ICI VIEWPOINTS

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ICI Commentary: What the Bank of England's System-Wide Exploratory Scenario Exercise (SWES) Tells Us

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In late November 2024, the Bank of England published the results of its first system-wide exploratory scenario (SWES) exercise—a year-long effort to model how various financial entities, including non-bank financial intermediaries (NBFIs) and banks, would respond to a significant liquidity shock. While the findings are inherently tied to the specific stress scenario created for the exercise, the results showed that open-end funds (OEFs) and money market funds (MMFs) were neither the catalysts for, nor the primary drivers of, market-wide liquidity stress events. This key takeaway—derived from the SWES using the Bank of England's assumptions—closely resembles conclusions of the real-world analysis ICI conducted on US bond mutual funds' and MMFs' impact on US fixed income markets during March 2020.[1]

Dispelling the Longstanding Narrative on OEFs

Following the COVID-19 market shock in March 2020, many US and international financial stability regulators fixated on bond OEFs and MMFs as the primary source of financial instability. The prevailing belief expressed in fora like the Financial Stability Board and the Financial Stability Oversight Council was that bond OEF and MMF redemptions triggered mass selloffs of assets that significantly distorted markets and exacerbated liquidity stress. ICI disagreed, presenting detailed analysis demonstrating that OEFs and MMFs were not the primary drivers of liquidity deterioration in comparison to much larger roles played by macroeconomic conditions and collective sales by other financial market participants. Despite ICI's efforts, the financial stability community continued to repeat its narrative about the central role of bond OEFs and MMFs in liquidity events as if it was undisputed fact.

Hopefully, the SWES will succeed in changing some minds. The results of the exercise show that OEFs and MMFs demonstrated resilience in managing liquidity stress and are just one of many components in the financial ecosystem.

SWES Results: Liquidity Pressures Driven by Margin Calls, Not Fund Redemptions

An important finding from the SWES exercise is that OEFs and MMFs were ***not*** the primary source of liquidity stress. The drivers of liquidity needs under the SWES scenario were:

- **Variation margin calls:** Representing **85%** of liquidity pressures, reflecting heightened market volatility.
- **Initial margin calls:** Making up **8%** of liquidity demands.
- **Investor redemptions:** Accounting for only **7%** of liquidity needs, including from OEFs and MMFs.

These figures underscore that redemption activity—long theorized as a potential major destabilizing factor in market stress events—was marginal compared to the outsized impact of margin calls. This should be a wake-up call for those who have continued to disproportionately focus on funds as the primary risk to financial stability.

Resilience of OEFs and MMFs: Not Just a Quirk of This One Scenario

Yes, the SWES exercise was scenario-specific, but its findings provide valuable insight on the resiliency of OEFs and MMFs in the United Kingdom. OEFs and MMFs were able to meet redemption requests without significant difficulty. This is not just a lucky outcome of this particular scenario—it reflects that:

- The pooled structure of OEFs did not inherently create systemic instability.
- Indirect sales by OEFs were a minor part of total market stress—for example, indirect OEF-driven sales of sterling corporate bonds and asset-backed securities (ABS) in the exercise totaled just £4.5 billion, a negligible fraction of the overall market.
- Liquidity pressures were concentrated elsewhere in the financial system—***most notably, direct sales by insurance companies and pension funds, which made up 63% of sterling corporate bond sales***.

Some key findings from the excise include the following:

1. Money Market Funds Demonstrated Resilience

The SWES exercise revealed that all participating MMFs experienced redemptions following an initial shock to asset prices as investors needed cash to cover margin calls. Despite these outflows, MMFs successfully met redemption requests using their liquid assets. Notably, MMFs representing about 50% of the sterling MMF sector did not face significant pressure due to their practice of maintaining liquidity levels above regulatory requirements. This outcome aligns with ICI data[2] showing that US MMFs tend to hold liquid assets beyond the mandated minimums as a prudent business practice.[3]

2. Open-End Funds Demonstrated Resilience

a. Liquidity Mismatch Risk

OEFs, which allow investors to redeem their holdings on demand, are often cited by policymakers as a potential source of liquidity strain during market stress. However, net redemptions from investors were relatively small—£7 billion from insurers—and OEFs had no issues meeting redemption requests during the SWES exercise.[4]

b. Correlated Behavior Across Funds

The SWES report raised concerns about theoretical correlated behavior among OEFs during market stress, which could amplify financial instability. This refers to the risk that multiple funds in similar asset classes may experience redemptions at the same time, potentially triggering a “fire sale” effect.

