FINANCIAL STABILITY IN EUROPE

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NBFIs, systemic risk, and regulatory challenges

The non-bank financial intermediary (NBFI) sector has grown greatly since the global financial crisis (GFC), occupying an increasingly large share of total financial assets -- around one-half at present versus 42% in the wake of the GFC. NBFIs are also of increasing systemic importance to the financial system. In the euro area alone, where NBFI assets have doubled since the GFC, estimates are they provide at least one-fifth of funding for banks.

The growth of the sector has brought many benefits, but also new risks. While the NBFI sector is very heterogeneous, comprising a wide range of different type of entities, it is useful to classify vulnerabilities according to key categories, in particular liquidity, leverage, and interconnectedness.

Liquidity mismatches characterize those intermediaries with business models that involve liquidity transformation such as money-market funds and open-ended funds (OEFs). These can create a first-mover advantage for investors, with potentially shock-amplifying and destabilizing effects on asset markets.

Leverage poses additional risks, particularly at hedge funds which fund the purchase of securities with borrowed funds such as repos. These hedge funds often operate under conditions where the ability of investors to identify leverage is curtailed. The case of Archegos Capital Management, which collapsed in 2021, showed that hidden, synthetic leverage can be embedded in derivative exposures. Private market funds that provide small firm finance can show procyclical accumulation of leverage in their operations. Hidden leverage and liquidity risks are also prevalent in the crypto sphere of decentralized finance (Defi). Vulnerability is exacerbated when leverage and liquidity risks combine.

NBFIs are often tightly connected across each other and with the banking sector. For example, OEFs and hedge funds can be linked to banks through derivates exposures, banks may have substantial lending exposures to private-credit borrowers, and NBFIs hold bank securities. This means that stresses can quickly spill over to other parts of the financial system.

One insight of analysis of the NBFI sector is that risk management practices which are useful from an individual institution's perspective can amplify procyclicality of the financial system. One such practice is margining. Margins are a key element of non-bank credit intermediation and their level can affect overall debt capacity. In response to increases in risk, spikes in margins can trigger system-wide deleveraging and exacerbate liquidity shortages.

Such systemic vulnerabilities emerged during the March 2020 disturbances in US bond markets. Hedge funds, engaging in leveraged relative value trades that exploited differences in Treasury cash- and futures markets, had become a key part of the ecosystem supporting liquidity. But when volatility surged in 2020, margins on Treasury futures rose quickly, and hedge funds needed to deleverage and unwind positions. Elsewhere, bond OEFs engaged in discretionary asset sales well above the amounts needed to cover redemptions, while prime funds hoarded liquidity by shortening maturities of their commercial paper investment. These all contributed to a deterioration of system-wide funding liquidity. Similarly, in September 2022, there was a systematic liquidity shortage in the UK gilt market triggered by margin calls at heavily leveraged pension funds. In these instances, central banks had to intervene to restore orderly conditions.

The interconnectedness of NBFIs underscores the need for a systemic approach to their regulation.

Despite progress over the past years, much remains to be done in implementing adequate policy responses. One issue is that in the absence of sound regulation, implicit reliance on central bank interventions in cases of stress encourages excessive risk taking over the longer run. It is key that policy responses be characterized by a macroprudential, systemic approach. Such an approach should also take the many interlinkages between the banking and NBFI sectors into account, so that the mitigation of risk in one sector does not merely result in increased risk in the other. The cross-border activities of many NBFIs underscores the importance of international coordination. Lastly, it is well recognized that improved NBFI data availability is key for enhanced risk monitoring.

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Growing importance and potential vulnerability of NBFI -Japan's point of view

For the last two decades, nonbank financial intermediation (NBFI) has grown rapidly, accounting for around 50% of total global financial assets while the market share of NBFI is around 30% in Japan. Major players are insurance companies, broker-dealers and investment funds while private funds or hedge funds have limited presence. The share of NBFI is small in Japan but we closely monitor the development of NBFI. From Japan's point of view, I would like to raise two points.

First, as nonbank financial institutions (NBFIs) enlarged their presence in the global market, Japanese financial institutions have also increased their investment or credit exposure to these entities. This trend has strengthened the interconnectedness of Japan's financial system with these global NBFIs, increasing the risk of cross-border spillovers in cases of significant repricing.

