



Response to the FSB Consultative Document “Strengthening Oversight and Regulation of Shadow Banking”¹

1. Introduction

The HFSB welcomes the opportunity to respond to the Financial Stability Board (FSB) Consultation on “Strengthening Oversight and Regulation of Shadow Banking”.

The Hedge Fund Standards Board (HFSB) is the guardian of the Standards drawn up by international investors and hedge fund managers to create a framework of discipline for the hedge fund industry. The HFSB's mission is to promote the Standards through collaboration with managers, investors and the regulatory community.

The HFSB actively engages with the regulatory community and has responded to consultations on issues in relation to hedge fund regulation, including recent consultations from the European Commission, ESMA, IOSCO and others.

The HFSB is pleased to continue to play a role in the regulatory process and help FSB address issues in relation to oversight and regulation of shadow banking, particularly as they relate to hedge funds.

2. General observations

The Hedge Fund Working Group (the predecessor of the HFSB) was put together in 2007 specifically to address general investor concerns and issues of financial stability. The final report (published in 2008) highlighted potential issues in the context of concentration of holdings and unwinding of positions during periods of market stress. It also indicated that strong risk management frameworks at individual firm level (including liquidity risk management, stress testing and scenario analysis) were a powerful mechanism for mitigating such financial stability risk concerns.²

In its consultation on hedge fund redemptions in 2009³, the HFSB addressed potential damaging externalities that can arise in the context of fund redemptions and the handling of situations of liquidity distress. These findings highlighted that adequate disclosure and mechanisms which ensure

¹ Consultation Documents: <http://www.financialstabilityboard.org/>, http://www.financialstabilityboard.org/publications/r_121118.pdf; http://www.financialstabilityboard.org/publications/r_121118a.pdf

² See HFWG Final Report (Section 9.5: The Global dimension/Financial Stability [p. 33]; and Appendix H: Financial Stability Dimension [p. 106])

³ HFSB Consultation CP1/2009: Redemptions (<http://www.hfsb.org/?page=11474>)

fair treatment of investors were a necessary ingredient to enhance overall financial stability. These findings also were considered in IOSCO's CR01/11 on "Principles of Redemptions in Collective Investment Schemes".

In summary, these examples show that a solid "bottom-up" conduct framework involving strong risk management practices and adequate disclosure to investors is a necessary condition for a stronger and more resilient financial system.

Terminology

Some of the activities covered in the "shadow banking" discussion indeed have evolved in the "shadow" of large banks and should have been consolidated into the banks' balance sheets. However, many other activities, such as asset management and ETFs, have no resemblance to banks, and, therefore, "shadow banking" might not be the best term here. For example, the FSB Consultative Document uses the description "non-bank credit intermediation" and the European Commission's Green Paper uses the term "non-bank credit activity" to describe "shadow banking". These terms, we believe, reflect the nature of this activity better. An alternative term could be "market-based finance".

3. Consultation responses

Q1. Do you agree that the high-level policy framework effectively addresses shadow banking risks (maturity/liquidity transformation, leverage and/or imperfect credit risk transfer) posed by non-bank financial entities other than MMFs? Does the framework address the risk of regulatory arbitrage?

The HFSB believes that the two stage approach proposed by the FSB provides a useful framework to reflect the evolving nature of the financial system: firstly, looking at all non-bank credit intermediation, and secondly, focusing on the subset of non-bank credit intermediation where maturity/liquidity transformation and/or flawed credit risk transfer and/or leverage create potential risks.

The HFSB would like to highlight a number of observations and areas for improvement:

1. The overarching principles (p. 11) seem to suggest that (1) all activities identified in the high level framework pose shadow banking risk and, therefore, should be subject to oversight and (2) that it is only in a second stage that authorities should collect the information needed to assess the extent of risk posed by the relevant activity. We respectfully suggest that it might be logical to reverse the order of this process: the FSB framework provides a "long list" of economic functions, which might give rise to "shadow banking" risks. Regulators should collect information (Principle 2) to determine the nature and degree of "shadow banking" risk, which determines whether further oversight is needed. It appears unlikely that all activity mentioned will actually pose "shadow banking" risk, and in light of the very broad scope of the framework, it will be necessary to focus the regulatory effort on those areas which are most likely to be of relevance (also see comment 4.b) on the high level assessment below).

2. In the context of economic function 1, existing regulatory frameworks, industry practice and existing data collection efforts by regulators already might sufficiently cover the relevant areas addressed both in the toolkit and the proposed data collection template, thereby suggesting that no additional measures are required. In the EU for example, the AIFM Directive covers many areas referred to in the toolkit (including data collection), and the introduction of another layer of regulation should be avoided. In the US, the form PF requires investment managers to report significant amounts of data to the SEC. Further work is needed to better harmonise the different global approaches to data collection and information sharing, and IOSCO is well positioned to spearhead these efforts.

