



Response to the FSB Consultative Document “Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions”

The HFSB welcomes the opportunity to respond to the Financial Stability Board (FSB) Consultation on “Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions” (NBNI G-SIFIs).

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. In that spirit, the HFSB actively engages with the regulatory community and has responded to consultations on a broad range of 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 assessment methodologies for identifying NBNI G-SIFIs.

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 the level of individual firms (including liquidity risk management, stress testing and scenario analysis), as well as better counterparty risk disclosure, were powerful mechanisms for mitigating such financial stability risk concerns.¹

In its consultation on hedge fund redemptions in 2009², 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 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.

Over recent years, the HFSB has contributed to the discussion about the nature of the “shadow banking” universe and the systemic relevance of parts of the asset management industry, including

¹ See HFWG Final Report (Section 9.5: The Global dimension/Financial Stability [p. 33]; and Appendix H: Financial Stability Dimension [p.106])

² HFSB Consultation CP1/2009: Redemptions (<http://www.hfsb.org/?page=11474>)

hedge funds. Apart from strong industry standards, such as the Hedge Fund Standards, enhancing the resilience of the Hedge Fund industry in a bottom up fashion, the HFSB agrees that better transparency/disclosure to regulators helps improve global understanding of the financial system, including the role of hedge funds. Recent regulatory efforts to gather data via Form PF in the US and the AIFM-D – data collection template in Europe, alongside industry-driven efforts such as Open Protocol, will allow regulatory bodies to analyse the alternative investment sector in greater detail and replicate the existing UK FCA Hedge Fund Survey (and Hedge Fund as a Counterparty Survey) on a global scale.

Consultation responses

Q1-1. In your view, are the three transmission channels identified above most likely to be the ones transmitting financial distress of an NBNI financial entity to other financial firms and markets? Are there additional channels that need to be considered?

We agree that the three transmission channels³ can transmit financial distress. In the context of both the exposure/counterparty channel and the asset liquidation/market channel, the impact of losses on other market participants plays an important role. Therefore, from a systemic risk perspective, it is important to highlight that the relevance of both channels as a transmission mechanism is dependent on the endogenous reactions of market participants/affected counterparties.⁴ Market participants and counterparties with deep pockets will react very differently to an extreme adverse shock compared to someone who funded the position with short-term debt. Therefore, the assessment of the vulnerability of counterparties/market participants will help identify the most likely transmission channels.

The role of shock absorbers:

As indicated in the FSB consultation paper (p. 29), the investment management sector has a “shock absorber feature”, whereby fund investors absorb the negative effects that might be caused by financial distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system. This highlights that market participants, such as investment funds, with the ability to absorb losses contribute to a healthier and more resilient financial ecosystem. The following example illustrates this:

The burst of the dot-com bubble left many investors (including retail investors) and asset managers with significant losses. In total, the stock market crash of 2000-2002 caused the loss of USD 5 TN in the market value of companies⁵. Investors with the ability to absorb losses took the hit, banks remained unaffected since the bubble was not credit financed, and there were no financial stability concerns. In contrast, the subprime crisis in 2008 not only hit investors/funds, but directly affected bank balance sheets and endangered systemically relevant financial institutions.

Q2-1. Does the high-level framework for identifying NBNI G-SIFIs (including the five basic impact factors) adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system and economic activity? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed? If so, why?

³ 1.) Exposure/counterparty channel; 2.) Asset liquidation/market channel; 3.) Critical function or service/substitutability

⁴ See Bubbles, Financial Crises and Systemic Risk, p.64,

<http://www0.gsb.columbia.edu/faculty/moehmke/papers/BrunnermeierOehmkeHandbookSystemicRisk.pdf>

⁵ Source: <http://articles.latimes.com/2006/jul/16/business/fi-overheat16>

The high-level framework for identifying NBNI G-SIFIS (including the five basic impact factors) capture how failure of NBNI financial entities could cause disruption.

Q2-2. Is the initial focus on (i) finance companies, (ii) market intermediaries, and (iii) investment funds in developing sector - specific methodologies appropriate? Are there other NBNI financial entity types that the FSB should focus on? If so, why?

The initial focus areas seem appropriate.

Q3-1. Is the proposed scope of assessment outlined above appropriate for operationalising the high-level framework for identifying NBNI G-SIFIs? Are there any practical difficulties associated with the proposed scope of assessment?

The assessment methodology applies “at the highest level of the firm that is a financial entity and on a globally-consolidated basis”. While the approach to aggregate total exposure makes sense for banks and insurers, it is less clear in the context of an asset manager: an investment firm might manage hundreds of clearly segregated, non-interconnected funds with potentially different underlying asset classes and strategies. There is no justification for aggregating these funds as if though they created risks similar to those in a large, single bank balance sheet. Indeed, the segregation into different asset pools can enhance the overall resilience by limiting distress to one given portfolio.

