Leverage in Non-Bank Financial Intermediation: Consultation report

Response to Consultation

MFA

Recommendation 1

1. **Is the description of the financial stability risks from leverage in NBFI accurate and comprehensive? Are there additional vulnerabilities or risk dimensions related to NBFI leverage that authorities should consider for monitoring purposes?**

The FSB should recognize that different types of market participants use leverage in different ways. The alternative asset management industry has exhibited consistent and modest use of leverage over time, as exhibited in reporting on Form PF submissions in the United States and the UK Financial Conduct Authority hedge fund surveys. With respect to private credit in particular, the Federal Reserve concluded in its 2023 Financial Stability Report that, "the financial stability vulnerabilities posed by private credit funds appear limited. Most private credit funds use little leverage and have low redemption risks, making it unlikely that these funds would amplify market stress through asset sales."

Regulators should recognize that, for alternative asset managers, leverage is often employed as part of hedging transactions that moderate the overall risk of the fund's portfolio and thus do not present any of the purported financial stability risks. For example, alternative asset managers commonly invest capital raised from investors in long debt and equity positions and rely on derivatives to hedge against currency or interest rate risks. As a result, the net exposure in the portfolio is far less than the combined gross exposure of all the individual positions. In addition, private credit funds provide diverse and flexible funding to operating companies that is important to the overall growth of the economy. Alternative asset managers use leverage to free up capital that they can invest in businesses of all sizes. Moreover, alternative asset managers are active participants in the primary and secondary markets, using leverage to finance their investment, trading arbitrage and hedging activities, which cumulatively enhance price discovery and market efficiency. The use of leverage, in a way that is prudently risk managed, helps facilitate these important activities, which, in turn, are key to maintaining market stability and growing the real economy.

The FSB recommends that regulators have a framework in place to identify and monitor vulnerabilities related to NBFI leverage and related purported financial stability risks. In the United States, an effective monitoring framework for the alternative asset management industry currently exists. Alternative asset managers provide regulators with information about their leverage, borrowing, and other activities through Form PF. The U.S. Federal

Reserve also relies on Form PF and regulatory reporting from bank counterparties to assess financial stability risks posed by the alternative asset management industry and publishes this assessment in an annual Financial Stability Report. In addition, the U.S. Financial Stability Oversight Council ("FSOC") engages in efforts to monitor risks from the alternative asset management industry that are duplicative of the reporting described above.

2. What are the most effective risk metrics that should be considered by authorities to identify and monitor financial stability risks arising from NBFI leverage?

Regulators should rely on risk metrics that are best suited to the parties and the trading or financing relationship. This could include considering net and adjusted measures of leverage that are currently available to regulators. Gross notional exposure ("GNE"), without appropriate netting and adjustments, presents an incomplete view of a firm's risk. Rather than relying on GNE, regulators should use more comprehensive risk metrics currently available to them, such as those that account for netting and adjustments, to assess risk more accurately.

The reason that GNE does not provide a complete picture of a firm's exposure is because the same gross exposure amount can have very different risks depending on the characteristics of the position. For example, consider the first-percentile loss (meaning the maximum losses that will occur 99 percent of the time) for each of the market positions held by the following three firms over a five-year period:

	Firm 1	Firm 2	Firm 3
Exposure at Year 0	$1 billion notional exposure to the S&P 500	$1 billion notional exposure to generic 5-year UST	$500 million notional exposure to generic 5-year UST and $500 million notional exposure to UST futures contracts
First-Percentile Loss at Year 5	$88 million	$16 million	$3 million

Although each of these positions had the same GNE, the ultimate losses for each exposure varied significantly due to the unique risk profile of the exposures. This example demonstrates that regulators need to consider other measures of leverage, such as those that reflect netting and adjustments, to accurately assess the risk associated with a firm's market exposure. This will allow regulators to more accurately assess a fund's true market or counterparty exposure. Regulators should also tailor the metrics they rely on to match the risk profiles and strategies of the market participants and the trading or financing relationship.