3. As indicated in our response to questions 3+4, the regulatory toolkit needs to be calibrated carefully so as not to exacerbate financial distress. The FSB also should explore market-based solutions which are capable of addressing the concerns highlighted in the FSB Consultative Document.

4. The HFSB also would like to point out two areas where further work is required to (1) enhance the functionality of the proposed framework (-> **a) High level assessment**), and (2) ensure that the resulting policies encourage the development of a more diverse financial system by not inhibiting sustainable non-bank financing activity (-> **b) Diversity in the financial system**).

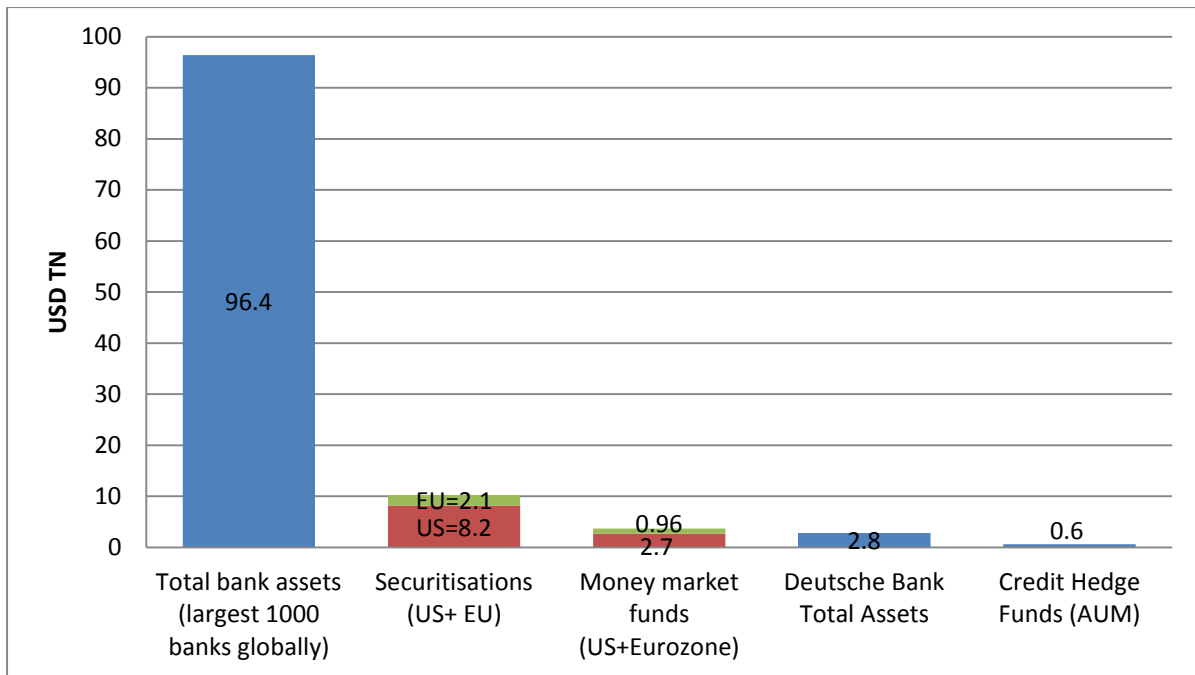
a) High level assessment

While the FSB's structured approach provides a useful framework to parcel out individual areas for further analysis, it is important that the framework also caters for the bigger picture of the overall financial landscape, in order to help regulators and political decision-makers better understand the actual size and relevance of the different areas of financial activity referred to in the framework.

Chart 1 compares some of the non-banking credit activities referred to in the FSB framework with the traditional banking system. This assessment highlights that many of the areas of finance referenced in the framework are very small in comparison to banking. The credit hedge fund sector, for example, accounts for approximately USD 630BN in assets under management, which is marginal in comparison to the size of the banking sector, and it is a great deal smaller than the total assets of a single large bank (USD 2.8TN).

Chart 1: Comparison of the size of different parts of the financial system (in USD TN)⁴

⁴ Total assets of largest 1000 banks: IFSL Research: Banking 2010, Euro Area money market funds: Q3 2012 https://stats.ecb.europa.eu/stats/download/bsi_mmf/bsi_mmf/bsi_mmf_u2.pdf; Credit hedge funds account for 630BN in AUM, Source AIMA, The role of credit hedge funds in the financial system; Securitisations: Market outstanding March 2011, OECD Journal, Financial Market Trends, Volume 2011- Issue 1 www.oecd.org/finance/financialmarkets/48620405.pdf



Current efforts by regulators to collect more information about the financial sector will help to develop this high level assessment and will provide policy leaders with a clear picture of financial activity. This also might help the important efforts to prioritise the regulatory initiatives in the non-banking credit area.

b) Fostering diversity in the financial system

As indicated in the FSB Consultative Document, it is crucial that potential regulatory measures do not inhibit sustainable non-bank financing models that do not pose “shadow banking” risks. Indeed, many non-banking players generate benefits for the financial system and the economy by providing alternative funding and competition in financial markets that may lead to innovation, efficient credit allocation and cost reduction.