Therefore, an approach based purely on such top-line numbers likely will produce many false positives. An alternative approach would look at the size of individual funds (or families of funds pursuing the exact same strategy, where indeed funds act in a correlated fashion) within an investment firm.

Q3-2. In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

Two materiality thresholds have been proposed for investment funds: USD 100BN in net AUM and, specifically for Hedge Fund Managers, USD 400-600BN in Gross Notional Exposure (GNE)⁶. As indicated in the response to Q3-1, a materiality threshold based on a firm-wide perspective may result in a large number of false positives, which regulators will have to assess in more detail. However, the distress of an individual fund may not exhibit any broader financial distress via the transmission channels described in section 1.

In addition, we have provided below a few additional conceptual observations on GNE and how it has been employed by regulators in other contexts:

- GNE does not differentiate by type of derivative (e.g. swaps, options etc.)--all are counted equally in the GNE calculation, although they may exhibit very different characteristics in a distress scenario. For example, for an option, in the case of a counterparty default, all that

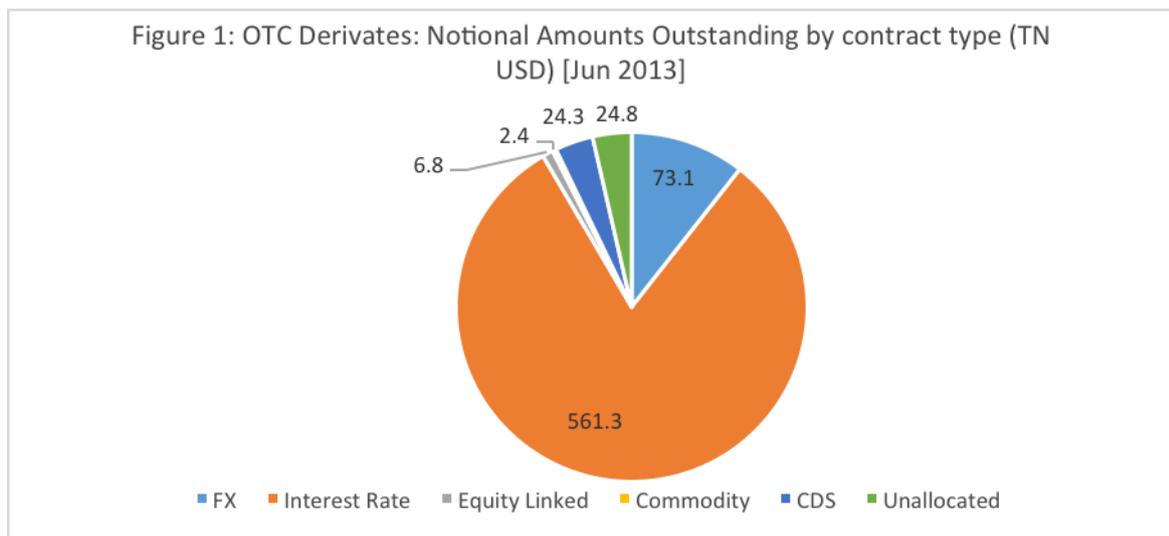
⁶ GNE= Absolute sum of all long and short positions, considering notional value (delta adjusted when applicable) for derivatives.

can be lost is the premium.⁷ Therefore, two fund portfolios may exhibit identical GNEs, but will have very different effects on the systemic risk transmission channels.

- GNE does not take into account hedging or the risk profile of instruments used. It is important to note in this context that the FCA Hedge Fund Survey uses GNE to assess the “market footprint” of a hedge fund manager but does **not** employ this measure to assess the investment or market risk of portfolios.⁸
- In the indicator-based measurement approach of the Basel assessment methodology for global systemically important banks, the size factor is based on the *Total exposures* as defined for use in the Basel III leverage ratio⁹: Derivatives are incorporated using replacement cost + add on¹⁰, but not based on the notional exposure. However, the notional exposure (of OTC contracts) is one of three factors that help determine the complexity of financial institutions.

This highlights that a GNE as an absolute standalone measure has some limitations.

One possible way to put the GNE measure into a meaningful context is to assess it in relation to the size of the relevant derivative market. The analysis below suggests that a GNE threshold of USD 400-600BN is very low in relation to the size of the global interest rate contract market (USD 561 TN), but large in the context of commodity contracts (notional outstanding: USD 2.4 TN) (see Figure 1). This suggests that a differentiated threshold as a function of underlying derivative market might be more appropriate.



