



## Alternative Investment Management Association

Secretariat of the Financial Stability Board  
c/o Bank for International Settlements  
CH-4002, Basel  
Switzerland

Sent by email to: [fsb@bis.org](mailto:fsb@bis.org)

14 January 2013

Dear Sir / Madam

### **AIMA's response to the FSB's Initial Integrated Set of Recommendations to Strengthen Oversight and Regulation of Shadow Banking**

AIMA welcomes the opportunity to respond to the Financial Stability Board's (the 'FSB') consultation documents entitled 'An Integrated Overview of Policy Recommendations' (the 'Overview'), 'Policy Framework for Strengthening Oversight and Regulation of Shadow Banking Entities' (the 'Framework') and 'Policy Recommendations to Address Shadow Banking Risks in Securities Lending and Repos' (the 'Securities Lending and Repos Paper').

AIMA supports the G20's objectives of strengthening the oversight and regulation of the shadow banking system and the work carried out by the FSB in this area. We welcome the activities-based approach which the FSB proposes adopting in relation to regulating shadow banking entities and the FSB's approach to enhancing reporting in securities lending and repo markets to inform future policy action. However, we have some concerns with the recommendations made in the Framework and the Securities Lending and Repos Paper, which we set out below.

AIMA would like to highlight in this response that there are well-established differences between hedge fund managers or asset managers in general and banks which warrant a differentiated regulatory approach:

- Investors in funds seek particular risk exposures: bank depositors generally do not seek exposures to bank loans, trading portfolios or other risk portfolios;
- Hedge funds can control, manage and change their liquidity profiles ex-ante by aligning their redemption policies with the liquidity profiles of the funds and ex-post by potentially limiting or even suspending redemptions (and therefore lengthening their liability profiles) depending on the market liquidity situation;
- Hedge funds create bespoke liquidity conditions for particular funds or even groups of investors which then match the liquidity profiles of the invested instruments (managed accounts, single investor funds);
- Hedge funds do not offer a guarantee, or do not hold themselves out in such a way as to give an impression to guarantee the redemption of the original investment at par or at a pre-specified time;
- The absolute majority of the hedge fund investor base is now composed of sophisticated institutional investors, who are in the business of making investments and understand or are deemed to understand fully the risks involved in making hedge fund investments and have the ability and resources to anticipate and manage the risks associated with those investments.

Extending banking or bank-like micro-prudential regulation, which we do not consider to be the most successful regulatory model to date, to activities such as asset management, risks undermining financial stability and economic growth. We therefore propose that, where regulation exists already or has been recently introduced, changes are proposed only where clear market or regulatory

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failures emerge as part of the review and evaluation of these frameworks following their implementation.

### The Framework Consultation

#### *The use of specific examples and the proposed economic functions based framework*

AIMA largely supports the approach of the FSB's workstream tasked with assessing the extent to which non-bank financial entities other than money market funds are involved in shadow banking ('WS3'). However, we consider that it should be clarified that any additional regulation of already regulated entities should focus on those entities that are systemically significant and the use of specific examples of shadow banking entities throughout the Framework could undermine this approach as the type of entity rather than the systemic significance of the entity becomes the relevant factor.

As we explained in our [response](#)<sup>1</sup> to the FSB's paper "Shadow Banking: Scoping the Issues", AIMA considers that hedge funds, both individually or collectively, are not systemically important and can be seen as a stabilising as opposed to a destabilising element of the financial system.

On page 5 of the Framework, WS3 states that:

"authorities are expected to refer to the five economic functions set out ... in assessing their non-bank financial entities' involvement in shadow banking. These economic functions will allow authorities to categorise their non-bank financial entities not by legal forms or names but by economic function or activities, and provide international consistency in assessing their risks."

The proposed framework expressly states that non-bank financial entities should be assessed "not by legal forms or names but by economic function or activities." It is therefore potentially unhelpful, for WS3 to give specific examples using legal forms or names of entities that would be, in WS3's opinion, shadow banking entities.

For example, the economic function "management of client cash pools with features that make them susceptible to runs" could be re-drafted as follows:

"Management of client cash pools that (a) entail credit intermediation, (b) are leveraged, (c) engage in maturity or liquidity transformation, (d) provide investors with an explicit or implicit constant/fixed NAV, and (e) are susceptible to runs."

