Update on Asset Management and Non-bank Financial Intermediation in Belgium

ABSTRACT

This article summarises the main findings of the most recent joint update report on asset management and *Non-bank financial intermediation* (NBFI) by the Financial Services and Markets Authority (FSMA) and National Bank of Belgium (NBB), published on 6 May 2021. It is the third update of the joint NBB-FSMA report on Asset management and NBFI, formerly referred to as shadow banking, which was submitted to the Minister of Finance and the High-Level Expert Group (HLEG)[1], and subsequently published, in September 2017.

1. Introduction

The joint NBB-FSMA report of 2017 was published as result of a recommendation by the HLEG for such a joint report as regards the systemic risks stemming from the asset management and shadow banking sectors, their interconnectedness with other (financial and non-financial) sectors and related consumer protection aspects. The main goal of the

[1] In 2015, the Minister of Finance announced the establishment of a High-Level Expert Group (HLEG) on the Future of the Belgian Financial Sector, with a mandate to reflect on the position of the Belgian financial sector, the main challenges it is facing and its long-term prospects. The report of this HLEG ("The future of the Belgian financial sector") was published on 12 January 2016 and one of the findings related to the growth of the non-bank financial sector: "*This downsizing and deleveraging of the banking activities went together with an increase in the non-bank and in particular the so-called shadow banking activities, leading to some diversification of the funding sources and instruments but also to potential risks which will need to be monitored.* [...] *While this parallel banking sector (shadow banking) offers scope for wider diversification of funding sources, an increased loss absorption capacity of the economy, and potential efficiency gains in capital allocation, it could also render financing flows more opaque and possibly increase risks through more extreme liquidity risks and leverage positions.* [...] *To the extent that the shift towards more non-bank intermediated finance becomes structural – potentially supported by the EU's Capital Markets Union initiative – there may be a need to extend the supervisory and macro-prudential reach and to ensure close coordination and information exchange between supervisors both at national as well as EU levels.*"

joint FSMA-NBB monitoring update reports is to present annual updates of the key statistics used in the initial joint report and of the related assessments and conclusions regarding potential systemic risks. The reports also contain a review of relevant national and international developments, regulations and ongoing policy work.

In line with the Financial Stability Board (FSB)'s decision in October 2018 to change the terminology, the latest update reports now use the better-suited term *Non-bank financial intermediation* (NBFI) for what was previously called *shadow banking*. This terminology change does not affect the substance, or the coverage of these reports compared to the first reports.

The joint NBB-FSMA report of 2017 and the subsequent updates are available on the websites of the NBB and FSMA[2].

2. Market-based financing

The growth of the NBFI and asset management sectors relates to the ongoing evolution towards a more market-based financial system, where an increasing share of financial intermediation occurs outside the banking sector.

This market-based financing provides a valuable alternative to bank funding and helps to support real economic activity but if it is involved in bank-like activities such as maturity or liquidity transformation and facilitating or creating leverage, it may also contribute to risks to financial stability and create additional risks for investors, directly or through its interconnectedness with other sectors.

Market-based financing can take many forms, and the NBB and FSMA were asked to focus their joint report on asset management and NBFI. As both sectors overlap only to some extent, the report analyses the Belgian asset management and NBFI sectors separately, to map and comment all relevant aspects. Various ways of defining and measuring the sectors are reviewed and relevant activities and regulations are documented. A detailed overview of the existing and ongoing regulatory requirements shows that NBFI entities are subject to regulation, although in a different manner than banks and insurance companies and focusing on consumer protection[3]. The report also highlights the links and interconnectedness that exist between both sectors and other Belgian financial intermediaries on the one hand and the Belgian non-financial private sector on the other.

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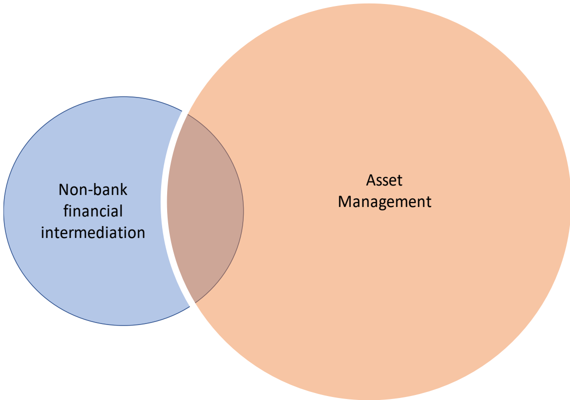
[2] www.nbb.be; www.fsma.be.