As an example of this overall point, regulators should not use gross synthetic leverage metrics to assess the risks associated with derivative positions. As stated by the Bank of England, "GNE is not informative about the potential losses and liquidity demands that a fund could face" with respect to synthetic leverage because GNE does not consider the sensitivity of derivatives to different risk factors, offsetting exposures to derivative positions, or the purpose of a derivative exposure to increase or hedge risk. Therefore, to avoid providing regulators with an inaccurate impression of the risks associated with these positions, rather than requiring that bank counterparties report gross synthetic leverage from

derivative positions with alternative asset managers, regulators should instead focus on adjusted synthetic leverage which more accurately reflects risk.

3. **What are the most effective metrics for the monitoring of financial stability risks resulting from:**

(i) specific market activities, such as trading and investing in repos and derivatives

To effectively measure and monitor financial stability risks from market activities such as securities financing transactions ("SFTs") (including repos) and derivatives, regulators should focus on the activities of dealer counterparties and for cleared products, CCPs. In particular, regulators should evaluate the margin and collateral levels that dealers and CCPs require from their alternative asset manager counterparties and the counterparty default rates that dealers and CCPs report.

In addition, regulators should focus their metrics on the activities of dealer counterparties because dealers and similar sell-side entities are accustomed to complying with reporting requirements. This approach would improve the quality of information that regulators receive, and therefore the quality of metrics they develop to assess financial stability risk. By contrast, alternative asset managers and similar buyside entities are not as experienced with regulatory reporting and typically report more limited information on a delayed basis. Alternative asset managers would need to invest significant time and resources to develop the quality of reporting systems that dealers already have in place.

The SCOOS is an example of a market-driven approach to financial stability risk metrics that collect data from dealers on their SFT and OTC derivatives activities and allows regulators to monitor financial markets in a dynamic way. The SCOOS collects qualitative information on credit terms and conditions in securities financing and OTC derivatives markets, which are important conduits for leverage in the financial system. The survey panel for the SCOOS began by including 20 dealers and over time has been expanded. These firms account for almost all of the dealer activity in dollar-denominated securities financing and OTC derivatives markets.

(ii) specific types of entities, such as hedge funds, other leveraged investment funds, insurance companies and pension funds

Metrics focused on the financial stability risk stemming from alternative asset managers should be based on data that is already reported through existing alternative asset manager disclosures, such as Form PF in the United States and Annex IV in Europe. Alternative asset managers currently report extensive information to the European Systemic Risk Board ("ESRB") on Annex IV and to the SEC in Form PF. These reports include information on stress tests, portfolio information including collateral, margin and cash reserves, counterparty exposures, the financing sources for alternative asset managers, and detailed analyses of funds' asset and liability liquidity, including redemption provisions.

(iii) concentration and crowded trading strategies

Specific metrics are not needed to measure concentration in the alternative asset management industry because the financial stability risk resulting from concentration is very limited with respect to alternative asset managers. The alternative asset management sector includes many strategies that tend to be less correlated with each other than in broader markets, and the diverse strategies mitigate or diffuse collective risks because the strategies have different underlying risk profiles, assets, and liquidity constraints. In certain

circumstances, investors of all sizes trade securities in parallel based on news or economic events, but it would be inappropriate to attribute this correlation specifically to alternative asset managers or investment funds more generally.

Recommendation 3

4. What types of publicly disclosed information (e.g. transaction volumes, outstanding amounts, aggregated regulatory data) are useful for market participants to enhance their liquidity or counterparty credit risk management? Are there trade-offs in publicly disclosing such information and, if so, what would be the most important elements to consider? What is the appropriate publication frequency and level of aggregation of publicly disclosed information?

Regulators currently disclose valuable market data to market participants. In limited circumstances where regulators determine that public disclosure of data on alternative asset managers' activities is warranted, MFA encourages regulators to only publish aggregated, anonymized data. MFA advises strongly against any public position disclosure that would compel investment funds to directly or indirectly publicly reveal their otherwise confidential investment positions and trading strategies. Academic research has shown that the public disclosure of otherwise confidential investment positions – even on a limited basis and with long reporting timeframes – impairs investment returns and negatively impacts market quality and efficiency. The potential consequences of such disclosures include: (i) facilitating copycatting and free-riding; (ii) allowing other market participants to reverse engineer investment theses and trading strategies; (iii) compromising investors' ability to establish and risk manage right-sized positions without having outsized market impact; and (iv) reducing incentives to conduct fundamentally driven research. These adverse consequences, in turn, negatively impact market quality and efficiency by impairing the price discovery process, diminishing market efficiency and liquidity, and undermining the critical role that actively managed investment strategies play in the markets.

