Box 5

HEDGE FUND RISK TRANSPARENCY

Three important issues are frequently raised in public policy discussions concerning hedge funds: risks to financial stability, regulation, and transparency. There is an ongoing debate as to whether the solution to financial stability concerns lies in regulating these institutions or in enhancing their transparency. The general view is that direct regulation of hedge funds may be neither desirable nor feasible, and that so-called indirect regulation – through the regulation of counterparties and creditors of hedge funds as well as by raising investor awareness – may be the best way to manage hedge fund-related risks. The indirect approach places great emphasis on regulated entities (e.g. prime broker banks) applying prudent risk management and market discipline in their dealings with hedge fund clients.[1] As such, for the approach to work, the information disclosed to regulated counterparties by a hedge fund must be sufficient to allow them to monitor their risks effectively. A key concern in applying this approach is that banks are often not informed in a sufficiently detailed and timely fashion on the entire portfolio held by individual hedge funds (hereafter "the portfolio problem"), and are therefore unable to detect crowded (concentrated) trades across their hedge fund clients.[2] The portfolio problem carries with it the risk of building up excessive leverage, whereas crowded (concentrated) trades may threaten liquidity available in major financial markets. Both of these aspects were important during the near-collapse of LTCM, a large hedge fund, in September 1998. The purpose of this Box is to provide an overview and assessment of various proposals that have been made to enhance the transparency of hedge fund activities, and to shed some light on some potential market-based solutions to the portfolio problem.

1 It should be acknowledged that investors can also have their say, and have increasingly been doing so, by shying away from placing their funds with the most opaque hedge fund managers. For a broader discussion on counterparty risk management and related operational risk and transparency issues in particular, see also Counterparty Risk Management Policy Group (2005), "Toward Greater Financial Stability: A private Sector Perspective", July.

2 Banks can also face challenges in firm-wide aggregation of multiple trading, financing and investment exposures to individual hedge funds or groups of hedge funds with similar strategies. See ECB (2005), "Large EU Banks' Exposures to Hedge Funds", November.

Following the LTCM incident, many international investigations and initiatives were undertaken with the aim of preventing the reoccurrence of similar crises. Most of them underscored the need for enhanced transparency by highly leveraged institutions (HLIs), foremost among them hedge funds. In April 2000, the Financial Stability Forum (FSF) published a report[3] which analysed four basic measures for improving the information available on the activities of hedge funds and other HLIs.

The first measure relates to *enhanced reporting to supervisors and regulators by HLI counterparties*. This route has been followed by the UK's Financial Services Authority (FSA), which regularly collects information from selected prime brokers on their largest exposures to hedge funds.[4] According to the FSF report, a limitation of the approach is that such reporting and information exchange would be primarily directed at improving the supervision of the credit provider, and would also only be available to regulators. Hence, it would not directly strengthen the market discipline applied by hedge fund counterparties, although supervisors can also step up their oversight of counterparty risk management processes.

The second measure considered by the FSF was *confidential reporting by HLIs to authorities* without public disclosure of the reported information. Indeed, some of the largest hedge funds seem willing to share information with supervisors, including reporting information on their risk profiles. A drawback of this option, however, is that voluntary disclosure may yield only a fragmented picture of overall hedge fund activities. Moreover, the approach carries with it the possibility of regulatory moral hazard in that HLI counterparties might come to believe that the authorities are in a position to use the information they receive to prevent undesirable outcomes, thus reducing the incentive for these counterparties to carry out their own due diligence effectively.

The third measure analysed by the FSF as an efficient way of ensuring proper credit and market discipline was *public disclosure by all HLIs,* whether regulated or not. There is widespread acknowledgement that the nature of disclosures should not compromise the legitimate proprietary interests of the entities making them. For instance, according to the Investor Risk Committee of the International Association of Financial Engineers (IAFE), disclosures should minimise the possibility of adverse impacts on hedge fund returns.[5] It should also be recognised that hedge fund disclosures can become outdated very quickly in fast-moving markets, and there is no agreement among practitioners on what would constitute comprehensive risk disclosure.

In April 2001, the Multidisciplinary Working Group on Enhanced Disclosure[6] came up with proposals aimed at promoting a level playing-field in transparency among all financial intermediaries. It encouraged greater and more comparable disclosure, and identified possible areas for improvement in disclosure practices that should enhance the understanding of the risks borne by all financial intermediaries. For example, it concluded that a more complete view of an institution's exposure to risk would require information being disclosed about the variation of intra-period exposures – particularly in the form of high, median and low values.

3 See FSF (2000), "Report of the Working Group on Highly Leveraged Institutions", April.
4 It should be noted that the FSA acknowledges that some large leveraged hedge fund portfolios would still go undetected if large positions were spread across several banks.
5 See IAFE Investor Risk Committee (2001), "Hedge Fund Disclosure for Institutional Investors", July.
6 See Multidisciplinary Working Group on Enhanced Disclosure (2001), "Final Report to BCBS, CGFS, IAIS and IOSC", April.

So far these proposals have not influenced the actual disclosure practices of either regulated or unregulated firms.