[3] In particular, the statute of an asset manager is comparable to the statute of an investment firm under MiFID.

Chart 1: Non-bank financial intermediation and asset management



3.Evolution of the Belgian asset management and NBFI sectors over time

3.1. Overview of the Belgian asset management sector

Asset management refers to the segment of the financial industry that is involved in the management of financial assets on behalf of investors, either through the collective management of an investment fund or through the discretionary management of an individual investor's portfolio. Those investors can be households or non-financial corporations as well as professional investors such as financial institutions. The reports provide a description and an overview of the asset management sector in Belgium, based on various definitions and data sources that can be used to document the size of different forms and types of asset management-related activities.

The size of the asset management sector in Belgium depends on the yardstick used to measure it (see also Table 1). The evolution of its size depends to a large extent on the mark-to-market changes in the value of the assets under management in line with global capital market developments. Net assets of Belgian investment funds, at the core of the asset management sector, rose to € 191 billion at the end of 2020 (up from € 185 billion at the end of 2019), while assets under management of Belgian asset managers climbed to € 269 billion. Assets generating fee and commission income for Belgian banks, which include also foreign investment funds distributed to Belgian residents, reached € 621 billion at the end of 2020. Most of these assets are part of authorised or registered investment funds, life-insurance policies, or Belgian institutions for occupational pensions, while part of them are simply clients' portfolios managed on a discretionary basis by the banks themselves.

Table 1: Gross statistics of asset management activities relevant for Belgium (€ *billion)*

	(Net) Assets [1]				
	2016	**2017**	**2018**	**2019**	**2020**
Belgian investment funds	**144**	**175**	**164**	**185**	**191**
Public	127	155	147	165	172
Non-public	17	19	17	20	19
Belgian asset managers	**248**	**292**	**219**	**246**	**269**
Assets under collective management	146	181	130	144	165
Assets under discretionary management	103	111	90	102	104
Assets under investment advice	2	2	3	5	9
Assets generating fee and commission income for Belgian banks	**531**	**582**	**545**	**617**	**621**
Assets managed in the bank	336	365	350	396	406
Collective management	193	214	209	243	262
Discretionary management	143	151	141	153	144
Collective investment products distributed but not managed	195	217	195	221	215
Foreign investment funds held by Belgian residents [2]	**189**	**214**	**201**	**236**	**235**
Households	100	114	95	107	108
Other investors	89	100	106	129	127
Investments of Belgian insurance companies in investment funds [2]	**46**	**50**	**48**	**60**	**61**
Investments of Belgian institutions for occupational retirement provision in investment funds	**21**	**25**	**25**	**30**	**33**

Source: FSMA, NBB.

Notes:

This table presents the gross statistics (€ billion) that are discussed in the joint FSMA-NBB Update Report on Asset management and Non-bank financial intermediation in Belgium (2021) concerning the assets involved in the Belgian asset management sector and asset management related activities in Belgium. ***[1]*** *For the Belgian investment fund sector the net asset value (NAV) is reported. For Belgian asset managers the assets under management (AuM) are reported. For Belgian banks the assets involved in asset management activities that generate fee and commission income are reported. For foreign investment funds held by Belgian residents the size of the holdings by households and other investors is reported; for insurance companies and institutions for occupational retirement provision (pension funds), the size of their holdings of investment funds is reported.* ***[2]*** *The data for 2020 for foreign investment funds held by Belgian residents and for investments of Belgian insurance companies in investment funds refer to end-September 2020.*

3.2. Overview of the Belgian NBFI sector

NBFI is, as such, not identified in the available statistical reportings and needs to be derived from existing statistics on a best effort basis. Moreover, many definitions of NBFI exist.

One such definition is that of the Financial Stability Board (FSB), defining NBFI as "*credit intermediation that involves entities and activities fully or partially outside the regular banking system*". Chart 2 shows the delineation of the sector, starting from the total assets of the very broad FSB-defined "NBFI sector"[4]. It consists mainly of money market funds (MMFs) and non-equity investment funds (€ 129 billion) and — to a much more limited extent — of firms engaged in loan provisioning that is dependent on short-term funding such as leasing, factoring or consumer credit companies, not part of banking groups (€ 2.4 billion) and of securitisation that is not retained on banks' balance sheets (€ 6.4 billion).