During the 2008 GFC, the interconnectedness of banks and NBFIs led to the substantial unwinding of positions in light of counterparty risks, causing the materialization of systemic risk.

Even after the GFC we have observed similar incidents, such as the dash-for-cash of MMFs during the Covid-19 which affected Japanese market, the Archegos collapse and the unwinding of liability-driven investments in UK. These experiences suggest that NBFIs are potentially a source of systemic risk to the global financial system. While the Basel 3 reforms have enhanced the resiliency of the global banking system, it has induced global liquidity to shift from banks to less regulated entities such as NBFIs. Meanwhile, the supervisors and regulators have confronted challenges such as data gap, limited transparency or hidden leverage to address NBFI issues.

Therefore, we should be vigilant at the development of NBFI. In this regard, I am especially focusing on private debt funds. Private debt funds raise relatively long-term funds from institutional investors and extend lending to firms including SMEs that find difficulties to access bank loans due to relatively low creditworthiness, less borrowing track records or idiosyncratic business models.

While they may contribute to those firms' funding needs and enhance economic growth, their assets tend to be less liquid and they need to have appropriate risk management framework. Despite their current share in the global market being fairly limited, private debt funds have continued to grow, previously as a result of the search for yield under the low-for-longer environment before the Covid-19 pandemic, and recently amid Basel 3 implementation for banks.

The exposure of Japan's financial institutions to global private credit funds are increasing, with a concentration towards some big players. Given the systemic implication of the private credit funds and the above-mentioned challenges for supervisors or regulators, we need to remain vigilant.

Secondly, NBFI may enlarge their direct presence in Japan's market as well. There are two potential drivers: Japanese firms' strong appetite for restructuring their business and the government initiatives for shifting savings to investments. As for the first driver, many Japanese firms who have abundant cash and retained earnings are moving toward restructuring their business portfolios through M&A, spin-off/out or MBO, making fixed or research and development investments or changing their business models.

It is more important for us to exploit opportunities while mitigating risks associated with NBFIs.

The environmental changes, including improvement in corporate governance, transition to moderate inflation, structural labor shortage, digitalization, carbon neutral, increasing inbound tourists and geopolitical risk, seem to be at the back of the trend shift. These structural changes may attract NBFIs and many global private equity/debt funds are expanding their operations in Japan. NBFIs further activate financial intermediation in complementing capital constraint of banks. As for the second driver, the government has taken various measures to boost investment and to support asset management businesses, including the introduction of new NISA (Nippon Individual Savings Account) that provides account holders with a vehicle for investments with tax saving benefits. In April 2024, J-FLEC (Japan Financial Literacy Education Company) was established to enhance the financial literacy of the public with cooperation of the government, the Bank of Japan and the relevant industrial organization. As half of the Japanese households' 2,000 trillion yen of financial assets are bank deposits, there may be room for NBFIs to provide good products and services.

Growing importance and potential vulnerability of NBFI are two sides of the coin. It is more important for us to exploit opportunities while mitigating risks associated with NBFIs.

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Methods of improving financial stability need holistic approach

Financial stability shows strong connection with competitiveness, financial stability risks can also be reduced by improving economic competitiveness. That is why the one of the key priorities of the Hungarian rotating presidency is to further strengthen the competitiveness across European countries. The unfavourable geopolitical and macroeconomic developments of recent years have had different effects on individual EU member states and have been treated differently, depending on the given state's size, economic structure and development, energy exposure, and their eurozone membership. At the EU level, long-term persistence of significant regional differences is still an important risk, therefore, in order to improve the long-term competitiveness, it is imperative to reduce the differences between the less developed and the developed countries and regions. This shows strong correlation with the Hungarian rotating presidency's other key priority, namely the cohesion policy, which also intends to ensure to eliminate gaps between countries and between different areas and regions in the same country. To properly handle financial stability, it would need to go hand in hand with the reduction of the financial risks of these countries and the strengthening of their financial system, which includes improving their economic competitiveness as well, therefore, a certain holistic approach would be needed.