The banking crisis has shown that diversity of financing sources can enhance the overall resilience of the system, while overreliance on a few homogeneous players (i.e. banks) is dangerous and costly - crises will become more likely, contagion effects will be more pronounced and no well-developed alternative sources of funding will be available to the economy.

In the run-up to the banking crisis, for example, many global and regional banks had become very similar to each other:

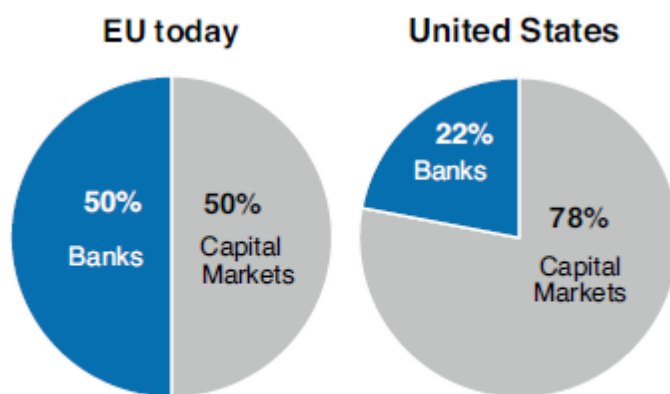
- a) Excessive risk-taking in similar asset classes such as subprime mortgages (often presumably less risky highly rated senior tranches of such assets, driven by regulatory capital arbitrage considerations)
- b) Convergence in banks’ approach to risk measurement (reliance on very few rating agencies, internal rating-based approaches with similar calibrations, identical regulatory risk weightings)

- c) Exposure to the same funding risks (short-term paper)
- d) Large degree of interconnectedness among banks

These characteristics have contributed to the homogeneous behaviour banks have exhibited during the crisis and have contributed to the systemic nature of events. Rather than dealing with a single failing bank, regulators had to deal with a failing banking sector.

In addition, the strong reliance on banking as a source of finance in many economies has exacerbated the cost of the crisis (Chart 2 compares the relative size of banking in the EU vs. the US).

Chart 2: Capital markets versus banks in the EU and the US⁵



We believe that this highlights the need for a more diverse financial system and the development of non-banking/capital market-based financial activity which is more resilient to shocks and does not exhibit the same damaging side effects/externalities as banks. The HFSB repeatedly has highlighted that the future is likely to bring a great deal more market-based finance (see HFSB contribution in: World Economic Forum Report: Rethinking Financial Innovation⁶) in light of on-going efforts to make banking more resilient and stable, which also will make banking more expensive. More market-based finance means that

- a) the corporate sector has more financing options,
- b) investors have more choices, and the markets allow them to manage their risks better,
- c) capital markets help spread risks more widely, rather than allowing risk-taking to be concentrated in a small number of banks,
- d) end investors can absorb losses, instead of the cost being met through the tax payer bailout of banks, and
- e) capital markets provide fertile breeding ground for financial innovation with a large number of entrepreneurial players.

⁵ Source: IMF Global Financial Stability Report 11/2011 (Selected indicators on the size of the capital markets, 2010), Definitions: Capital Markets = Stock Market + Debt securities; Banking sector = Bank assets

⁶ See excerpt of the WEF report at www.hfsb.org/files/td_article_for_wef.pdf

The assessment of the banking crisis also highlights that (more) regulation does not necessarily produce better outcomes, as seen during the banking crisis, where the increasing homogenous nature of banking (i.e. reliance on rating agencies, similar risk models, capital arbitrage resulting in increasing similarity of risk profiles) was driven, at least partially, by (originally well-intended) regulation.

The HFSB, therefore, would like to encourage a high-level dialogue on policies that foster a more diverse financial system and, in particular, how more financial activity and innovation in non-banking finance can be developed in order to attract capital and ultimately enable economic growth.

