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Out of the shadow:
A macro-prudential framework for NBFI in the EU

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#CMU
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Whereas market financing is becoming increasingly important, structural vulnerabilities in the shadow banking sector remain unaddressed. To ensure that capital markets are a source of economic prosperity rather than financial instability, the European Commission in its new term should strengthen the macro-prudential framework for non-bank financial intermediation (NBFI). As developing and integrating Europe's capital markets can help to provide innovative companies with risk capital, non-systemic NBFI entities should not be overburdened with micro-prudential regulation. However, the build-up of systemic risks in the NBFI sector must be addressed before they reach a dangerous level and central banks are forced to come to the rescue. This paper makes recommendations for tackling the structural vulnerabilities posed by NBFIs and their potentially dangerous ties with banks and the broader economy.

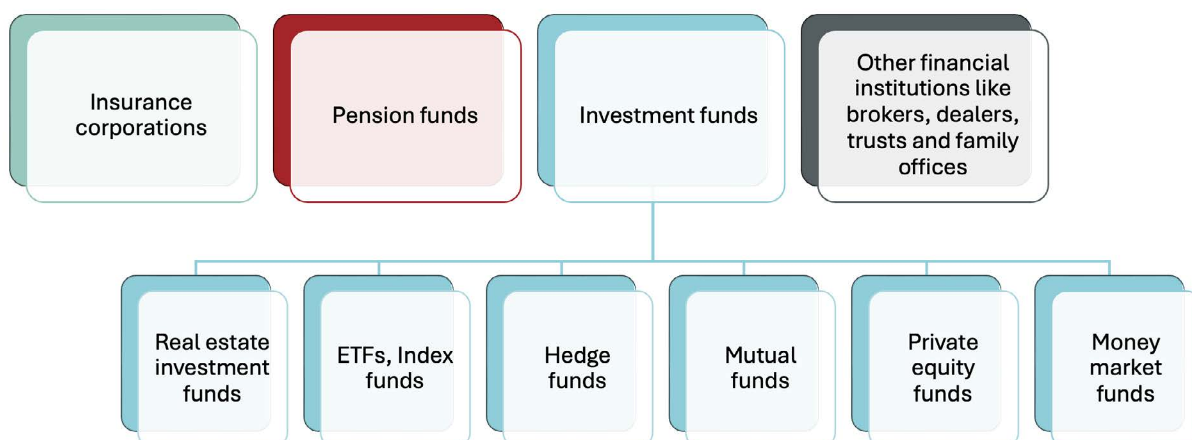
The importance of non-bank financial intermediation (NBFI) is growing. Tighter banking regulation following the global financial crisis, the desire to reduce the economy's dependence on bank financing, as well as more than a decade of low interest rates have resulted in a bigger share of NBFI within the global financial system. With the EU striving for a capital markets union, this trend is set to continue. Although no silver bullet, capital markets can contribute to narrowing Europe's investment gap by helping to divert funds from mid-tech, old industries towards innovative start-ups and scale-ups. However, the integration of markets can also bring with it new risks to financial stability. The dash for cash in 2020 or the UK gilt crisis in 2022 required extraordinary central bank interventions, such as the purchase of non-financial commercial paper and the extension of lending operations, to restore market functioning. These cases highlighted structural vulnerabilities in the NBFI sector and revealed the limits of micro-prudential regulation – that merely enhances entity-level resilience – in guaranteeing system-wide financial stability.

To realise the benefits of the capital markets union (CMU), it is vital that market-based financing is a resilient and sustainable source of funding. While individual NBFI entities may not be of systemic importance, their collective actions may generate systemic risk. When several players implement similar strategies, this could transmit and amplify adverse shocks to the rest of the financial system and the real economy, particularly in times of market stress. To assess the adequacy of macro-prudential policies for NBFI, the European Commission recently gathered feedback from stakeholders in a targeted consultation. This paper argues that with the growth of NBFI and its potential systemic relevance, the EU should urgently address any structural vulnerabilities and implement an effective macro-prudential policy framework for NBFI. Preventing the build-up of systemic risks is the precondition for market-based financing to boost the European economy and exploit the full potential of the Savings and Investments Union.