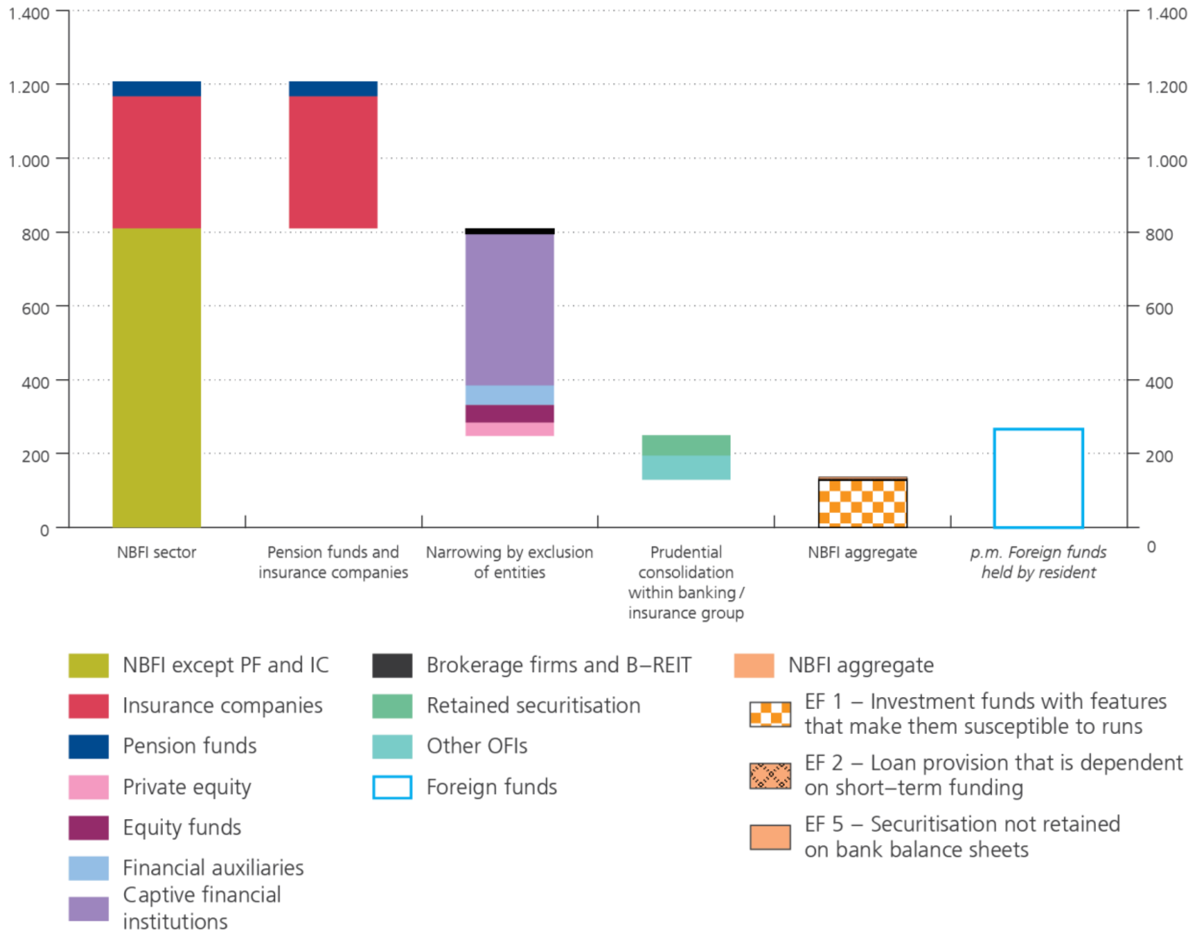
The Belgian NBFI sector according to the FSB definition has been very stable in recent years (see Chart 3): its size amounted to € 138 billion at the end of September 2020, compared to € 137 billion at the end of 2019, € 139 at the end of 2018 and € 148 billion at the end of 2017. According to this FSB definition, the Belgian NBFI sector thus only represents around 1/10 of the total financial assets held by the Belgian non-bank financial sector and 1/20 of the assets of the total Belgian financial sector (including bank sector assets).