Regulatory arbitrage

Question 1 also highlights the risk of regulatory arbitrage and whether the framework adequately addresses this. There are two forms of regulatory arbitrage that the FSB should consider:

- a) Regulatory arbitrage leading to **distortions in risk-taking** by institutions and related build-up of hidden risks and
- b) Regulatory arbitrage opportunities where **non-bank credit intermediation creates similar negative externalities** as banks; yet they are not subject to bank-style prudential regulation

a) Distortions in risk-taking

In the context of risk-taking in financial services, regulatory arbitrage usually refers to situations where the “real”⁷ risk of an asset is lower than the assigned risk by a regulatory risk weighting approach. Thus, regulated institutions have no incentive to hold on to the asset given the high amount of capital they are required to hold for this asset. This results in a lower risk-adjusted return on capital. Vice versa, institutions might have an incentive to hold on to assets where the regulatory capital requirement is low, while the “real” risk is high.

This type of regulatory arbitrage can arise in areas where risk-taking is tightly regulated, such as banking and insurance, but does not play a role in the context of economic function 1 (asset management), where there are no, or only very limited, regulatory restrictions on risk-taking, and bank-style capital requirements do not apply.

⁷ The “real risk” might still be a subjective number, relying on experimental past data (of defaults), expert knowledge, and (factor) models to calibrate the probability on a scale from 0 to 1.

Regulatory risk arbitrage in banking

Under Basel I where banks had to hold a constant 8% capital for most non-government bond style risk, the regulatory capital requirements have resulted in banks holding high risk assets on their balance sheet, while securitising low risk assets. Basel II has tried to rectify this by introducing a more differentiated risk-weighting approach (e.g. the internal rating-based (IRB) approach), in order to align regulatory capital requirements more closely with actual risk-taking / economic capital.

Critics have suggested that capital regulation based on risk weightings has encouraged innovation to circumvent regulatory capital requirements (for example via off balance sheet vehicles that were not consolidated for regulatory capital purposes, or credit insurance--which played a major role when the financial crisis unfolded).

This example highlights that regulatory arbitrage arises in situations when risk-taking (and the resulting ability to generate profits) is restricted by regulation. However, in the context of banking, there obviously are very good reasons to prevent excessive risk-taking in light of the damaging externalities emanating from banks when they get into trouble.

No regulatory risk arbitrage in asset management

In institutional asset management, risk-taking is driven by investor risk appetite and is governed by the offering documents and the stated investment objectives and risk parameters of the investment fund.⁸ Regular reporting ensures that investors and their advisers can monitor the risk-taking and performance of the fund, and redeem their investments in accordance with the redemption policy of the fund when needed. Asset management is much more “project-like” in nature: hundreds of funds close every year (usually due to underperformance and subsequent investor redemptions), without any systemic implications. This is completely different from banking, where bank failure, particularly of significant institutions, can have major negative external effects (beyond the equity and bond holders of the bank).

In situations where an asset manager fraudulently takes excessive risk (beyond the stated limitations), both the threat of possible legal sanctions against the asset manager and market pressures (investor redemptions) serve as a powerful deterrent and, perhaps more importantly, negative systemic externalities do not arise.

This market-based approach also counteracts complacency in the form of investor over-reliance on “risk regulations”, since institutional investors with “skin in the game” are fully in charge. Adequate investor disclosure is a key precondition for this market-based system to work. The Hedge Fund Standards address this via detailed and frequent risk disclosure to investors and counterparties, and Standards on risk management and fund governance.⁹

Most importantly, bank-style regulatory risk arbitrage does not arise in this system, since there are no regulatory capital requirements, and investor risk appetite drives the overall risk-taking of the sector. Also, there are no negative externalities when funds have to close due to investor redemptions/underperformance.

b) Non-bank credit intermediation

The consultation paper also refers to regulatory arbitrage opportunities where non-bank credit intermediation creates similar negative externalities as banks, yet, they are not subject to bank-style prudential regulation.

⁸ Certain retail “fund” regulations such as UCITS have some limitation on concentration and counterparty risk, however, the key factors determining risk-taking in the fund are the fund specific risk characteristics.

⁹ See Hedge Fund Standards: Section A: Disclosure, Section C: Risk management (including disclosure)

The HFSB agrees with the overall logic of this approach and also agrees that the assessment should look out for situations where bank-style maturity and leverage transformation happens in stages via multiple entities or off a bank's balance sheet (but with ultimate recourse to the balance sheet in case of distress). We would suggest that the characteristics to look for when determining whether an institution has bank-like features include

1. Deposit-like funding structures
2. Significant maturity transformation (e.g., guaranteed daily liquidity, while investing in less liquid assets)
3. Significant role in operating the payment system

The systemic potential of such institutions can be exacerbated where (1) and/or (2) are combined with leverage.

The hedge fund industry generally and credit hedge funds in particular do not exhibit deposit-like funding structures nor do they perform significant maturity transformation. It has become industry practice to allow for "gating" in situations where there is a threat of illiquidity; this is to ensure fair treatment of investors in situations of distress. In addition, hedge funds are not involved in operating the payment system. Therefore, we believe there is no indication that the credit hedge fund sector has bank-style characteristics.

