ISDA response to European Commission consultation paper on hedge funds

Introduction

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 780 member institutions from 56 countries on six continents. These members include most of the world’s major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the risks inherent in their core economic activities. For further information, please visit www.isda.org.

ISDA welcomes this consultation paper from the European Commission, and is delighted to have the opportunity to provide input into the European Commission’s considerations on this issue.

ISDA would also like to mention that it has discussed this paper with other interested associations, including the London Investment Banking Association (LIBA) and the Alternative Investment Management Association (AIMA), and that its views have been coordinated with these associations.

Executive Summary

ISDA recognises that the European Commission believes that many parts of the capital markets need to be re-examined for signs of market or regulatory failure, in light of the financial crisis. We recognise that this review on hedge funds should also be viewed in the context of the G-20 objective to ‘ensure that all financial market participants are regulated or subject to oversight, as appropriate to their circumstance.’

We welcome the inference in the consultation paper that hedge funds are one of the areas where there is as yet ‘no clear consensus on whether regulatory change is needed or whether other avenues could be considered’. The stated intention of the European Commission to begin, in examining the hedge fund sector, with an analysis of self-regulatory actions (as exhorted by the G-20) is also welcome.

We believe however, that the progress and success of industry bodies in delivering applied best practices should be analysed before conclusions are drawn as regards the need for regulatory alternatives to such industry approaches. As such we caution against the conclusion that already seems to have been reached in the paper (page 3) that the ‘responses to and conclusions from this consultation will serve as the basis for an appropriate regulatory initiative which the Commission will present before the next European parliamentary elections, thus forming part of a wider review of the adjustments
needed in the European or international regulatory framework in the aftermath of the crisis’. We believe that such a conclusion pre-judges the outcome of this consultation and indeed of the review of the hedge fund industry’s success (or otherwise) in its promotion of industry best practices, and contradicts the European Commission’s oft-repeated adherence to the principles of better regulation.

Nevertheless, we acknowledge that the current review may result in some changes to regulation around hedge funds, and endorse the views of AIMA as expressed in its response to the European Commission’s consultation, on what further regulation of hedge funds might appropriately entail (if remedies other than regulation have been deemed insufficient).

The introduction to the consultation paper refers to hedge funds’ use of ‘the credit derivative and other structured products’ that have been at the heart of the recent financial crisis’.

The extent of hedge funds’ use of CDS varies significantly, depending on the strategy employed by individual funds.

ISDA disagrees with the assertion that credit derivatives have been ‘at the heart of the recent financial crisis.’ On the contrary, we highlight that the credit derivatives market is the only credit market currently ‘open’ – and as such the only market in which it has been possible to price credit risk. The price transparency afforded by CDS markets has been of enormous help to market participants, regulators and governments in addressing the financial crisis.

In addition, the ability to mitigate credit risk through the CDS market has been of benefit to market participants with exposures in credit markets.

We believe negative views about credit derivatives in this crisis are due to e.g.

- the mistaken belief that credit derivatives are not regulated (they are regulated through MIFID, MAD, the CRD and several other EU Directives);
- the myth that risks associated with CDS are not reflected accurately in company’s balance sheets (they are, subject to mark-to-market accounting);
- A misunderstanding of the real size of the risk associated with the credit derivatives market, with many commentators quoting the size of the notional market, even though this bears no relation to real risk (as notional figures include the value of reference entities on which e.g. CDS are written, as well as hedging and back-to-back transactions). The size of obligations in the credit derivatives market, before credit-risk mitigation measures, is officially measured by public authorities at $4 trillion – some 10-15 times less than the size of the obligations in the bond
markets. Furthermore, CDS are ‘zero-sum’. Parties to a transaction have equal and opposite exposure to the changes in the ‘price’ of credit risk of a specified entity. For every losing side to such a contract, there is a winner. And for every buyer of protection, there is a willing seller;

- A confusion of terms between CDS and other similar-sounding instruments whose entire economic function is to provide investments linked to assets that included sub-prime mortgage loans. Only a small portion of the CDS universe was linked to the US housing market;

- A misapprehension that the credit derivatives industry did not already have sound risk management tools in place. Through close-out netting and collateralization (both given legal effect by ISDA documentation), major participants in OTC derivatives markets actively manage counterparty exposure, through diversification and limits. Half of the exposure mentioned in the previous bullet point is collateralized. Furthermore, industry had established tools and procedures to deal with major market events like the Lehman Bros default, which was handled smoothly and exactly as advertised, through the ISDA cash settlement mechanism.