What we mean here by "are susceptible to runs" is that such entities are unable to control sudden surges in investor redemptions through contractual or other means.

Whilst the examples given on page 6 of the Framework of entities that may fall within the activity of management of client cash pools with features that make them susceptible to runs are more specific, it could be made clear that, wherever examples are given, they are only examples of entities that could potentially, but do not necessarily, possess all of the features of the relevant economic function.

Generally, the provision of examples by the FSB should not preclude the process of assessing entities by their economic function or activities by presupposing that certain entities based on their legal forms or names are performing shadow banking functions.

The use of examples is all the more concerning when the description of the economic characteristics of those entities appears to be deficient. On page 9 of the Overview, the FSB states that "leveraged credit hedge funds" are an example of a shadow banking entity that carries out "management of client cash pools with features that make them susceptible to runs." This is particularly surprising since, as we have explained in our previous submissions to the FSB, hedge fund structures are designed to deal with stressed market conditions and are normally, as a matter of ex-ante structuring, able to restrict investor redemptions through gates, side-pockets, suspensions or as otherwise allowed by their prospectuses. The aim of these tools is precisely to defend the fund structures from exposures to investor runs.

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<sup>1</sup> See <http://www.aima.org/en/document-summary/index.cfm/docid/E3D6E90A-A6E1-4B10-BB34CBBFAAED132>



In addition, the FSB has described the shadow banking system as “credit intermediation involving entities and activities (fully or partially) outside the regular banking system.” Importantly, the function “management of client cash pools with features that make them susceptible to runs” appears wide enough to capture the management of client cash pools that entail any financial intermediation or investment management business, not just those client cash pools that entail credit intermediation.

Not all forms of non-bank financial intermediation should be labelled as shadow banking if, as is often the case, they do not involve the distinctive features of banking - deposit-like liability structure, leverage and maturity transformation - the distinctive features which create distinctive risks. The FSB paper recognises this in the preface to each of the Consultative Documents by stating “[I]ike banks, a leveraged and maturity-transforming shadow banking system can be vulnerable to runs.”

The reliance on short-term liabilities, as for banks, to fund illiquid long-term assets is not generally relevant for hedge funds and the risk for bank-like runs should be limited. Maturity/liquidity transformation in hedge funds should therefore not be subject to systemic risk concerns to the same extent as for those institutions whose liability profile is extremely short-term and who cannot or do not as a matter of general sound practice control their liquidity or redemption profile.

### The policy toolkits

AIMA agrees with the five general principles that should be applied by competent authorities when using the tool kit and consider that it is of the utmost importance that these principles are adhered to. For example, the FSB states that “regulatory measures should be carefully designed to target the externalities and risks the shadow banking system creates” and that “regulatory measures should be proportionate to the risks shadow banking poses to the financial system”. The policy tool(s) adopted should be proportionate to the degree of risks posed by the non-bank financial entities, and should take into account the adequacy of the existing regulatory framework as well as the relative costs and benefits of applying the tool.

As mentioned above, there are well-established differences between hedge fund managers or asset managers in general and banks which warrant a differentiated regulatory approach and whilst these tools may be appropriate to apply to other entities, their use in relation to hedge funds would be disproportionate. AIMA considers that several of the tools suggested by the FSB are inappropriate and none of the tools should be applied to entities which are not systemically important. The application of restrictions on the maturity of portfolio assets (tool 1), limits on leverage (tool 2) and the three tools suggested by the FSB which aim to manage liquidity risk (tool 3) would be inappropriate tools to apply to hedge funds since, as we explain further in **Annex 1**:

- investors in hedge funds seek particular risk exposures; imposing restrictions on the maturity of assets would restrict investors’ ability to do so;
- investors in hedge funds invest on a variable return basis (i.e. they understand that their investment is at risk);
- hedge funds already operate on low levels of leverage when compared to banks ; and
- hedge funds are uniquely capable of managing their liquidity profiles so as to mitigate, not accentuate, procyclicality.

### The Securities Lending and Repos Paper

#### Minimum haircuts and numerical floors

The repo and securities financing markets are well established and play an important role in today's capital markets by providing liquidity that reduces the cost of trading and promotes price discovery.



