NON-BANK FINANCIAL INTERMEDIARIES

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In this episode, Agnès Bénassy-Quéré, Deputy Governor of the Banque de France, sheds light on the growing role of non-bank financial intermediaries (insurers, investment funds, family offices, etc.) in financing the economy. She discusses the risks these actors face: financial leverage, liquidity issues, and interconnections with the broader financial system. Three recent crises illustrate these vulnerabilities: the 2020 Covid crisis, the Archegos collapse, and the UK mini-budget turmoil of 2022. Despite increasing regulation, challenges remain to strengthen the sector's resilience and limit systemic risks, notably through a macroprudential approach and system-wide stress testing.

Voice-over: Welcome to Dialogue &co. In this episode, Agnès Benassy-Quéré, Deputy Governor of the Banque de France, explains the risks linked to a significant but little-known category of financial entity: non-bank financial intermediaries. Although they have become vital for financing the economy, their activities can pose a threat to financial stability. So how do we go about regulating them? Agnès Benassy-Quéré answers questions from Lucile Rives, the Banque de France's podcast editor. Enjoy the podcast.

PART ONE: WHAT ARE NON-BANK FINANCIAL INTERMEDIARIES AND WHAT ROLE DO THEY PLAY IN FINANCING THE ECONOMY?

LUCILE RIVES: Hello Agnès. Today we're going to talk about non-bank financial intermediaries. It's a bit of an obscure category as it basically defines players according to what they're not: they're not banks. Obviously, that doesn't help much because what is and isn't a bank is pretty broad. So Agnès, what exactly are we talking about?

AGNÈS BÉNASSY-QUÉRÉ: That's right Lucile, we're all familiar with banks. I've got a bank account, you've almost certainly got a bank account. You've probably also got a bank card, maybe a passbook savings account like a Livret A, maybe even a popular savings account. Some people have even got a share account with their bank. There are fewer of those, but they do exist... Yet we're a lot less familiar with non-bank financial intermediaries. Even so, according to INSEE, 31% of French households had a life insurance contract in 2021, consisting of a euro or unit-linked fund.

- In the case of euro funds, insurers invest your money in government and corporate bonds, in other words in securities that pay a fixed rate of interest.

- With unit-linked funds, insurers invest in a range of financial products offering variable rates of return, and can either invest your money directly, or buy products managed by specialist firms.

So insurers, which are not banks, invest in money market funds, bond funds, equities, venture capital, alternative funds such as hedge funds, real estate funds, and so on. None of these are banks. You can also invest directly in these funds yourself, or go via an insurer. So insurers are not banks and funds are not banks, but they still act as intermediaries between savers, like you and me, and borrowers, investors, firms, governments... These non-bank intermediaries allow you to invest, for example in the stock market, but in a diversified way and without having to pick the securities yourself, check prices and switch your money back and forth.

LUCILE RIVES: You mentioned insurers and funds, but the problem with defining these entities according to what they're not is that the list is potentially infinite. Are there any other entities that qualify as non-bank financial intermediaries?

AGNÈS BÉNASSY-QUÉRÉ: We've already talked about insurers, who make up a large share of non-bank financial intermediaries, funds… but there are all sorts of firms that fall under the same category. There are financing companies, securitisation vehicles, which we call special purpose vehicles or SPVs, brokers, trusts and certain family offices.

LUCILE RIVES: I'm maybe more familiar with some than with others – especially brokers, who I know provide services to investors in financial markets. Financing companies as well, because the name is pretty self-explanatory; they provide financing but, because they're not banks, they don't take deposits from the general public. Can you define the other entities you mentioned? SPVs, trusts and family offices?

AGNÈS BÉNASSY-QUÉRÉ: The most mysterious ones are probably the SPVs – they're securitisation vehicles which, as we said, transform bank debt into financial securities that can be sold on the market. They're legal entities created for a specific project, specifically to hold an asset, isolate the risk and set up a potentially complex financing structure.

A trust is a legal arrangement whereby assets are transferred to a trustee who manages them on behalf of designated beneficiaries, for example a family – as in the case of the Rockefeller family trust – or a foundation, as in the case of the Bill and Melinda Gates Foundation.

