INTUITION

The Intuition Finance Digest

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NBFIs come under regulators' spotlight

Nonbank financial institutions (NBFIs) such as hedge funds, private equity firms, and money market funds have taken a growing share of financial intermediation from traditional banks. This shift toward so-called "shadow banking" has heightened concerns about systemic risk, prompting regulators to step up scrutiny of the sector.

The EU is the latest jurisdiction to turn up the heat on NBFIs, with the ECB preparing new stress tests amid growing concerns over systemic risks. While hedge funds and private equity firms have drawn particular attention due to their relatively light regulatory oversight, the upcoming assessments are also expected to cover pension funds and insurers.

Lending growth by NBFIs has steadily outpaced that of traditional banks, reinforcing concerns about the opacity of their practices and disclosures. As key components of the shadow banking system, these entities often engage in complex and less transparent activities, which can amplify risks such as leverage and liquidity mismatches. Regulators and some market observers fear that, if left unchecked, these factors may pose significant threats to regulated banks and the broader financial system.

Developments in Europe follow similar moves in the US and UK that reflect comparable regulatory concerns.

Fed tests for NBFI credit and liquidity stress

The Federal Reserve (Fed) recently announced an "exploratory analysis" into risks to the banking system, focusing initially on how banks might be affected by adverse conditions impacting their NBFI borrowers.

To assess the risks of credit and liquidity shocks to NBFI borrowers during a severe global recession, the Fed will simulate macroeconomic conditions equivalent to the "severely adverse" scenario used in its broader 2025 banking supervisory stress tests.

The exploratory analysis will also consider additional credit and liquidity stress factors likely to affect specific categories of NBFIs, including:

- A sharp deterioration in the credit quality of assets held by highly leveraged NBFIs that extend credit, resulting in downgrades to their own credit ratings
- Heavier reliance on bank credit lines, as NBFIs – historically more dependent on these facilities during periods of stress – draw down their available funding more aggressively

Bank of England tests

Late last year, the Bank of England released results from an exercise modeling how a financial crisis would impact on the nonbank sector. The Bank's November Financial Stability Report highlighted significant and growing interlinkages between UK banks and nonbank finance, as UK investment banks provide market-based finance (MBF) that supplies liquidity and funding to NBFIs.

The Bank's report also noted banks' substantial counterparty credit exposures, including to leveraged counterparties such as private equity firms and hedge funds via prime-broking activities. Were NBFIs to reduce exposure to riskier credit assets, such as leveraged loans, banks could face mark-to-market losses in their origination, underwriting, and syndication activities.

Lending to NBFI sector accelerates

A new report by Barclays research analysts states that US bank lending to NBFIs has risen fivefold over the past decade to over USD1 trn. This figure accounts for more than 10% of all US banking loans and 5% of assets.

Essentially, banks are lending less directly to end-customers and more to NBFIs, which in turn deal directly with those customers.

According to Barclays, this shift is largely driven by capital requirements. In the US, most commercial exposures carry a 100% risk weighting, whereas loans to NBFIs may carry risk weightings as low as 20%.

Implications of market shock

As for the wider implications of a market shock, the Fed is expansive on the cascading and interlinked effects throughout financial markets.

Its exploratory market shock is described as a sudden dislocation to financial markets arising from expectations of reduced global economic activity and higher inflation expectations. Under these conditions, the US dollar is expected to appreciate against other major currencies. Interest rates and commodity prices would increase, threatening persistent inflation. Yields on short-term Treasury securities could rise sharply, while long-term yields would increase to a lesser extent. Anticipated defaults would push credit spreads wider.

In equity markets, prices would fall in response to slower economic growth, while volatility would increase amid heightened uncertainty. This volatility would cause certain equity positions to severely underperform market indexes.

In this scenario, hedge funds unable to meet margin calls would be forced to liquidate equity positions at a loss. The Fed assumes the five hedge funds with the largest counterparty exposures for each bank would fail, illustrating the potential cascading impact on the broader financial system.

Conclusion

It's notable that this increased regulatory focus on NBFIs and shadow banking is unfolding amid broader deregulatory pressures from the Trump administration in the US. This may suggest tension between the administration and financial authorities – a recurrent theme this year worth keeping an eye on.

Intuition Know-How has several tutorials relevant to the content of this article:

- Financial Authorities (Europe) – ECB
- Financial Authorities (US) – Federal Reserve
- Financial Authorities (UK) – Bank of England
- Regulation – An Introduction
- Markets Regulation – An Introduction
- Banking Regulation – An Introduction

TradFi embraces DeFi in landmark blockchain initiative

An initiative between a group of financial institutions and the world's most publicly used blockchain promises to accelerate the migration of real-world assets onto the distributed ledger.

