

Response to Commission Consultation | Assessing the adequacy of macroprudential policies for non-bank financial intermediation (NBFI)

Brussels, 22 November 2024

Q1. Are there other sources of systemic risks or vulnerabilities stemming from NBFIs' activities and their interconnectedness, including activity through capital markets, that have not been identified in this paper?

Financial stability is a pre-condition for growth and competitiveness, so it is important that differences between bank and non-bank regulation are levelled up where the nature of risk and activity is the same. The fragmented nature of the NBFI market means that some risks remain unaddressed and/or further build up, and some entities are not in scope of regulation, such as family offices and sovereign wealth funds. We draw particular attention to the following risks:

Correlation risk, caused by herding, should receive more attention in this review and when defining regulatory and/or supervisory interventions (such as stress tests). Several recent cases where NBFIs required supervisory intervention, such as the gilts sell-off in 2022, the energy price shock in 2022, and the Covid sell-off in 2020, show how patterns of similar asset ownership among different institutions can amplify and transmit stress. NBFIs tend to build up correlated exposures during upcycles, which become self-reinforcing in downcycles. When these exposures relate to less liquid assets, liquidity squeezes are predictable and may create 'doom loop' dynamics that spread losses. Correlation risks can be amplified by the increasing adoption of artificial intelligence and algorithmic trading. While **countercyclical macroprudential instruments** now exist in banking regulation, there are no adequate equivalents in most parts of the NBFI universe (except for the liquidity buffer regime in MMFs).

The combination of **excessive leverage and concentration risk** is of particular concern, especially in areas where transparency for supervisors still appears to be deficient (e.g. OTC derivative markets, activities of family offices such as Archegos). These risks were explicitly highlighted by the ECB in its November 2024 Financial Stability Review. The introduction of central clearing obligations post-crisis may have added new potential systemic vulnerabilities, which need to be managed.



Climate-related financial risks should be explicitly addressed, where NBFIs contribute to or are exposed to climate-related physical and transition risks. This is increasingly necessary in case the development of climate risk management requirements for banks and insurers encourages risks to migrate to non-banking financial institutions. Climate-related financial risks could manifest as solvency or liquidity threats to NBFIs, and climate-related losses could be transmitted between interconnected firms. NBFIs' interactions with EU sustainable finance rules and the quality of their climate risk-management (including risks arising from their counterparties) should be considered as part of the NBFIs regulatory rulebook and prudential supervision.

From the macroprudential perspective, appropriate monitoring tools (such as transparency and stress-testing) should be the basis to understand the risk and to design measures to address it. As of now, there is no evidence that climate-related risks are priced in and considered as part of the traditional financial risk metrics, which are largely based on quantitative approaches that consider short-term time horizons of risk materialisation and are calibrated based on historical data. Building on the experience of the recent system-wide fit-for-55 climate scenario exercise, we support similar, yet more comprehensive system-wide exercises, to assess climate-related vulnerabilities. Importantly, the scope of the NBFIs coverage should be expanded beyond regulated funds only.

Q2. What are the most significant risks for credit institutions stemming from their exposures to NBFIs that you are currently observing? Please provide concrete examples.

The high reliance of some NBFIs on banks for their liquidity management heightens the risk of an NBFIs shock **draining bank liquidity** as NBFIs call on their bank credit lines at the same time, as happened during the 2022 UK gilts episode. Such risks could also run in the other direction towards banks, similar to when the simultaneous withdrawals of corporate deposits led to the collapse of Silicon Valley Bank in 2023.

Supervisory monitoring may need strengthening to gather more information about concentration and asset-liability dependencies between banks and NBFIs in both directions, as well as ownership interdependencies between banks and NBFIs, and banks' complex exposures to unregulated entities (such as via derivatives). To make the best use of this data, supervisors may need clearer guidance about when to intervene.



Q3. To what extent could the failure of an NBFi affect the provision of critical functions to the real economy or the financial system that cannot easily be replaced? Please explain in particular to which NBFi sector, part of the financial system and critical function you refer to, and if and how you believe such knock-on effect could be mitigated.