Instead, regulators should only publish data on alternative asset managers that is aggregated and anonymized. Example of this include the SCOOS, which we discussed above in our response to Question 3(i), the Federal Reserve's Financial Stability Report ("Financial Stability Report"), the CFTC's Commitment of Traders Report, and the SWES. The Financial Stability Report relies on comprehensive data collected through Form PF to evaluate and publish aggregated and anonymized data on leverage in the alternative asset management industry. For example, the November 2024 Financial Stability Report says that recent data from Form PF "indicated that measures of leverage averaged across all hedge funds were at or near the highest level observed since these data became available in 2013." The CFTC's Commitments of Traders Report relies on confidential daily large-trader data that dealers provide to the CFTC, which the CFTC aggregates, anonymizes, and publishes. In addition, the SWES aggregates data from a group of banks and NBFIs to assess how they perform in a stress environment. For example, the SWES revealed that a sudden increase in haircuts or contraction in available repo could significantly impact the positions that alternative asset managers hold in the UST repo market.

Recommendation 5

5. **Do Recommendations 4 and 5 sufficiently capture measures that would be used to address the scope of non-bank financial entities under consideration in this report? In what ways may the policy measures proposed in the consultation report need to be adjusted to account for different types of non-bank financial entities?**

The activity-based and entity-based measures described in Recommendations 4 and 5 would not effectively address the purported financial stability risks associated with alternative asset managers' use of leverage.

Following the 2008 financial crisis, regulators implemented requirements such as derivatives clearing, margining, and reporting which bolstered the resiliency of these markets, in which alternative asset managers are active participants. This market-wide solution minimizes the risk that the failure of any individual market participant, including an alternative asset manager, would spread to its counterparties or more broadly to the rest of the financial system. Since 2008, regulators and market participants have strengthened counterparty risk management practices through both regulation and market practice, further reducing the likelihood that counterparty exposures, even in periods of market stress, would have widespread impact on financial markets. For example, quarterly Form PF reports filed by alternative asset managers in the United States show that alternative asset managers overwhelmingly obtain their financing through collateralized arrangements from sophisticated dealer counterparties with robust risk monitoring. In a December 2020 report, the Government Accountability Office concluded that these dealer counterparties could absorb losses associated with exposure to leveraged borrowers, including alternative asset managers, suggesting that interconnectedness between alternative asset managers and dealer counterparties would not pose significant risk to the financial system.

Alternative asset managers actively manage their risk by controlling redemptions and implementing robust risk management practices. Alternative asset managers control the timing and amount of redemptions by investors through contractual arrangements to manage their liquidity risk. By controlling redemptions, alternative asset managers can greatly mitigate fire sale concerns. Form PF reports provide detailed analyses of alternative asset managers' asset and liability liquidity, as well as redemption provisions. Alternative asset managers also manage their market and leverage risk by building redundancy into their risk management processes. For example, firms provide risk guidelines to front-line portfolio managers to ensure that portfolio managers operate within the firm's risk appetite. In addition, management within each business unit and risk management personnel operating outside of the business units oversee and challenge portfolio managers' activities.

Existing regulations and market practices allow alternative asset managers and their dealer counterparties to effectively manage counterparty credit risk. Additional activity-based or entity-based systemic regulation is unnecessary for the alternative asset management industry and could result in unintended consequences for the financial markets.

6. **In what circumstances can activity-based measures, such as (i) minimum haircuts in securities financing transactions, including government bond repos, (ii) enhanced margin requirements between non-bank financial entities and their derivatives counterparties, or (iii) central clearing, be effective in addressing financial stability risks related to NBFI leverage in core financial markets, including government bond**

markets? To what extent can these three types of policy measures complement each other?