Family offices are dedicated structures set up to protect and grow the assets of wealthy families. Family offices provide comprehensive services, including investment management, tax management, succession planning, philanthropy, governance, and so on. There are some big family names in the sector, such as the Soros Fund Management, the Archegos Fund and the Rothschild Family Office

What they all have in common is that they collect money from investors – families or other investors – and then reinvest it. What's really specific about them is that, unlike banks, they're not allowed to collect and hold sight deposits. That's really what distinguishes banks from non-banks. And non-banks don't have access to central bank funding – we'll talk more about that as it's their main weak spot.

LUCILE RIVES: In the 2010s, after the crisis, we used the term "shadow banking" to refer to players who weren't covered by traditional banking regulation. Is non-bank financial intermediation the same as shadow banking?

AGNÈS BÉNASSY-QUÉRÉ: Yes and no. The term shadow banking was used after the 2008 crisis to refer to financial intermediation that fell outside the realm of traditional banking regulations. But today the term is no longer used, as a large share of non-bank financial intermediaries are in fact tightly regulated. For example, in Europe, insurers are covered by a very strict regulation known as Solvency II, while in France they're supervised by the *Autorité de contrôle prudentiel et de résolution* (ACPR), in the same way as banks.

However, non-bank financial intermediaries make up a very broad and diverse category. Some of them are still subject to very few regulations. You could call it shadow banking in a way, although the term isn't used much anymore. It's not really a problem if these sectors remain small and largely disconnected from the rest of the financial world, especially banks. But what we're seeing today is that they're getting bigger and bigger, and eventually they'll pose a systemic risk – in other words a risk to the entire financial system.

LUCILE RIVES: How big are they exactly, these non-bank financial intermediaries, especially in relation to banks?

AGNÈS BÉNASSY-QUÉRÉ: According to the Financial Stability Board (FSB), which was set up after the global financial crisis to monitor and coordinate the regulation of non-bank players, non-banks held around $239 trillion of assets at the end of 2023, which is roughly half of all global financial assets.

In France, they hold a smaller share, around 31% of total financial assets, and about half of that is in the hands of investment funds. In some countries, such as Ireland and Luxembourg, the share is obviously much higher because these countries are home to large numbers of global investment funds.

It's a very dynamic sector. Non-bank financial intermediaries' global asset holdings are estimated to have doubled between 2011 and 2023, and investment funds' holdings are estimated to have tripled over the period. In France, the proportion has remained relatively stable, as their holdings accounted for around 33% of total assets in 2008. That means that, in France, finance is still largely dominated by the banks. But at global level, as non-banks have increased their share of assets, the weight of banks in global finance has declined. This is partly down to the surge in stock market valuations, so in the value of the equities held by non-bank funds. But it's also due to the tightening of banking regulation after the global financial crisis, which has led to a form of regulatory arbitrage – where certain financial activities are shifted to players subject to less regulation.

LUCILE RIVES: So at global level, these non-bank players hold nearly as much in financial assets as banks. Does that mean they play an important role in financing the economy?

AGNÈS BÉNASSY-QUÉRÉ: Yes they do, and that's what's really positive about it: non-bank financial intermediaries have become an essential cog in the financing of the real economy. For example, in the final quarter of 2024, European funds and insurers held €335 billion of French non-financial corporation debt securities, in other words short and long-term debt, out of a total of €2,070 billion of French corporate debt – that's including bank credit. That means they held around 16% of French non-financial corporation debt, so yes, they're very important, and, for firms, they're a good way of diversifying their financing sources. They're a useful complement to bank loans, which are still the dominant form of financing in France.

PART TWO: THE RISKS POSED BY NON-BANK FINANCIAL INTERMEDIARIES: LEVERAGE, LIQUIDITY, INTERLINKAGES

LUCILE RIVES: That gives us a clearer idea of what non-bank financial intermediaries are, and what benefits they offer for investors and for the financing of the economy. But I imagine there must be downsides too. Can you tell us more about the risks linked to non-banks?