1 The rise of NBFI

The NBFI universe is very heterogeneous. NBFIs comprise very diverse sectors, including asset management companies and investment funds, family offices, brokers, dealers, pension funds, insurance companies, and other non-bank entities (Figure 1). These different entities have diverse business models and are subject to different regulatory frameworks. Some of these entities act as agents on behalf of their clients, e.g. asset managers, while others, such as insurers, hold assets on their own balance sheet. While the Financial Stability Board (FSB) has developed a negative definition with NBFIs viewed as all financial institutions that are not central banks, banks, or public financial institutions, there is no clear-cut definition for some NBFI entities, such as family offices.

Figure 1: Major players in the NBFI universe.



Source: Own illustration.

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Since the global financial crisis of 2007/2008, the NBFI sector has massively increased its footprint. This represents a long-term structural trend, but also results from the retreat of banks in response to stricter regulations. Within the eurozone, the NBFI sector more than tripled from €13 trillion in 2004 to €45 trillion at the end of 2023 (Figure 2). In the same period, the NBFI's share of total financial sector assets increased from 37% to 53%. The expansion of the NBFI sector has been mainly driven by other financial institutions and collective investment vehicles, which include a variety of institutions such as hedge funds, money market funds, and fixed income funds, that are engaged in activities involving

Figure 2a. Financial assets held by different NBFI sectors in the euro area (in EUR trillion)

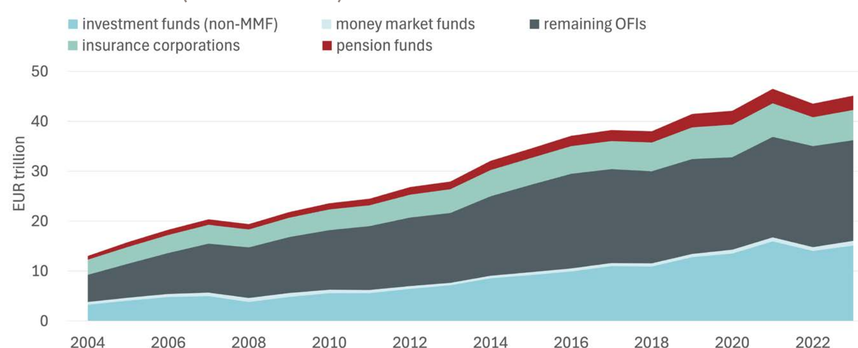
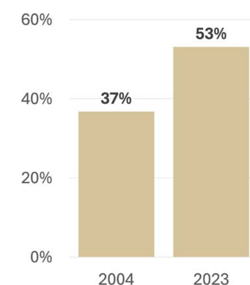


Figure 2b. NBFI's share of total financial sector assets (in %)



Source: Author's own illustration, based on Eurostat.

Notes: OFIs (Other Financial Institutions) include financial auxiliaries, CFIs, money lenders, and other financial intermediaries (except insurance corporations and insurance funds). Data missing for Ireland, Italy and Slovenia. Data incomplete for Belgium, Estonia, Malta, Netherlands, Portugal, Spain and Cyprus.

Despite the observed growth in NBFI activities, several factors are still hampering the development of European capital markets. The fragmentation of EU equity markets, the lack of a developed venture capital environment in the EU and the variation in capital market development across national markets are all leading to higher financing costs and greater inefficiencies in the allocation of capital. In addition, euro area retail participation in capital markets remains limited. Furthermore, a substantial part of European savings are invested outside of the EU. Together, this points to a lack of opportunities for investors in domestic markets and difficulties for EU firms seeking funding, especially in technology sectors.

The prerequisite for economic prosperity is financial stability. NBFIs offer a broad range of investment and funding opportunities and are, in principle, a healthy source of diversity in external financing that can help make the financial system more resilient to credit risk. Recent high-level reports by Enrico Letta and Mario Draghi have emphasised the importance of advancing Europe's capital markets. This is particularly relevant for innovative growth firms in Europe that cannot rely on a deep and liquid market for risk capital as in the US. Deepening financial integration and cross-border risk sharing is not only a big political challenge, but also implies an even greater role for NBFI, which may exacerbate existing vulnerabilities, increasing the frequency and severity of crises. To make the CMU project a success, policies that ensure financial stability, especially in times of stress, are vital. Only if NBFI develops in a sustainable and resilient manner can Europe reap the benefits of market-based financing.

