

Hedge Funds and Financial Stability

Hedge funds have become increasingly important participants in global financial markets. While the sector remains relatively small within the overall nonbank financial intermediation sector, its market footprint has grown rapidly. Hedge funds now hold about \$13 trillion in assets, more than three times their 2013 level, while gross notional exposures have reached about \$40 trillion. Unlike most other financial intermediaries, hedge funds face few constraints on their investment strategies and borrowing, allowing them to adjust exposures across markets rapidly. While the growing presence of hedge funds can support market functioning in normal times, key vulnerabilities, including leverage, fragile investor funding, and crowded trades, may amplify price dislocations and liquidity strains during periods of stress.

Against this backdrop, this chapter examines the evolution of the hedge fund sector and its implications for financial stability. Using granular data on more than 25,000 hedge funds, it documents a highly concentrated sector in which a small number of fund managers account for a large share of assets under management. The chapter further shows that portfolio similarity has increased, heightening the risk of herding and crowded trades. At the same time, leverage is concentrated in a few strategies and obtained primarily from the largest dealer banks, while end investors are highly sensitive to fund performance, increasing the potential for synchronized investor withdrawals.

The chapter finds that hedge funds tend to trade against price movements in calm markets, supporting liquidity and price discovery. Under market stress, however, this stabilizing role weakens, especially among smaller funds. Leverage, crowded positions, and correlated investor redemptions can trigger synchronized deleveraging and asset sales. In stress episodes, equities held by more vulnerable funds experience sharper price declines and greater volatility, particularly when high leverage is combined with crowded positions or correlated investor withdrawals. Stress can also spread beyond the hedge fund sector when adverse shocks to hedge funds spill over to the large dealer banks that act as their prime brokers. These spillovers are more pronounced for banks with riskier and more leveraged clients. Hedge funds can also amplify the effect of global risk shocks more broadly on equity prices, particularly in markets with a larger hedge fund presence and thinner liquidity. In foreign exchange markets, crowded and leveraged carry trades can unwind rapidly in the face of adverse shocks, amplifying market volatility and spilling over into other asset classes.

To strengthen financial market resilience, policymakers should enhance surveillance to monitor systemic risks arising from the hedge fund sector. Closing data gaps should be a priority, including on leverage, derivatives exposures, securities financing transactions, prime broker relationships, and investor redemption arrangements. Stronger cross-border reporting and information-sharing arrangements are also essential. Systemwide stress tests and scenario analysis can help identify vulnerabilities and amplification channels before they materialize. Prudential measures should be calibrated to the nature and source of underlying vulnerabilities while preserving the beneficial role that hedge funds play in financial markets. Where risks arise from potential synchronized deleveraging across many funds, activity-based measures, including stronger collateral management, may be appropriate. Where risks are concentrated in specific firms or exposures, entity-based tools such as risk-based leverage limits and large-exposure limits may be warranted. Supervisors should ensure that prime brokers maintain robust counterparty risk management. Central banks should maintain credible, targeted, and operationally ready backstops to address severe dysfunction in core financial markets. International cooperation is needed to promote consistent implementation and limit regulatory arbitrage across jurisdictions.

To see the full report, please refer to the English version here:

<https://www.imf.org/en/publications/gfsr/issues/2026/10/13/global-financial-stability-report-october-2026>