The repo and securities financing markets improve market liquidity, create more efficient settlement, lead to tighter dealing prices and are believed to reduce the cost of capital for issuers (including governments). At a time of global credit contraction and reduced overall market liquidity it is important that the repo market is free to operate in an efficient manner and additional regulations do not detrimentally impact on the market and create further reductions in liquidity and/or credit contraction. This is especially important given that a number of governments are currently looking to reflate their economies and finance significant deficits. This will only be possible if the repo and securities financing markets are operating effectively.

The repo and securities financing markets are dynamic, constantly evolving and truly global in nature. In order for these markets to operate effectively this dynamic flexibility needs to be retained. Therefore, any regulatory requirements or recommendations for establishing a set methodology for calculating haircuts needs to take this into account. On that basis, we have the following recommendations to make:

- 1) any standards must be set globally (without any regional variations) to reflect the global nature of the repo markets and to prevent regulatory arbitrage based on location;
- 2) the range of instruments that are utilised in the repo and securities financing markets are extensive and so any methodology framework would need to take account of the different natures of such instruments. The more detailed the recommendations or rules, the more problematic this process will become; and
- 3) given the above, any calculation methodology standards set should be based on the high level principles reflected in section 3.1.2 of the Securities Lending and Repos Paper rather than specific numerical parameters, as any limits will soon become outdated minimum standards and will not be capable of reflecting the dynamic nature of the market.

Although the list of relevant factors to be considered seems to be comprehensive, such factors should be set globally on a high level principle basis and it should be left to an individual firm to utilise the factors for its specific model. Additionally, the length of the repo/financing arrangement is a vital consideration.

AIMA considers that a balance needs to be struck between having a regulatory framework which allows managers to protect client assets by retaining discretion over their haircut policy and the application of micro-prudential tools, such as minimum mandatory haircuts. Market participants should be permitted to retain the bargaining power that is currently available to them to negotiate haircuts on a contractual basis. The introduction of minimum haircuts would be likely to result in a loss of that bargaining power, as these haircuts would be likely to become the norm in the market. Introducing a minimum of 100% for all market participants would permit investors or their investment manager to make decisions regarding the level of haircut they believe is appropriate for a given loan/collateral combination or a given counterparty. However, introducing a mandatory minimum haircut of any other amount could result in reduction in market liquidity and reduced income to investors.

As outlined above, there are intrinsic difficulties associated with establishing a common methodology for calculating haircuts. It is our view that this issue is magnified in the context of numerical floors. Given the global nature of the market, the numerous instruments that can be used in financing trades and the constantly evolving dynamics of the market it would prove impossible for a global body to set effective numerical floors for the entirety of the market. Additionally any attempt to set numerical floors could end up being impacted by non-economic considerations and would end up being placed into crude and unrealistic groupings.

On that basis, it is AIMA's view that the establishment of numerical floors is unnecessary at this time, especially given the disclosure proposals outlined in the FSB recommendations, and would be impractical, if not impossible, to implement effectively on a global basis



### Application of numerical floors

If a numerical haircut floor framework is to be applied, AIMA considers that it should apply to all qualifying transactions between all types of counterparties, so that all market participants are equally subject to these floors.

In relation to sovereign bonds, we consider that these should not be exempt from numerical floors since, as the FSB acknowledge, sovereign bonds are subject to default risk, even in domestic currency, and thus can have procyclical risk premia and leverage in the financial system can build up against sovereign bond collateral.

### Re-hypothecation of client assets

AIMA suggests that only the first<sup>2</sup> of the three principles suggested by the FSB in relation to what national authorities should ensure regulations governing re-hypothecation of client assets address is appropriate. Requiring that only entities subject to adequate regulation of liquidity risk should be allowed to engage in the re-hypothecation of client assets opens the question as to what is "adequate". The parties should be able to agree between themselves how assets will be allocated and if investors are made aware that their investments may be re-hypothecated, they should be free to make this decision.

For the same reason as above, AIMA also considers that it would be inappropriate to introduce harmonised rules which set a limit on re-hypothecation in relation to client indebtedness.

### Central Clearing

In relation to central clearing, AIMA considers that if minimum haircuts are imposed central clearing would not be workable. Exposure to counterparties should be a factor in the liquidity of an instrument and haircuts should reflect this. Central clearing supposes that margins are imposed in order to reduce counterparty exposure. By contrast, imposing minimum haircuts would effectively mean that one party has to be over collateralised in relation to the other. We are unclear therefore how the FSB propose that a framework for minimum haircuts would work alongside central clearing and would welcome clarification in relation to this point.