Financing counterparties currently rely on haircuts, margin requirements, and central clearing to help them manage their counterparty credit risk. Financing counterparties negotiate these requirements into the terms of their transactions with alternative asset managers. Each of these tools can be effective at reducing risk to individual financing counterparties and to the financial system.

Financing counterparties developed these standard market practices to effectively manage their counterparty risk. Regulators can support the stability and efficiency of financial markets by encouraging these best practices to be adopted across the market. Regulators should not, however, prescribe specific activity-based measures that banks and their counterparties must use to manage their risks. The risks posed by a particular alternative asset manager to a bank counterparty are based on the unique features of the parties and the trading or financing relationship. For example, a transaction with a traditional credit fund, where the risk involved is unlikely to be idiosyncratic, does not merit the same degree of diligence as a fund with a complicated trading strategy. Prudent risk management practices also include providing certain disclosures to bank counterparties. Market participants have mutually determined the disclosures that bank counterparties require to effectively manage their risk, which notably does not include position-specific information. Position-specific information is not needed for risk management purposes and disclosing such information could run counter to important commercial objectives because, for example, such information is highly sensitive and disclosing this information to bank counterparties could inadvertently reveal information about confidential proprietary trading and counterparty diversification strategies. Bank counterparties are better positioned than regulators to know what requirements to impose on alternative asset managers to effectively manage their counterparty credit risk.

Haircuts and margin requirements can be effective tools that bank counterparties should consider using, but regulators should not restrict banks' flexibility to choose the appropriate tool and calibrate the requirements to each relationship with a different counterparty. This is especially true when the market identifies new measures for managing counterparty credit risk that may prove to be more effective. Regulators can further mitigate risk through increased mandatory central clearing. In addition, risk management tools, particularly haircuts and margin requirements, come with a cost to market participants that ultimately affects the broader economy. It is important that bank counterparties apply haircuts and margin requirements that are appropriately tailored to the unique risks posed by each counterparty and trading or financing relationship to avoid unnecessary costs and market inefficiencies.

7. **Are there benefits to dynamic approaches to minimum margin and haircut requirements, e.g. where the requirements change based on changes in concentration or system-wide leverage? If so, what types of indicators capturing concentration or system-wide leverage should the requirements be linked to?**

Dynamic margin requirements protect bank counterparties from risks associated with their counterparties, which include alternative asset managers. Dynamic margin requirements, however, also (i) increase the bank's monitoring costs and (ii) correspondingly increase the counterparty's costs in complying with the margin requirements in the agreement.

If the bank counterparty is required to implement dynamic margin requirements without regard to its counterparty, then the overall increase in costs will often outweigh the corresponding reduction in risk. Dynamic margining can also create liquidity risk for alternative asset managers because the margin requirements can swing significantly and require alternative asset managers to post additional margin without any notice. The pressure that dynamic margining puts on alternative asset managers can increase the risk to the bank counterparty that the alternative asset manager fails.

Bank counterparties would be better served by refraining from implementing dynamic margining measures and using the cost savings to absorb against potential losses. Bank counterparties are best positioned to determine the approach to margin requirements that mitigate their risk of loss based on their counterparty and the type of exposure.

8. **Are there any potential unintended consequences from activity-based measures beyond those identified in the consultation report?**

Yes, as discussed above in our response to Question 6, a prescriptive activities-based approach would limit the flexibility that alternative asset managers and their bank counterparties have to appropriately manage their risk based on the idiosyncratic nature of each counterparty and transaction. Activities-based measures could also increase the cost to finance trades, increase volatility, and reduce liquidity in the market.

9. **For non-centrally cleared securities financing transactions, including government bond repos, what are the merits of margin requirements compared to minimum haircuts?**

Regulator-driven margin requirements and minimum haircuts are both unnecessary to manage risk from non-centrally cleared SFTs. As discussed above in our response to Question 6, the bank counterparties in these transactions are better positioned to determine what information they need to manage their risk from the particular trading or financing relationship.