Under the narrower definition of the European Banking Authority (EBA) framework[5], the NBFI sector accounted for € 14 billion at the end of September 2020 (versus € 21.5 billion at the end of 2018). In both the FSB and EBA aggregates, the main component of the total is accounted for by the eligible Belgian investment funds (close to 95 % under the FSB framework, € 129 billion out of € 138 billion).

4 Previously called MUNFI, the monitoring universe of non-bank financial intermediation. For the 2020 FSB Global Monitoring Report on Non-Bank Financial Intermediation, the FSB decided to modify this terminology to be less technical and gain better public accessibility.

5 Under the EBA framework, only money market funds (MMFs) and some alternative investment funds (AIFs) are considered to fall within the scope of the definition of NBFI. The FSB framework encompasses not only MMFs and highly leveraged investment funds but all investment funds, with the exception of equity funds.

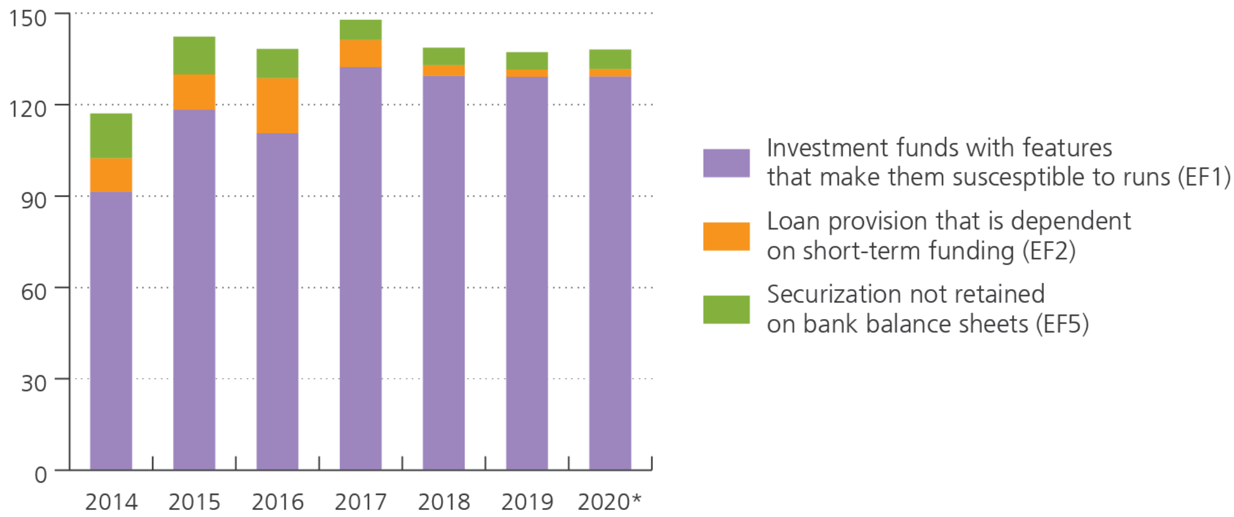
Chart 2: Delineation of the Belgian NBFI sector according to the narrow FSB definition (€ billion, September 2020)



Source: NBB calculations based on NAI data.

Notes: *NBFI = Non-bank financial intermediation; PF = Pension fund; IC = Insurance company; OFIs = Other financial intermediaries; B-REIT = Belgian Real Estate Investment Trust*

*Chart 3: **Belgian NBFI sector, broken down by economic function, according to the narrow concept of the FSB** (€ billion)*



Source: NBB calculations based on NAI data.

Notes: **Data for 2020 refers to September 2020*

4. Monitoring framework, current regulation and ongoing policy work

Aggregate numbers on the size of asset management and NBFI sectors should not be used as a *prima facie* measure of underlying risks (or changes therein). They can only serve as a starting point for delving deeper in the — very heterogeneous — nature of the underlying assets and liabilities and their links with other sectors of the economy. In that perspective and following an assessment of the drivers of recent changes in the key statistics for the Belgian asset management and NBFI sectors, it appears that the qualitative findings and conclusions from the initial report from 2017 on the systemic risks associated with asset management and NBFI still remain broadly unchanged. The dynamic development of some of the key indicators underscores nevertheless again the need for maintaining a close monitoring of these sectors going forward, including for the interconnectedness with other financial and non-financial sectors in Belgium.