Nevertheless, other risks could affect the financial stability. Financial stability risks increased in the past years due to rising geopolitical tensions, higher-than-expected inflation and tightening financial conditions. This highlighted several risks to financial stability: the deterioration of the macroeconomic outlook, coupled with the tightening of financing conditions, which heightened balance sheet stress for NFCs (Non-Financial Corporation) and households. The risks stemming from a sharp fall in asset prices that could trigger large market-to-market losses, which in turn might amplify market volatility and cause liquidity strains is also be mentioned. Furthermore, the risks to asset quality and the profitability outlook of credit institutions are to be regarded. In addition to these risks, there are further increase in vulnerabilities in the commercial real estate (CRE) sector, an increased probability of large-scale cyber incidents and a sovereign debt dynamic affected by slower economic growth and tightening financial conditions, as the ESRB's 2023 Risk Monitor pointed out as well. Although in Hungary, the financial stability is considered to be strong, spillover effects may arise at any time especially stemming from the current geopolitical landscape, since the small and open Hungarian economy is exposed to cross border effects and risks.

The phenomenon of Non-Bank Financial Intermediation (NBFI) has been always a challenge for supervisory authorities. The current macroeconomic context of relatively weak growth has added further risks to financial stability through the activity of NBFIs. In Hungary, there are basically two types of connected risks to be mentioned. Banks finance the lending and leasing transactions of their own subsidiaries, but also of other financial institutions, therefore due to potential deficiencies in NBFI's risk management, repayment of refinancing loans may become questionable. Countries that more heavily rely on bank-based finance, such as Hungary, exhibit much lower systemic risk related to non-banks. A systemic feature of the Hungarian financial sector is the predominance of banking intermediation and the moderate interconnectedness between the banking and non-banking financial sub-sectors. NBFIs' activity is even riskier if it connects to shadow banking, which can threaten the stability of the financial sector as a whole.

Financial stability needs holistic approach: both reduction of risks and competitiveness are needed.

The NBFI category also includes non-bank financial enterprises (NBFEs). Most of these financial enterprises are licensed to lend in Hungary, but they operate outside the banking system. Given that NBFEs are not allowed to engage in deposit collection activities, the key risk from a financial stability perspective is the possibility of non-repayment of funds by credit institutions, though the volume of loans managed by them is quite small compared to banks. Nonetheless, NBFEs also belong under the direct supervision of the Magyar Nemzeti Bank (Central Bank of Hungary) (similarly to those Hungarian NBFIs which operate in the financial corporations sector), thus the risk is more elevated in NBFI undertakings which are not under supervisory control.

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NBFI risk - Thinking beyond size

Non-bank Financial Institutions (NBFI) such as investment funds, insurance companies, pension funds, and other non-bank providers of financing have been on the regulatory agenda for many years both domestically and at international groups such as IOSCO and the FSB. As co-chair of the FSB Working Group on Leverage in NBFI (WGLN), certain risks and issues in this sector have been a particular focus.

NBFI's perform an important role in managing savings and providing an alternative to bank-based financing but may also pose risk to the financial system. When discussing their implications for financial stability, the size of the sector is often cited, as is the risk of liquidity mismatch and use of leverage. And of course, that is right: the global NBFI sector has seen significant growth since the global financial crisis.

But to understand the extent to which there is a build-up of risk within the sector and whether that can threaten the broader financial system, it is important to move beyond a discussion of size and explore where we can detect areas of concentration and interconnectedness.

Looking at cases of crystallised risk across the diverse NBFI landscape in recent years, concentration of risk is the single common denominator. The dash for cash in 2020 saw concentration risk in the form of crowded trading in US Treasury markets, the collapse of Archegos in 2021 and the Nickel crisis in 2022 involved large concentrated exposures, and LDI funds' concentrated ownership of long-dated index-linked Gilts contributed to the LDI crisis in 2022.

So, what actions should be taken to identify and reduce the risk of build-up of concentrated and interconnected positions in NBFI?

The first line of defence must be financial services firms' own risk management processes, for which transparency is critical: NBFIs should have the necessary information to understand their liquidity needs, while banks and others should have knowledge of the counterparty risks they are exposed to. Improving systems and controls related to this is crucial, and more work is needed.

Regulators also need to consider how they can more effectively identify where concentration is building up in the system. Focussing on developing a common understanding of data needs and harmonising data standards across the international regulatory community, as well as encouraging data and information sharing, will provide more transparency.

