Response to FSA Discussion Paper 09/2[1]: A regulatory response to the global banking crisis

Introduction

The Hedge Fund Standards Board (HFSB) was set up to act as custodian of the Best Practice Standards published by the Hedge Fund Working Group in 2008 and to promote conformity to the Standards. It is also responsible for ensuring that they are updated and refined as appropriate. Over 50 managers from the UK and abroad – totalling approximately USD 200BN in assets under management - have already committed to the process of the HFSB, and more are expected to sign up to the Standards over coming months. The HFSB expects its Hedge Fund Standards to be widely adopted and an increasing number of investors to use the Standards in their due diligence. It is important that policy leaders trust that the HFSB will implement this market based regime with the industry and encourage adoption as well.

The HFSB is pleased to have the opportunity to respond to the FSA's Discussion Paper DP09/2, A regulatory response to the global banking crisis.

Consultation responses

The HFSB agrees with the approach in the Turner Review, rooting decisions about the regulatory response in a clear analysis of the causes of the crisis. Since the crisis originated as a banking crisis, quite naturally, many parts of this consultation focus on shortcomings in the context of banks, capital adequacy (for banks) and banking supervision.

Accordingly, many of the consultation questions focus on banks and are outside the remit of the HFSB. However, we are very pleased to comment on issues with direct and indirect relevance to hedge fund investors and the managers themselves.

The subsequent section titles refer to structure of the FSA's Discussion Paper DP09/2.

Section 3: The role of inadequate capital and liquidity in causing instability

(p. 61-84)

Q1: Are there shortcomings in the international prudential framework not already identified in the DP that are relevant to the analysis?

No comment.

[1] FSA DP 09/2 is available at: http://www.fsa.gov.uk/pages/Library/Policy/DP/2009/09_02.shtml

Q2: What are the measures supervisors should take to mitigate the risks to depositors and other unsecured senior creditors of secured funding, taking account of the benefits of such funding where used to an appropriate degree?

No comment.

Section 4: Solutions through micro-prudential measures

(p. 85-94)

Q3: Do you agree with the proposals to redefine the definition of capital with a stronger emphasis on going concern loss absorbency?

No comment.

Q4: Should IRB banks be required to use a system such as variable scalars, or equivalent, whose effect is to limit the potential for procyclicality in capital requirements to a level that would be produced by a TTC ratings system?

No comment.

Q5: Are there any other key issues that the review of trading book capital should cover?

No comment.

Q6: How should the leverage ratio capture (i) off-balance sheet exposures and (ii) derivatives?

Although this question relates to banking institutions, we would like to highlight that financial statement based leverage ratios have certain limitations. Leverage merely measures the sensitivity of a portfolio to changes in risk factors such as market prices, but do not account for the actual volatility of the underlying risk factor (which should then be looked at separately). There can also be instances where a risk reducing transaction increases some leverage financial statement based measures, while decreasing others.

Approaches to overcome these shortcomings of classical financial statement based leverage measures include risk based leverage measures (eg Volatility/equity; VAR/equity; stress loss/equity; other loss measure/equity), which incorporate the risk component (including the impact of derivatives and off balance sheet positions) in the equation. However, these measures usually rely on models/various assumptions and are therefore more complex to determine and comparison between financial institutions is more complicated.

In summary, the FSA rightly highlights that "a leverage ratio is not a panacea, and therefore, it should be implemented only as part of a broader prudential framework", and as we highlight later in our response, a range of risk management and measurement tools are necessary to effectively manage and control balance sheets/portfolios.

Q7: Should the numerator of the leverage ratio be Core Tier 1 capital or should a broader measure of capital be used?

No comment.

Section 5: Macro-prudential policy

(p. 95 – 118)

Q8: Should these reforms be applied to smaller and domestic banks, building societies and investment firms? If so, how can this be achieved in a proportionate manner?

HFSB agrees that it might not be appropriate to impose the same prudential regulatory framework on every deposit taker and investment firm, irrespective of its size and application. However, we also acknowledge that a differential approach could give rise to "boundary issues", and have some impact on competition.

In the context of investment firms (here: hedge fund managers), HFSB does not see a case for expanding prudential banking regulation: Only if hedge funds were to behave like banks, they should be regulated like banks. As stated in the Turner Review, "Hedge funds in general are not bank like in their activities". For example, hedge funds are not retail deposit takers, they do not provide a material maturity transformation function, losses are ultimately borne by investors, and leverage has been significantly lower than in the banking sector.

In relation to the hedge fund sector, three elements should form the basis for a macro-prudential framework:

1. A robust micro-prudential framework plays an important role, including registration of managers, and strengthening of the market based process involving investors and counterparties as the most efficient mechanism to enhance the robustness of the industry.