2 The case for taking the systemic view

The current regulatory framework for NBFIs has not been designed with the macro-prudential aim of reducing the build-up of systemic risk. Rather, it has a strong focus on ensuring investor protection and market integrity. Various micro-prudential tools enshrined in current regulations on investment firms (AIFMD, UCITS, MMFR, IFR/IFD) or insurers (Solvency II) include provisions on capital, liquidity, and risk management that enhance entity-level resilience. However, the systemic perspective is different: its focus is on the potential impact that NBFIs as a whole could have on the broader financial system and economy. Recent episodes of market turmoil such as the 'dash for cash' during the COVID pandemic in 2020, the UK gilt market crisis in 2022 and the price volatility in European energy derivative markets in the same year or financial mismanagement at Archegos in 2021 have shown that the current regulatory framework for NBFI is inadequate to contain associated systemic risk.

The primary objective of a macro-prudential perspective in the regulation of the NBFI sector would be to ensure that this growing segment of the financial sector is resilient to adverse shocks. This would enhance financial stability and address systemic risk. Additionally, it would back effective transmission of monetary policy by helping to ensure that NBFI provides a resilient and sustainable source of funding to the real economy. This in turn would benefit the development of resilient capital markets in Europe, as NBFIs are core participants therein. Furthermore, it would help to make the banking system more resilient, given growing interconnectedness between banks and NBFIs. To mitigate the systemic risks posed by NBFI, some national authorities have used micro-prudential tools to address what are macro-prudential risks, but there is no harmonised framework across the EU and the tools available are incomplete.

Fifteen years ago, the recognition of system-wide issues in the banking sector gave rise to the macro-prudential approach to banking regulation and supervision. Reforms in the wake of the global financial crisis have strengthened banks and reduced their systemic impact. However, looking only at tighter bank regulation will likely overstate reductions in systemic risk, including the risk of NBFIs demanding too much extraordinary liquidity from banks under stress. Authorities will consequently have to intervene more often than optimally to preserve the ecosystem of NBFI-bank intermediation, either by direct rescues of NBFIs or by indirect rescues through the banking system. Central bank liquidity assistance, however, should not be the default option for filling the gaps in the regulatory framework for NBFIs. The expectation of such assistance creates moral hazard, leading to resource misallocation. In addition, liquidity assistance may also conflict with other policy objectives, for example when a surge in inflation calls for monetary policy to be tightened.

Against this backdrop, the evolving nature of the financial system requires strengthening the macro-prudential perspective in NBFI regulation. In general, the principle "same activity, same risk, same regulation" should apply. However, a sound macro-prudential framework for NBFI cannot simply transpose the current framework for the banking sector. Applying the approach developed for banks to the diverse set of entities and activities that make up the NBFI universe would be ineffective. The need for a bespoke macro-prudential framework lies in the specific features that distinguish NBFIs from banks and the different ways in which various segments of the financial sector contribute to systemic risk. It is less the risk-bearing capacity of an NBFI's balance sheet and more the potential for contagion and shock amplification throughout the system, not forgetting added pro-cyclicality, that should be looked at.

3 Structural vulnerabilities in the NBFI sector

Systemic risk can arise when NBFIs amplify shocks, with adverse implications for the wider financial system and real economy. The sector's growing footprint within that system, as well as in financing the real economy directly, could magnify the systemic impact of vulnerabilities within it. For example, growing interlinkages within the financial system can cause vulnerabilities in NBFIs to spill over to banks, impacting that sector's own resilience. NBFI vulnerabilities can also affect the functioning of markets in times of stress, given the growth in capital market f funding for the economy. The FSB and the ESRB have identified three main structural vulnerabilities which can contribute to the build-up of systemic risk: (i) structural liquidity mismatches, (ii) excessive leverage, and (iii) and interconnectedness. According to the European Commission, (iv) limited and fragmented macro-prudential supervision of NBFIs across EU member states may also serve to create systemic risk for the EU's financial system. These four structural vulnerabilities can also interact and reinforce each other.