The EU's 2020 **Central Counterparties (CCP)** Recovery and Resolution Regulation is untested and too new to be included in this consultation, although it must be reviewed by mid-2027. Given the seriousness of a potential CCP failure, supervisory monitoring should focus on the adequacy of CCPs' resources for recovery and resolution, and CCP failures should be included in the design of system-wide stress tests.

Critical functions provided by banks, **including payment services, deposit taking, and credit provision** could potentially be threatened when regulatory arbitrage structures transfer activities from banks to non-banks, while leaving banks still exposed to credit, market or liquidity risks. This might arise when banks provide credit or liquidity to NBFIs. This could be mitigated by reducing regulatory arbitrage. One proposal for doing this is for central banks to use their collateral eligibility frameworks to discourage bank funding of NBFIs, for example setting haircuts that prioritise banks' direct lending to non-financial corporations over their lending via NBFIs. This could be very similar to the ECB's existing programme of targeted longer-term refinancing operations (TLTROs). It would lean against regulatory arbitrage and help to internalise NBFIs' systemic risk costs ([see Acharya et al, 2024, Where Do Banks End and NBFIs Begin?](#)).

Insurance protection gaps, for example where insurers restrict cover for flood or wildfire risks in some locations, could disrupt mortgage provision and the market for mortgage securities. One mitigation approach could be to promote climate adaptation measures, for example, via adaptation-related clauses in insurance contracts. Further research to appropriately reflect climate-related risks, as well as adaptation measures, in the calculations of insurers' solvency capital requirements (technical provisions, investment and underwriting risks) is essential. In particular for the market risks in investment portfolios, we strongly support the policy options to increase risk charges for specific types of exposures related to fossil fuels, as suggested in [EIOPA's report](#) based on the findings of empirical studies. From the macroprudential perspective, climate change mitigation remains key to managing long-term climate-related risks in the financial system.

Fund ownership of public goods (in particular, by alternative investment funds/private equity) – such as social care, education, health, housing, water and other essential infrastructure – using levered ownership structures creates a heightened risk of bankruptcy and bailout of services with public good characteristics. One mitigation could be to extend the two years



prohibition on asset stripping (AIFMD, Article 30) indefinitely in relation to assets with important public good aspects and/or too-big-to-fail characteristics.

Some NBFIs activities may require **regulatory attention beyond the core prudential focus** of this consultation, such as where NBFIs:

- circumvent sustainable finance and product labelling rules,
- support tax avoidance and secrecy,
- concentrate market power (in particular in terms of company ownership) at the expense of competition, such as in asset management
- support extractive financial engineering techniques, for example in relation to public services or infrastructure,
- exploit investors through inadequate disclosure of fees and performance, for example by some AIFMs,
- create vulnerabilities to cyber threats from geopolitical rivals.

Q4. Where in the NBFIs sectors could systemic liquidity risk most likely materialise and how? Which specific transmission channels of liquidity risk would be most relevant for NBFIs? Please provide concrete examples.

NBFI sub-sectors with significant derivative exposures can **transmit liquidity risk to the banking sector via margin calls from CCPs**. For example, the 2022 spike in UK gilt prices triggered unexpectedly high margin calls by pension funds following LDI strategies. In the same year, the spike in energy prices following the Russian invasion of Ukraine had a similar effect on energy producers who had hedged against falling prices in energy futures markets. In both cases, sudden increases in margin calls faced by UK pension funds (and hedge funds engaged in UK gilt basis trades) and European energy producers led to large drawdowns of bank credit facilities by those NBFIs. Future shocks in derivatives markets could be triggered by a wide range of scenarios, leading to sudden increases in margin calls in a variety of markets: credit default swaps, interest rate swaps, government bond futures, or derivatives on equities, commodities and foreign exchange. **Bank supervisory stress tests should seek to identify patterns of such exposures and assess whether banks can withstand sudden increases in demand for liquidity (and counterparty risks) from NBFIs, triggered under a range of scenarios.**

Correlation risk also interacts with liquidity risk: sudden cyclical downturns trigger 'fire sales' of assets, which affects less liquid assets in particular. Redemption calls (in open-ended funds)



deplete liquidity and reinforce spirals of further 'fire sales', in some cases accelerated by automated or AI-generated trading strategies.

Q5. Where in the NBFIs sectors do you see build-up of excessive leverage, and why? Which NBFIs could be most vulnerable? Please provide concrete examples.