10. **In what circumstances can entity-based measures, such as (i) direct and (ii) indirect leverage limits be effective in addressing financial stability risks related to NBFI leverage in core financial markets?**

Regulators should not prescribe leverage limits that bank counterparties must impose on alternative asset managers. As with our response to Question 6 above, regarding the need for bank counterparties to have the flexibility to apply their own activities-based measures to manage their counterparty credit risk, bank counterparties should also have the authority to establish leverage limits as they see fit to manage their risk based on the specific circumstances of the parties and the trading and financing relationship.

In addition, leverage limits have at times contributed to, or exacerbated, periods of market stress. For example, in recent years, growth in the UST market has outpaced the capacity of the banks, broker-dealers, and proprietary trading firms to make markets and intermediate UST transactions. Although the markets have grown, the relative ability of these firms to absorb net market flows, particularly during periods of increased market stress and volatility, has decreased due, at least in significant part, to regulatory constraints and other limitations on balance sheet and capital capacity allocated to UST market activity.

11. **Are there ways to design and calibrate entity-based measures to increase their risk sensitivity and/or their effectiveness in addressing financial stability risks from NBFI leverage?**

    As discussed above in our response to Question 10, entity-based leverage requirements are inappropriate for alternative asset managers. Regulator-driven leverage requirements cannot be calibrated to address the risks from alternative asset managers' use of leverage as effectively as leverage requirements imposed by bank counterparties.

12. **Are there any potential unintended consequences from entity-based measures beyond those identified in the consultation report?**

    Yes, as discussed above in our response to Question 10, entity-based leverage requirements are inappropriate for alternative asset managers and can exacerbate market stress.

13. **To what extent can activity-based and entity-based measures complement each other? What are the main considerations around using these two types of measures in combination?**

    As discussed above in our responses to Questions 6 and 10, activities-based and entity-based measures are both inappropriate for alternative asset managers. They would not complement each other. Rather, if authorities were to implement both measures, the combination of the two would have a significant impact on the operation of the SFT and derivative markets and likely reduce liquidity available to market participants.

Recommendation 6

14. **How could counterparty credit risk management requirements for leverage providers be enhanced to be more effective in addressing financial stability risks from NBFI leverage in core financial markets, such as government bond repo markets? In what circumstances can they be most effective?**

    MFA agrees with the FSB's objective of enhancing standards to manage counterparty credit risk, but encourages authorities to adopt requirements that are risk-based and permit bank counterparties to manage their credit and liquidity risk in a way that is proportional to the risks associated with each counterparty and trading or financing relationship. As important market participants in the capital markets, alternative asset managers should and do apply sound risk management practices, both to minimize risks to their own firm and to the financial markets more broadly. The market encourages prudent risk management to ensure that alternative asset managers and their dealer counterparties maintain their trading and financing relationships and are not exposed to undue risk.

    MFA believes that regulator-driven, prescriptive requirements would apply a one-size fits all approach and not permit bank counterparties to customize their margin and collateral requirements to best mitigate their counterparty credit risk. This would create friction in the markets, increasing costs, delaying transaction timing, and increasing the chance that proprietary information would be improperly obtained or disseminated. These issues could discourage parties from engaging in repo and derivative markets, reducing market liquidity. In addition, prescriptive activity-based or entity-based restrictions are bound to become outdated, failing to reflect ever-changing markets and thereby adversely affecting market functionality.

Instead, MFA recommends that regulators permit bank counterparties to preserve the flexibility to deal with counterparty credit risk in a nuanced manner that tailors the requirements to the needs of the individual alternative asset manager and the trading or financing relationship. At the same time, all market participants would benefit if prevailing best practices in risk management are consistently followed by banks and their counterparties.

Recommendation 7

15. Would a minimum set of disclosures to be provided by leverage users to leverage providers be beneficial in improving counterparty credit risk management and reducing financial stability risks from NBFI leverage, including concentration risks? If so, which types of information and what level of granularity should (and should not) be included in this minimum set and why?