3.1 Structural liquidity mismatches

Liquidity mismatch occurs when the liabilities of NBFI entities are more liquid than the assets in which they invest. For open-ended funds (OEFs) and money market funds (MMFs), structural liquidity mismatch can be driven by a discrepancy between the redemption terms offered to investors and the amount of time it may take the fund managers to liquidate holdings in an orderly manner, i.e. with no substantial impact on transaction costs or prevailing market prices. In the presence of structural liquidity mismatches, fund investors may have the incentive to redeem ahead of peers (the so called "first mover advantage"), especially when faced with adverse shocks. Such dynamics could amplify these shocks, by triggering "excess" redemptions that require fund managers to engage in larger asset sales. Inadequate preparedness for margin and collateral calls is another source of liquidity risk. It can arise if financial intermediaries do not adequately factor in potential liquidity needs stemming from unexpected calls on their derivatives/repo positions – in particular if these are highly leveraged.

To ensure that funds can meet redemption requests and other short-term obligations without facing liquidity crises, both UCITS (Undertakings for Collective Investment in Transferable Securities) and AIFs (Alternative Investment Funds) are subject to liquidity management requirements. These include having liquidity management tools (LMTs) for handling periods of market stress, such as extension of notice periods, redemption gates, or swing pricing. However, individual asset managers may be hesitant to use LMTs because of reputational concerns and stigma effects. As supervisors in the EU, to date, can incentivise but not trigger the use of LMTs, there is a risk that liquidity mismatches are not timely addressed and a systemic liquidity crisis builds up. Another major concern is the liquidity buffer requirements for MMFs (Money Market Funds), where the EU – unlike the United States and the UK – has not implemented the relevant FSB proposals (Table 1). The fragmented regulatory landscape could lead to a shift of liquidity risk towards EU MMF markets, which is especially worrying because of the international dimension: EU MMFs provide more funding to non-EU than EU issuers and are more used by non-EU investors than EU ones. Last but not least, the EU allows amortised cost accounting for the category of Low Volatility Net Asset Value (LVNAV) MMFs as long as the gap between the stable and marked-to-market NAV stays below a certain threshold. Although LVNAVs are permitted to invest in a broader range of assets, including commercial paper and certificates of deposit, amortised cost accounting makes them look as safe as a bank deposit and can lead to sudden price corrections when investors discover that their money is actually at risk – as in the March 2020 market turmoil.

Table 1: Liquidity buffer requirements for different MMF categories in selected jurisdictions

MMF type		EU (no reform)		UK (proposals) LVNAV and VNAV	US (finalised) Prime Institutional MMFs
		VNAV	LVNAV		
Liquidity requirements after reforms	DLA	7.5%	10%	15%	25%
	WLA	15%	30%	50%	50%

Source: Own illustration, based on ESRB.
Notes: DLA = Daily Liquid Assets; WLA = Weekly Liquid Assets.

3.2 Excessive leverage

Leverage amplifies existing risks such as liquidity risk. Leverage can be financial (i.e. borrowing) or synthetic (i.e. derivative exposures), and it can be either on the balance sheet of NBFIs or off the balance sheet (e.g. by holding shares in investment vehicles that use leverage techniques). The use of uncleared derivative contracts to achieve synthetic leverage is especially problematic because the counterparty risk in these bilateral trades is much higher than for derivatives cleared through central counterparties while both market participants and supervisors lack transparency. Excessive leverage, once it becomes unsustainable due to related financing costs, can lead to sudden unwinding of positions in the market with potentially systemic consequences. When leveraged NBFI entities using similar investment strategies sell similar assets at the same time, this can trigger a downward spiral of falling prices and "fire sales". Subsequently, stress may spill over to the real economy or to other parts of the financial system such as banks, either through the counterparty default channel or through common asset exposures. Excessive leverage in the NBFI sector can also directly compromise funding for the real economy because highly leveraged NBFIs are likely to reduce their corporate financing in times of stress. While high leverage is typically associated with AIFs, it can also build up in some UCITS funds pursuing hedge fund-like strategies.