However, the SWES results ***did not*** support this theory. The specific examples cited—ABS funds and sterling corporate bond funds—showed negligible sales into their underlying markets (£2.5 billion and £2 billion, respectively) over the two-week timeframe, indicating limited impact on market stability.

c. Access to Liquidity and the Role of Banks

One notable finding was the disparity between fund managers’ expectations of accessing additional repo financing and the reality of banks’ willingness to provide it. More than half of fund managers viewed additional repo as an option for managing liquidity needs, yet over a third of them would not have been able to secure additional repo financing from the banks participating in the exercise. It is important to note, however, that repo markets are global. While UK-based “SWES” banks may have been reluctant to provide additional repo to OEFs, other banks (not participating in the exercise—for example, non-UK banks) may be willing to engage in repo transactions to satisfy liquidity needs.

3. Ineffectiveness of Liquidity Fees to Stem Redemptions by Insurance Companies and Pension Funds

The SWES report found that liquidity pressures stemmed ***primarily*** from the insurance and pension sectors, which were considered insensitive to deteriorating prices. Direct sales by these sectors accounted for 63% (£5 billion out of £8 billion) of total sales in sterling corporate bonds during the scenario. Indirect sales through OEFs accounted for only £1 billion. This raises questions about the effectiveness of swing pricing and redemption fees as tools to improve financial stability. The exercise showed that these mechanisms did not meaningfully reduce sales but instead shifted from indirect sales to direct asset sales by insurers and pension funds.

4. Regulators Have Created a System Where Buffers Are Not Effectively Utilized

The SWES report highlighted that NBFI firms sold assets to rapidly recapitalize their liquidity buffers, suggesting that regulatory frameworks have inadvertently created a system where liquidity buffers act as a “concrete pillow” rather than a shock absorber. Policymakers should consider the balance between setting adequate buffer levels to promote stability and avoiding levels that could incentivize destabilizing behavior.

ICI has previously pointed out this issue in the context of MMFs. During the market stress of March 2020, MMFs maintained 30% weekly liquid assets (WLA) in line with regulatory requirements. However, this buffer acted as a barrier rather than a tool to absorb shocks. ICI’s analysis found that ***MMFs could have met record-high redemption rates for several weeks without central bank assistance if they had been permitted to draw down on their WLA buffers***.[5]

Implications for Other Jurisdictions Considering Similar Exercises

Regulators in other jurisdictions considering their own system-wide stress exercises should approach them without preconceived notions about OEFs as primary drivers of financial instability. The Bank of England’s findings highlight that while OEFs experience liquidity pressures, they were not the dominant force amplifying stress across financial markets. Instead, these exercises should be designed to evaluate how different market participants interact under stress holistically, rather than reinforcing a pre-determined regulatory narrative.

A Call for a More Nuanced and Objective Understanding of Financial Stability

The SWES exercise serves as an important reminder that financial stability is not about singular actors—it's about the interplay between different market participants. Although the outcomes were a product of the specific scenario tested by the Bank of England, the fundamental market dynamics and interrelationships revealed by the exercise provide valuable insights on possible vulnerabilities that bear close watch in a stress event. Policymakers should acknowledge that financial instability is rarely caused by a single sector and instead focus on a broader, data-driven approach to assessing risk.

The SWES exercise reaffirms what ICI data has shown for years: OEFs and MMFs have not been the primary source of liquidity strains in stress events following the global financial crisis, and recent regulatory enhancements have further strengthened their resilience. While no stress test can predict every crisis, this exercise offers a valuable lesson for global regulators: understanding financial market stability requires looking beyond long-held assumptions and investigating where systemic vulnerabilities truly lie.

For policymakers and regulators who have spent years framing OEFs and MMFs as the current epicenter of market fragility, the SWES results should prompt reconsideration of policy priorities. A well-functioning financial system requires policies underpinned by clear-eyed and objective empirical analysis—not misplaced theoretical narratives.

Notes

[1] See, *ICI Viewpoints*, "On Closer Look, a Very Different Picture of Funds' Role in the Commercial Paper Market," April 21, 2021, at www.ici.org/viewpoints/21_view_mmf1 and a series of *ICI Viewpoints* on bond mutual funds' role in the fixed income markets at https://www.ici.org/covid19.

[2] See, *Monthly Money Market Fund Holdings January 2025*, Investment Company Institute at www.ici.org/research/stats/mmfsummary/nmfp_01_25. In the United States, MMFs are required to hold a minimum of 25% in daily liquid assets and 50% in weekly liquid assets.

[3] The SWES exercise further revealed that MMFs faced less redemption pressure from insurance companies and pension funds than in previous crises. This outcome was not a fluke, but a result of concrete steps taken by the industry in the past few years to better prepare for stress events. Most notably, pension funds and insurance companies pledged more non-cash collateral to meet margin calls, thereby reducing their need to redeem MMF shares in the exercise.

[4] Although the SWES report noted that "fund managers struggled to predict the extent to which redemptions would be driven by fund investors' liquidity needs," the exercise did collect anticipated OEF redemptions from pension fund and insurance company participants based on their liquidity needs and waterfalls, providing an internal cross-check within the SWES on expected OEF redemptions.

[5] See, "Experiences of US Money Market Funds During the COVID-19 Crisis," Investment Company Institute, November 2020, at pages 35-36.

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