Q2. Do the five economic functions set out in Section 2 capture all non-bank financial activities that may pose shadow banking risks in the non-bank financial space? Are there additional economic function(s) that authorities should consider? If so, please provide details, including the kinds of shadow banking entities/activities that would be covered by the additional economic function(s).

Better definitions required

The HFSB agrees with the approach to identify economic functions rather than focussing on legal entities or "labels". However, the FSB should follow through with this approach within each of the economic functions and provide a clear definition of the respective economic activity, rather than focussing on the listing of possible entity labels (e.g. "credit investment funds..." under economic function 1). The listing also might suggest (incorrectly) that the activities included in the list automatically pose "shadow banking" risks without further assessment.

In the context of economic function 1 (managing client money)¹⁰, a more generic definition of the features that make *managed client cash pools* more susceptible to runs could look as follows:

- a) Mispricing of mutual credit / fixed income fund shares relative to portfolio value in times of distress (e.g., in the context of constant NAV money market funds)¹¹

¹⁰ P. 6 Consultative document

- b) ALM mismatches in credit fund portfolios, which can be exacerbated through market distress
 - Sudden withdrawal of funding/leverage
 - Sudden reduction in liquidity in the relevant market segment

Such a more clearly tailored definition also ensures that regulators do not just base their frameworks on the relevant examples provided in the Consultative Document but actually follow up with a rigorous assessment via data collection to assess the actual extent of “shadow banking” risk. In line with the overarching principles, this ensures that the policy response is focussed on relevant economic activities, proportionate to the risk exhibited by those activities, and remains adaptable, rather than enshrining a rigid framework based on the examples/labels provided under each economic function.

“Run” risks are already addressed in many fund set-ups (Economic function 1)

The consultation paper refers mainly to the contagion effect in the context of “run” risks¹², but there is a much more obvious negative externality, which is that long-term investors in funds might be discriminated against if they do not redeem: In the context of a) (as per above), redeeming investors will be redeemed at a price higher than the actual NAV of the portfolio, at the expense of remaining longer term investors. In the context of b), long-term investors will be left with the illiquid remainders of a portfolio (“bottom of the barrel risk”), while redeeming investors are paid off from the proceeds of the sale of the liquid portions of a portfolio (hence the incentive to run on funds).

There is a spectrum of approaches for addressing these issues, ranging from commercial, market-driven approaches to regulatory intervention.

Market-based systems usually provide a framework for (i) price discovery, (ii) balancing of supply and demand, (iii) competition, and, in particular, (iv) penalisation of market participants who do not meet their clients (i.e. investors’) expectations. The hedge fund industry is a good example of such a market-based system, with hundreds of funds closing down every year and hundreds of new ones emerging – a “Darwinian” process driven in large part by fund/manager performance and adherence to good standards.

The HFSB believes that there can be a market-driven approach to “solving” the externalities highlighted in the context of economic function 1, i.e. by internalising them.

In the context of issue a), the market-based solution would be to allow fund share prices to fluctuate in line with underlying market value, which is common in the hedge fund industry and most other areas of asset management. In the context of b), better investor disclosures and behavioural standards can help address the negative externalities in relation to fair treatment of investors. In

¹¹ Distortions can also arise when the fund shares are priced below the portfolio value, creating conflicts of interest between new and existing investors in the fund.

¹² See page ii, Preface to the Consultative Document

2009, the HFSB consulted on issues in relation to handling of redemptions in times of distress and analysed in detail the negative externalities arising in this context. The related amendments to the Hedge Fund Standards were published in 2010, with significant focus on better investor disclosure about the handling of situations of liquidity distress in order to enable better investment decisions (see Standard 2.1 – Exit terms).¹³ The new Hedge Fund Standards and Guidance have complemented existing Standards covering liquidity risk management, exit terms and governance.

Interestingly, by addressing the direct negative externalities arising for investors, many of the broader systemic concerns (e.g. contagion) arising from “run risk” are being addressed implicitly.

Should regulators “second guess” the markets?

The strong focus on contagion risk in the FSB Consultative Document raises a sensitive issue, which has previously come up in the IOSCO Consultation Report CR01/11 on Principles on Suspension of Redemptions in Collective Investment Schemes (CIS). IOSCO has referred to “fire sale prices” and “danger of vicious circles” in describing situations of “runs on funds”, and it has suggested that it may be appropriate for the responsible entity to consider suspending redemptions in certain limited circumstances, such as runs on CIS assets.