Source: BIS

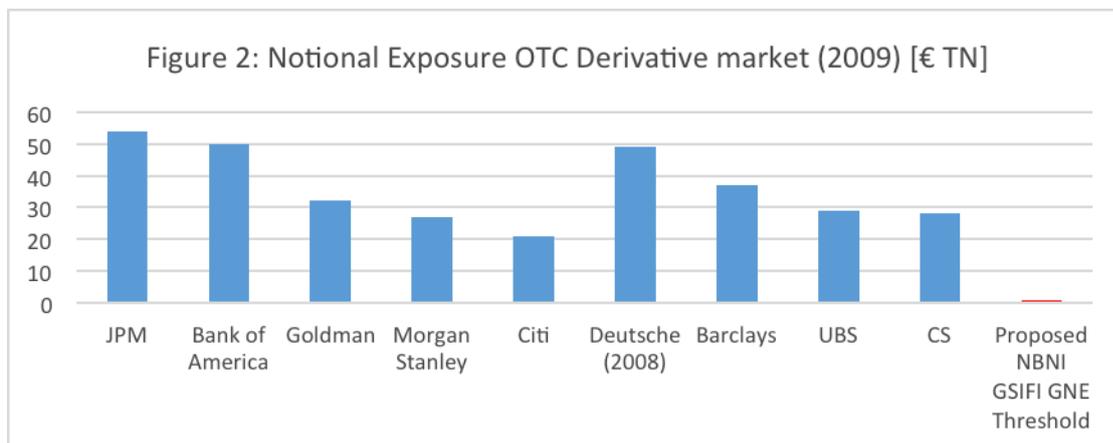
Finally, one also can compare the proposed GNE threshold with notional exposures observed at major banks (Figure 2) in order to get a sense of the relative calibration of the threshold.

⁷ Example: A portfolio consisting only of call and put options might have a high GNE, but it is unclear how the failure of such a fund has any impact on counterparties.

⁸ P. 6, FCA Hedge Fund Survey, March 2014, <http://www.fca.org.uk/static/documents/hedge-fund-survey.pdf>

⁹ See p. 9, Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement, Basel Committee on Banking Supervision, July 2013

¹⁰ See p. 8, <http://www.bis.org/publ/bcbs251.pdf>



Source: p.61, ECMI Research Report No. 5/April 2010, Shaping Reforms and Business Models for the OTC Derivatives Market: Quo vadis?, Diego Valiente

(<http://books.google.co.uk/books?id=jbJvbjQ77nwC&printsec=frontcover#v=onepage&q&f=false>)

This comparison suggests that the GNE threshold appears to be calibrated at a fairly low level.

All this shows that it is indeed difficult to establish the “right measure and number” for the materiality threshold and that there is a trade-off between “ease of application” versus “targeting precision” as per the analysis above. If the above considerations are not built into the initial materiality assessment, they should form part of any subsequent analyses carried out by regulators. As mentioned in response Q6-5, regulators should work with available data collected through Form PF/AIFM-D Appendix.

Q3-3. Are there any practical difficulties in applying the materiality thresholds?

See answer to Q3-2.

Q3-4. In your view, what is the appropriate threshold level, taking into account the range given above (USD 400-600 billion in GNE), for hedge funds? Please also provide reasons with data to back it up.

See answer to Q3-2.

Q3-5. Do you think that it would be beneficial to set additional materiality thresholds based on “global activity”? If so, please explain the possible indicator and the level on which materiality thresholds should be set (with reasons for selecting such indicator, the level and any practical challenges).

See answer to Q6-6.

[Q4 and Q5 cover sector specific methodologies for finance companies and market intermediaries and, accordingly, we have not covered them in this consultation response]

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

The proposed definition of investment fund is appropriate.

Q6-2. Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

Both transmission channels are feasible. The FCA Hedge Fund survey has assessed the relevance of both the exposure/counterparty and the asset liquidation/market channel:

- The financial leverage (prime brokerage financing, direct secured or unsecured lending, repo transactions), which gives rise to counterparty risk, accounts for only 2% of total leverage (the other 98% is synthetic leverage via derivatives). Unsecured lending is very small as most counterparties demand some form of collateral for any financing of Hedge Fund positions.¹¹ The total amount of financial leverage was USD 446BN. Given the mostly secured nature of such funding, it appears unlikely that counterparties will incur significant losses in the situation of a stand-alone hedge fund failure.
- The market footprint of hedge funds was analysed in terms of gross exposure. The footprint ranged from 0.1% (FI bonds) to 6% (commodities), concluding that most surveyed hedge funds do not account for a significant proportion of trading volume.¹²

The availability in the future of better data (through, for example, ESMA data collection and Form PF) will allow further assessment of this risk transmission mechanism on an industry-wide basis.

