EU financial regulation

EU plans sweeping stress test of non-banks

Move likely to raise concerns among hedge funds and private credit groups of greater regulatory scrutiny

Officials at the EU's main financial watchdogs are still discussing the details but they are optimistic it could be launched next year © Michael Probst/AP

Martin Arnold in London

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EU regulators are planning their first stress test to look for vulnerabilities in the financial system outside of banks, reflecting fears about the rapid growth of less regulated groups such as hedge funds and private equity.

The plans by European authorities to examine the impact on the wider financial system of a potential market crisis, which would also include pension funds and insurers, follow a similar debut exercise by the Bank of England last year.

Officials at the EU's main financial watchdogs are still discussing the details of such a system-wide stress test of non-bank institutions, but they are optimistic that it could be launched next year, according to two people involved in the talks.

The move is likely to raise serious concerns among hedge funds, private credit groups and money market funds that they could be subjected to greater scrutiny and restrictions by European regulators in the future.

Since the 2008 financial crisis, the provision of loans has shifted from banks' balance sheets towards other firms that behave like traditional lenders but are more lightly regulated.

Non-banks accounted for about a quarter of the total €19tn stock of loans in the Eurozone at the end of 2023, according to the European Central Bank, which said "more and more loans are being provided by insurance corporations and pension funds".

Supervisors are growing increasingly concerned about the opacity and potential risks these firms could present, as well as links back to the banking system. Lending by Eurozone banks to such non-bank firms has tripled since 1999 to reach €6tn by the end of 2023.

Non-banks have been central to several episodes of market turmoil in recent years, including a dash-for-cash in bond markets after the pandemic hit, the collapse of family office Archegos Capital Management three years ago, and a liquidity crunch at energy traders after Russia invaded Ukraine.

“We’ve seen some crisis episodes . . . where liquidity risk spillovers came from the NBFI, non-bank financial intermediation space,” Claudia Buch, chair of the ECB’s supervisory board, told the European parliament in a recent hearing.

“So, it’s important that this is also well understood and well regulated,” Buch said. “So not all NBFIs are more risky than banks or other financial institutions, but we need to address the risks there in the right way and also the regulation needs to be targeted to those risks.”

EU regulators also worry that the region has been slow to tighten rules for money market funds, which are an important source of funding for banks, leaving them with lower minimum liquidity requirements than those in the US and UK.

Some national authorities in Europe have already announced they are planning to launch a similar stress test of so-called non-bank financial intermediaries (NBFI), including those in France.

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The EU exercise would build on the specific sector-focused stress tests already carried out regularly for banks, insurance companies, money market funds and clearing houses in the 27-country bloc.

The aim is to examine how a crisis would spread between different parts of the financial system and whether this could magnify the shock rather than absorbing it.

Discussions have included the European Banking Authority, the European Securities and Markets Authority, the European Insurance and Occupational Pensions Authority and the ECB, as well as the European Commission and the European Systemic Risk Board. The regulators and the commission all declined to comment.

The commission said on Friday it would delay the implementation of tougher capital requirements for banks' securities trading businesses by a year until early 2027. The delay will allow Brussels to wait for clarity on whether the US will go ahead with the rules agreed by global regulators on the Basel Committee on Banking Supervision.

The BoE involved more than 50 City of London institutions in its so-called system-wide exploratory scenario — which included the theoretical default of a hedge fund — to model how a period of stress would ripple through non-bank firms.

City firms were relieved when the BoE said resilience was "comparatively high" in liability-driven investment funds in pension schemes, which had caused a crisis in gilt markets two years earlier.

But it also warned that fire sales of assets by pension funds, hedge funds and other investors could magnify a market crisis, especially as many had "mismatched expectations" about their ability to raise cash in a meltdown.

Additional reporting by Paola Tamma

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