This raises an important question in light of the potential regulatory interventions that might result from the FSB toolkit: should decisions (usually by fund boards) about suspensions of redemptions only be based on issues relating to fair treatment of investors in the relevant fund or should they also be based on concerns about presumable contagion and “vicious circle scenarios”? Indeed, a related question also arises: should such decisions even be mandated by regulatory intervention?

The HFSB would recommend that the FSB clarify how “contagion” risk is being measured and how decisions in relation to suspensions of redemptions are being made. We also would recommend that the FSB clarify, in particular, how perfectly appropriate market price corrections are being distinguished from presumable damaging contagion. In its conclusions from its own consultation in 2009, the HFSB solely focussed on fair treatment of investors as the only determining factor for a slow down or suspension of redemptions, it did not include any reference to wider market contagion. In the HFSB response to the IOSCO Consultation Report CR01/11, the HFSB recommended that restrictions around suspensions of redemptions should only be justified in situations when fair treatment of investors is impaired. However, in situations where fair treatment of investors can be ensured, redemptions should not be suspended (for “contagion” reasons).

¹³ See www.hfsb.org -> Standards -> Consultations -> CP1

Q3. Are the suggested information items listed in the Annex for assessing the extent of shadow banking risks appropriate in capturing the shadow banking risk factors? Are there additional items authorities could consider? Would collecting or providing any of the information items listed in the Annex present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

General comments (relating to economic function 1):

1. The HFSB agrees with the FSB's suggestion to assess the overall size of the relevant activity under consideration as a starting point in the assessment. This might also help to prioritise any potential regulatory efforts, in light of the broad approach taken via the five economic functions.

2. Harmonisation of data-gathering among regulators is an important factor, and the HFSB believes that IOSCO is well-positioned to play a leading role in this effort. Also, existing data collected by regulators (e.g., via Form PF in the US or the UK FSA Hedge Fund survey) should be drawn on in order to avoid duplication of data collection efforts.

3. The necessary effort to analyse the data and draw meaningful conclusions should not be underestimated. The UK FSA's hedge fund survey (which also includes non-credit hedge funds) has provided a blueprint for the type of analyses that can be done based on consistent data collected from the UK hedge fund industry. Most importantly, the analyses show that (i) the footprint of the overall hedge fund industry in most markets is small and (ii) bank risk-taking vis a vis hedge funds is only a very small portion of bank capital. The market segment relevant in the context of economic function 1 of the FSB framework (i.e., credit/loan investment funds) only accounts for a very small fraction (5-8%) of the total assets (USD 400BN) covered in the survey.¹⁴

4. The analyses should not only cover numeric factors but also address behavioural and governance aspects. For example, the hedge fund industry has strengthened its approach to handling situations of liquidity distress, and fund documentation increasingly contains clauses allowing for precisely the type of measures suggested in the toolkit to manage redemption pressures in stressed market conditions. We would suggest that this reduces the need for mandated regulatory intervention.

5. The results of initial analyses should be used to prioritise and revisit the need for possible regulatory intervention. Many jurisdictions are currently in the process of introducing new regulations, including more data collection, and the results of these efforts should be considered before new measures are being taken. In many instances existing rules and industry practices address the concerns raised by the FSB, and the data collection templates that are currently rolled out might cover many of the aspects included in the FSB template.

The Hedge Fund Standards Board has played a leading role in driving better Standards in the hedge fund sector over recent years, and we are available to assist regulators in developing a better understanding of the sector; indeed, we would be very interested in helping in any way we can and

¹⁴ FSA: Assessing the possible sources of systemic risk from hedge funds (February 2012)

will make the resources of the Board available to the FSB as it proceeds through this consultation process.

Specific comments (relating to Annex/economic function 1):

The term “maturity transformation” is often referred to in a banking context. Banks usually borrow money on shorter time frames (e.g., via customer deposits) than they lend money out (bank loans to customers). The proposed information field “maturity transformation” now applies this “logic” to asset management. However, there are a number of observations that we suggest need to be considered to avoid a distorted perspective on actual maturity transformation:

- The proposed approach to “maturity transformation” might have relevance in the context of loan funds and microcredit, where direct loans are being made to companies and individuals and these loans are unlikely to be traded and will be held to maturity.
- In corporate bank lending, syndicated lending exists, with a secondary market for trading loans, as well as increasing activity of specialist credit fund managers, often specialised in distressed assets that banks are willing to sell. Such credit funds usually exhibit longer lock-ups, reflecting the maturity of underlying assets or the time it takes to work out distressed assets.
- However, in the context of regular funds investing in corporate and government bonds, the proposed approach does not provide a meaningful picture on “maturity transformation”:
 - The logic would suggest that a fund investing in liquid bonds with very long times to maturity (e.g., 30-year government bonds) and allowing investors daily or weekly redemption performs significant maturity transformation. This notion is incorrect, since the assets can be sold instantly in the markets in almost all circumstances. Indeed, no one would suggest that investment funds investing in listed equities perform unlimited maturity transformation (since equity holders are never redeemed).
 - In addition, the UK FSA Hedge Fund survey calculates maturity transformation by looking at the liquidity profile of investments, rather than the maturity of assets.
- The data field for the weighted-average original maturity has limited information content on “maturity transformation”. It would be helpful to better understand how this measure is to be used / interpreted.
- It is unclear what is meant by “long-term” assets. A more precise definition is needed.

