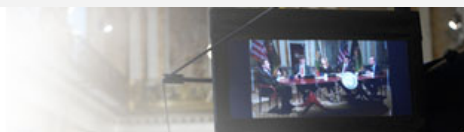


## U.S. DEPARTMENT OF THE TREASURY

## Press Center



## Remarks by Deputy Assistant Secretary Jonah Crane at a Meeting of the Financial Stability Oversight Council

11/16/2016

### *As Prepared for Delivery*

**WASHINGTON** - Thank you Secretary Lew and members of the Council. Let me begin by thanking staff from Council member agencies who have participated in the analysis by the hedge fund working group. This analysis relied on data and expertise from all of the members of the working group.

Today's update is part of the Council's ongoing review of asset management products and activities. In May 2014, the Council hosted a public conference on asset management that brought together a diverse group of industry and non-industry participants and helped shape the Council's initial approach to its work. In December 2014 the Council issued a notice that asked for public input on whether risks to U.S. financial stability could arise from certain asset management activities.

We carefully considered the public input, and over the past two years have continued to engage extensively with stakeholders. Our analysis has concentrated on five areas of potential risk, including the use of leverage by private funds. We also extensively considered regulations and industry practices that reduce risk. This past April, the Council issued a public statement describing its initial analysis of potential risks and discussing steps that could be taken to address those risks.

The April statement noted that hedge funds themselves are not directly regulated and their major counterparties, and the markets they operate in, are regulated by various agencies with different jurisdictions. Accordingly, no single regulator has all the information necessary to evaluate the complete risk profiles of hedge funds. Data from advisors to hedge funds, collected by the Securities and Exchange Commission on Form PF and provided to the Office of Financial Research, is very useful in many respects. However, it does not provide complete information on the risk exposures arising from hedge fund leverage or potential practices that may reduce the risk associated with reported leverage levels. As a result, FSOC is uniquely positioned to bring together authorities with the data and expertise to assess potential financial stability risks and monitor those risks over time.

As noted in the Council's April statement, the relationship between leverage and risk, and whether that risk may have financial stability implications, is not straightforward or simple. But there is ample evidence that leverage, in combination with other factors, can contribute to risks to financial stability. The most well-known example is the 1998 failure of Long-Term Capital Management, a fund with \$4 billion in net assets under management but over \$125 billion in gross assets, and over \$1 trillion in gross exposures before its failure.

The hedge fund industry has continued to grow, and there are now dozens of funds managing at least \$10 billion of net assets. Industry-wide net assets under management totaled \$3.4 trillion as of the first quarter of this year, exceeding peak levels from before the financial crisis. Hedge funds may also be increasingly acting as liquidity providers in many markets.

On average, hedge funds do not appear to employ significant amounts of leverage. But, as the Council's April statement noted, "the use of leverage appears to be concentrated among a small number of hedge funds." Moreover, fund strategies that typically employ the highest amounts of leverage have grown as a percentage of overall hedge fund assets. This use of leverage means that their market footprint far exceeds their assets under management.

To better understand whether hedge funds' use of leverage might pose potential risks to financial stability, the Council created a staff-level interagency working group with three objectives:

- 1) First, to use regulatory and supervisory data to evaluate the use of leverage, in combination with other factors, for purposes of assessing potential risks to financial stability.
- 2) Second, to assess the sufficiency and accuracy of existing data and information.
- 3) Third, to consider potential enhancements to current measurements of leverage, including risk-based measures.

The Council asked the working group to provide an update in the fourth quarter of this year. Today we will describe the progress the working group has made on each of its three objectives, and suggest two areas of focus for continuing work.

### **Risk Analysis: Fire Sales and Counterparty Exposures**

The working group has focused on two channels through which hedge funds' use of leverage could pose potential risks to financial stability: (1) by causing or contributing to significant disruptions of key financial markets through forced selling, or (2) by transmitting stress to counterparties that are large, highly interconnected financial institutions. In each case, we have identified factors that could increase or mitigate the risks, and we have also identified areas where regulators do not currently have access to the necessary data to assess the extent of the risks.

#### *Market Disruption from Forced Asset Sales*

With respect to potential market disruptions from forced selling, the use of significant leverage means that even small changes in asset prices could lead to margin calls or funding pressures, particularly for funds relying on short-term funding. Margin calls or increased haircuts on collateralized funding—or even counterparties' refusal to roll over funding altogether—could require hedge funds to rapidly liquidate positions, particularly if they do not hold sufficient unencumbered cash or liquid assets to meet funding needs.