The interests of investors and counterparties are closely aligned with those of hedge fund managers, and they are best suited to scrutinise managers in relation to risk, valuation, governance and conduct issues and to require the disclosure they need to make adequate investment decisions and provision of credit/leverage. The HFSB feels that this approach is extremely effective, since it relies on those who have most at stake. In particular investor's allocations are the most powerful incentive for managers to improve standards. This process helps to reinforce the Darwinian process of weeding out underperformers and those who do not meet industry best practice. This mechanism leaves no room for complacency, either on the side of investors (who need to perform due diligence), or on the part of managers (who will be eliminated if they do not meet the standards). Equally important, there is no false comfort (which a regulatory regime seeking to protect investors can introduce to the system). This is exactly what the HFSB and the Hedge Fund Standards provide.

2. The second component relates to macro prudential efforts in relation to the interaction of (systemically relevant) large banks and their hedge fund counterparties, and involves requiring these banks to manage their counterparty risks to hedge funds, as required in FSA's banking supervisory regime. In addition, FSA's Prime Brokerage survey is a suitable approach to get a better understanding of bank's risk appetite vis a vis hedge funds.

3. Although the recent crisis has not provided any evidence on systemic issues in relation to hedge funds, additional macro prudential efforts can focus on collecting data from hedge fund managers to continuously assess the potential impact of the hedge fund industry, and to reassess the analysis of systemic relevance from time to time. However, in this context, it is important not to develop a "stand alone approach" for the hedge fund industry, but to embed these analyses in a more holistic

"systemic risk dashboard", which looks at risk taking across economic and financial market activities beyond sectoral and even national borders.

Q9: Do you agree with the FSA's reasons for favouring a range of policy measures to deal with macro-prudential policy issues rather than adjusting the Basel II risk-based capital requirement?

The HFSB agrees with FSA's approach to introduce a range of policy measures, rather than adjusting the Basel II risk based capital requirements. Similar to most areas of (idiosyncratic) risk management, it is useful to have a diverse set of risk measures and tools in a systemic context as well, to avoid single edged views on risk and foster better quantitative and qualitative understanding of the full complexity of risk.

Q10: What should be the focus of the FSA's initiatives on valuation and disclosure in UK banks' accounts so as to maximise their impact on market confidence?

No comment.

Q11: Do you agree with the FSA's analysis of the implications of accounting standards for procyclicality?

No comment.

Q12: How best should prudential regulators address the problem of procyclicality through counter-cyclical reserves/buffers?

No comment.

Q13: Do you agree that serious consideration needs to be given to establishing some form of global supervisory architecture for international audit firms?

No comment.

Q14: What macro-prudential policy tools should be considered other than those mentioned in this DP?

No comment.

Q15: What are your views on the effectiveness of a core-funding ratio as a measure to constrain excessive asset growth?

No comment.

Q16: What types of institutions should be exempt from such a core funding ratio? How would any exemptions limit the effectiveness of the measure?

A core funding ratio seeks to impose a constraint on the overall quality of liabilities, by for example including retail deposits and long term wholesale funding, while excluding short term money market instruments. As stated earlier, hedge funds do not exhibit bank like features, therefore, bank type capital requirements are not needed. In particular, hedge funds are not deposit taking and do not rely on short term wholesale funding. Therefore, investment firms, such as hedge funds should be exempt.

Q17: To what extent would market discipline and the convergence of supervisory practices be improved by the disclosure of information relating to Pillar 2 assessment? What information would be most useful?

No comment.

Section 6: Scope of regulation

(p. 119-130)

Q18: Are there other considerations that are relevant to the assessment of the issues and risks posed by the boundary question?

Since hedge fund management is a regulated activity in the UK, the boundary question does not apply with UK managers. With respect to the fund (the product), the question arises if there are any incremental regulatory measures required in relation to the product to help achieve the regulatory objectives (a. retail protection, b. financial stability, and c. market integrity). HFSB sees no evidence for that: a. The Hedge Fund industry does not cater directly to retail investors, b. financial stability concerns in relation to hedge funds are unclear[2] and appropriate measures to assess the systemic impact of the industry and foster understanding of the interconnectedness with the banking system are in place (PB survey) or underway (HFM survey), c. regulation addressing market integrity (such as market abuse laws) apply to all market participants including hedge fund managers, regardless of where the actual fund is located, and should therefore be addressed in the respective specific rules and regulation applicable to all.

Q19: Is the escalating response set out here the right way to deal with the threats to financial stability and consumer protection posed by unregulated financial activities and institutions? Or should the FSA, along with other regulators, develop an alternative approach?

HFSB generally agrees that an assessment framework is needed to determine whether a direct or indirect regulatory approach is appropriate and what measures are proportionate to meet the regulatory objectives.

Q20: What are the implications of subjecting parent holding companies for financial services groups to direct powers to comply with the requirements of the prudential framework?

No comment.

Section 7: Systemically important firms

(p.131 – 136)

[2] As highlighted in the consultation paper, "(...) There is no doubt that the growth of activities, such as maturity transformation and leverage within unregulated vehicles such as ABCP conduits and SIVs contributed significantly to the credit expansion that sowed the seeds of the current crisis. At the same time, it is much less clear that hedge funds, which tend to dominate any discussions on the boundary issue, have so far directly contributed significantly to the causes of this crisis." (DP 09/2, p. 123)

Q21: Are there other issues which regulators should take into account when assessing their response to the evidence from the current crisis that some financial institutions have been deemed too big to fail fully? If so, what are they?