Reflecting the economic reality of the situation, settlement of the totality of CDS contracts on a given ‘reference’ entity (i.e., a contract between two parties, where one pays the other upon the default of the named entity - Lehman Brothers for example) happens on the basis of net risk transfer, i.e. taking into account the offsetting positions. Net risk transfer runs at less than 10% of the notional amounts outstanding (adjusted for any recovery value on the entity’s debt), hence the $5 billion changing hands upon the default of Lehman, rather than $72 billion in notional CDS on that entity. Various parties have protested that this difference was not apparent – yet it was on exactly this basis that CDS had settled a dozen times before, in the ISDA administered ‘auctions’.

The introduction to this consultation paper also reflects on some of the ways in which hedge funds have been affected by the recent financial crisis, in particular how a number of phenomena have directly affected their performance: Deterioration in asset prices affecting their performance, and causing loss to investors and fund failures;

- Hedge funds’ reliance on leverage and borrowing – causing them to scale back their lending;

- The difficulties caused by large-scale withdrawals by investors – causing further downward pressure on asset prices.
ISDA would make the point that all of these developments are symptoms, and not causes of the financial crisis. Hedge funds have been affected by the financial crisis – but they are not the source. The financial crisis is in large part the result of the failure of regulated credit institutions to manage risk exposures.

Section 1 – Scoping the Issues

1. Are the above considerations sufficient to distinguish hedge funds from other actors in financial markets (especially other leveraged institutions or funds)? If not, what other/additional elements should be taken into account? Do their distinct features justify a targeted assessment of their activities?

ISDA chooses not to make any comment on this question.

2. Given the international dimension of hedge fund activity, will a purely European response be effective?

The effectiveness of a purely European response (to the possible role or responsibility of hedge funds in the financial crisis) depends on the nature of that response.

The consultation paper acknowledges that conclusions should only be drawn after the ‘pronounced international character of these markets is taken into account’. Over-regulation in Europe may drive hedge funds to seek more commercially and fiscally advantageous locations.

The consultation paper has been drawn up partly in line with the G-20 objective to ‘ensure that all financial market products and participants are regulated or subject to oversight, as appropriate.’

ISDA recognises that the European Commission’s review of issues surrounding hedge funds is in keeping with the medium term goal, as expressed in the G-20 communique, for ‘countries or regions to review and report’ on the structure and principles of regulatory systems to ensure compatibility ‘with a modern and increasingly globalized financial system.’

The G-20 also called on ‘national and regional regulators to formulate their regulations and other measures in a consistent manner.’ Any European approach to this issue should be implemented in coordination with, and in consideration of the approaches and views of the EU’s major trading partners.
if this approach is to be effective in ensuring appropriate regulation, in terms of both financial stability and the competitiveness of European financial markets.

Section 2 – Systemic Risks

Commentary

Hedge funds offer sophisticated investors above average returns, but such investments always involve a degree of risk. Experienced investors are aware of the risks and should know that in some years hedge funds will fail to achieve high returns and some may even go out of business. When hedge funds fail, the effects are generally manageable and contained, with minimal potential for adverse consequences feeding into the real economy.

Reviews conducted by bank supervisors in 2004 and 2005 indicated that banks had become more diligent in their dealings with hedge funds. In most cases, substantial resources have been devoted to expanding and improving the staffing of the risk-management functions related to hedge fund counterparties.