The Covid-crisis and the related "dash for cash" across global financial markets in March 2020 showed in this connection several vulnerabilities in specific subsegments of the money market fund sector and some open-ended investments funds investing in less liquid assets, such as certain segments of the corporate bond market and real estate. While interventions by central banks and national authorities contained the spill-overs of these developments, they also triggered a number of regulatory and supervisory actions to review and address the revealed vulnerabilities. Following the market turmoil and concerns related to the potential materialisation of liquidity risks, Belgian money market funds and other Belgian public open-ended investment funds were monitored very closely as of March 2020. The monitoring allowed the FSMA to track net inflows or outflows into certain segments and specific funds. It showed that the Belgian public open-ended investment fund industry was overall strongly resilient to the market developments in March 2020. In conclusion, the market developments can be considered as a "live stress test" for the Belgian investment fund industry, as it replicated some of the market dynamics and challenging liquidity conditions that regulators have worried about the last years. While some Belgian public open-ended investment funds saw large redemptions during this period, all redemption requests could be managed. None of these funds had to suspend redemptions.

For a subset of the Belgian investment funds, the main risk is liquidity risk, and particularly the risk of sudden, large-scale redemptions, stemming from a potential mismatch in the liquidity of an investment fund's assets and its redemption profile. While most of the investment funds within the Belgian asset management and NBFI sectors are open-ended, the associated liquidity risks are already partly addressed through several lines of defence. First, the relevant legislation imposes detailed *asset eligibility rules* on Belgian public open-ended investment funds, which strongly mitigate liquidity risk for these types of funds. These funds are in general only allowed to invest in listed financial instruments, deposits, units of other investment funds subject to similar (asset eligibility) rules, and derivatives, subject to certain restrictions. Real estate, commodities, unlisted securities, loans and other alternative asset classes are, in principle, excluded as eligible assets for the existing public open-ended investment funds. Second, authorities organise thematic reviews of UCITS' managers liquidity risk management. For example, in partnership with the ESMA, FSMA conducted during 2020, a Common Supervisory Action (CSA) on the supervision of UCITS' managers liquidity risk management and an assessment of the liquidity risk for corporate debt and real estate funds. Third, the Royal Decree of 15 October 2018 has introduced a legal framework for public open-ended funds to set up a number of liquidity management tools: swing pricing, anti-dilution levy and redemption gates. Together with international bodies such as the ESRB, ESMA and IOSCO, the FSMA stressed the importance of the timely availability and use of the liquidity management tools, particularly in times of market stress. During 2020, the FSMA has required that asset management companies and investment companies make at least one of these liquidity management tools available to all Belgian public open-ended funds. At the end of 2020, one or more liquidity management tools was available to the vast majority of the Belgian public funds for which the introduction was requested.

The risk analysis of the Belgian NBFI sector (€ 138 billion according to the FSB definition, chart 3), covering financial stability and considerations with respect to consumer protection, is based on a set of credit, liquidity and leverage metrics and the key findings are as follows:

- The main risk for the *investment funds* that are part of the Belgian NBFI sector (€ 129 billion) is *liquidity transformation* and essentially reflects the redemption risk linked to the fact that the liabilities of the funds are mostly composed of units redeemable on a daily basis that are not (fully) covered by assets with similar liquidity.

As highlighted above, the composition of the Belgian investment fund sector makes that this risk is mitigated by *several lines of defence*.