Forced sales by hedge funds could cause a sharp change in asset prices, leading to further selling, substantial losses, or funding problems for other firms with similar holdings. This could significantly disrupt trading or funding in key markets. In addition, while hedge funds may act as liquidity providers during times of low volatility, if they were to cease these activities during periods of stress, the resulting loss of liquidity could magnify the forced sale dynamics. Empirical research also shows that forced selling by hedge funds, precipitated by funding constraints, could contribute to market dislocations in certain asset classes.

Beyond liquidity pressures, there are two additional factors that are relevant to an analysis of the potential risks from fire sales: (1) the size of positions, and (2) correlation of strategies. The risk of instability is greater if leveraged investors hold large positions that could be difficult for the market to absorb in a rapid deleveraging event, or if many funds or other market participants hold similar positions or have correlated strategies. In addition, the potential for fire-sale dynamics increases if a fund holds relatively less-liquid assets, due to the difficulty of selling those assets without affecting market prices.

One measure of the potential for a forced unwind of leveraged positions to cause market disruption is simply the size of a position relative to market size or average trading volumes. Many funds track similar measures, often as part of their assessment of how quickly they could exit a position if necessary. The working group's analysis of position-level data for interest rate derivatives, provided by the Commodity Futures Trading Commission (CFTC), showed that positions held by a relatively small group of funds constituted a meaningful share of certain key markets, relative to both market size and trading volume. Position sizes were more modest in other cases. Further work is required to better understand the implications of the results.

With respect to correlation, more detailed reporting of asset class exposures or more frequent returns data would greatly improve our ability to identify correlated strategies.

### *Counterparty Risk*

The second channel the working group has focused on is the potential for hedge funds to transmit stress to their counterparties. In recent years, these risks have been somewhat mitigated by increased central clearing of derivatives and other regulatory reforms, including minimum margin requirements for uncleared derivatives—which currently are being phased in.

An examination of available data suggests that counterparties' exposures to hedge funds are meaningful and should be analyzed further. Some of the largest banking institutions appear to have large notional exposures to hedge funds in uncleared interest rate and foreign exchange swaps. A majority of derivatives exposures for the largest funds, however, are centrally cleared, and a significant amount of bilateral swaps, not traded on centralized exchanges, are now cleared and subject to regulatory oversight.

Further, exposure to a small group of funds constitutes a significant percentage of aggregate credit extended to funds, which consists primarily of repo and other secured borrowing. Significant losses at these funds could transmit stress to their counterparties under extreme but plausible market moves. Data on margin posted by funds to their counterparties, which are not currently available to us, could provide a useful risk-based measure of these exposures.

### **The Next Phase of Work**

Our analysis provides insight into how hedge funds' use of leverage could present risks to financial stability, but more work is needed to assess the extent of these potential risks. The working group proposes two areas of focus for the next phase of work: (1) addressing data gaps and limitations, and (2) continued monitoring of potential financial stability risks, including further refinement of measurements of leverage.

### *Data Gaps and Limitations*

Additional data are necessary for us better to assess potential risks to financial stability. The working group's recommendations focus on maximizing our use of existing data sources, and on collecting additional data that are likely to be readily available and would provide significant additional insight beyond what is currently reported. Based on those principles, the working group has five recommendations regarding data:

- **Improved data harmonization and sharing:** It is difficult to use certain existing regulatory data sources because reporting is not standardized across financial market utilities and regulatory agencies. In particular, the working group believes swap data repositories should continue working with the CFTC and standard-setting bodies to establish consistent standards for reporting swaps data. Data sharing among relevant regulators is essential for evaluating potential risks to financial stability posed by hedge funds.
- **More granular exposure data:** More detail regarding hedge funds' portfolio exposures (for example, information on the tenor and asset class of their fixed income investments) and historical volatility would allow better estimates of netting and provide insights into fund strategies and correlations between funds, helping us assess both fire sale and counterparty risks.
- **Funding terms:** Information about the terms of the financing hedge funds rely on, such as the maturities of their obligations and the extent to which they use overnight funding, would allow better estimates of asset/liability matching. This is particularly relevant for assessing the risk of asset fire sales caused by funding stress.
- **Bilateral repo data:** Collection of bilateral repo data is important to better understand the cash positions of hedge funds and the terms on which those positions are financed.
- **Posted margin and unencumbered cash:** More comprehensive information on hedge funds' posted initial margin and unencumbered cash would provide key insights into potential counterparty exposures and the ability of funds to withstand margin calls without resorting to forced asset sales.

