Who Bears the Liquidity Risk? Comparative Analysis of Bank Liquidity Supports to Non-Bank Financial Institutions

Xinyue Chen*

This paper investigates the legal and regulatory treatment of bank-provided liquidity support to non-bank financial institutions (NBFIs). The focus is on those NBFIs that are structurally exposed to liquidity risk and therefore prone to seek bank support both during idiosyncratic liquidity risk and during periods of systemic stress. The issue raises fundamental questions about interconnectedness between banks and NBFIs, the allocation of risks between different sectors of the financial system, and the appropriate limits of regulatory intervention.

Although often overshadowed in public debates by the regulation of banks, NBFIs are essential to the functioning of modern money markets. They provide cash-like instruments to investors seeking short-term, safe, and liquid investments, while simultaneously serving as an important short-term funding source for banks themselves. When NBFIs come under liquidity stress, bank-provided liquidity support has the potential to stabilize markets by stabilizing investor runs and mitigating fire-sale losses. At the same time, however, such support transfers risks from the NBFI sector onto banks—institutions that are already systemically significant and subject to prudential regulation precisely to safeguard financial stability. Whether and how such support should be permitted is therefore a pressing regulatory question. We see regulatory approaches across jurisdictions vary considerably with respect to the permissibility of liquidity support and the prudential treatment of such support under bank liquidity regulation. These divergences can be traced to jurisdiction-specific differences in money market structures, investor composition, regulatory traditions, and the broader framework governing NBFIs.

This paper addresses three central research questions: (1) **What are the benefits and risks of bank-provided liquidity support to NBFIs?** (2) **Why do regulatory frameworks in the U.S., EU, and China adopt different regulatory attitudes towards liquidity support?** and (3) **How can prudential regulatory rules prevent regulatory arbitrage and preserve financial stability?** By engaging these questions, the paper contributes to legal scholarship in two ways. First, it provides a detailed analysis of the trade-offs inherent in permitting or restricting liquidity support. Second, it highlights the distributive choices embedded in regulatory design across jurisdictions, showing how these choices determine whether risks are borne by banks, investors, or taxpayers. In this way, the paper bridges legal theory and financial stability, demonstrating how technical rules governing liquidity support raise broader questions of money market efficiency, systemic risk regulation, and distributive justice.

I. Understanding NBFIs and Liquidity Risk

The term *non-bank financial institution (NBFI)* is broad, encompassing all financial institutions that, unlike banks, cannot accept deposits but can nevertheless perform functions such as investment, lending, or risk pooling. Many NBFIs, such as insurance companies or pension funds, are relatively stable. But there are also some NBFIs that perform *liquidity*

* PhD Candidate at Amsterdam Center for Law & Economics, University of Amsterdam.

transformation—the process of issuing short-term liabilities while investing long-term or illiquid assets—similar to banks. These entities are vulnerable to sudden liquidity shocks because, unlike banks, they lack access to deposit insurance or central bank liquidity facilities.

Two representative examples are:

1. **Asset-Backed Commercial Paper (ABCP) conduits**: special-purpose vehicles that issue short-term commercial paper to finance long-term assets, such as consumer loans or trade receivables. Liquidity stress arises when investors refuse to roll over the short-term paper, leaving the conduit unable to meet obligations until long-term assets mature.
2. **Money Market Funds (MMFs)**: open-ended mutual funds that issue redeemable shares backed by short-term securities (e.g., commercial paper, certificates of deposit, and government securities). Runs occur when large number of investors redeem shares, forcing MMFs to sell less liquid assets at prices lower than amortized cost, thereby incurring fire sale losses and triggering further redemptions.

Both ABCP conduits and MMFs are deeply intertwined with the banking system. ABCP conduits allow banks to move long-term loans off their balance sheets, funding them by short-term commercial paper. MMFs, meanwhile, are among the largest purchasers of bank-issued commercial paper and certificates of deposit. Liquidity stress in either sector therefore directly impairs bank funding channels, translating disruptions in money markets into systemic vulnerabilities.

II. Historical Episodes: The 2008 Global Financial Crisis and the 2020 COVID-19 Shock

The vulnerability of NBFIs to runs is not theoretical. During the 2007–2008 Global Financial Crisis (GFC), widespread concerns about the quality of assets backing ABCP triggered runs on ABCP conduits. Investors refused to roll over paper, outstandings plummeted, and risk spreads soared. MMFs, many of which held ABCP in their portfolios, then suffered valuation losses. When some funds appeared at risk of "breaking the buck" (i.e., being unable to maintain a $1 share price), redemptions surged, forcing fire sales. The losses suffered from fire sale triggered further runs.

In the 2020 COVID-19 market turmoil, MMFs again faced severe outflows. This time the trigger differed: rather than concerns about asset quality, investors feared that illiquidity would subject them to redemption gates or liquidity fees. Yet the dynamic was similar—large withdrawals, fire sales, and destabilizing feedback loops.