AGNÈS BÉNASSY-QUÉRÉ: Alongside the benefits to the economy, there are also risks. And that's what we're working on at the Banque de France and different international bodies. The main risk is that we might find ourselves with a combination of excessive debt in the case of certain entities, liquidity risk and significant interlinkages with the rest of the financial system, especially the banking sector.

Let's take the first item on that list: debt. A lot of financial intermediaries use what's called leverage, in other words debt, to invest more than they have in capital and thereby increase their financial firepower and profits.

LUCILE RIVES: Can you give us an example so we can really see what leverage is?

AGNÈS BÉNASSY-QUÉRÉ: Sure. Imagine an investment fund has €100 in capital. Without leverage, or debt, it will invest those €100, let's say in a project with an expected return of 10% per year. The gain after one year will be 10% of €100, so €10.

Now let's assume that the same fund can borrow €200 on top of its €100 in capital, which means it can now invest €300 (and not €100) in the same project paying a 10% return per year. Let's say the interest rate on the loan is 3%. After one year, the gain will be €30 (10% of €300 instead of 10% of €100). You then need to subtract the interest paid on the loan: 3% of €200, that makes €6 in interest payments. So the net gain will be €30 minus €6, which makes €24. That gives a return on capital of 24%, €24 on capital of €100, instead of 10% without leverage.

LUCILE RIVES: So leverage, which is borrowing to invest, allows the fund to maximise its gains when the project delivers the expected rate of return. But what happens when there's a turnaround in the market?

AGNÈS BÉNASSY-QUÉRÉ: True, leverage allows a fund to increase its gains, but it also increases its losses when things go wrong on the market. Let's take our example: the project can deliver 10%, but it can also lead to a loss, let's say of 10%. For the fund, the loss is proportionate to the amount invested. If the amount invested is €100, without leverage, the loss is 10% of €100, so €10. The initial capital was €100 and it now falls to €90.

Suppose the fund borrowed €200 and invested €300 instead of €100. The loss is 10% of €300, so €30. It also has to pay the interest on the loan, which is still €6. That means its initial capital of €100 will fall by €36. The loss is therefore 36% and the amount of capital falls from €100 to €64.

The problem is that, most of the time, the fund will have borrowed its €200 on the repo market, which is a contraction of "repurchase agreement".

LUCILE RIVES: Ok, why don't we take a minute to explain what a repo market is and how it works because I've a feeling we're going to need to know if we want to understand the risks linked to leverage.

AGNÈS BÉNASSY-QUÉRÉ: You're right, because that will bring us on to the subject of liquidity risk, which, when combined with high debt levels, is a problem, and so a major vulnerability for non-banks.

The repurchase agreement or repo market is a sort of short-term loan market where the loans are guaranteed by securities. A repo is an agreement between two parties whereby one temporarily sells the other securities in exchange for cash. For example, I sell you some securities and you pay for them in cash. That means I get some short-term cash. We also agree that I will buy back the securities after a pre-set period, and at a price agreed in advance.

In the case of our fund, it wants to borrow €200 and it has securities, but it doesn't want to sell them permanently. However, it would like the cash to invest in that project we talked about paying a 10% return. What it does is it sells its securities temporarily, for example to a bank, which pays for them in cash, and it also agrees to buy them back at the end of a set period, at a price agreed in advance. To make sure the fund will buy back the securities at the agreed price, the lending bank asks it to provide funded assets as a guarantee – for example, the assets purchased as part of the project, offering a 10% return. These are pledged as a guarantee, to secure the amount of the loan.

LUCILE RIVES: But why does the fact that funds borrow on the repo market and guarantee their loans with securities pose a risk? Maybe we can look at the example of our fund that borrowed €200 to invest in the project with the 10% return, because if the interest on the loan is lower than the expected return, that looks like a good deal to me.

AGNÈS BÉNASSY-QUÉRÉ: Yes, it's a brilliant idea, provided everything goes as expected, because it will bring in a lot of money. The problem comes when the value of the assets pledged as a guarantee falls, by 10% for example. Then the lending bank can ask for a bigger guarantee. That's called a margin call.

The fund will quickly need to find the extra liquidity to cover the margin call, €30 for example, and if it doesn't have enough cash, it will have to sell some of the assets in its portfolio, which will obviously make asset prices fall even further.