Q4. Do you agree with the policy toolkit for each economic function to mitigate systemic risks associated with that function? Are there additional policy tool(s) authorities should consider?

The proposed policy toolkit suggests restricting the investment strategy of funds to make them less susceptible to runs.

Tool 1: Restrictions on maturity transformation

This tool seems to be targeted at constant NAV funds, as an alternative to allowing variable price formation for the fund's shares.

Tool 2: Limits on leverage

The HFSB has highlighted in the past that there is limited justification for introducing leverage limits for hedge funds.¹⁵

If there is concern about excessive risk-taking in systemically relevant banks (e.g., by providing leverage to hedge funds), this should be addressed in the context of bank capital frameworks, but investor risk-taking via hedge funds should not be restricted. The UK FSA Hedge Fund survey has highlighted that bank exposure to hedge funds is very small in relation to bank capital.

If there is a concern about “downward spirals” and “pro-cyclicality”, imposing leverage limits raises serious questions about regulators “second guessing” the markets and restricting investors’ risk appetite. During the financial crisis, we saw significant drops in prices in many types of assets (e.g., ABS, bank stocks, sovereign debt). In hindsight, many of the price corrections that had occurred at the time were popularly labelled as “fire sale prices”, “downward spirals” or presumable “speculative attacks”; yet, as we now know, these price corrections turned out to be perfectly legitimate, as they reflected the riskiness of the underlying assets. While it is self-evidently in everyone’s interest to avoid “bubbles” in the first place, we respectfully would suggest that regulators may not be best-placed to assess and, indeed, potentially “second guess”, the viability of investments. As a result, we believe it is difficult to justify regulatory interference with investors’ desire and ability to take risk.

As noted above, we feel it is important to remember that market-based systems do provide a framework for price discovery, balancing supply and demand and competition. At times, some investors may have appetite for more risk-taking (which can include increasing leverage), which in turn enables allocation of risk capital to economic activity that might otherwise not happen. At other times, investors might prefer to reduce risk (which can include reducing leverage). Ultimately, overall investor risk appetite will influence price formation in the market, and, not surprisingly, the market price of risky assets falls when there is a rising risk aversion (or awareness). Indeed, in situations where market prices fall, a regulatory leverage limit can even exacerbate market price

¹⁵ See HFSB response to ESMA’s draft technical advice on the AIFMD (07/2011), page 6 (www.hfsb.org/?page=12135)

movements, by forcing investors to sell (in order not to exceed the leverage limit), when in fact the investor might be prepared to hold on to the asset.

Therefore, regulatory intervention, for example via leverage limits, can have unintended consequences, such as (i) distorting the price formation in certain markets or instruments, (ii) preventing important capital allocation (to potentially viable activities) and (iii) also potentially preventing investors from aligning their portfolios with their risk appetite.

We believe that a better way to address concerns in relation to risk-taking in funds (via leverage or otherwise) is better investor disclosure. Disclosure to investors is a key feature of the Hedge Fund Standards, enabling better investment decisions and monitoring by investors. Most importantly, it puts those in charge who have “skin in the game” and, thereby, the greatest incentive, to monitor the investments.

Tool 3: Tools to manage liquidity risk:

The FSB highlights issues in relation to fair treatment of investors as a key concern in the context of less liquid portfolios. The HFSB consulted on precisely these types of issues in 2009 and published Standards to address the relevant negative externalities (see HFSB Consultation Paper CP 1 on Handling of Redemptions and the relevant feedback statement published in 2010)¹⁶ Rather than interfering with investor risk appetite (via regulatory imposed concentration limits, limits on investments in illiquid assets, mandated liquidity buffers) as proposed in the FSB Toolkit, the HFSB’s solution focusses on investor disclosure (of exit terms) and relevant tools to handle situations of liquidity distress (such as gating) to ensure fair treatment of investors. This is in addition to existing Hedge Fund Standards on liquidity risk management, investor disclosure and fund governance.¹⁷ The HFSB believes that professional investors are best positioned to assess the validity of fund terms, strategy and risk profile (e.g., redemption features, strategy, governance structures); indeed, in most specialised areas of finance, it appears unlikely that regulators have the relevant skill and experience to judge the investment risk and second guess investors’ own assessments, particularly when there are robust disclosure requirements. As highlighted above in the context of tool 2, regulatory intervention in risk-taking in markets can have negative, unintended consequences and, indeed, may even create “false comfort” (investors start to rely on the regulators’ assessment when making their investment decisions). Finally, there is also concern that this intervention could drive homogeneity in the financial system, rather than a healthy diversity of views on risk (see also answer to Q1b), and, therefore, could end up being counterproductive.