The UCITS Directive and the AIFMD both have specific requirements related to leverage. UCITS funds, on the one hand, have pre-defined limits with regard to borrowing (10% of assets) and global exposure to derivatives (up to 100% of net assets). However, being able to calculate exposure to derivatives by the Value-at-risk (VaR) approach allows UCITS funds to acquire considerable leverage, leaving a gap in the regulatory toolkit. The AIFMD, on the other hand, does not directly impose an overall leverage limit, but asks AIF managers to set internal leverage limits based on risk management processes and to regularly report leverage to regulators. As the only explicit, ex ante macroprudential tool, Article 25 of the AIFMD enables national supervisors to impose specific leverage limits on certain AIFs, if they believe leverage poses risks to financial stability or to the investors in the AIF. However, the current AIFMD reporting framework exempts private equity funds from considering the leverage present at portfolio company level (look-through approach) and this is despite the fact that, just as in the larger public markets, risk-taking in private markets is procyclical and may have broader financial stability implications. Taken together, data gaps and the lack of a coherent calculation method may obscure the full extent of leverage in NBFIs. This makes it harder for supervisors to detect the build-up of large, concentrated leveraged positions and to adopt appropriate mitigating measures.

3.3 Interconnectedness among NBFIs, within the financial system and with the broader economy

Greater financial intermediation via the NBFI sector has resulted in increased interconnectedness within it, between NBFIs and banks, and between the NBFI sector and the real economy. These interconnections are not a risk per se, but act as channels through which shocks affecting the NBFI sector can be transmitted to other parts of the financial system and/or the real economy. Given the crucial role of banks in providing credit to the EU economy and taking deposits, the linkages between banks and the NBFI sector merit special attention. While the European CMU agenda seeks to reduce reliance on banks by advancing EU capital markets, the intermediation activities and risks of NBFIs and banks have become intricately intertwined and they should not be thought of as operating in parallel or as substitutes. Examples of this transformation include corporate and mortgage loans, short-term funding, and contingent funding activities, as well as the growth of bank loans to such intermediaries (Table 2). Indirect linkages between NBFIs and banks may also take the form of ownership ties, as most of the largest asset management companies operating in the EU are owned by banks which may create step-in, reputational and operational risks for the bank in cases where the affiliated asset manager is enduring financial stress.

Table 2: Examples of transformations of intermediation activities across NBFI and bank sectors

Transformation	Examples
Loans and Mortgages: Loans shift from being made and held by banks to being made by NBFIs with collateralised or senior financing provided by banks.	• Banks make senior loans to private credit companies. • Banks make collateralised loans to mortgage REITs. • Banks hold senior tranches of MBS and CLOs.
Activities Using Short-Term Funding: Activities that require short-term funding transform from being conducted and funded by banks to being conducted by nonbanks and funded by banks.	• Banks offer warehouse financing to nonbank mortgage, CLO, and other ABS originators. • Banks make short-term loans to private equity companies, including subscription finance loans. • Banks sponsor CP or directly lend to nonbank mortgage servicers.
Contingent Funding: While the footprint of NBFIs has grown relative to that of banks, banks retain responsibility for providing contingent funding in the form of credit lines to the NBFI sector.	• Banks provide credit lines to NBFIs to be drawn down during periods of stress. • Banks bear mutualised counterparty risk as derivative clearinghouse members and provide credit lines to NBFIs to meet margin requirements.

Source: CEPR article by Viral Acharya, Nicola Cetorelli, and Bruce Tuckman.

Notes: REIT = Real Estate Investment Trust; MBS = Mortgage-Backed Security;
CLO = Collateralized Loan Obligation; ABS = Asset-Backed Security; CP = Commercial Paper.

To minimise the risks posed to banks arising from their exposures to NBFIs, banks are required to report their ten largest exposures to "shadow banking" entities. In addition, the European Banking Authority (EBA) issued guidelines that lay down requirements for banks to set internal limits on their individual exposures to "shadow banking" entities (alleviating micro-prudential concerns) and on their aggregate exposure (alleviating macro-prudential concerns). Bank supervisors can assess and challenge banks' internal limits and risk mitigation plans and take supervisory measures. The EBA guidelines, however, are non-binding and do not set quantitative thresholds but only qualitative criteria. While the ECB claims to scrutinise the shadow banking exposure of the banks under its remit, it cannot be taken for granted that national supervisors in all EU member states do the same. To enhance the effective supervision of financial conglomerates, i.e. large financial groups which are active in different financial sectors (banking/investment services and insurance) and that often operate cross-border, the Financial Conglomerates Directive (FiCoD) sets, inter alia, an overall solvency requirement and foresees the appointment of a single supervisory authority for the conglomerate. However, the FiCoD fails to set provisions for liquidity management and applies only to conglomerates that include at least one company active in the insurance sector. As a result, conglomerates consisting only of a bank and an asset manager do not come under the FiCoD.