As discussed above in our response to Question 3(ii), alternative asset managers that operate in the United States and Europe are currently subject to a minimum set of regulatory disclosures in Form PF and Annex IV. In these disclosures, alternative asset managers must report extensive information to regulators about systemic risk metrics, including stress tests, collateral, margin and cash reserves, and counterparty exposures. Bank counterparties also require alternative asset managers to provide them with significant information as part of negotiating the terms of a trading or other counterparty relationship. Bank counterparties are better positioned than regulators to know what information they need from their counterparties to manage their counterparty credit risk. Alternative asset managers and dealer counterparties can negotiate the appropriate information to share with each other in a dynamic environment. As markets shift and new or different information becomes relevant to prudent risk management, counterparties can adjust what they share with each other accordingly.

If alternative asset managers were required to provide their bank counterparties with additional disclosures mandated by regulators, however, the disclosures are unlikely to be as dynamic. The disclosures also may not initially provide bank counterparties with the appropriate information they need to manage their counterparty risk. Regulator-driven disclosure requirements may result in a check-the-box exercise that increases costs on parties while distorting markets and behaviors.

Rather than impose prescriptive disclosure requirements, regulators should instead play a role in establishing principles for bank counterparties to follow when developing their disclosure and risk management practices. For example, prudential authorities may acknowledge and expect that banks should: (i) establish internal standards for the quality and frequency of disclosures; (ii) make risk appetite decisions based on the full range of disclosures provided to the bank; and (iii) condition doing business with the counterparty on the quality of that counterparty's disclosures.

These guiding principles could be particularly important in a competitive market, where competitors can require additional information from nonbank counterparties to manage their risk. By establishing risk management principles based on prevailing best practices, regulators can enhance disclosures and help ensure that all market participants maintain the same high standards for risk management that established bank counterparties currently follow. At the same time, these principles would still preserve flexibility for banks to

determine the disclosures that are appropriate for each counterparty and trading or financing relationship.

16. **What are the main impediments that leverage users face in sharing additional or more granular data with their leverage providers? Is there a risk that a minimum recommended set of disclosures may lead leverage users to limit the information they share with their leverage providers to that minimum set?**

As discussed above in our response to Question 15, bank counterparties are in a strong position to negotiate with alternative asset managers for additional information about the alternative asset manager. Banks do not face any significant impediments to receiving data from their counterparties. By negotiating over information for each deal, bank counterparties can tailor their information requests to the specific risks associated with the counterparty and the trading or financing relationship.

This approach is more efficient and more effective at obtaining necessary data than mandating a minimum set of disclosures. If authorities require alternative asset managers to provide specific information to bank counterparties for every deal, it would often result in wasted resources as the alternative asset managers incur costs to provide their counterparties with information that is not necessary for that transaction. In addition, if alternative asset managers are required to provide certain information to counterparties, they may be less willing to negotiate with bank counterparties to provide additional information that is more applicable to assessing the counterparty credit risk of that transaction.

17. **Should such a minimum set of disclosures rely on harmonised data and metrics to ensure transparency and efficiency in the use of such information for risk management purposes? Do respondents agree that such a minimum set of disclosures should be based on the list of principles outlined in the consultation report? If not, which principles should be added, deleted or amended?**

Regulators should not prescribe minimum disclosures that alternative asset managers must provide to dealer counterparties. As discussed above in our response to Question 15, the disclosures that bank counterparties require to assess and manage their counterparty credit and liquidity risk are unique to each alternative asset manager and each trading relationship. Different types of trading relationships and different alternative asset managers may warrant different disclosures from the alternative asset manager. Regulators can play an important role in establishing uniform disclosure principles for bank counterparties to follow, but regulators should not go further and prescribe mandatory disclosure requirements because it could restrict the flexibility that bank counterparties currently have to negotiate for the information that they need from alternative asset managers to manage their risk.

18. **Should leverage users be required or expected to provide enhanced disclosures (beyond that provided in normal market conditions) to their leverage providers during times of stress?**

No, as discussed above in our response to Question 15, authorities should not require alternative asset managers to provide particular disclosures to counterparties at any time because bank counterparties can more effectively obtain the unique information they need for each transaction by negotiating with alternative asset managers.