Dealers universally require hedge funds to post collateral to cover current credit exposures and, with some exceptions, require additional collateral, or initial margin, to cover potential exposures due to market shocks. Risk managers measure current and projected exposures to hedge fund counterparties, and more firms use stress-testing methodologies to assess the sensitivity of their exposures to individual hedge funds if the market moves substantially. Note the prime broker only makes a loss when the value of the collateral in liquidation is less than the loans advanced, not necessarily when hedge funds themselves make losses.

Measuring the different risks from hedge funds is best done from the different market players' perspectives. The investors' risks include poor performance, operational risk, fraud, and illiquidity, among others. The fund faces economic risks either through poor performance or low asset size, and operational risks. And the prime broker faces both counterparty risk and the risk of fraud.

The primary mechanism for regulating excessive leverage and other aspects of risk-taking in a market economy is the discipline provided by creditors, counterparties, and investors.
Hedge fund risks are measured and managed through ongoing consideration of, inter alia, directionality, exposures to market jump risks (e.g. crashes), use of metrics - net assets/net market value, monitoring for concentrations, liquidity (mark to market assumes the position is liquid), and through changes to the portfolio (trading strategy, funding, portfolio p&l).

Risk management tools include, operational reports (daily margin reports, daily collateral call summary), and risk analytics (like liquidity reports, concentration reports or large exposure reporting, and reports on changes to the portfolio, perhaps caused by extreme market events, cash movement redemptions, investments, etc.).

3. **Does recent experience require a reassessment of the systemic relevance of hedge funds?**

We believe regulators can continue to help foster an environment in which market discipline, in particular counterparty risk management, helps to constrain excessive leverage and risk-taking. Effective market discipline requires adequate information and transparency to reliably assess risk profiles, and also requires the relevant systems and controls to ensure appropriate monitoring of exposures and limit setting relative to the risks identified. Placing the onus on market participants to provide discipline makes good economic sense as there should be enough incentives in place on behalf of the private investors to ensure counterparty risks are well understood and information flows are forthcoming.

4. **Is the 'indirect regulation' of hedge fund leverage through prudential requirements on prime brokers still sufficient to insulate the banking system from the risks of hedge fund failure? Do we need alternative approaches?**

We believe the prudential standards used by national regulators in leading European hedge fund markets are appropriate.

Prime brokers use a range of tools to manage their risk, including risk testing along the lines of VaR modeling, back testing against p&l market moves, scenario analysis including worse case loss across a number of disaster scenarios, monitoring portfolio statistics, and event risk looking at merger risks, bond maturity risks, and other relevant events.

Any consideration of more direct regulation would need to take into account the additional costs imposed in the form of moral hazard, the weakening or loss of market discipline, and the consequences for market liquidity should hedge funds be prevented from providing this. We believe that investors, creditors, and counterparties have significant incentives to appropriately rein in hedge funds' risk-taking and leverage (we underline again that that hedge funds have not been the root cause of the financial crisis).
We caution against measures imposing inappropriate restrictions on the amount of leverage that can be made available to hedge funds in light of the proven ability of creditors and counterparties to manage this risk. The effect of such steps could be to drive hedge fund business out of Europe to less transparent, less well-regulated jurisdictions.

We encourage rigorous stress testing, with tests run at the individual hedge fund counterparty level, and focused work on the part of dealers towards deep understanding of aggregate risks and measurement of exposures to the hedge fund sector in the event of market shocks.

5. *Do prudential authorities have the tools to monitor effectively exposures of the core financial system to hedge funds, or the contribution of hedge funds to asset price movements? If not, what types of information about hedge funds do prudential authorities need and how can it be provided?*

Many regulatory authorities have now issued guidance on risk-management practices for hedge funds and prime brokers, and the majority of bank supervisors now actively monitor and conduct targeted reviews of banks' dealings with hedge funds.

We understand that through the regulation of the prime brokerage sector supervisors can gain valuable insight into exposures to the core financial system to hedge funds and the contribution of hedge funds to asset price movements. We note that some regulators (such as the FSA) have developed bilateral dialogues with both prime brokers and the hedge fund community in order to evaluate counterparty exposures and risk.