3.4 Lack of supervisory consistency and coordination

The structural vulnerabilities of NBFI and its cross-sector and cross-border interlinkages are not reflected in the current governance of EU macro-prudential supervision. Two major shortcomings are preventing the effective oversight of systemic risks in the European financial system. First, data availability and data sharing remain incomplete. While considerable progress has been made since the global financial crisis, regulators lack the data to assess key risks in private markets and are especially short of information on exposures between private markets and traditional banks. In addition, data sharing arrangements among and between central banks and competent authorities do not ensure that all relevant authorities have timely and efficient access to collected data. Second, there is a lack of supervisory coordination within the EU. Whereas NBFIs operate across borders, supervision is carried out primarily at national level. In one of the rare cases where a macro-prudential measure under the AIFMD was activated, the Central Bank of Ireland introduced a yield buffer requirement for GBP-denominated LDI funds and coordinated this move with the Luxembourgish regulator. While ESMA, based on input from the ESRB, issues advice to national authorities and "shall try to ensure that a consistent approach is taken", no effective mechanism for coordination exists at EU level and there is only limited experience on the coordinated use of macro-prudential powers when facing a broader EU-wide risk to financial stability.

The lack of supervisory consistency and coordination has far-reaching implications for financial stability. First, where national supervisors exercise their macro-prudential powers individually, this opens the door for regulatory arbitrage with NBFIs moving their business to another EU country with lower requirements. Second, the opaqueness of private markets created by a lack of data allows risks to migrate from well-regulated banks to NBFI sectors with lower transparency requirements. As a result, the allocation of activities in the financial system can become inefficient, NBFIs and banks may jointly take more risk than socially optimal, and supervisors may face difficulties in spotting potential problems and enforcing existing regulation. A special version of the concealment of risks is the evasion of carbon financing from banks to the NBFI sector, where banks often channel funds through (tax) secrecy jurisdictions. This "greenlaundering" complicates regulators' efforts to reduce banks' climate-related risks and allows stranded assets to pile up in other parts of the financial landscape, with potentially sudden price corrections endangering system-wide stability.

4 Building blocks of a macro-prudential framework for NBFI

Against this background, there is merit in strengthening the macro-prudential framework to prevent the build-up of systemic risks and allow central banks to keep their powder dry. While a fine-tuning of the regulatory perimeter might conceivably be necessary to address new risks emerging from family offices or crypto assets, there is no need to overdo micro-prudential regulation of entities and activities that are not systemic. However, the macro-prudential framework for NBFI should be strengthened to keep up with the sector's systemic importance. This section presents recommendations for addressing the most pressing vulnerabilities (Table 3). The guiding principles for these reform proposals are that an increase in market-based financing is welcome to support productive investment as long as it does not damage the resilience of banks and the broader economy and, to achieve that, supervisors have adequate transparency and ex-ante powers to intervene early on – similar to a watchful bodyguard.

Table 3: Priorities for an effective EU macro-prudential framework for NBFI

Vulnerability	Major shortcomings		Recommendations
Structural liquidity mismatches	MMFs	EU liquidity buffer requirements below other jurisdictions	Follow FSB recommendations for increasing liquidity buffer requirements
		Constant prices for LVNAVs create the wrong impression of deposit-like investments	Abolish amortized cost accounting
	OEFs	Asset managers do not take the systemic view and thus hesitate to activate LMTs	Grant supervisors the power to activate micro-prudential LMTs and introduce a dedicated ex-ante macro-prudential liquidity tool
Excessive leverage	Synthetic leverage opaque		NBFIs to report exposures to regulated firms providing finance or acting as derivative counterparties; Implement FSB minimum haircut framework for securities financing transactions
	Leverage of private finance opaque		Apply AIFMD look-through approach to private equity
	UCITS can obtain substantial leverage despite existing micro-prudential limits		UCITS funds using VaR to report leverage under the commitment approach
	Supervisors cannot limit leverage of UCITS on macro-prudential grounds		Grant supervisors macro-prudential powers to limit leverage of UCITS funds
Interconnectedness among NBFIs and between banks and NBFIs	Only qualitative, non-binding limits for banks' NBFI exposures		Introduce quantitative and binding limits for banks' NBFI exposures
	FiCoD applies only to groups with insurance business and does not contain provisions on liquidity management		Upgrade FiCOD to include also bank/asset manager conglomerates and group liquidity requirements
	Supervisors lack the full picture of risks across sectors		Run regular system-wide stress tests
Lack of supervisory consistency and coordination	Lack of data, especially on private finance		Require private finance to report data
	Authorities do not have timely access to data collected by others		Ensure efficient data exchange and work towards a central data hub
	NBFIs primarily supervised at national level, macro-prudential measures apply only domestically		Build colleges of supervisors, introduce reciprocation regime, and give ESMA top-up powers
	Climate risks migrate from banks to less transparent NBFIs		Require banks to report Scope 3 emissions

