

Best practices in monitoring systemic risks arising from hedge funds

IMF-FSB Users Conference on the Financial Crisis and Information gaps

John Fell

Washington, D.C., 9 July 2009

Outline

- **Two approaches to monitor hedge fund-related risks to financial stability**
- **Currently available information sources:**
 - quantitative (statistical) data and other information
 - official **ECB** statistics on hedge funds
- **Wish-list suggestions**
- **Concluding remarks**

Analysis of risks to financial stability

Two possible complementary approaches:

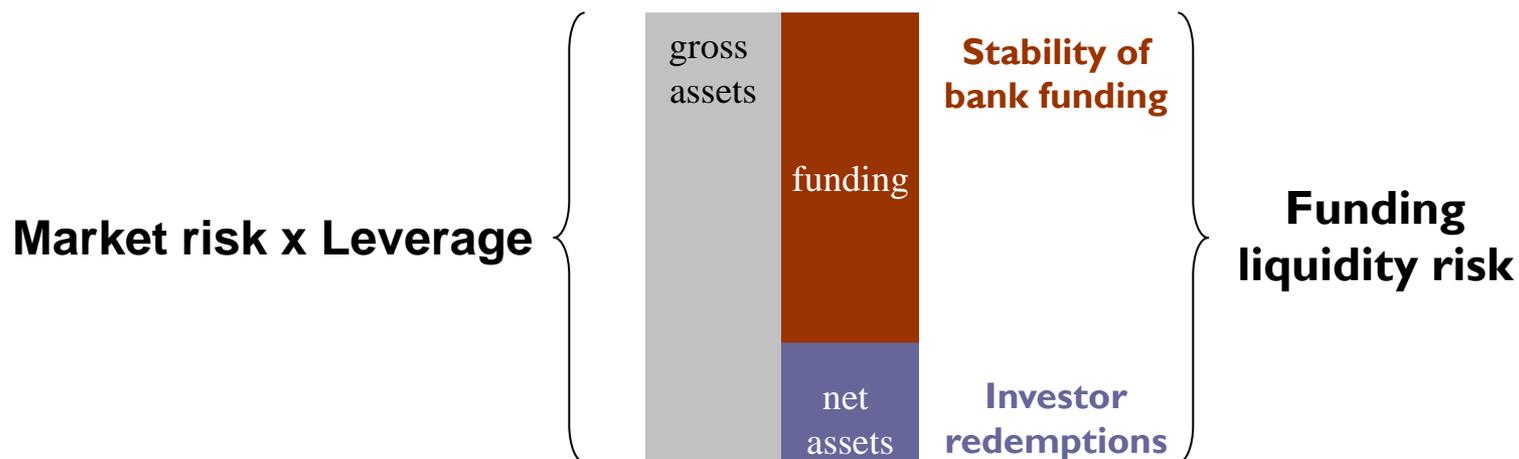
- **Adverse impact on creditor banks (including direct and indirect risks) and financial markets. Analysis from banks' and financial markets' functioning perspective**
- **Focus on risks faced by hedge funds themselves as non-bank financial institutions with a specific set of risks. This facilitates the assessment of potential implications for banks and financial markets**

Scope of monitoring: large hedge funds and their management firms?

Endogenous vulnerabilities of hedge funds ...