No comment.

Q22: What are your views on the balance between varying the intensity of supervision according to the impact and risk that an individual firm poses, and having policy frameworks and approaches that differentiate across-the-board according to a firm's systemic significance?

No comment.

Section 8: Groups and intra-group exposures

(P 137-144)

Q23: Are there other aspects of group structures that the FSA should be taking into account?

No comment.

Q24: Is the increased focus on group structures and intra-group relationships and increased supervisory cooperation the right way to deal with the threats to financial stability and consumer protection posed by large, international group structures? In what circumstances would a greater focus on individual legal entities be warranted?

No comment.

Section 9: Responding to events – international architecture

(p. 145-158)

Q25: How can the international architecture be arranged to provide the most effective early warning of threats to financial stability and challenge to national authorities and in an apolitical way?

No comment.

Q26: Is this the most effective way of organising colleges on the one hand and crisis management groups on the other?

No comment.

Q27: Do these options represent the right approach to the problems posed by EEA branching?

No comment.

Q28: Are the functions of rule-making capability and supervisory oversight the right ones to be given to a European institution that has the characteristics described here?

In our view, the transfer of responsibilities to European institutions should observe the subsidiarity principle. If supervisory objectives can be better and more efficiently achieved by local authorities, responsibilities should not be transferred, which is the case for the Hedge Fund industry.

Section 10: Market issues

(p.159-182)

Q29: Does the DP highlight the correct issues concerning the role of CRAs and the use of their ratings?

No comment.

Q30: Are the approaches outlined to address these issues appropriate and proportionate?

No comment.

Q31: What options should a review of the use of structured finance ratings in the regulatory framework consider?

No comment.

Q32: Is this the most appropriate framework for post-trade transparency or are there other aspects we should be considering?

Transparency is the linchpin in the market based HFSB regime, and we agree with FSA that transparency is essential for efficient and well-functioning markets.

In relation to 10.57 (Transparency of positions to market participants), HFSB has previously commented in its response[3] to DP09/1 (Discussion Paper on Shortselling) on individual firm disclosures in the context of short selling. One of the important conclusion is that a rigorous framework is needed to determine the exact issues that disclosures are seeking to address (and to whom the disclosure is relevant), and to ensure that the disclosure itself does not give rise to market distortions (see below).

> *Excerpt from HFSB response to DP09/1 (Question 11):*
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> *FSA mentions among the benefits of enhanced transparency that short selling conveys a signal to markets that a firm is overvalued (5.7). Along those lines, one could equally argue that on every short sale, there is a buyer, thereby signalling to markets that the stock is undervalued. Therefore, the "net signal" is actually not indicative at all of whether the stock is over or undervalued. In addition, short selling is used in hedge transactions, where only the relative directional movement of a shorted stock matters (in relation to the respective long position), irrespective of whether the market rises or falls. Therefore, HFSB would argue that <u>all information is reflected in today's market price, irrespective of whether short selling has occurred or not.</u> The aggregate impact of short selling might have reduced that price, but thereby this information is included in today's market price.*
> *Portraying that short selling activity is a signal to other investors that a stock is overvalued is only true under the assumption that the parties short selling the stock have better information than those buying the stock. If some investors assume that mostly hedge fund managers engage in short selling and that hedge fund managers have better information, then they might give more weight to the fact that short selling occurs (rather than just assuming that today's price is the best estimate of future value).*
> *The problem arises if regulators now argue that short selling can convey a signal, because they*

[3] Public comment on FSA's Discussion Paper on Short Selling (DP09/1) by the HFSB (answers Q5, Q11- Q21): http://www.hfsb.org/sites/10109/files/public_comment_on_fsa_short_selling_consultation_(final).pdf

implicitly tell market participants that short sellers indeed have better information, and thereby encourage herding behaviour based on short selling disclosures. HFSB believes that it would be an arbitrary decision to enhance disclosure on the grounds of "additional valuable information" and that this might lead to market distortions/less efficient price discovery.

Q33: Are there other measures which the FSA should be considering or promoting in international fora?

HFSB would welcome the FSA promoting the Hedge Fund Standards as a meaningful and powerful process to promote transparency for the hedge fund industry in international fora.

Q34: What other considerations should the FSA take into account with respect to OTC derivatives infrastructure?

No comment.

Q35: Are any (other) changes to clearing arrangements needed? If so, what should they be?

No comment.

Q36: Are any changes to settlement arrangements needed? If so, what should they be?

No comment.

Section 13: Implications for other regulated sectors

(p.205-206)

Q37: Which of the issues set out for discussion in this DP are most relevant to other regulated sectors?

No comment.

Q38: Are there any lessons which have been learned in other sectors which could be applied to banking?

No comment.