Q6-3. Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone entity basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.

Focus levels (i) is appropriate: an investment firm might manage hundreds of clearly segregated, non-interconnected funds with potentially different underlying asset classes, strategies and separate management teams in charge and there is no reason for aggregating these as if they were a singular integrated balance sheet (as Focus level (iv) would require). In fact, the segregation into different asset pools can enhance overall resilience by limiting distress in one given portfolio. Where separate funds pursue the exact same strategy and act in a correlated fashion, they can be treated as a family of funds (focus level ii).

Q6-4. Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

The methodology should not “hardwire” any prioritisation of particular activities or groups of activities, given that the assessment of what might be considered “systemic” might change over time. This would enable regulators to incorporate more flexibly the findings of other analyses of systemic risk, e.g. in the context of the banking and insurance G-SIFI frameworks.

Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

¹¹ p. 19, FCA Hedge Fund Survey, March 2014, <http://www.fca.org.uk/static/documents/hedge-fund-survey.pdf>

¹² P. 9, Assessing the possible sources of systemic risk from hedge funds (FSA, 07/2011)

As indicated in our responses to Q3.2, the GNE measure should be improved by, for example, looking at GNE in relation to the total OTC derivative market size and differentiating by type of instrument used (e.g. options vs. swaps).

In general, a flexible approach should be taken in relation to the specific impact factors, driven by availability from the existing data collection exercises (Form PF, AIFM Appendix). For example, some factors (e.g., Indicator 3-3: Investment strategies (or asset classes) with less than 10 market players globally) might not be readily available on a globally consistent basis from the underlying data set and therefore cannot be assessed properly at present.

Obviously, the long-list of funds produced by applying the indicator model does not allow any final conclusions on systemic risk, and a second stage of in-depth assessment is needed in order to eliminate false positives and to initiate further in-depth assessment by the relevant national regulator, as appropriate.

Q6-6. For “cross-jurisdictional activities”, should “the fund’s use of service providers in other jurisdictions (e.g., custody assets with service providers in jurisdictions other than where its primary regulator is based)” be used?

It is not clear whether it can be assumed that a more internationally diversified fund (which therefore has more cross jurisdictional activities, including service providers in other jurisdictions) automatically has a greater systemic relevance than a fund concentrated in a single market (with more concentrated relationships). It is also unclear whether this information is readily available from existing data collection efforts. Finally, the number will likely be highly correlated with the existing indicators 5-1 (# jurisdictions where the fund invests) and 5-2 (# of jurisdictions where the fund is sold), and therefore will have only marginal additional explanatory power.

Q6-7. Is the definition of “net AUM” and “GNE” appropriate for assessing the “size” (indicators 1-1 and 1-2)?

The net AUM definition is adequate. As mentioned above in our answer to Q3.2, net GNE as a size measure has certain limitations, and its “explanatory power” should be coupled with looking at it in the context of relevant derivative market size, type of instrument etc.

Q6-8. Is the definition of “investment strategies” sufficiently clear for assessing the “substitutability” (indicator 3-3)?

It is appropriate to take into account the specific investment strategy/features, but it is unclear whether this information will be available consistently across all jurisdictions. It is also unclear whether it is actually “collectable” via the various data templates:

- A particular investment strategy might be very unique, but the data collection template will only allow a manager to select from the pre-defined set of strategies (or select “other”), which means, in effect, that this information cannot be collected. Where managers are able to specify an investment strategy as part of the data collection effort, there may be many different ways of labelling the same strategy, thereby requiring a “manual assessment” of the global dataset to assess this particular factor, which is probably not viable.
- A strategy might be very unique, but the underlying asset class could still be some large mainstream segment (global equities) where the individual manager plays only a marginal role in the overall market context.

Q6-9. Would collecting or providing any of the information included in the indicators present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

Please see answers to Q6-6 and 6-8 for specific examples. In general, available information supplied as part of Form PF, AIFM-D Appendix etc.

Q6-10. Are there additional indicators that should be considered for assessing the relevant impact factors? For example, should “the fund’s dominance in a particular strategy (as measured by its percentage of net AUM as compared to the total AUM also be considered for “substitutability”? Similarly, should “leverage” or “structure” of a fund also be considered for assessing “complexity”? Please explain the possible indicators and the reasons why they should be considered.

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Q6-11. Should certain indicators (or impact factors) be prioritised in assessing the systemic importance of investment funds? If so, please explain which indicator(s) and the reasons for prioritisation.

At this stage, all factors should be assessed. It will be easier to (1) assess the validity of individual factors (including correlation between factors) once the model has been tested, and/or (2) add factors as appropriate once more granular data becomes available.