4.1 Liquidity

Among the areas where progress is most needed are MMFs, which were at the heart of the global financial crisis and March 2020 turmoil. In order to strengthen the resilience of MMFs in times of market stress and prevent a shift of liquidity risk towards them, the EU should no longer ignore the call of the ESRB and others and raise the liquidity buffer requirements for private debt MMFs to a level comparable to that in other jurisdictions. In addition, a mandatory requirement for public debt holding could help to diversify MMFs' liquidity sources given that public debt typically has higher market liquidity. Furthermore, the EU should follow the recommendation of ESMA and other regulators and remove the ability for LVNAVs to use amortised cost accounting. This would avoid any confusion with bank deposits and eliminate unintended cliff effects related to possible transformations from LVNAV to VNAV funds in periods of stress. What's more, a variable share price would also reflect the underlying asset value more accurately, reducing first-mover advantages associated with a decline in asset values.

With regard to open-ended funds, liquidity management tools (LMTs) are insufficient to prevent the build-up of risks if individual asset managers do not activate them because they fail to include any system-wide perspective in their decision-making. Consequently, there is a strong case for strengthening the involvement of authorities in the activation of specific LMTs, where warranted to safeguard the stability of the entire financial system. As outlined by the Eurosystem, a bigger role for public authorities could be achieved either through greater regulatory prescription on the activation of LMTs or through direct powers to authorities, for cohorts of funds. Furthermore, there would be merit in complementing micro-prudential LMTs with an explicit macro-prudential liquidity tool for both AIFs and UCITS that resembles the existing Article 25 AIFMD measure for leverage and allows authorities to specifically target structural liquidity mismatch in OEFs ex-ante.

4.2 Leverage

Non-bank leverage is another key issue where macro-prudential gaps should be closed. First, to address the risks posed by synthetic leverage obtained via uncleared derivative contracts, NBFIs should more fully disclose their relevant exposures to prime brokers, banks and other regulated firms providing finance or acting as derivative counterparties. To further reduce the risk of surprise margin calls resulting in fire sales, the EU should adopt the FSB minimum haircut framework for securities financing transactions that protects the collateral receiving counterparty in a repo transaction. Additionally, the EU could envisage – as suggested by the ESRB – mandatory margin requirements for bilaterally cleared transactions, so that both counterparties of a securities financing transaction are protected.

Second, in order to curb hidden financial leverage in private finance, the AIFMD look-through approach should apply also to private equity funds so as to get transparency on the leverage of their portfolio companies.

Third, to avoid UCITS funds acquiring substantial leverage, all funds using VaR should be required to regularly report and disclose information on their leverage based on the commitment approach. This would enable authorities to better monitor leverage use and risks to financial stability. In addition, the macro-prudential powers for imposing leverage limits or other restrictions available under Article 25 AIFMD should be granted to supervisors under the UCITS Directive as well.

4.3 Interconnectedness

The risk of contagion between NBFIs and traditional banks should be reduced. As a first step, the EBA guidelines on qualitative requirements for banks' credit exposures to the shadow banking sector should be enshrined in binding EU legislation and enhanced by quantitative limits for individual and aggregate exposures. Second, to reduce step-in or reputational risks stemming from bank-affiliated asset managers, the scope of the EU Financial Conglomerates Directive (FiCoD) should apply also to financial groups not engaged in the insurance business and include provisions for liquidity management at group level.

