EUROPEAN CENTRAL BANK

EUROSYSTEM

COURTESY TRANSLATION

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President

Mr Marco Zanni
Ms Francesca Donato
Mr Valentino Grant
Mr Antonio Maria Rinaldi
Members of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 28 May 2021

L/CL/21/121

Re: Your letter (QZ-029)

Honourable Members of the European Parliament, dear Mr Zanni, Ms Donato, Mr Grant and Mr Rinaldi,

Thank you for your letter, which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 20 April 2021.

The European Central Bank (ECB) has been monitoring developments in the hedge fund industry and their potential impact on financial stability for a long time.[1] In our official publications, including the semi-annual Financial Stability Review, we have on several occasions analysed and highlighted risks stemming from non-bank financial institutions (NBFIs) as well as from excessive leverage and interconnectedness which, in some cases, are difficult to quantify owing to gaps in the data. The May 2021 Financial Stability Review is no exception in this respect.[2]

In response to your question on potential systemic risks from hedge fund investments in situations of market stress, let me first say that since 2008 competent authorities at the global level have introduced reforms to

[1] See, for example, "Growth of the hedge fund industry: financial stability issues", *Financial Stability Review*, ECB, December 2004, available at: https://www.ecb.europa.eu/pub/pdf/fsr/art/ecb.fsrart200412_02.en.pdf?5e31d90e6dc69a608edd34be50814aee; and *Large EU banks' exposures to hedge funds*, Banking Supervision Committee, November 2005, available at: https://www.ecb.europa.eu/pub/pdf/other/largeeubanksexposureshedgefunds200511en.pdf.

[2] See Financial Stability Review, ECB, May 2021, available at: https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202105~757f727fe4.en.pdf.

improve the resilience of the financial system. As a result, large banks are now more and better capitalised, less leveraged and take on less liquidity risk compared with the period before the global financial crisis. This contributes to safeguarding banks and the financial system as a whole against losses, including those related to hedge fund exposures.

Derivatives regulation is another area where international coordination has proved fruitful. New rules on margins and mandatory central clearing for certain instruments are important steps towards a more resilient financial system.

However, structural developments, and in particular the rapid growth of the NBFI sector, call for further efforts. The ECB continues to actively contribute to the international work of all the relevant fora, including the Financial Stability Board and the European Systemic Risk Board, to strengthen the risk monitoring, supervision and regulation of NBFIs, including hedge funds.[3]

Let me now turn to your question on systemic risks stemming from significant fluctuations in interest rates owing to the widespread use of financial leverage and interest rate swaps. Interest rate swaps are mainly used to hedge against changes in interest rates by a wide range of financial and non-financial entities and therefore serve an important economic function.[4] However, institutions such as hedge funds also use derivatives to take speculative positions. As recent events have shown, high levels of speculation, particularly when leveraged, can cause concentrated losses among financial institutions.[5] Furthermore, this highlights the possible channels of contagion that exist in the form of margin calls, default cascades and fire sales, which leads me to reiterate the importance of greater transparency and strengthened regulation for NBFIs.

Yours sincerely,

[signed]

Christine Lagarde

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[3] See, for example, *Macroprudential Bulletin*, Issue 12, ECB, April 2021, available at: https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/index.en.html.

[4] In this respect, net exposures in derivatives are usually considerably smaller than gross exposures and notional values.

[5] The specific case of Archegos Capital Management, which you mention in your letter, is further discussed in section 2 of the Financial Stability Review, ECB, May 2021, available at: https://www.ecb.europa.eu/pub/pdf/fsr/ecb.fsr202105~757f727fe4.en.pdf.

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