These topics have been the focus of discussions at the FSB and IOSCO for this very reason. We are currently considering these issues in the FSB WGLN, which I co-chair along with Cornelia Holthausen from the ECB. Our group has identified concentration and interconnectedness as key vulnerabilities in the system, with the potential to amplify episodes of stress. Some of the policy solutions we and other international groups are exploring include enhancing transparency so that authorities and market participants are better able to identify and manage concentration and interconnectedness. For example, we are developing a toolkit of metrics that can help authorities better monitor and assess the build-up of risks related to leverage use in NBFI, and we are also exploring ways to enhance cross-border cooperation and sharing of information.

The first line of defence must be financial services firms' own risk management processes.

We are also considering whether there are achievable means of making certain types of data more publicly accessible. This would help both financial services firms for the purposes of their risk management, and regulators in their oversight function. Public disclosure requirements already make a wide range of information available to market participants with the aim of helping them to better understand market dynamics. For example, the Commitment of Traders reports introduced in the UK and the EU by MiFID II provide transparency regarding exchange-traded commodity derivatives positions, by highlighting open interest held by the various categories of market participants and how this evolves over time.

Similar reports have existed in US markets for decades, many of which also include information on the concentration of open interest among the largest four and eight market participants. Centralised financial market infrastructures, such as trading venues, central counterparties and trade repositories already collect significant data, and arguably further public disclosure of aggregated and anonymised information could aid the market. Clearly the utility of any information would have to be carefully weighed against its costs.

We look forward to continuing this important discussion to support enhanced confidence in our global markets, including during the WGLN's public consultation which is expected to run at the beginning of 2025

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The 'NBFI' label

Labels sometimes cloud objective analysis when they are imprecise. In the financial sector, the label "Non-Bank Financial Intermediaries" (NBFIs) has been applied to a broad range of institutions engaging in very different activities: insurance and reinsurance companies, asset managers, mutual funds, BDCs, private equity funds, hedge funds, venture capital funds, broker-dealers, pensions, money market funds, crypto-asset firms, non-bank mortgage lenders, family offices and many others. Unfortunately, this has led some to view all NBFIs as the same—and equally risky—even where their actual activities do not support that conclusion. This is particularly true for regulated businesses such as asset managers, broker-dealers and insurance companies. Policymakers should look past the NBFI label and assess institutions based on their respective activities and risks, rather than approaching NBFIs with a 'one size fits all' mentality.

Leveraging the benefits and strengths of diverse NBFIs, while considering the particular risks their various activities pose, is critical for the resilience and development of the economy. The global financial crisis prompted stricter regulations targeting the fundamental risks inherent to the bank deposit model. In turn, many NBFIs have become instrumental in providing diversity in liquidity, financing and investment opportunities, and have foundations on fundamentally safe, long-term capital positions. A nuanced understanding and assessment of these businesses is essential in making informed prudential and regulatory decisions.

As many have acknowledged, the EU and US credit markets differ in their allocation between the banking and investment sectors: in the EU, banks provide roughly 2/3rds of credit, whereas in the US, banks provide a little over 1/3. Given bank pullback following the crisis, this allocation has constrained the availability of credit in the EU on a relative basis—since 2013, the compound annual growth rate in credit to non-financial corporations in the EU has been roughly half that of the US. Over the same period, EU GDP growth has been nearly flat compared to roughly 5% compound annual growth in the U.S.

Why has this gap opened? A 'one-size-fits-all' perspective regarding NBFIs may have played a material part. For example, insurance companies with long-dated, predictable liabilities are ideally suited to hold long-duration assets that fund real economy needs, such as mortgages and asset-based loans. Paradoxically, the Solvency II framework has imposed high capital requirements on securitizations and longer-duration credit assets notwithstanding such stable liabilities, which has discouraged insurers from financing the real economy through long term investment grade investments. This often results in insurers holding assets that are much shorter in duration than liabilities. In effect, this deprives European economies from one of the major potential offerings from the diversity within NBFIs.

Modest changes to regulatory requirements can unlock significant economic activity. For example, as many have written, European policymakers should consider recalibrating rules that have treated securitizations harshly and inconsistently with their economic risk, and eventually examine methods to foster mechanisms for long-term credit formation when matched to suitable liabilities. A larger securitization market would allow banks to bring long-term investor capital to the table, in turn releasing capital and spurring additional financing activities to help grow the economy. Enabling Europe's life insurers to support long-term credit could unlock over €1 TN in financing to fund European economic growth and fuel financing needs for the green economy, infrastructure and national defense, among others.