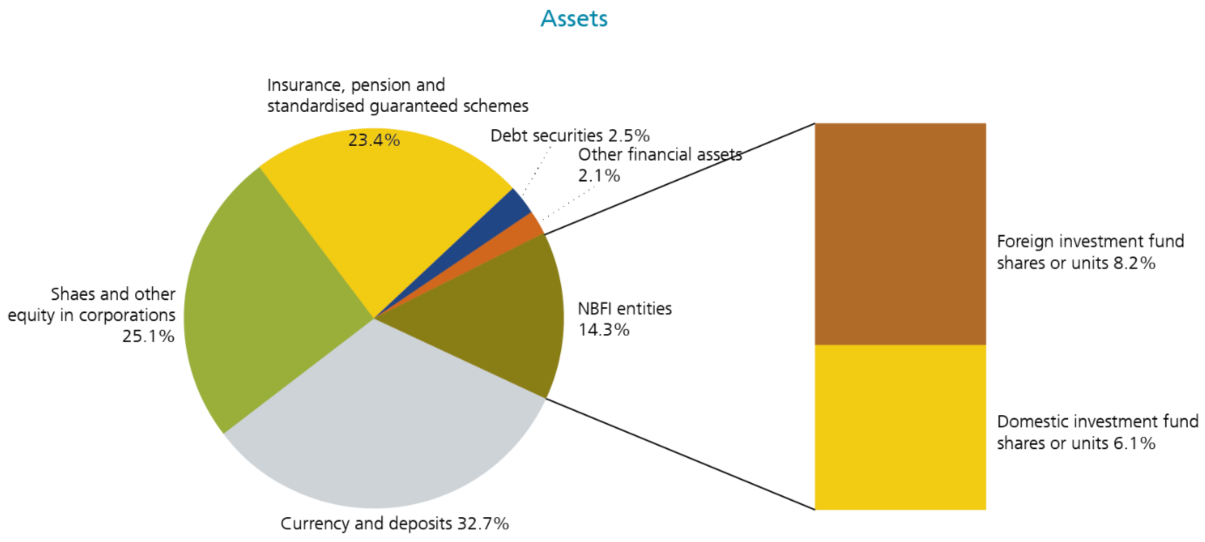
- Risk metrics for the *Belgian finance companies* — such as leasing, factoring, consumer credit and mortgage companies and other finance companies —, can only be calculated for all the entities of this sector taken together, including those being part of banking groups. These metrics reveal that their position with respect to liquidity transformation is rather comfortable and maturities on both sides of the balance sheet are relatively balanced. They do have *leverage, but it is relatively contained* compared to banking sector averages. Many of these entities are prudentially consolidated into banking groups and are therefore not part of the Belgian NBFI sector according to the FSB definition. Hence, the *sub-segment of the finance companies that is part of the NBFI sector is small* (€ 2.4 billion). But the products that these intermediaries offer can expose already vulnerable borrowers to significant leverage.

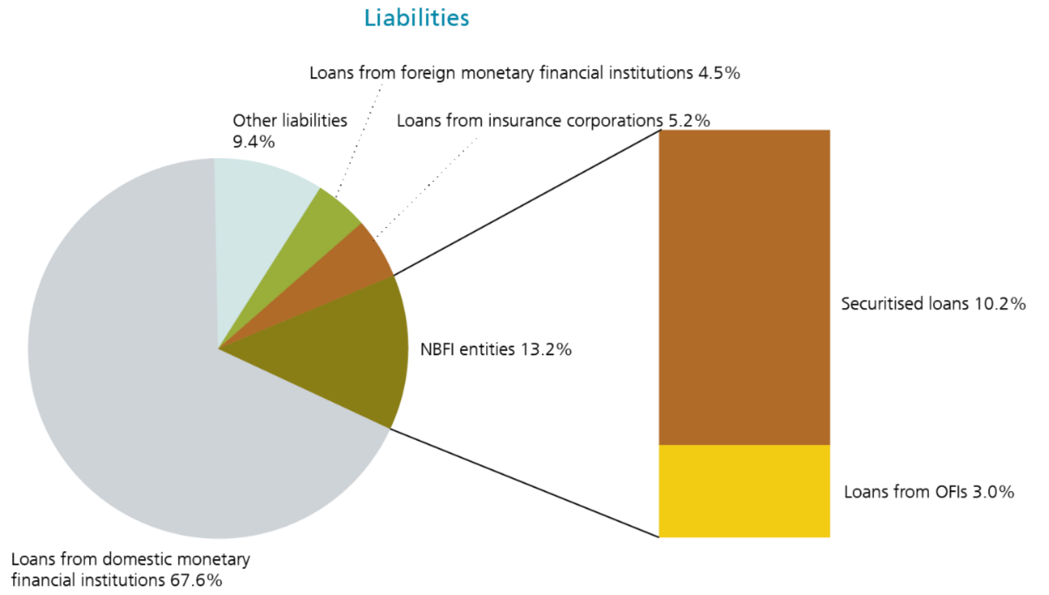
- The risk metrics for the *securitisations* (of which only the non-retained securitisations are part of the Belgian NBFI sector; € 6.4 billion) show that *leverage is the most important risk*. Their *position with respect to liquidity transformation is rather comfortable and maturities on both sides of the balance sheet are relatively balanced*. Given these limited maturity or liquidity mismatches, leverage should in principle be less of a problem as there will most likely not be a need to liquidate the assets.