We highlight five areas of concern in relation to leverage: private equity, private credit, family offices, sovereign wealth funds, and crypto-based lending.

The use of Net Asset Value loans by **private equity (PE)** firms to add layers of leverage on top of already-levered portfolio companies is a source of concern. NAV loans reportedly quadrupled in three years to USD 16.4bn in 2023 (see Financial Times, 30 Sep 2024, "Private equity's 'layered leverage' needs more scrutiny, says PGIM chief"). Systemic risks could arise from practices that cross-collateralise PE assets and add further leverage to assets that are already encumbered. Supervisors' application of leverage limits under AIFMD may need adjusting to better monitor and control these risks.

While **private credit** funds are less leveraged than bank credit, they may create new pockets of systemic risk, particularly from the use of leverage to fund the private credit fund itself, such as bank loans or loans secured on the fund's assets, and risks stemming from the ability of investors in private credit funds to absorb losses. Any substantial use of bank credit to fund private credit funds may suggest that the activity is partly motivated by regulatory arbitrage and should be discouraged (see Acharya proposal in our answer to question 3). Also relevant is the 'customer overlap' between the entities that borrow from private credit funds and the borrowers or investees of private equity firms and leverage loans, meaning that private credit, private equity and leverage loan providers could all face similar stresses if a highly leveraged corporate were to collapse; and the 'investor overlap' between institutions that invest in private credit funds and those that invest in private equity funds and leverage loans, which could increase the chances of a systemically important investor (such as an insurer or large pension fund) getting into difficulties. Possible focuses for supervisory monitoring to mitigate these risks could include (i) the ability of private credit fund investors to absorb losses, and (ii) the extent of linkages from loan-originating private credit funds back to the banking system. The recent review of the AIFMD and revisions related to loan-originating AIFs tackles some of the risks, for example with provisions to prohibit AIFs from originating loans with the sole purpose of transferring them to third parties, and requiring liquidity management for open-ended funds in order to reduce liquidity mismatches. However, it does not directly tackle investors' loss-absorption capacity and it only assesses bank linkages in one direction: the new AIFMD Article 25.2 requires supervisors to flag where a loan-originating fund might be an important



source of counterparty risk to a bank but it does not require supervisors to monitor the extent to which private credit funds are themselves funded by bank credit, which may be more useful as a supervisory red flag.

Family offices can be a source of leverage that needs better monitoring. As principles rather than agents, which do not raise money from the public and whose only investors are the funds themselves or their parent undertakings, family offices appear to fall outside of UCITS and AIFMD (Article 3.1). Nevertheless, they can introduce financial stresses through leveraged trading strategies, as demonstrated by the Archegos case. On the view that ‘all leverage is other people’s money’, one mitigation would be to extend AIFMD disclosure requirements to family offices, in cases where funds meet certain leverage thresholds, in aggregate and ratio terms. Disclosures should enable supervisors to identify individual sources of risk, such as Archegos, as well as trends where several family offices following similar strategies collectively present a risk.

The same leverage-related threats could in theory emerge from **sovereign wealth funds** (SWFs). SWFs that support social security and pension systems are expressly excluded from AIFMD by Article 2.3.e. Nevertheless, information about the use of leverage by SWFs that could contribute to the build-up of systemic risk in the EU’s financial system would be useful for supervisors to have, including through cooperation with supervisors in third countries where SWFs are based outside the EU.

An area for further investigation might be the growth of bank and non-bank leverage secured on **crypto assets**. We suggest extending the Commission’s obligation under MiCAR (Article 142) to report on the need to regulate lending and borrowing of crypto-assets to include lending secured on crypto assets.

Q6. Do you observe any systemic risks and vulnerabilities emerging from crypto assets trading and intermediaries in the EU?

MiCAR does not structurally separate activities that inherently cause **conflicts of interest**, such as operating marketplaces, market making, ‘own account’ trading, and agency brokerage. The risks highlighted by the FTX case are not fully covered by MiCAR, as it currently stands. Structural separation, as has been the established practice in ‘traditional’ securities trading, should be introduced.

Crypto lending is also not included in MiCAR, so that potentially market-destabilising leveraged trades in crypto assets, which also featured in the FTX case, are not regulated.