Global policymakers committed to robust and resilient capital markets should adjust their perspective from viewing NBFIs primarily as a uniform source of systemic risk to recognizing their invaluable role in financing the real economy in a safe and sustainable manner. Tailoring regulation to address the particular activities and, yes, risks of each type of NBFI will unlock economic growth while guarding against systemic risk.

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Non-Bank Financial Intermediation: all NBFIs are not equal

Since the Global Financial Crisis (GFC) in 2007-2008, many global and regional supervisors as well as regulators have worked on enhancing Financial Stability. As a first wave of actions, the G20 leaders at the Pittsburgh Summit in 2009 decided to reinforce regulations in the financial sphere (including regarding the non-banking sector). At EU level, it led to a significant series of legislations such as EMIR for derivative markets, CRD/CRR for banks, and the Alternative Investment Fund Managers Directive (AIFMD) for non-UCITS asset managers.

The debate for further regulatory work was reactivated following the March 2020 turmoil as well as significant failures such as the Archegos case in the US. In particular, considering the non-banking nature of Archegos, the Financial Stability Board (FSB) wondered if that case should not lead to enhanced actions towards the wider non-banking sector – today known as Non-Bank Financial Intermediation (NBFI). The European Systemic Risk Board (ESRB) expressed similar reflections.

At EU level, following the March 2020 turmoil and FSB's as well as ESRB's reports, the European Commission was very active in tackling the topic of NBFIs. Based on ESRB's requests, it initiated a review of the AIFM and UCITS Directives specifically aimed at reducing the potential financial stability risks involved in investment funds: mandatory liquidity management tools, EU regulatory framework for loan-originating funds (including a leverage cap), EU UCITS fund reporting complementing the EU AIF one, EU reporting on fund risk management and portfolio management delegations. And currently, ESMA is working on related secondary legislation, which will have to be implemented by early 2026 by all EU-based AIF and UCITS asset managers.

So, what are the remaining areas of uncovered risks embedded in NBFI activities in the EU?

Regarding EU regulated fund managers, ahead of the forthcoming implementation of the new stringent regulatory measures mentioned right above, the facts show that today the leverage embedded in their activities is low: the leverage of UCITS funds is capped at 100% of their Net Asset Value, and regarding EU non-UCITS funds the European Financial Stability and Integration Report issued by the European Commission in June 2024 states that "EU AIFs do not show substantial levels of leverage and most do not use leverage or do so only to a small degree." It clearly illustrates that the progressively enhanced and implemented EU regulatory framework has reduced risk over time.

Still, for the rest of NBFIs, are they appropriately regulated and supervised as compared to the potential risks they pose to financial stability?

For instance, since the origin of AIFMD, family offices like Archegos have been explicitly excluded from the AIFMD framework (see AIFMD Recital 7). So, among NBFIs, you may still find such rotten apples which are not regulated and not limited in their actions. Importantly, the fact that some types of NBFIs are not regulated as entities means that they are hardly known (if not known at all) by regulators. Conversely, EU regulated managers and funds are by nature under the ongoing scrutiny of securities regulators, through the whole process of licensing, monitoring, enforcement and possibly sanctions by those securities regulators: being a regulated entity means that the regulator knows you and can ask you any information at any time.

To conclude and reflecting more widely on how to tackle NBFIs and the risks they represent in the EU, regulators and supervisors may act in three cumulative or alternative ways.

First, a priority action at legislative level should be given to extend the scope of regulation towards some types of currently not regulated market players such as family offices, as regulation brings knowledge and information to the related regulators: this is the safest way to anticipate and reduce the risk of occurrence of systemic risk on financial markets.

Second, on the side of securities regulators, we might wonder if the tools currently used for market surveillance couldn't be more systematically upgraded (maybe with the help of AI) to allow for improving scrutiny and detection of who is systemically active.

Being a regulated entity means that the regulator knows you.

Last, regarding banking supervisors, ensuring a better monitoring of the counterparty risk assessment obligations to be applied by banks is probably key, to avoid dramatic events generated by some non-regulated NBFIs contaminating their banking counterparts, as it was the case for Archegos. Proposing guidelines for counterparty risk management by banks is fine (see the very recent BCBS' consultation on that topic) - but effective supervision of rules is critical too.