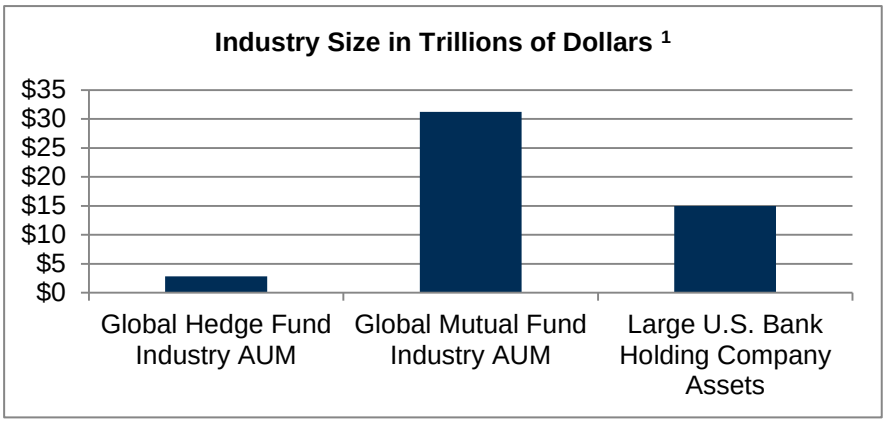
Hedge Funds in the U.S. Financial System

Size, Built-in Safeguards & Existing Regulations Prevent Industry from Posing Systemic Risk

The Financial Stability Oversight Council's (FSOC) recently requested information on asset managers to help determine which activities, if any, pose a systemic risk to the financial system. In response, MFA submitted a letter outlining why hedge funds are not sources of systemic risk and will not destabilize the U.S. financial system during periods of crisis. While risks are intrinsic in the activities of the broader financial industry, the relatively small size of the hedge fund industry compared to other market participants, existing regulations, and built-in safeguards all prevent the industry from posing systemic risk to the U.S. financial system.

Overall Industry Size & Concentration: The hedge fund industry currently manages less than $3 trillion in assets, a relatively tiny slice of U.S. financial markets. Mutual funds, for example, manage more than $31 trillion in AUM. The hedge fund industry is also not concentrated by any measure. Only a few firms have more than a 1 percent market share of the industry's total AUM, and every firm is well below 10 percent. In fact, it takes 100 firms together to reach approximately 50 percent of the total AUM managed by all hedge fund managers in the U.S.[2]



Closures: Hedge fund closures are straightforward transactions. Funds are easily wound up and liquidated under existing corporate and bankruptcy laws. During the financial crisis, many hedge funds were liquidated, but neither created nor amplified systemic risk. Not a single hedge fund required a government bailout during the recent, or any past, financial crisis.

Regulatory Oversight and Transparency: Regulators have extensive oversight of hedge fund managers and a wealth of information about their activities. For instance, large hedge fund managers file extensive reports about their portfolios and counterparty exposures with the SEC, CFTC, and the Office of Financial Research, including quarterly reporting of stress tests. Moreover, the market activities of large hedge funds are subject to substantial reforms put in place following the financial crisis, including the Dodd-Frank Wall Street Reform and Consumer Protection Act.

Investors: Hedge fund investors are sophisticated in their own right and often hire third-party consultants to monitor their hedge fund investments. They require hedge fund managers to address risk in a robust and transparent manner with their investors.

Leverage and Borrowing: Hedge fund leverage is, on average, considerably lower than that of banks and insurance companies.[3] Furthermore, almost all of the borrowing done by hedge funds is fully collateralized, which minimizes counterparty risk. To further protect against potential destabilization, hedge funds' positions and associated collateral are subject to daily mark-to-market requirements. Together, these factors significantly reduce the risks associated with hedge funds' use of leverage.

Asset/Liability Matching: Hedge funds are unlikely to engage in forced selling (aka: fire sales) due to investor redemption requests and distributions. Investors agree to limit capital withdrawals and provide advance notice, allowing hedge funds time to manage more orderly asset sales. Hedge funds also hold cash in reserves to meet margin calls and pay other obligations as they arise.

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[1] Bank assets under management as reported for banks with more than $10 billion dollars under management according to the Federal Reserve System's National Information Center.

[2] As reported by Absolute Return's "Billion Dollar Club" asset listing and Institutional Investor's "*2014 Hedge Fund 100*."

[3] Leverage ratios are reported by Financial Conduct Authority's 2014 hedge fund survey, National Bureau of Economic Research working paper and Federal Insurance Office's 2014 annual report.