In addition to these areas where more information would be helpful, there are likely also opportunities to refine Form PF to reduce firms' compliance burdens without undermining the Council's ability to monitor financial stability risks. Minimizing reporting burdens while improving the timeliness and usefulness of the reported data would benefit market participants as well as regulators. We expect significant engagement with stakeholders to try to meet those objectives.

#### *Continued Monitoring*

The hedge fund industry is dynamic and continues to evolve, so it will be important to continue to monitor the industry. The working group recommends that Council member agencies continue to coordinate their efforts to evaluate the potential risks to financial stability posed by the use of leverage by hedge funds. Specifically, we recommend that regulators periodically review available data and analyze funds' use of leverage, in combination with other factors, to identify potential emerging risks to financial stability from fire sales or counterparty risks, consistent with the analytical framework outlined by the working group. We also recommend that key findings from this analysis be shared regularly with the Council and the regulators of relevant leverage providers.

Notably, hedge funds operate in markets alongside many other players, and they are diverse in their strategies. Risks arising from hedge fund activities are more likely to arise when other market participants' activities also contribute to the vulnerabilities. As a result, an important element of our continued monitoring will be an analysis of broader fund flows and other financial market developments to identify asset classes or strategies that may be more vulnerable to fire sale or counterparty risks.

Hedge funds are important participants in the financial markets, but no single regulator has the authority or the information to identify or address the risks hedge funds' use of leverage could pose. Our continued monitoring will help us identify risks as they emerge and evolve.

#### *Leverage Measures*

Finally, the working group has also identified measures of leverage that are helpful in assessing potential risks to financial stability. Gross notional exposures are commonly calculated and readily available, and have been incorporated into our analysis. But future monitoring that incorporates a range of leverage measures could provide better insight into the potential risks underlying those positions. The working group has identified four categories of leverage measures, all of which should be incorporated into the analysis of potential risks:

- *Gross measures*, such as gross notional exposure and gross asset value, represent important "adverse case" framing of exposures that can be useful in identifying potential financial stability risks, especially for funds with offsetting positions that have low exposures on a net basis. However, gross exposures overstate risk in normal markets, in part because they count hedges as increasing exposures.
- *Adjusted gross exposures*, which account for volatility of the underlying assets, can help to normalize exposures across asset classes that have very different risk profiles. However, like unadjusted gross exposures, these measures do not account for the benefits of hedging.
- *Net exposure measures*, such as net notional exposure or the "commitment" approach being adopted under the European Union's Alternative Investment Fund Managers Directive, can account for the netting of offsetting positions. However, these measures generally require complex, subjective self-reporting of offsetting positions. Even a simpler approach that provides a rough estimate of hedging would require more detailed portfolio data, such as tenor and product exposures for fixed income investments.
- *Risk-based metrics*, such as value-at-risk (VaR), can provide a more holistic view of risk-taking. However, funds calculate VaR in different ways, limiting the ability to compare VaR measures across funds. Moreover, VaR measures may not account for tail events. Additional "stress test" reporting would provide a more complete picture of risk. The amount of initial margin funds post to their counterparties could act as a proxy for risk, because initial margin generally represents a market estimate of potential loss. Therefore, this information would be useful in estimating potential counterparty exposures.

#### **Conclusion**

The working group's analysis represents a substantial improvement in our understanding of an important segment of the financial markets. Just a few years ago, before there was reporting on Form PF and the establishment of swap data repositories, there was little transparency into the potential risks to financial stability that could arise in this industry. And before the creation of the Council, there was no entity with the duty and authority to look across the system to identify and monitor these risks. The hedge fund working group has made significant progress in identifying channels for the potential transmission of risks, factors relevant to assessing those channels, data gaps and limitations that impede our ability to identify evolving risks, and metrics for measuring the risks associated with hedge fund leverage. The further analysis and continued monitoring recommended by the working group will provide the transparency needed to identify risks to financial stability as they emerge.

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