In France, funds are only moderately leveraged overall, especially compared with international hedge funds. At global level, some highly exposed funds have leverage of up to 20 or 25 times their capital. That's as if our fund, with €100 in capital, invested €2,500 instead of €100 or €300. If the value of the investment falls by 10% say, 10% of €2,500 makes €250. With an initial capital of €100, that means the fund no longer has enough capital to cover the loss and will go bankrupt.

LUCILE RIVES: OK, I can see the danger of being leveraged. You said that, to cover banks' margin calls, funds have to sell their assets quickly, which exacerbates the fall in prices. That's what we call liquidity risk, in other words the difficulty of selling assets quickly without affecting their value. How does this liquidity risk affect non-bank financial intermediaries?

AGNÈS BÉNASSY-QUÉRÉ: Let's go back to our example. The fund has €100 in capital that's owned by 10 investors, who each put in €10. Suppose there's a temporary market downturn and the 10 investors want their money back straight away. How can the fund pay them back if its investment has fallen by 10% and it still has to pay back the bank?

Luckily, that's an extreme case and it doesn't happen all the time. Some funds, such as money market funds, invest in liquid assets, so they can sell at any time without incurring losses, because they're selling short-term assets whose value doesn't change much over time.

Other firms are closed-end funds, which means subscribers or investors can't ask for their money back immediately. They have to wait until things improve.

But some funds, called open-ended funds, have a mismatch between their assets and liabilities, and that's where the problems start: on the assets side you've got securities, illiquid investments, shares, bonds, real estate, illiquid loans. Then on the liabilities side you've got fund shares that are liquid, in other words investors can ask for their money back at any time, be they households or institutional investors – we mentioned insurers earlier. When there's a crisis and investors want their money back quickly, we get an imbalance and, as the fund can't ask the lender of last resort, the central bank, for money, it has to sell off illiquid assets in a hurry, but there might not be much demand for them so prices can start to fall rapidly.

It's even more of a problem when investors all want to be the first to get out: if you know your fund doesn't have enough liquidity to pay everyone back and will have to sell off assets, you might start thinking you won't get your money back if you're at the back of the queue. That's the theory of bank runs, which here applies to investment funds – when even people who don't need liquidity immediately still rush to withdraw their funds because they're worried they won't get their investment back. It's a major vulnerability, and the more leveraged the fund, the bigger the risk.

If it only affects a small fund, it's not too bad; the investors might lose some money, the fund might collapse, but it's not a disaster. But if it's a bigger fund that has borrowed a lot from the banks, there can be a knock-on effect on other players, and that's when we need to start worrying. Especially if several large funds sell off their assets in a hurry; that will cause asset prices to fall for everyone, including banks, which will suffer indirect losses caused by the drop in asset prices.

LUCILE RIVES: But banks also use leverage. And they transform maturities. What's the difference between the risks linked to banking activities and the risks linked to non-banks?

AGNÈS BÉNASSY-QUÉRÉ: That's a very good question. You're right, banks collect our deposits, which are very liquid, and grant medium to long-term loans, for example to households so they can buy real estate, or to businesses so they can invest. They also sometimes borrow from funds on financial markets, or from other banks over the short term, to finance long-term loans. So yes, they do transform maturities.

But there are two big differences between banks and non-banks. The first is that, since the 2008 crisis, banks have had to comply with a much stricter regulatory framework, notably with the Basel 3 accords. Leverage, or debt, is strictly regulated, and banks also have to keep a share of their assets in liquid securities and deposits. This means they can cover withdrawals without having to sell off illiquid assets immediately. They also have to maintain a minimum ratio of capital to assets. We know that bank capital levels have increased massively since 2008, so they are capable of covering any losses.

The second big difference between banks and non-bank financial intermediaries is that banks have access to central bank financing. For example, if large numbers of depositors withdraw their money at the same time, banks can borrow from the central bank using securities as a guarantee, so they don't have to sell assets on the market.