As the FSB acknowledges, the existing incentives to use CCPs in 'safe' markets seem sufficiently strong (e.g. balance sheet netting) and no further regulatory or other actions appear necessary. In the other market segments, the pros and cons are more broadly balanced or may vary based on the market structure and institutional set-up specific to various jurisdictions. In these markets, it may not be desirable to encourage the use of CCPs in every case and national/regional authorities should evaluate the costs and benefits of CCPs in their particular markets.

We hope you find our comments useful and would be more than happy to answer any questions you have in relation to this submission.

Yours faithfully,

A handwritten signature in blue ink, appearing to read "J. Król".

Jiří Król  
Director of Government and Regulatory Affairs

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<sup>2</sup> Namely that financial intermediaries should provide sufficient disclosure to clients in relation to re-hypothecation of assets.



**Annex 1 - Why the application of restrictions on the maturity of portfolio assets (tool 1), limits on leverage (tool 2) and the three tools suggested by the FSB which aim to manage liquidity risk (tool 3) would be inappropriate tools to apply to hedge funds**

***The application of restrictions on the maturity of portfolio assets (tool 1)***

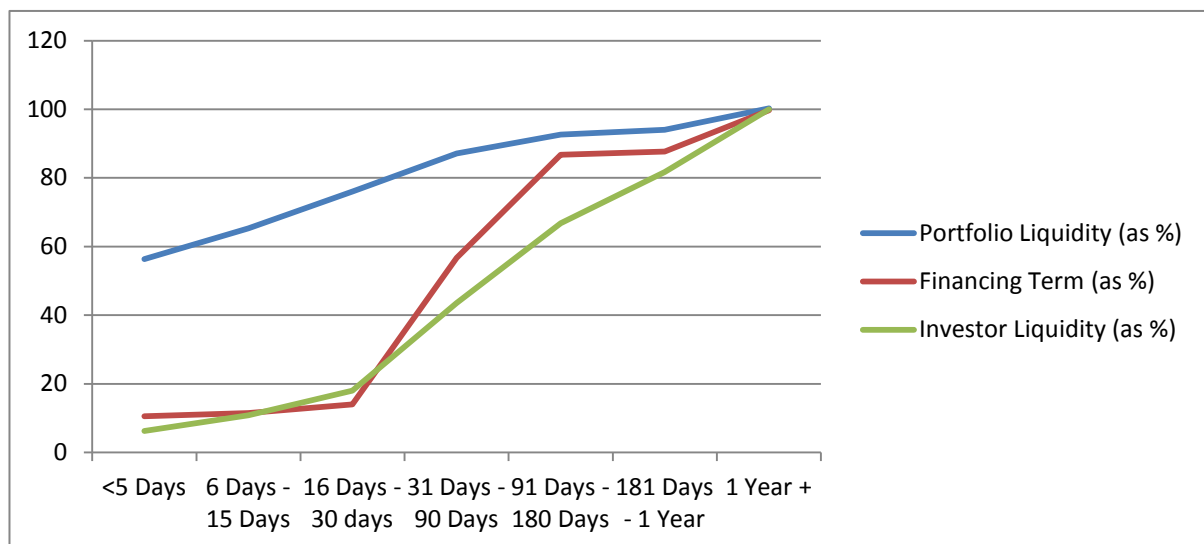
As acknowledged by the FSB,<sup>3</sup> imposing restrictions on the maturity of portfolio assets would restrict investors' desired risk return profiles. As stated above, investors in funds seek particular risk exposures and necessarily understand that their return is variable: bank depositors generally expect a non-variable return and do not seek exposures to bank loans, trading portfolios or other risk portfolios. Pension funds which have long dated liabilities need unrestricted access to long-dated assets. Imposing restrictions on maturity of assets would therefore be inappropriate in the hedge fund sector.

Credit hedge fund managers employ a diverse range of investment strategies, ranging from direct corporate lending to the trading of complex derivatives. A common feature that exists throughout these strategies is the acceptance of credit risk on behalf of the borrower. This credit risk has asymmetrical qualities relative to other market risks in that the upside of the risk is bounded by the return of capital at a future date at par. Traditionally, the focus of these investment strategies has been on corporate credit, but recent global events have meant that sovereign credits have also become part of the opportunity set that hedge fund managers invest in.

Hedge funds do engage in maturity and liquidity transformations to some extent but as the data below shows, the transformations often run in the opposite direction than what would be expected for a 'shadow banking' institution.