System-wide stress tests would help to address systemic risks. To identify and mitigate potential negative spillover effects across the financial system and to the real economy, financial supervisors need a full picture of risks across sectors and how risks will evolve under stress. This is why system-wide stress tests including the NBFI sector and banks should be conducted regularly. The most urgent analytical priorities include a better modelling of second-round effects, as well as of direct and indirect interlinkages between banks, insurance companies, pension and investment funds through common asset holdings and fire sales, and of the risks of cross-border spillovers. As the first central bank globally, the Bank of England recently conducted a system-wide stress test exploring how the UK financial system would respond to a market shock. The EU could build on the Bank of England's model for developing its own system-wide stress tests as well as use the experience collected under the one-off exercise carried out by the European Supervisory Authorities (EBA, EIOPA, and ESMA) and the European Central Bank (ECB) that together analysed the impact of climate-related transition risks on the financial sector.

4.4 Supervision

The vulnerabilities in the NBFI sector and the risks stemming from its interconnectedness warrant consistent and coordinated supervision. On the one hand, supervisors should be able to assess risk exposure at the level of all the funds managed by a specific asset manager, even if its portfolio management team, risk management team, and the funds themselves are located in different EU member states. On the other hand, where systemic events affect more than one country, supervisory measures should be applied in a consistent and coordinated manner. To overcome national fragmentation, four financial regulators have suggested that relevant national competent authorities should together build supervisory colleges to jointly assess the total risk of large cross border NBFI groups. To adopt, if warranted, macro-prudential measures, a two-step approach could be envisaged. First, an EU-wide reciprocation mechanism would ensure that a macro-prudential measure such as a leverage limit enacted by one NCA of the supervisory college applies to all funds irrespective of where they are domiciled. Second, ESMA's coordinating powers would be strengthened, including the option to impose EU-wide measures based on recommendations from the ESRB. Such "top up" powers for ESMA should not overrule national measures but add to existing ones or require the adoption of new measures. In the medium term, there might also be merit in making ESMA the central supervisor for large cross border NBFI groups, if accompanied by a revised governance and funding framework as well as a more harmonised set of financial market rules applicable throughout the EU.

To allow for effective supervision, collecting and sharing NBFI data should be improved. As a matter of priority, data provision on private equity and private credit should be enhanced as it is the fastest growing part of the NBFI sector and at the same time the area with the least data currently available. This would help to spot hidden risks, detect interlinkages with banks as the largest lenders to private credit funds, and assess the potential of negative effects on the real economy if it receives ever more financing from private markets. Furthermore, the exchange of existing and new data among supervisors and between central banks and supervisors should be facilitated so that all relevant public authorities have timely and efficient access to granular NBFI data. In the medium term, a single hub for data reported to public authorities should be created, following the model of the European Single Access Point (ESAP) that makes data on EU companies and investment products centrally available. Last but not least, banks should be required to report Scope 3 emissions that include the greenhouse gas emissions produced by the banks' clients. This would render transparent the migration of climate-related risks from banks to the NBFI sector and allow financial supervisors to act against regulatory arbitrage and the concentration of sustainability risks.

5 Conclusion

Encouraging individual investors to take more risks and making the system more resilient must be two sides of the same coin. A central task for the new Financial Services Commissioner Maria Luís Albuquerque will be to advance the CMU project. In Commissioner Albuquerque's mission letter, however, Commission president Ursula von der Leyen asked her to also focus on the macro-prudential aspects of non-bank financial institutions. Given that structural vulnerabilities in the NBFI sector continue to threaten financial stability, Albuquerque should not put urgent reforms on the back burner. With NBFI strongly intertwined with traditional banking, action must not stop at the boundaries of the NBFI universe, but go on to tackle its potentially dangerous ties with banks and the broader economy.

The creation of an EU framework for macro-prudential supervision of NBFIs will face political headwinds but is essential. Further integrating financial supervision at EU level and enhancing transparency through additional reporting will likely face resistance from the financial sector and individual governments, but is indispensable to support the beneficial role that non-banks play in financial intermediation. With new forms of financial intermediation emerging and risks evolving, this macro-prudential approach will need to develop over time, expanding the regulatory perimeter to additional entities and eventually embrace activity-based requirements.

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