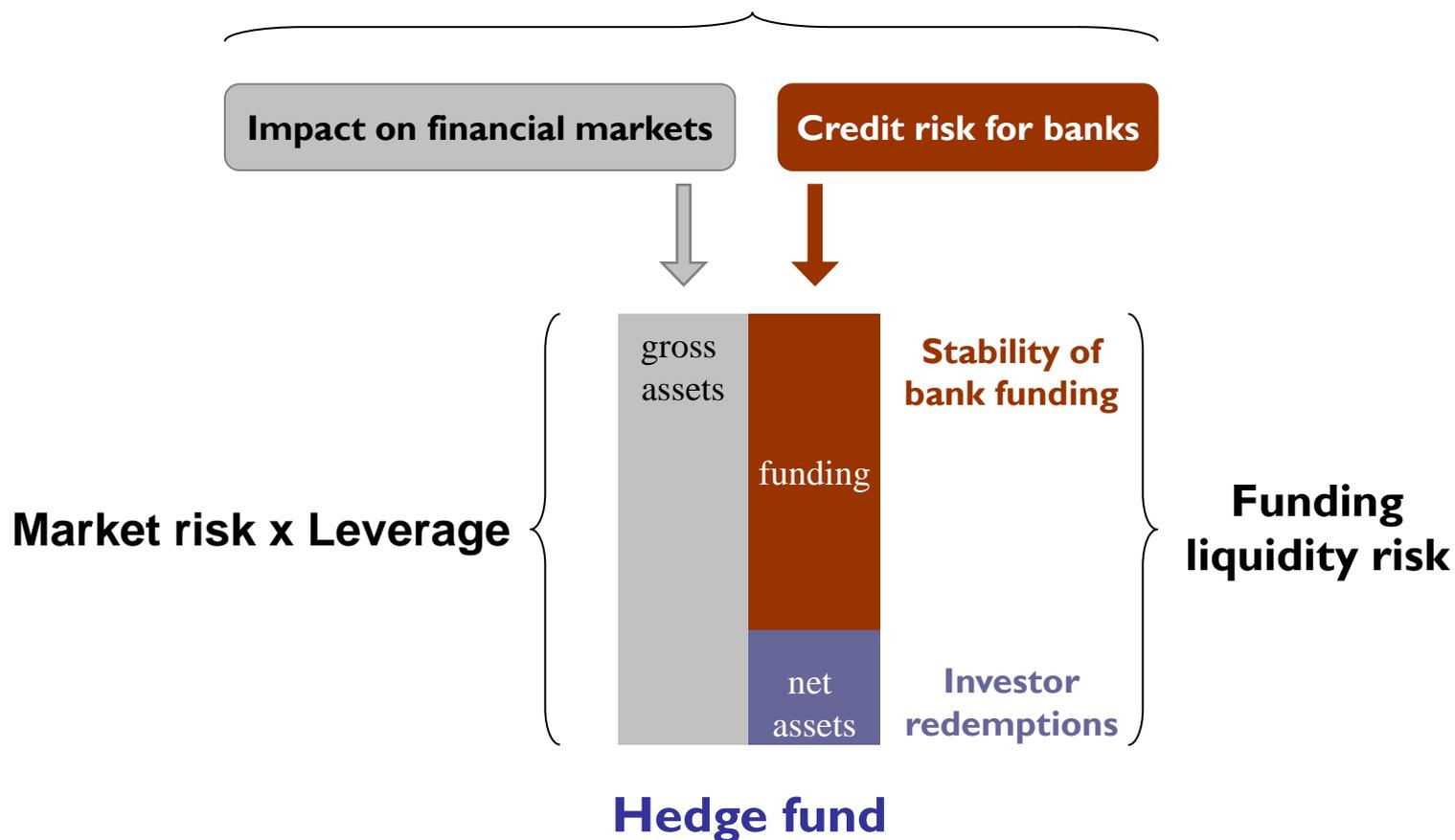
- **Risks faced by hedge funds**
 - investment risk
 - funding liquidity risk {leverage}

Hedge fund



... and implications for the financial system

Implications for the functioning of the financial system



Currently available information sources

Quantitative (statistical):

- commercial hedge fund databases
- quarterly industry (asset flow) reports
- hedge fund return indices
- some supervisory data on banks' exposures, when available
- official statistics (e.g. Cayman Islands Monetary Authority data, harmonised ECB statistics on investment funds)

Qualitative and mixed:

- dedicated financial media
- academic papers
- market surveillance

See also L. Papademos, "Monitoring hedge funds: a financial stability perspective", *Banque de France FSR*, Special issue on hedge funds, April 2007.

