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Leibniz Institute for Financial Research SAFE

Dear Marius Luta,

In this edition of the digital newsletter of the Leibniz Institute SAFE, we discuss the liquidity implications of ending the ECB's TLTRO III program. We also present research on how the tone of a shareholder letter can influence mutual fund flows.

We hope you enjoy reading about our research and welcome your feedback at newsletter@safe-frankfurt.de.

Mandatory repayments to the ECB may leave banks with insufficient reserves

TLTRO III repayments have had divergent impacts on national banking sectors. SAFE researchers highlight the liquidity challenges that may lie in store for the euro area.

Most of the 2.2 trillion euros in liquidity support provided by the European Central Bank (ECB) to euro area banks under TLTRO III - the third series of the Targeted Longer-Term Refinancing Operations - has been repaid. This has significantly reduced the ECB's balance sheet, which fell from over 8.5 trillion euros at the end of 2021 to some 6.8 trillion euros at the end of January 2024, without active quantitative tightening measures. An analysis conducted by SAFE researchers Florian Heider and Jonas Schlegel at the request of the European Parliament's Committee on Economic and Monetary Affairs (ECON) examines TLTRO III repayments in 2022-23, focusing on the German and Italian banking sectors. A key

finding of this research is that future TLTRO repayments could lead to bank reserve scarcity at the country level.

As of January 2024, about 80 percent of TLTRO III funding had been repaid, following two major repayment periods: 795 billion euros were voluntarily repaid between November and December 2022, while 503 billion euros were mandatorily repaid in June 2023. Voluntary repayments were driven by higher interest rates on reserves, while mandatory repayments required banks to repay regardless of their liquidity needs. As future repayments in 2024 will also be mandatory, bank reserve levels could become an issue of concern. German banks repaid the most of their TLTRO III funding during the voluntary period, while Italian banks repaid significantly more during the mandatory period. This indicates that Italian banks have been in more need of TLTRO III funding than German banks.

Both TLTRO III and quantitative easing (QE) create excess reserves at the ECB. Despite TLTRO III redemptions being worth nearly 2 trillion euros, aggregate liquidity in the euro area banking system from QE measures remains large. However, liquidity levels differ considerably at the country level. By the end of 2024, Italy's banking sector reserves are expected to be two percent of total assets, compared with ten percent in Germany. Accordingly, repayments in 2024, although smaller, may have a significant impact on liquidity levels in some countries. Mandatory future repayments may leave some banks with insufficient reserves, requiring effective interbank markets to redistribute resources.

For example, looking at the interbank funding market of Italian banks during the mandatory repayment phase in June 2023, there are indications that banks were able to replace some of their TLTRO funding with interbank borrowing. In the past, ample reserves minimized the need for interbank funding, thereby preventing economic shocks. This may change as banks become more dependent on interbank markets. Therefore, closer monitoring of interbank lending is needed, as it remains unknown whether the cross-border interbank market will be able to offset further reserve reductions. Nevertheless, the ECB can address the liquidity stress by increasing QE or introducing a new series of TLTROs. Yet insofar as such intervention becomes necessary, this would indeed highlight the dependence of some banks on central bank funding.

Read SAFE White Paper No. 101 here

Notable Research: Tone of shareholder letters affects flows to mutual funds

Mutual Fund Shareholder Letters: Flows, Performance, and Managerial Behavior

By Alexander Hillert, Professor for Finance and Data Science at SAFE, Alexandra Niessen-Ruenzi, University of Mannheim, and Stefan Ruenzi, University of Mannheim

In their paper "Mutual Fund Shareholder Letters: Flows, Performance, and Managerial Behavior," which is forthcoming in the journal *Management Science*, the authors examine how mutual fund shareholder letters – including in particular their mood and tone – influence investor behavior and fund performance. Based on a detailed textual analysis of US open-end equity mutual fund shareholder letters from 2006 to 2021, the study finds that the tone of these letters significantly affects mutual fund flows. Investors tend to react positively to a less negative tone, resulting in higher net inflows, while a more negative tone leads to lower net flows. This effect is particularly pronounced for younger funds, as investors have less historical performance data to rely on, and therefore place greater weight on qualitative disclosures.