LUCILE RIVES: At the start of this episode, you mentioned three factors that explain the risks linked to non-bank financial intermediaries. We've seen the dangers of excessive leverage and liquidity risk. The third factor is interlinkages with the rest of the financial system, especially banks. How are non-banks and banks interlinked?

AGNÈS BÉNASSY-QUÉRÉ: There are two types of links – direct and indirect. Direct links are when bank assets include loans to investment funds, as we've just seen. But on the liabilities side, banks also borrow from funds, mainly from money market funds that invest in bank debt securities.

There can also be indirect links. For example, when a fund has to sell off massive amounts of assets to cover withdrawals or margin calls, and several funds do it at the same time, that can push down asset prices for everyone, including for other players exposed to the same securities. Banks and insurers will see a fall in the value of their assets, leading to losses.

You might think that's OK, because each individual fund is limited in size. But some funds are really big. For example, at global level, the large index-linked funds that track the S&P 500, which is the main stock market index in the United States, those funds have assets of over $5 billion under management. They're not exactly small. They also tend to adopt similar investment strategies. So even if a fund is small, if it behaves like its peers, it's as if we had a systemically important fund. In France, for example, money market fund investments are often concentrated in short-term debt securities issued by banks. That means there's a risk they'll all behave in the same way if bank financing comes under pressure.

PART THREE: EXAMPLES OF CRISES

LUCILE RIVES: Leverage, liquidity, interlinkages: we've covered all the vulnerabilities. Has a combination of all three factors already caused a crisis?

AGNÈS BÉNASSY-QUÉRÉ: Yes. I can give you three main examples. First, in March 2020, at the start of the pandemic, there was a run on liquidity. Lots of investors wanted to withdraw their money from funds, and money market funds had to sell short-term bank or non-financial corporation securities on markets that had become highly illiquid. That means there weren't many buyers. The ECB had to step in and buy securities to stop the short-term private debt market from collapsing. The Bank of England and US Federal Reserve also intervened.

RADIO EXCERPT 1 (RTS morning show on 31 March 2023): *What happened to Crédit Suisse? The rate rise shone a stark light on the risks linked to speculative loans. They were first identified by hedge funds, which sold Crédit Suisse securities, accelerating the stock market downturn, and causing customers to panic and withdraw their assets en masse.*

LUCILE RIVES: That's an excerpt from the morning show on Swiss radio station RTS on 31 March 2023. Agnès, what happened to Crédit Suisse and how does that relate to the funds we've been talking about today?

AGNÈS BÉNASSY-QUÉRÉ: It was March 2021, so a year after the crisis at the start of the pandemic. The Archegos Capital Management fund, which was a family office, wasn't subject to all the usual reporting obligations that apply to funds precisely because of its status as a family office. It was highly exposed to derivatives, using leverage, meaning it had a lot of debt. Its exposure was concentrated in a few tech stocks, so, when those stocks fell sharply, Archegos could no longer meet the margin calls we talked about earlier and its bank counterparties, notably Crédit Suisse and Nomura, which had loaned money to Archegos, racked up losses of over 10 billion, half of this for Crédit Suisse alone.

LUCILE RIVES: Let's listen to another excerpt to talk about the third crisis.

RADIO EXCERPT 2 (La Polémique, BFM Business, 30 September 2022): *UK borrowing rates have shot up to Italian levels. The Bank of England is going to hike its key rates. It's done something completely unprecedented, in response to what can only be called a panic, and at a time when its main focus should be bringing down inflation: on Wednesday it decided to purchase an emergency £65 billion of UK government 15, 20 and 30-year debt. Because all the UK pensions funds were offloading their 30-year bonds, on the grounds that a 30-year horizon is now just too uncertain.*

LUCILE RIVES: That was an excerpt from Nicolas Doze's segment on BFM Business, from 30 September 2022. Can you explain why the Bank of England intervened in September 2022? And the same question as before – how does that relate to funds?