Both the asset management and NBFI sectors present, to varying degrees, *contractual* asset, liability or off-balance sheet links with other sectors of the economy, be they households, non-financial corporations, banks or other financial intermediaries such as insurance companies and pension funds. In some cases, there may also be non-contractual links, as in the case of the so-called step-in risk (implicit guarantees of a sponsor to asset management vehicles to avoid reputation risk for example). This interconnectedness is not new, and the mapping of these links as part of the work undertaken for the report has helped to demystify to a large extent the aggregate interlinkages that are shown in the whom-to-whom exposures of the financial accounts.

For the <u>Belgian households (chart 4) and the non-financial corporations</u>, the links with NBFI entities highlighted are mainly the expected ones (investments of households in investment funds; leasing, factoring and other forms of non-bank financing in the case of the non-financial corporations) and the associated risks seem to be contained. Belgian households that invest in investment funds are in general characterized by higher incomes which limits potential wealth effects linked to an important decrease in the asset values of the investment funds. Belgian non-financial corporations have thin connections with the asset management and NBFI sector, both at the asset side and liability side.

Chart 4: Breakdown of households' financial assets and liabilities (% of total, end September 2020)



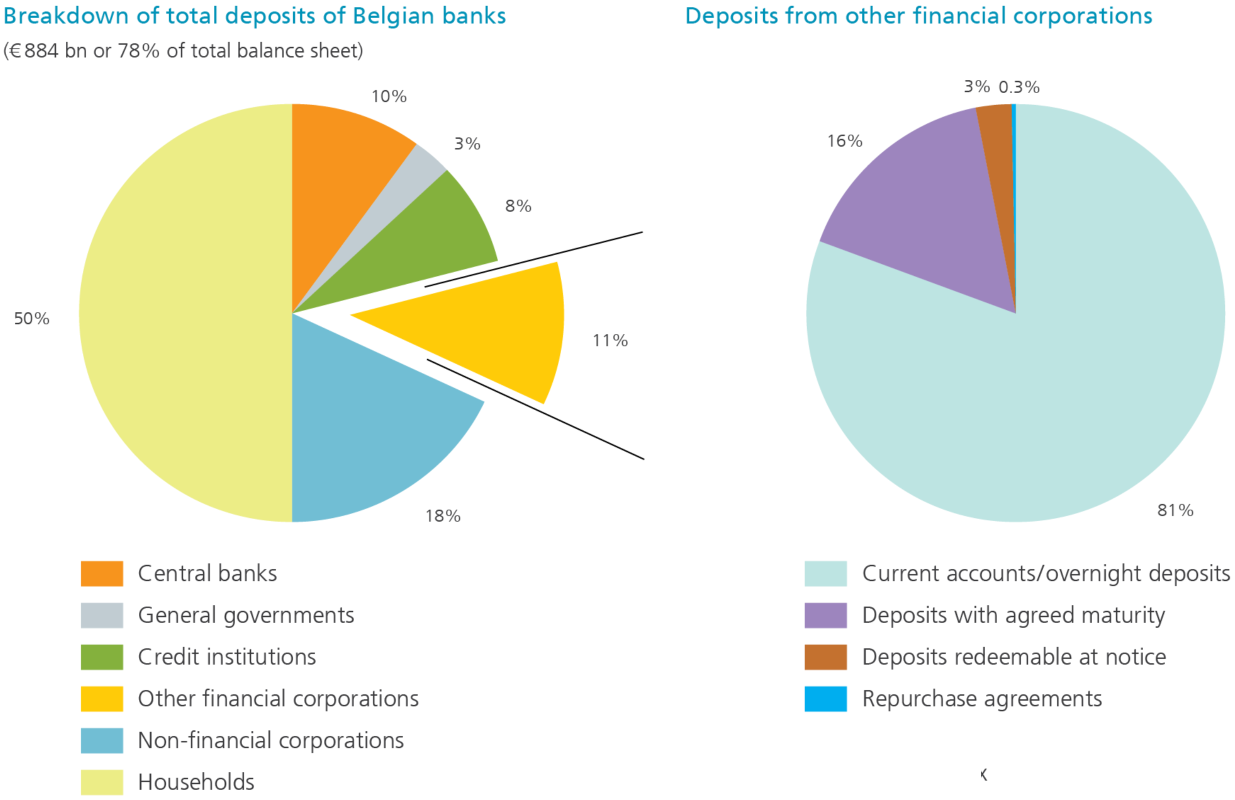


Source: NBB (Financial accounts statistics).