Tool 4: Tools for managing redemption pressures in stressed market conditions

Side pockets, redemption gates and suspensions of redemptions are commonly referred to in hedge fund offering documents as tools to be employed in situations of liquidity distress and to ensure fair treatment of investors. However, such instruments should only be employed if there is concern

¹⁶ www.hfsb.org/?page=11474

¹⁷ See Standards 1, 12.1, 16, 21-22, www.hfsb.org/?section=11502

about fair treatment of investors. As highlighted in the answer to Q2, investors should not be restricted in their decision to redeem in situations where fair treatment is possible.

As a general rule, fund boards are best positioned to make the assessment and take decisions to manage redemption pressures in the context of the individual underlying funds. We believe this market-based approach is much more effective than regulatory intervention, since the boards will have the relevant insight and understanding of the portfolios, individual assets and related risks to take these decisions in a timely and appropriate fashion. It appears unlikely that regulators will have the ability to assess potentially hundreds of individual funds to determine whether measures to manage redemption pressures should be taken. In addition, there is a risk that regulators take broad brush decisions (for example, imposing restrictions on all relevant funds), thereby interfering with hedge fund investors' ability to manage their portfolios and preventing important and legitimate price formation (corrections) to take place. The Consultative Document also mentions the dangerous signalling that such regulatory intervention can have; we agree that this is a significant, and unwanted risk. We would add that such intervention may well deter other investors (who might be prepared to buy the assets) from entering the market for fear of overpaying for the underlying assets.¹⁸

Therefore, current common practice, where investors are in charge of assessing the exit terms of their investments in light of the nature of underlying assets and the investment strategy, appears to be most suitable to avoid situations where unfair treatment might hurt investors or create "runs". Indeed, investors are fully aligned and have an interest in seeing that such situations are dealt with appropriately. As a result, we believe that the current market-based solution appears to produce the desired outcomes.

Q5. Are there any costs or unintended consequences from implementing the high-level policy framework in the jurisdiction(s) on which you would like to comment? Please provide quantitative answers to the extent possible.

Unintended consequences arise in situations where the framework encourages regulators to interfere with risk-taking by investors and price formation in the market. For example, leverage limits in the context of economic function 1 can create sudden forced selling of assets in situations where market prices fall, and investors might be forced to sell assets into a falling market to meet the regulatory requirements, even if they are prepared to hold on to the assets. As a result, in such circumstances, leverage limits will exacerbate any contagion in the market.

The framework also imposes a significant burden/responsibility on regulators, who will have to assess individual funds and investments from a risk perspective and override /"second guess" investor risk-taking. We query whether regulators have the expertise or sufficient resources to assume this role. Major investors employ large investment teams, and invest significant sums in technology and analytics, to assess the risk of investments and portfolios, and it is unclear how this

¹⁸ This is in analogy to the effect of short selling bans, see HFSB response to the European Commission Consultation on Short Selling (July 2010): www.hfsb.org/?page=11647 p.2-3

expertise can be replicated easily within regulators. This type of regulatory interference also creates the risk of complacency/false comfort of investors, who might think that regulators have assessed the risk (and, thereby “approved”) of individual funds, rather than investors assessing the risks themselves. As noted above, we believe the investor is the best economic agent to assess the risks, since he has "skin in the game" and the tools to do the analysis. It is important to highlight that the measures proposed in the toolkit for economic function 1 do not lie outside the scope of what investors would assess when making investment decisions in any event (fund concentrations, exit terms, etc). For these reasons, we believe that the market-based approach appears the best solution for addressing these concerns. As mentioned earlier, the HFSB has addressed many of the issues raised in the toolkit in its own standards, through standards on investor disclosure to enable better investment decisions. Regulatory effort, therefore, should be focused on ensuring better investment disclosure rather than making regulators responsible for the monitoring/risk assessment of investments.

The prominent role given to regulators in the context of risk assessment also gives rise to concerns about homogeneity in the financial systems, with singular views on risk being driven by regulators themselves (see discussion about diversity in the financial system in section 1), similar to the "risk monoculture" created by the overreliance of banks on a few rating agencies.

This should not prevent regulators from assessing the distribution and build-up of risk in the economy via the data collection efforts; however, care should be taken not to push regulators to assume the role of investors.