In both crises, banks stepped in. They provided liquidity backstops to ABCP conduits, repaying investors and limiting ABCP defaults. In the U.S., almost all ABCP programs carried bank liquidity guarantees, and in 2008 more than 97% of outstanding ABCP covered by guarantees was repaid in full. Banks also supported their affiliated MMFs by purchasing assets or shares, thereby replenishing liquidity and reducing outflows. The SEC facilitated asset purchases between banks and their affiliated MMFs by issuing No Action Letter, supplementing emergency

facilities launched by the Federal Reserve. Empirical evidence indicates that such liquidity support measures were effective in mitigating investor outflows from MMFs.

These interventions underscore the functional equivalence between bank-provided liquidity support and the official safety nets (deposit insurance and central bank lending) available to banks themselves.

III. The Benefits and Risks of Liquidity Support

Liquidity support offers undeniable benefits. From an ex-post perspective, it reduces the likelihood of panic-driven runs and prevents fire-sale losses that harm both investors and markets.

From an ex-ante perspective, access to bank-provided liquidity support enables NBFIs to maintain a lower share of liquid assets as a buffer against potential liquidity shocks, thereby allowing them to allocate more capital to illiquid but higher-yielding investments. This investment strategy enhances portfolio returns, which in turn attracts greater investor inflows during periods of market stability. Such inflows benefit not only the sponsored NBFIs themselves but also the banks that provide the liquidity support, given that NBFIs constitute a significant source of short-term funding for banks. Accordingly, increased inflows into NBFIs ultimately lower the cost of short-term funding available to banks.

Yet the risks are equally significant. By reducing the need for NBFIs to self-insure against liquidity shocks, liquidity support encourages them to hold fewer liquid assets and to invest more heavily in illiquid, higher-yield assets. This creates fragility. When stress occurs, banks must honor commitments, which reduces their high-quality liquid assets and increases their risk-weighted exposures. This can impair banks' ability to lend to the real economy and even trigger runs on the banks themselves.

Moreover, liquidity support may expose banks to regulatory breaches. In some cases, in order to comply with prudential regulations, banks have to withdraw support precisely when it was most needed, amplifying panic in NBFIs. In recognition of these risks, central banks have established emergency facilities—such as the U.S. Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF, 2008) and Money Market Mutual Fund Liquidity Facility (MMLF, 2020). Yet such interventions pose a moral hazard problem: if both banks and NBFIs expect central bank rescue, they may further underinvest in liquidity ex ante, leading to excessive risk-taking and higher bailout costs finally borne by taxpayers.

IV. Comparative Regulatory Approaches and Implications for Prudential Regulation

The central regulatory question is distributive: *who should bear the risk and loss when liquidity shocks occur—the NBFI sector, the banking sector, or ultimately the public sector through taxpayer-backed central banks?* Different jurisdictions answer this question differently, reflecting variations in money market structures, investor bases, and regulatory traditions.

- **ABCP conduits**: Both the EU and U.S. require banks sponsoring ABCP conduits to provide liquidity support. The rationale is that without such support, conduits could not issue paper at all, and ABCP is regarded as crucial for financing household and small-business loans. By contrast, China prohibits banks from guaranteeing or supporting trust products (legal form of ABCP conduits in China), reflecting concerns that such structures are used for regulatory arbitrage.
- **Money Market Funds**: In the U.S., external support by bank sponsors is allowed and, during crises, explicitly facilitated by regulators such as Federal Reserve Board and SEC. This reflects the importance of MMFs to U.S. bank funding. In the EU, however, any form of external support is prohibited, as regulators are more concerned about risk transfer from NBFIs to banks; moreover, European banks rely less on MMFs for funding and more on retail deposits. In China, support is not only permitted but even required for bank wealth management products (Chinese version of bank-affiliated MMFs), due to the predominance of retail investors with low tolerance for risk—unlike the institutional investor base that dominates in Europe MMFs.

These differences highlight how regulatory choices are shaped by the broader financial ecosystem and by judgments about which actors can and should bear risks.

If risks are permitted to migrate from NBFIs to banks, they must be addressed within the prudential regulatory framework for banks. Otherwise, over-reliance on central bank backstops becomes inevitable, effectively socializing private losses through taxpayer-funded bailouts. Existing prudential rules already impose requirements on bank liquidity facilities, but gaps remain. The paper's final section identifies potential avenues for regulatory arbitrage, whereby banks can provide liquidity support without holding sufficient capital or liquid assets against these commitments. Such gaps undermine the resilience of the system and heighten the risk of moral hazard.

V. Conclusion

The regulation of bank-provided liquidity support to NBFIs is a critical, though underappreciated, dimension of financial stability law. It raises core questions about the allocation of risk between private actors and the public sector and the design of prudential safeguards to prevent moral hazard. The experience of recent crises underscores both the stabilizing role of liquidity support and the dangers of risk transfer from market to banks. Comparative analysis shows that jurisdictions take divergent approaches, shaped by their money market structures, investor bases regulatory traditions. For legal scholars, this terrain offers an opportunity to interrogate how regulatory design mediates between market efficiency, systemic stability, and distributive justice in financial markets.