19. Should authorities design a minimum set of harmonised disclosures and guidelines on its application, or should they convene a cross-industry working group to do so? How do respondents believe such a standard should be incorporated into market practice? Through regulation, supervisory guidance, and/or via a Code of Conduct or similar approach?

MFA does not believe that authorities should set minimum disclosure standards for market participants. As discussed above in our response to Question 3(ii), alternative asset managers that operate in the United States and Europe are already subject to a minimum set of regulatory disclosures in Form PF and Annex IV.

Rather than requiring additional regulatory or public disclosures from alternative asset managers, regulators should instead focus their attention on harmonizing and improving the usefulness and efficiency of the regulatory disclosures required in Form PF and Annex IV. Regulators should seek to ensure that data reported from investment funds is harmonized across jurisdictions so that regulators can make an "apples to apples" comparison of fund data. Inconsistent data sets in the Form PF and Annex IV data (for example, inconsistent derivatives trade reporting) severely limits the usefulness of the data. Without accurate data from alternative asset managers that is comparable across jurisdictions, regulators cannot fully understand the strategies, investments, size, and risks of investment funds. In addition to any harmonization efforts, and more broadly, regulators should consider whether the data required to be reported is useful for its intended purposes or, alternatively, whether changes are warranted.

In addition to ensuring that disclosures are harmonized, as noted above, prudential regulators should also focus on enhancing their coordination across jurisdictions. The most effective way to identify and assess risks to the financial system is to monitor emerging risks at bank counterparties, including multi-jurisdictional examinations of key bank business lines. If prudential regulators work together across jurisdictions – for example, the Bank of England and the Federal Reserve collaborating on the SWES and the Financial Stability Report – they will be better positioned to understand and address financial risks posed to bank counterparties by NBFI leverage.

Recommendation 8

20. Are there areas where the principle of "same risk, same regulatory treatment" should be more consistently applied? Are there circumstances in which the principle should not apply or should not apply comprehensively?

Alternative asset managers should not be subject to the same regulatory treatment as banks because alternative asset managers have wholly inapposite and distinct risk profile than banks that poses significantly less risk to financial stability. This point is illustrated by the fact that over 1,000 alternative asset managers close every year, all without raising systemic concerns. According to a recent analysis by the Board of Governors of the U.S. Federal Reserve System, the failure of five hedge funds with the largest counterparty exposures to the U.S. global systemically important banks would result in losses of only between 1.0 and 1.2 percent of those banks' risk-weighted assets. This analysis demonstrates that even the largest alternative asset managers can fail without posing sizeable risk to their bank counterparties or the broader financial system. In contrast, the failure of a few significant banking institutions can lead to disruption and panic in the financial

system, as reflected in March 2023 with the failures of Credit Suisse, Silicon Valley Bank, Signature Bank, and First Republic Bank.

Banks are highly leveraged institutions that engage in maturity transformation and are critical to the functioning of the payments system. Alternative asset managers, however, are generally less leveraged and do not deal with the same issues of liquidity mismatch because investors in alternative asset managers have contractually agreed to lock up their investment and, thus, have no ability to withdraw funds on demand. As one example, private credit does not present the same risks as banks because private credit arrangements tend to involve the use of limited leverage and generally rely on long-term funding, as compared to the high leverage and short-term funding used by banks. In contrast, a bank is vulnerable to runs because it is unable to halt depositor withdrawals.

During times of stress, for a bank to meet the short-term liquidity demands of its depositors, the bank generally would need to sell long-term assets which can lead to significant losses for the bank. This scenario can create significant risk to the broader financial system and require government intervention. In contrast, alternative asset managers contractually limit investor withdrawals to prevent runs on the fund and to support investments in long-term assets and through market cycles. Alternative asset managers are also less leveraged than banks and hold more liquid assets, reducing their liquidity risk. For example, data from Form PF shows that alternative asset managers do not have the same kind of liquidity mismatch that banks have. In addition, a staff paper published by the SEC in May 2017 noted that most hedge funds have a “negative liquidity mismatch,” meaning that those funds hold relatively liquid assets compared to the combined liquidity of their liabilities plus equity.