surfacing in 2007, developments unfolded rapidly in the MMF industry. Both in Europe and in the US, the industry suffered from asset price drops and enormous investor redemptions. And the difficulties of the MMF industry spread to the banking sector and contributed to the general financial instability that prevailed in 2007–2009.

Although by now it is well known that the shadow banking system played a contagious role in the global financial crisis (Pozsar et al., 2010; Tucker, 2010), the absolute bulk of financial stability research has focused on the banking sector.[1] Studies on the role of MMFs in the crisis are few and primarily focused on developments in the US MMF industry (Dwyer and Tkac, 2009; McCabe, 2009; Brunnermeier, 2009; Baba et al. 2009). In response to these limits in the scope of academic research on financial instability and shadow banking, this article:

- Describes main events and developments of the European MMF industry during the global financial crisis of 2007–2009;
- Analyses transmission channels through which financial instability may spread from the MMF sector to the wider financial system; and
- Draws some policy conclusions on shadow banking and financial stability.

The article strives to capture the main events and the most vital actions and responses of the MMF industry and other key actors involved. A caveat is nevertheless necessary – it is of course impossible to provide a comprehensive account of all events. Not least because actions taken in response to financial instability often include elements that may have repercussions on corporate or political reputation, and therefore remain hidden from the public.

In the following section, we provide some relevant background information on the regulation and structure of the European MMF industry. Thereafter, Sections 3 and 4 describe the events and development of the MMF industry during the financial crisis. The first focuses on the troubles following disruptions in the markets of asset backed securities (ABSs) in 2007; the second on the period that followed the collapse of Lehman Brothers. Section 5 concludes by analysing the role of MMFs in financial stability and draws a number of lessons for policy.

2. European money market funds – background

MMFs began appearing in the US in the early 1970s, following regulatory limits to interest payable on bank deposits (Dwyer and Tkac, 2009). It took about a decade before the first MMF was created in Europe, but the reasons were similar – limits to interests on deposit accounts induced French asset managers to offer funds that could offer similar returns and characteristics as bank deposits, but without any restrictions on the interest yielded (Le Coz, 2009).[2] Over the years, European MMFs have grown into a EUR 1.3 t industry dominated by France, Luxembourg and Ireland (see Fig. 1).[3]

Up to recently, there has been no harmonization or regulation at the EU level on what constitutes a MMF (for recent developments, see Section 5). Typically, a MMF is set up as an Undertaking for

[1] The term shadow banking is commonly understood to encompass the range of non-bank institutions that to various extents provide liquidity services, maturity mismatch or leverage. It was coined by (McCulley, 2007) who views the development of MMFs as the birth of the shadow banking system (McCulley, 2010).

[2] Since 2004, such caps do no longer exist, but MMFs have still offered attractive yields in comparison to current accounting interest rates (Fitch Ratings, 2008).

[3] It is noteworthy that many MMFs that are domiciled in Ireland and Luxembourg are managed elsewhere, e.g., UK and Germany (Bengtsson and Delbecque, 2011).