Commercially available databases

Despite shortcomings, the largest data source for analytical purposes

- fund-level time series and other data, not restricted in terms of geographic coverage

Mapping of hedge fund activities by strategy

June 2007; % of capital under management

	primary focus					trade in				geographic focus				investment focus		
	equities	fixed income	commodities	currency	other	equities	fixed income	commodities	currency	global	US	Western Europe	Asia Pacific	distressed bonds	high-yield bonds	mortgage-backed securities
convertible arbitrage	42	40	–	5	–	82	82	...	32	33	45	18	15	9	18	–
dedicated short bias	10	41	–	–	–	57	41	5	4	46	93	1	1	–	41	–
emerging markets	36	43	–	5	–	66	59	13	56	39	–	...	18	23	24	1
equity market neutral	46	5	–	1	–	90	23	9	20	23	46	25	5	...	2	1
event driven	39	37	...	–	–	71	72	1	28	21	59	25	6	42	47	...
fixed income arbitrage	–	80	–	2	–	27	90	–	44	55	39	24	2	14	16	38
global macro	20	27	21	37	–	79	87	60	90	89	5	2	7	8	9	8
long/short equity hedge	66	6	1	4	...	91	24	8	35	30	24	26	5	6	4	...
managed futures	33	57	71	58	–	49	73	84	75	91	32	30	28	–	–	...
multi-strategy	26	64	5	6	–	94	87	14	37	57	39	11	9	34	40	8
TOTAL	43	32	7	9	...	77	55	16	42	42	30	20	8	17	18	5
fund of funds	39	28	15	14	–	70	58	34	45	68	24	20	11	25	27	21

equal or greater than 75
 equal or greater than 50 and less than 75
 equal or greater than 25 and less than 50

– zero
 ... close to zero

Sources: Lipper TASS database and ECB calculations.

What is the true size of the sector?

Information sources and end-2008 estimates of **capital under mgmt** in **USD trillion**:

- **commercially available databases plus other information sources**
 - **Lipper TASS:** **1.29**
 - **HFR (Hedge Fund Research):** **1.41**
 - **HFN (hedgefund.net):** **1.93**
 - *assets under administration*
 - *database and semi-annual hedge fund administrator survey*
- **data compiled from 11 hedge fund databases**
 - **PerTrac Financial Solutions:** **1.33**

Official ECB statistics on hedge funds

- **Key characteristics:**

- part of harmonised statistical information (fund-by-fund and mostly security-by-security) on the balance sheets of investment funds domiciled in the respective EU Member State
- monthly data starts in December 2008
- breakdowns by type of issuer and maturity of securities and holders of investment fund shares/units
- developed definition of hedge funds proved workable

- **Limitations for financial stability analysis purposes:**

- country-level data
- no information on investment strategies
- only hedge funds domiciled in the respective EU Member State

Coverage would improve if managers were asked to report information on all managed hedge funds, irrespective of fund's domicile

Wish-list suggestions

- **More time series information needed on:**

- Leverage**

- amount and sources
 - breakdown by maturity and the type of collateral
 - supply side: changes in security haircuts, initial margins

- Investment exposures** (at least broadly grouped)

Most of the above could be obtained via enhanced balance sheet data reporting

- **Database vendors could also be spurred into improving:**
 - the overall quality and completeness of data, and
 - especially information related to hedge fund attrition in order to facilitate research on hedge fund failures
- **Supervisors should ask banks for better Pillar 3 disclosures and also themselves make more supervisory data (that is too sensitive to be included in Pillar 3 disclosures) available publicly in a sufficiently aggregated form**

Concluding remarks

- **Recent regulatory initiatives may result in more aggregate information**
- **However, for financial stability analysis fund-level information remains indispensable and, therefore, hedge fund databases will remain important**
- **New reporting requirements should also take level playing field considerations into account**