AGNÈS BÉNASSY-QUÉRÉ: That was in September 2022, a little over a year after the Archegos and Credit Suisse episode, and it was what we call the mini-budget crisis in the United Kingdom – mini-budget in inverted commas because it caused a massive movement on the markets. So what was it? Pension funds, by definition, have long-term commitments to their customers, who are the people who invested their money with them with the intention of withdrawing it decades later. These funds had got into the habit of borrowing over the short term to buy long-term government bonds, to extend the maturities of their assets so that they matched those of their liabilities. They also had roll-over mechanisms because there aren't many very long-term assets on the market. These long-term bonds were used to guarantee borrowing, using the repo mechanism we explained earlier. But when the UK announced its mini-budget, which would have caused the deficit to rise massively, interest rates on UK government debt soared. When rates rise, bond prices fall, basically because if you've got a UK bond, let's say one that pays a rate of 3%, and the next day market rates are 4%, no one is going to want to buy your 3% bond, which means its price will fall until the coupon on the bond divided by its price gets to 4%, which is the market rate. So when rates rise, prices fall, which meant banks then issued margin calls, as they usually do, and the pension funds had to sell massive amounts of bonds to raise cash and cover those margin calls. The sell-off was so big that the Bank of England had to buy bonds to stop prices falling, at a complicated time when it was supposed to be normalising its monetary policy, so reducing the size of its balance sheet following the Covid crisis. When it was supposed to be normalising, it in fact, for a short period, had to buy debt in the market. In terms of communication, it managed it fairly well, this contradiction between the two actions.

PART FOUR: HOW CAN WE GO ABOUT REGULATING NBFI?

LUCILE RIVES: You said before that certain reporting regulations didn't apply to the Archegos fund. That brings me to the issue of the regulation of non-bank financial intermediaries. Are they currently regulated? And if yes, how?

AGNÈS BÉNASSY-QUÉRÉ: Regulation exists, but it's still highly fragmented. It depends on the fund type, which is fairly normal, but it makes the landscape a bit complicated. Take, for example, the case of money market funds, which have a strong presence in Europe; they're governed by the MMFR or Money Market Funds Regulation. It's a text that sets out precise rules, notably on liquidity buffers: they have to keep a set portion of highly liquid assets so they can cover any sudden withdrawals. It's pretty logical given what we said earlier.

Moving on to alternative funds – hedge funds or some real estate funds – they're covered by the European directive on AIFM, Alternative Investment Funds Management. This requires managers to report regularly on their activities, which means publishing data on their balance sheet, and informing the authorities, such as the AMF – *Autorité des Marchés Financiers* – in France, of the structure of their investment portfolio, their level of leverage, their liquidity risk, so a number of ratios. But this reporting relies on data provided by the funds themselves, which in some cases can make it less effective.

Funds for retail investors, such as UCITS – Undertakings for Collective Investment and Transferable Securities – are subject to the UCITS directive. This sets out rules on diversification and liquidity, because UCITS are standardised products for the general public and so they're the most strictly regulated.

Over time, there's been a tendency to try to harmonise the regulation. For example, in the case of the UCITS and AIFM directives, for retail and alternative funds, the last revision, which came into force in April 2024, harmonised liquidity management tools for all fund types.

What are liquidity management tools? They're tools that either limit capital outflows, for example withdrawals, which we call gates or redemption suspensions, or charge investors to access liquidity, for example fees or price adjustments that you pay the fund when you make unscheduled withdrawals.

LUCILE RIVES: But why won't these regulations prevent future crises?

AGNÈS BÉNASSY-QUÉRÉ: The problem is that certain tools are actually controlled by the fund managers themselves. They can be reluctant to activate them for fear of sending investors a negative signal. It's what we call the stigmatisation effect. If the fund activates the tools, it means there's a problem, so I'm immediately going to ask for my money back.

The second problem is the tools' calibration. Particularly where to set the activation threshold. If it's too high, there's no point activating it. If it's too low, there's a risk that activating it will be counterproductive. In other words, the fund might decide to activate redemption restrictions when daily requests exceed the threshold but aren't necessarily that much higher than usual. So instead of containing a crisis it can in fact exacerbate it.

LUCILE RIVES: There's another problem, which is that these rules are microprudential. In other words, they apply to each fund individually.