The authors also highlight the importance of honesty in such communications. Letters that align their tone with the fund's actual performance tend to maintain or increase investor confidence and net inflows, while discrepancies between letter tone and performance can discourage investors. Despite the strong correlation between letter tone and investor behavior, the study finds no consistent predictive power of letter tone for future fund performance. However, negative tone is associated with a decrease in idiosyncratic risk-taking and fewer benchmark-deviating bets by fund managers, suggesting a more conservative investment approach following negative communications.

The implications of these findings are significant for mutual fund companies, suggesting that shareholder letters can be used strategically to manage investor behavior and short-term fund flows. Yet, the study also underscores the importance of transparent and accurate communication for maintaining investor confidence and influencing investment decisions.

Read the full paper here

#SAFEHappenings

Sustainability reporting in theory and practice
Following the Sustainability Standards Conference in July 2022, SAFE, together with the IFRS Foundation, the International Sustainability Standards Board (ISSB), the Accounting Standards Committee of Germany (ASCG), and Goethe University Frankfurt organized an event in June 2024 dedicated to elaborating a global baseline for sustainability reporting. The conference, which was supported by the House of Finance and Deutsche Börse Group, brought together high-level regulators, practitioners, and academics to discuss progress being made towards a globally consistent reporting framework. Find a follow-up report and videos on all panels and talks here.

CEBRA Annual Meeting 2024 at the House of Finance
The annual conference of the Central Bank Research Association (CEBRA) returns to SAFE: After previously acting as a host in 2018, the Leibniz Institute SAFE is proud to host this conference for a second time on 28-30 August 2024 at the House of Finance on Campus Westend of Goethe University Frankfurt. Now in its ninth year, the CEBRA annual meeting welcomes researchers and practitioners to discuss a wide range of issues of particular interest to central banks, financial regulators, international financial institutions, and tax authorities. Scientific Director Florian Heider and SAFE Deputy Scientific Director Loriana Pelizzon will each chair a panel session at the event. The program and all other relevant information about the conference can be found here.

New format for SAFE Working Paper Series
Now available as an eJournal, the SAFE Working Paper Series presents the latest findings of Institute's academic staff and fellows. Stay abreast of current research at SAFE by subscribing to receive the paper series on SSRN. Subscribe here.

Handpicked Research Paper

Andreas Hackethal, Professor of Finance at Goethe University Frankfurt and Coordinator of the Pension Finance Lab at SAFE, recommends an academic research paper titled “Crowdsourcing Peer Information to

Change Spending Behavior":

"Michael Weber of Chicago Booth and Francesco D'Acunto and Alberto Rossi from Georgetown University have just published another exciting empirical paper at the intersection of finance, data, and technology in the *Journal of Financial Economics.* They use data from a FinTech to show that app users with significantly higher consumer spending than their peers were persuaded to reduce their consumption after being presented with data on average peer spending. Users adjusted their behavior only when the benchmark is peer-group specific (but not when the average was from the general population) and only when they overspent (but not when they underspent). Notably, this nudge works purely through the information channel, and is not driven by confounding events or social norms. The general implication is that app dashboards that present relevant social benchmark information can encourage desirable behavior at the individual level."

Find the paper here

Discover More

- **Event:** Assessing the Capital Markets Union – A decade on
- **Video:** SAFE-CEPR RPN EFA Policy Web Seminar: The ECB Financial Stability Review May 2024
- **SAFE Finance Blog:** Interest rate cuts? If you don't know what you are doing, do it gently (Ignazio Angeloni)
- All upcoming events and SAFE publications

About SAFE
The Leibniz Institute for Financial Research SAFE ("Sustainable Architecture for Finance in Europe") promotes interdisciplinary research and independent policy advice about the international financial system with a focus on Europe. The institute aims to contribute to a sustainable, crisis-proof financial architecture that stimulates innovation and serves economic and civil needs. Researchers from the fields of economics, law, and political science collaborate at SAFE on questions in the areas of Financial Intermediation, Financial Markets, Household Finance, Macro Finance, and Law & Finance.

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