Notes: *Shares of equity investment funds are excluded in the investment fund holdings shown in the chart (in line with the NFBI narrow measure as defined according to the FSB).*

As expected, the interconnectedness with NBFI entities and asset management activities is stronger for the Belgian bank and insurance sector, especially in case of "intra-conglomerate" entities. These links consist in the first place of contractual links and pertain for example to the funding received by banks from investment funds, asset management vehicles and NBFIs (chart 5 shows in this context the deposits received by Belgian banks from 'other financial corporations'). Banks also act as sponsor of these entities or as their derivative and securities lending counterparty. While no Belgian-specific issues were revealed at sector level or of systemic relevance, this interconnectedness requires further close monitoring, especially for non-contractual links and related “step-in” risks.

Chart 5: Breakdown of total deposits of Belgian banks *(end 2020, consolidated data)*



Source: NBB, FINREP.

5. Policy recommendations

5.1. General policy recommendations: follow-up

The importance of the asset management and NBFI sectors, as well as the interconnectedness of the NBFI sector with the banking sector and other sectors of the economy demand a continuation of the current monitoring efforts of both sectors by the FSMA and the NBB.

Since 2017, the reporting requirements of the asset management sector, the largest part of the Belgian NBFI sector, have continually been improving, in term of scope, quality and frequency. The data availability and consistency have significantly increased, as has the data analysis. This allowed for a closer monitoring of the asset management sector, which in turn enabled to strengthen its risk monitoring, in line with the first recommendation from the 2017 report. In line and ahead of European developments, the data collection and data analysis of Belgian public funds have been transformed.

Both the FSMA and the NBB have also continued to contribute to the work done by international/supranational institutions involved in the monitoring, risk assessment and policy implementation for NBFI (including, but not limited to, the FSB, IOSCO, ESRB, EBA and ESMA). The European and international efforts to address remaining vulnerabilities in the global NBFI-sector are also supported through the work in these international fora.

5.2. Specific policy recommendations: follow-up

Mismatches between the liquidity of open-ended investment funds' assets and their redemption profiles have been identified by the FSB, IOSCO and the ESRB as a potential risk to financial stability. Furthermore, if liquidity mismatches in investment funds are not managed properly, they may adversely impact investors in those funds. The international bodies therefore propagate a wider availability of liquidity management tools, which allow illiquidity costs to be passed on to those investors that cause them and/or to partially restrict the execution of redemption requests under certain conditions.

During the COVID-19 crisis, the Royal Decree of 22 April 2020 exceptionally enabled Belgian public funds to use liquidity management tools (swing pricing, anti-dilution levies and redemption gates) without any prior amendment to the prospectus. Meanwhile, the FSMA required making at least one of the above-mentioned liquidity management tools available to most Belgian public funds.

In line with the specific recommendation of the first NBB-FSMA report on asset management and NBFI, one or more liquidity management tools were available, at the end of 2020, to the vast majority of the Belgian public funds for which the introduction was required.

The 2017 report on asset management and NBFI also identified the need to mitigate potential risks related to the interconnectedness between the NBFI sector and asset management vehicles and other sectors of the Belgian economy (banks, insurance companies and pension funds, households and non-financial corporations). The importance of conglomerate supervisors to focus on such interlinkages and on regulatory arbitrage opportunities and the need to ensure that off-balance sheet activities are scoped into the perimeter of financial group supervision was also flagged by the International Monetary Fund (IMF) in 2018 when it published its Financial Sector Assessment (FSAP) report assessing the Belgian financial sector. The NBB has in that regard continued to closely monitor and analyze both the contractual and non-contractual links between NBFIs and asset management vehicles on the one side and banks and insurance companies on the other side, especially within financial groups. These efforts have been complemented by further developments in the regulatory field regarding bank supervisors' capabilities to deal with so-called "step-in risks" where supervised entities decide to provide financial support to an unconsolidated entity that is facing stress, in the absence of, or in excess of, any contractual obligations to provide such support to avoid reputational risk.