AGNÈS BÉNASSY-QUÉRÉ: Exactly. They don't take account of the consequences of funds' behaviour in underlying markets, when they sell off assets suddenly, or the contagion effects this can cause. In this sense, there's still room for progress. For example, for money market funds, there are rules on diversification and rules on how much individual funds can be exposed to a specific issuer, to limit their impact on the market. They also have to meet daily and weekly liquidity requirements, that are specifically defined in figures, in a regulation. So there are some rules in place to limit systemic risk.

If we look now at alternative funds, a recent development is an article that raises the possibility of a macroprudential measure – authorities could decide to limit the leverage ratio of certain funds. Ireland did it recently by restricting leverage for alternative real estate funds, which is a first in this field. Admittedly, leverage there was very high, but in France it's a lot lower.

LUCILE RIVES: In the crises you mentioned, central banks had to intervene as lenders of last resort. This liquidity of last resort is normally reserved for banks and is conditional on them meeting strict prudential rules – minimum capital ratios, liquidity ratios. Doesn't that create a moral hazard, in that non-banks know that the central bank will step in, so they have no incentive to avoid risk?

AGNÈS BÉNASSY-QUÉRÉ: It's a paradox in the current system. There's a sort of agreement between banks and central banks. Banks are closely regulated and, in return, they have access to lenders of last resort. What we're seeing today is that funds aren't subject to the same prudential requirements as banks, but in practice they can benefit indirectly from a sort of public safety net provided by central banks. This clearly raises the risk of moral hazard. Why behave prudently if you know that, in the event of a crisis, the central bank will come to the rescue?

LUCILE RIVES: What can we do about that paradox, to make the sector more resilient?

AGNÈS BÉNASSY-QUÉRÉ: It's a major challenge for regulators. Some institutions, including the Banque de France, want to take a macroprudential approach to the sector, in other words regulation that doesn't just apply to each entity individually, but rather takes account of interdependencies, cyclicality, so fluctuations over the credit or economic cycle, and the systemic nature of certain players or behaviours. The Banque de France and the ACPR have notably helped to draft a joint Eurosystem response to a European Commission consultation on the suitability of the macroprudential framework for non-bank financial intermediaries, and are pushing for a number of measures to be introduced at European level.

LUCILE RIVES: What exact measures are being proposed and supported, notably by the Banque de France?

AGNÈS BÉNASSY-QUÉRÉ: Some measures are relatively easy to understand. The first, of course, is to make it easier to access data, so regulators can assess non-banks' vulnerability; in other words, access to good quality data to better understand the three areas of risk: liquidity, leverage and interlinkages.

The second measure put forward is to classify open-ended funds – funds that are liquid for their investors – according to the liquidity of their assets. You've got funds that have liquid liabilities and liquid assets. That's less of a problem than funds that have liquid liabilities but illiquid assets. Classifying them according to their asset liquidity would allow regulators to set rules for the most vulnerable funds, liquidity management rules such as redemption suspensions.

A third proposal is to introduce liquidity buffer requirements for all funds, not just money market funds.

A final recommendation is to develop stress tests for the entire financial system. The Banque de France is preparing a pilot test this year. Like the stress tests carried out on banks and insurers each year, it would involve constructing an adverse or extremely adverse scenario and seeing how institutions' balance sheets adjust without causing losses. The idea would be to do this for the entire financial system, including all types of entity, and taking account of their interlinkages. It's a lot of work but it's interesting and useful given the potential systemic risks.

These recommendations obviously raise technical and political questions. As we've seen, the fund industry is extremely diverse, very international and often less transparent than the banking industry. Implementing these recommendations will be fairly complex. But it is becoming increasingly necessary because of the risks we've just talked about, and because we need a healthy and resilient non-bank financial sector as a basis for constructing our Savings and Investments Union. I encourage you to listen to the podcast about that project and how it could foster investment and increase returns on savings in Europe.

LUCILE RIVES: That's a perfect way to end: by inviting our listeners to listen to the very first episode of Dialogue &co in which you talk about that topic. Thank you very much Agnès Bénassy-Quéré.

Voice-over: Thank you to all our listeners. Don't forget to subscribe to Dialogue &co on your podcast platform and leave comments and stars. You can also email us your questions on economic issues at following address: podcast@banque-france.fr.

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