Q7. Considering the role NBFIs have in providing greater access to finance for companies and in the context of the capital markets union project, how can macroprudential policies support NBFIs' ability to provide such funding opportunities to companies, in particular through capital markets? Please provide concrete examples.

While some NBFIs provide essential functions such as pensions and insurance, useful services such as cash management, or financing for the economy and transition, others are less beneficial. For example, activities that increase stability risks while engaging mainly in regulatory arbitrage, short-term speculation, creating risk concentrations and leverage that do not benefit the productive economy, or other forms of financial extraction, can impede the EU's growth and competitiveness.

A more differentiated approach may be warranted: among the broad and very diverse range of NBFI entities, **not all business models are contributing to financing the real economy** in equal measure. Some business models, such as Principal Trading Firms, operate agency-based business models, usually with a limited capital base and very short time horizons. Their business model relies on high-frequency trading to benefit from small price misalignments, which may contribute, at the margin, to price discovery but reinforces volatility and pro-cyclicality. Whatever their potential contribution to the functioning of financial markets, their contribution to providing funding opportunities to companies is limited to non-existent. In periods of stress, their market-making activity tends to stop abruptly and the liquidity they contribute to the markets tends to evaporate as a result. Their reliance on prime brokerage (usually part of banking groups) only adds to pro-cyclical interconnectedness.

Similarly, **hedge funds** rarely take long-term 'buy and hold' positions in companies. Again, their investment strategies – albeit very diverse – usually do not build on fundamental assessments of, and commitments to individual companies but are, at best, based on sectoral, macroeconomic views or, in other instances, short-term, opportunistic, trading strategies. Whereas these funds do, a priori, operate a principal-based business model, their role as corporate investors, usually, can be described as incidental and fleeting. Even their contribution to market integrity (through arbitrage trades) and liquidity is questionable as they tend to operate with high leverage and are therefore susceptible to abrupt deleveraging in times of stressed market conditions. Their reliance on prime brokers for leverage again adds to pro-cyclical interconnectedness.

We draw on these two examples to illustrate the need for a more granular assessment of business models within the NBFI sphere. While recent amendments to the AIFMD and UCITS mark welcome progress they do not yet adequately address the contribution to systemic risk from particular business models. We would therefore suggest for the **Commission to review its**



regulatory stance on segments of the market which arguably contribute little to funding the real economy but add significantly to systemic risk overall.

Q11. Do you believe that the proposed enhancements to the stress testing framework listed above are sufficient to identify and mitigate liquidity risks effectively? If not, what specific elements would you suggest including in the strengthened supervision and remediation actions for detecting liquidity risks?

MMFs' indirect exposure to leverage. The consultation proposes to improve the timely access to data about portfolio composition. In addition to this, we suggest that MMF disclosures identify sources of indirect leverage, for example via MMFs' holdings of securitizations or assets with embedded derivative exposures. If concerns about such leveraged instruments emerge in a future stress situation, it could lead to outflows similar to when concerns about corporate bond yields caused outflows from LVNAVs (low volatility NAV) and VNAVs (variable NAV) during the March 2020 Covid episode. Advance disclosure of such indirect leverage exposures would strengthen risk management and supervision.

Q30. What would be the benefits and costs of creating a framework or a label in EU legislation for certain money market instruments (such as commercial papers) to increase transparency and standardisation? Should the scope of eligible instruments to such framework/label be aligned with Article 3 of Directive 2007/16/EC60? If not, please suggest what criteria would you consider for identification of eligible instruments. Please refer to our answer to Question 5.

Criteria for any such label should exclude instruments whose use in MMFs would promote an indirect increase in systemic leverage, such as securitizations, or assets with embedded derivative exposures.

Q46. How can leverage through certain investment strategies (e.g. when funds invest in other funds based in third countries) be better detected?

Please refer to our answer to Question 5.



Q48. Do stakeholders have views on macroprudential tools to deal with leverage of NBFIs that are not currently included in EU legislation?

Implementing limits on the re-use of collateral, which is not currently included in EU legislation on securities financing transactions, would help to constrain leverage in the NBFIs sector. The 2015 Securities Financing Transactions Regulation (SFTR) focuses on transparency in the repo, securities lending and other SFT markets but does not restrict leverage directly. Introducing more robust rules around haircuts and rehypothecation of client assets would help to avoid build-ups of excessive leverage in this area.