R3, a UK-based software group which has developed blockchains used by financial institutions including HSBC, Bank of America, Euroclear, and the Monetary Authority of Singapore, has struck a deal with the Solana Foundation that lets its clients issue and settle assets on Solana's public blockchain. The Foundation will also invest in R3 and take a board seat – an unmistakable vote of confidence in a network better known (until now) for memes and retail-facing apps.

Crypto ecosystems & tokenization

The world of digital assets is now familiar. Digital art and digital money are concepts well embedded in public consciousness, while crypto assets have captured massive attention – sometimes courting infamy.

Crypto assets are a subset of digital assets: they are private digital assets that use cryptography and distributed ledger technology (DLT) to record asset ownership and exchanges – typically on a blockchain where transactions are publicly viewable.

Because the blockchain is decentralized, meaning no single person or group controls it, all users collectively retain control. This allows transactions on the blockchain to occur without an intermediary, such as a financial institution – in other words, decentralized finance (DeFi).

The process through which tangible and intangible assets are converted into crypto assets is known as tokenization. Effectively, this creates a digital representation of the underlying asset in the form of a token recorded on a blockchain that can be traded more easily than the (often-illiquid) underlying asset. Tokenization has already been applied outside finance, including real estate where high-value properties can be divided into digital tokens, allowing investors to purchase fractional stakes in assets that were once the preserve of institutions or the ultra-wealthy.

Tokenization of traditional financial assets gathers steam

In the financial sphere, tokenization can be used to convert traditional instruments like shares, bonds, and investment funds into digital tokens recorded on blockchains.

These tokens represent ownership rights equivalent to those conferred by conventional means, such as physical certificates or digital entries in central securities depositories (CSDs). The key difference lies in the infrastructure: blockchain-based tokens can be transferred more efficiently, often reducing the need for multiple intermediaries.

A notable example of tokenization of traditional financial assets is BlackRock's USD Institutional Digital Liquidity Fund (BUIDL), its first tokenized fund issued on a public blockchain. This fund allows qualified investors to earn US dollar yields. Advocates of tokenization in financial markets cite the enablement of instantaneous and transparent settlement, expanding investor access to on-chain offerings, and allowing for transfers across platforms.

What R3's Solana deal means

R3's venture with the Solana Foundation is being positioned as a major step toward building what its backers call "internet capital markets" — a new infrastructure allowing regulated financial institutions to issue and transact real-world assets (RWAs) on a public blockchain. To highlight the scale of the opportunity, R3 cites the following:

- Tokenized RWAs have grown 80% over the past two years, reaching just over USD 22 billion
- This USD 22 billion represents only 0.0026% of the total tokenizable RWAs, underscoring the vast potential for expansion
- Standard Chartered forecasts that tokenized assets could exceed USD 30 trillion by 2034

On the TradFi side, the appeal lies in greater liquidity, access to new investor bases, more efficient settlement, reduced counterparty risk, and cost reductions through smart contract execution. For large institutions, it also offers a potential competitive advantage as capital markets continue their shift toward a more digital architecture.

For DeFi participants, the benefits include access to regulated real-world assets, which offer a degree of stability and diversification absent in most crypto-native offerings. It also opens the door to new yield opportunities backed by traditional assets, with potentially lower counterparty risk.

The sponsors present this as a breakthrough for institutional adoption of public blockchain infrastructure. And for many in TradFi, the push may also be defensive. As one insider put it: *"We know DeFi isn't coming to TradFi, so it's up to us to build the connective infrastructure that links DeFi and TradFi."*

Reality check

Amid all the fanfare, a reality check may be in order, and some of the projections referenced by the sponsors seem punchy. To reach USD 30 trillion by 2034 (Standard Chartered's projection) – from just USD 22 billion today – tokenized RWAs would need to grow more than 1,300%.

Meanwhile, the claim that current tokenized RWAs represent just 0.0026% of the total tokenizable universe implies tokenizable assets of around USD 850 trillion. That figure appears significantly inflated compared with other estimates, which put the total value of tokenizable assets closer to USD 250 trillion.

Still, even if tokenization falls short of the most ambitious forecasts, the broader momentum is real. The R3–Solana deal signals growing institutional interest in public blockchains, and the early use cases – however modest – do appear to be unearthing efficiencies in settlement, transparency, and market access. As infrastructure develops and standards mature, the real-world impact of tokenization is likely to grow.

***Intuition Know-How* has several tutorials relevant to the content of this article:**

- Digital Assets
- Crypto Assets – An Introduction
- Regulation – An Introduction
- Markets Regulation – An Introduction
- Anti Money-Laundering (AML) (2024)
- Blockchain
- Tokenization
- Crypto Derivatives
- DeFi