FSA data from the 2011 hedge fund survey<sup>4</sup> shows that the hedge fund liability profile is the inverse of that of a bank - i.e. the funding maturity is longer than the liquidity of the risk portfolio. The source and the term of hedge fund borrowings is also a relevant factor.

***Table 1 - Maturity transformation in hedge funds***



Source: Financial Services Authority, Hedge Fund Survey (February 2011)

<sup>3</sup> At 3.2.1 of the Framework.

<sup>4</sup> [http://www.fsa.gov.uk/pubs/other/hf\\_survey.pdf](http://www.fsa.gov.uk/pubs/other/hf_survey.pdf)



### *Limits on Leverage (tool 2)*

The FSB states that the leverage built up within the shadow banking system can amplify procyclicality. Hedge funds employ much lower levels of leverage (e.g. borrowing money) than banks. In its July 2011 report, the UK FSA estimated that the use of leverage by hedge funds managed from the UK remains largely unchanged in the aggregate (at approximately two or three times its net equity) compared with banks which are currently leveraged around 15 to 30 times their equity (down from as high as 40 or even 60 times prior to the crisis).

An analysis published by Hedge Fund Research Inc. (see table 2 below) reported that hedge fund industry leverage declined between 2010 and 2011, from 1.27 times to 1.1 times investment capital. Similar academic studies and hedge fund surveys carried out by various regulatory jurisdictions all conclude that the hedge fund industry has consistently employed relatively low levels of leverage.

Table 2 - Standard Leverage

Standard Leverage	Q1 2010	Q1 2011
All SM Fund Weighted	127%	110%
ALL SM Asset Weighted	239%	216%
Fund Size: <= 50 MM	108%	106%
Fund Size: 50-200MM	117%	107%
Fund Size: 200-500 MM	145%	131%
Fund Size:500M - 1B MM	173%	158%
Fund Size: > 1B	203%	189%

Source: HFR, Inc 2011 Hedge Fund Leverage Report

Leverage is central to the risks posed by shadow banking because high leverage creates high loss-given-default for intermediate tranches in asset-backed securities ('ABS'), and makes credit quality hard to estimate. Since ABS structures represent claims on cash flows from a portfolio of underlying assets, the rating of a structured credit product must take into account systemic risk. It is correlated losses which matter especially for the more senior (higher rated) tranches, and loss correlation arises through dependence on shared or common (or systemic) risk factors. Hedge fund leverage is an order of magnitude lower and the risks are correspondingly reduced.

### *Management of liquidity risk (tool 3)*

The information above shows that assets of hedge funds could normally be liquidated in a shorter timeframe than the period after which their liabilities (to investors and finance providers) would become due. Assets held by hedge funds could naturally be contractually long in maturity. The risks involved in this transformation, for both individual hedge funds and the whole financial system, are only mitigated by market liquidity to the extent that markets can be assumed to stay liquid in stressed conditions.

But hedge fund structures are also designed to deal with stressed market conditions and are normally, as a matter of ex-ante structuring, able to restrict investor redemptions through gates, side-pockets, suspensions or as otherwise allowed by their prospectuses. The reliance on short-term liabilities, as for banks, to fund illiquid long-term assets is not generally relevant for hedge funds and the risk for bank-like runs should be limited. Maturity/liquidity transformation in hedge funds should therefore not be subject to systemic risk concerns to the same extent as for those institutions whose liability profiles are extremely short term.

There is also good alignment of investor expectations as regards the underlying liquidity of investments. The annual survey of hedge fund investors conducted by Deutsche Bank underscores this important feature of the hedge fund market. Investors routinely accept extremely long initial lock-up periods whereby the invested funds cannot be redeemed before the lock-up period expires. The vast majority of hedge fund investors also accept quarterly or longer redemption periods.



Table 3 - What is the longest lock-up that you will accept on new hedge fund investments?

No lock up is acceptable	10.1%
Less than 6 months	6.0%
Less than 1 year	7.0%
1 years soft lock up	15.9%
1 years hard lock up	18.8%
2 years soft lock up	13.7%
2 years hard lock up	9.6%
3 years soft lock up	4.0%
3 years hard lock up	3.6%
3 or more years	5.1%
NA/Prefer not to answer	6.3%

Source: Deutsche Bank Alternative Investment Survey (2011)