The FSB recommended a ban on re-hypothecation of client assets for own account funding (recommendation 7.2 of the FSB 2013 report “Strengthening Oversight and Regulation of Shadow Banking”, which says: “In jurisdictions where client assets may be re-hypothecated for the purpose of financing client long positions and covering short positions, they should not be rehypothecated for the purpose of financing the own-account activities of the intermediary”). [Research from the ECB](#) supports this, showing that collateral re-use increases financial system leverage and that limits on collateral re-use would reduce financial market volatility

Unfortunately, the FSB’s recommendation 7.2 was not implemented in the SFTR. The [Commission’s 2017 report](#) on the SFTR describes in paragraph 4.4 what the EU has instead: a fragmented, scattergun approach in which rehypothecation is partly constrained via measures in MiFID I and II, ESMA Guidelines on ETFs and other UCITS issues, and the MMF Regulation. Some markets, such as AIF, family offices and sovereign wealth funds have no direct constraints on client asset rehypothecation (although AIFs are subject to leverage controls). Closing this loophole by adopting a clear, market-wide implementation of the FSB’s recommendation 7 in the SFTR would help to reduce the build up of leverage and stability risks through this channel.

Implementing minimum standards and floors for SFT haircuts, including with banks. The Commission’s 2017 report (link above, paragraph 4.6) notes two further implementation gaps from the FSB recommendations, which both allow leverage to build up via SFTs. Firstly, the FSB’s minimum standards for the methodology used to calculate haircuts, which are designed to apply to all market participants that receive collateral when providing securities financing, are applied in the EU only to UCITS. Secondly, there are no regulatory requirements at EU level regarding numerical haircut floors for bank to non-bank SFTs, partly because it was felt that this measure should first be incorporated into Basel III, a process that was delayed. Given the ability for many different types of market participants alongside UCITs to engage in SFTs, and the large market share of banks in arranging SFTs, these loopholes should be closed. One of the reasons given for not making progress on these FSB recommendations earlier was a



lack of data, which should no longer be a barrier. As the Commission's 2017 report notes: "It seems beneficial to assess the potential introduction of qualitative standards and numerical haircut floors on the basis of more granular SFT data which will be available once the comprehensive reporting obligations of SFTR become effective (according to the current planning as of 2019)".

In their most recent update of the CRR/CRD framework, the EU legislators have mandated EBA, in cooperation with ESMA, to report on the potential impact of implementing the minimum haircut framework by January 2028 (Art. 519e CRR), with a view to the Commission proposing legislation by January 2029. The mandate instructs EBA to assess the estimated impact of the framework for credit institutions in the EU and potential unintended consequences. This means that a critical element of the post-crisis regulatory framework will not be implemented in the EU for at least another five years.

Q55. What governance principles already laid out in existing system-wide exercises in the EU, such as the one-off Fit-for-55 climate risk scenario analysis or the CCP stress tests conducted by ESMA, could be adopted in such system-wide stress test scenario?

The variety of ways in which NBFIs can evolve and create systemic stresses means that system-wide supervisory monitoring and system-wide stress tests are particularly important.

System-wide stress testing exercises. With the growing interconnectedness in the financial system and increasing risks (as outlined in our responses to the previous questions), improved supervisory coordination in monitoring and addressing the risks are key to delivering on their financial stability mandate. In addition to the sector- or institution-specific stress tests, system-wide stress test exercises should be adopted as an essential tool to understand interdependencies within the financial system and possible second-round effects of risk materialisation. The design of such exercises can benefit from the experience of the recent system-wide fit-for-55 climate scenario exercise, yet there is a need to include a broader set of NBFIs entities to obtain a true system-wide view. The scope expansion is essential not to leave out pockets of risk which might be concentrated in less regulated entities. We understand that a precondition to be able to conduct such an exercise is availability of data, which will require strengthening of transparency provisions for certain entities/types of activities.



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Q68. Are there elements of the FSB programme on NBFIs that should be prioritised in the EU? Please provide examples.

Please refer to our response to question 48.



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