Section 3 – Market Efficiency and Integrity

Commentary

6. *Has the recent reduction in hedge fund trading (due to reduced assets and leverage, and short-selling restrictions), affected the efficiency of financial markets? Has it led to better/worse price formation and trading conditions?*

To the extent that market volumes reduce, because of a reduction in the number of participants, they are less efficient, and price formation becomes (to a degree) less efficient. In general, hedge funds are
important providers of liquidity in the market, and their participation enhances efficiency of financial markets.

There has been a clear loss of liquidity in the market due to short selling restrictions. Primary liquidity at the ‘touch’ (i.e. the amount of shares available at the best bid and offer) in European financials has decreased as short sellers have been forced out of the market, and average spreads (i.e. the difference between best bid and offer) have widened.

7. Are there situations where short-selling can lead to distorted price signals and where restrictions on short-selling might be warranted?

In extreme market conditions, there may be some basis for the imposition of short-term, temporary short-selling restrictions.

We don’t believe that, as measured over a period of weeks and months, short-selling itself distorts price signals on markets.

We refer you, in this context, to the conclusions of the recent study by Cass Business School, commissioned by AIMA, ISLA (International Securities Lending Association) and LIBA, which found that stocks subject to restrictions on the UK, US, Italian, French and German markets behaved very similarly both to how they behaved before their imposition and to how stocks not subject to the restrictions behaved. Similarly no systematic patterns were apparent in these markets which were consistent with the expected effect of the new regulations, i.e. there was no evidence of a reduced probability of large price falls.

Short selling should not be equated with market abuse. Short selling is a legitimate technique for expressing a view on the likely performance of an asset. Short-selling of equities or debt, or of any derivative written on the performance of equities or debt, already falls within the scope of the Market Abuse Directive.

8. Are there circumstances in which short-selling can threaten the integrity or stability of financial markets? In combating these practices, does it make sense to tighten controls on hedge funds, in particular, as opposed to general tightening of market abuse disciplines?
In circumstances in which the stability of financial markets is under threat, short selling may exacerbate the situation, and there may be a basis for temporary short-term measures, with a view to preserving stability.

However we see no basis for isolating hedge funds specifically in imposing these restrictions – it makes no sense to discriminate against any particular class of investor.

Hedge funds already have to comply with the Market Abuse Directive (MAD) to extent that they trade instruments within the scope of the MAD. With reference to the examples referred to in the foreword to section 3 (Market Efficiency and Integrity), we remind the European Commission that trading in credit default swaps is already within the scope of the MAD, and as such, we support prosecution of any cases against market participants that are proven to have engaged in abusive behaviour.

Section 4 – Management of Micro-Prudential Risks

Commentary

Prime brokers use a range of tools to manage their risk, including risk testing along the lines of VaR modeling, back testing against p&l market moves, scenario analysis - including worse case loss - across a number of disaster scenarios, monitoring portfolio statistics, and event risk, looking at merger risks, bond maturity risks, and other relevant events.

9. How should the internal processes of hedge funds be improved, particularly with respect to risk management? How should an appropriate regulatory initiative be designed to complement and reinforce industry codes to address risk management and administration?

We don’t believe that hedge fund risk management techniques have been found to be deficient in the financial crisis.

We note that AIMA is working with other hedge fund associations in other jurisdictions to develop a single set of accepted industry practices, as exhorted by the November 2008 G20 declarations.

Section 5 – Transparency towards Investors and Investor Protection
10. Do investors receive sufficient information from hedge funds on a pre-contractual and ongoing basis to make sound investment decisions? If not, where do the deficiencies lie? What regulatory response if any is needed to complement industry codes to make a significant contribution to the transparency of hedge fund activities to their investors?

ISDA chooses not to make any comment on this question.

11. In light of recent developments, do you consider it a positive development to facilitate the access of retail investors, subject to appropriate controls, to hedge fund exposures?

ISDA chooses not to make any comment on this question.