While existing sound practices for hedge fund managers tend to focus on disclosures to investors, regulators and counterparties,[7] a proposal was recently made along the lines of voluntary public disclosure, which encouraged hedge funds to seek external credit ratings.[8] The existence of credit ratings could help hedge funds to secure long-term financing, potentially eliminating funding uncertainties, for instance as to whether overnight lending will be made available by prime brokers. However, credit ratings are not free, which means that they might only be affordable for large funds. At the same time, credit ratings may not eliminate other potential sources of risks for financial stability, such as those arising from similar positioning across smaller hedge funds with less advanced risk management systems. Moreover, while credit ratings provide a measure of the long-term credit strength of a debtor, they may not be reflective of rapidly changing risk profiles, a characteristic of hedge funds which often pursue active investment strategies and have flexible mandates. Nonetheless, the main advantage of the proposal is that it is a market-based initiative. It is also important to note that for the proposal to succeed, it would require a critical mass of hedge funds seeking ratings, while it should be borne in mind that other proposed forms of voluntary public disclosure have not yet met with success.

The last measure discussed in the FSF report was to introduce an *international HLI credit register*. The effectiveness of such a measure depends on its design, particularly regarding a solution to the portfolio problem. A credit or position register would contain centralised information on the exposures of all significant regulated firms to HLIs, including not only exposures to hedge funds and other unregulated HLIs, but also to other reporting firms (e.g. prime broker banks). In addition to the potential regulatory moral hazard issue, this proposal immediately raises several practical questions.[9] First, how should HLIs, and hedge funds in particular, be defined? Second, who will collect such sensitive data given its proprietary nature and importance for the safeguarding of systemic liquidity in international financial markets? Third, who, in addition to regulators, would be granted access to the information gathered, and how would the surrounding legal issues be resolved? Fourth, given that data would need to be collected at least on a daily frequency and should include every on- and off-balance sheet position in order to account for offsetting positions, how should such information be aggregated and presented in a meaningful way without compromising proprietary interests? Moreover, the information summaries produced should enhance market discipline and provide market participants with early warning signals of looming financial stability risks.

An HLI position register, nevertheless, could help tackle the portfolio problem encountered by prime brokers when their hedge fund clients spread positions across multiple counterparties. This is because it would provide prime brokers with frequent and aggregated risk information on the whole portfolio of an individual hedge fund. However, in order to ensure a level playing-field, any contributing HLI, whether regulated or not, should be able to monitor aggregated risk

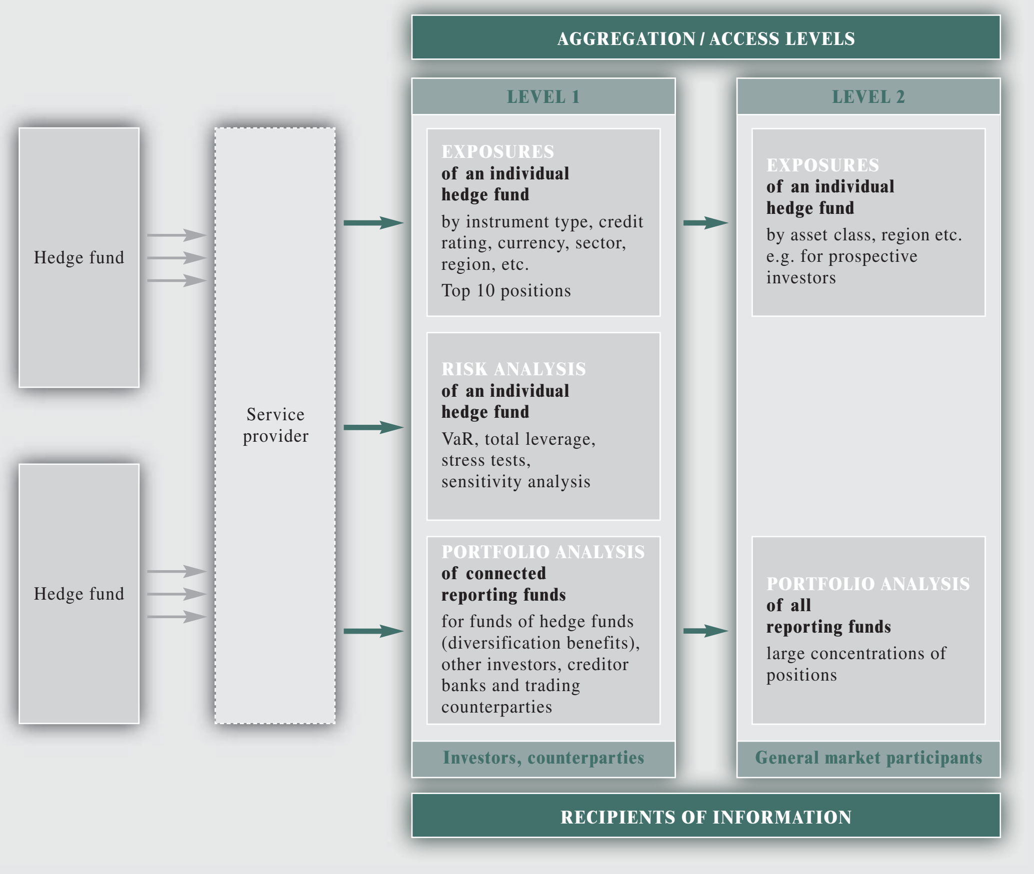
7 See, for example, AIMA (2002), "Guide to Sound Practices for European Hedge Fund Managers", August; MFA (2005), "2005 Sound Practices for Hedge Fund Managers", August.
8 See, for example, M. Westlake (2006), "German Hedge Fund Scheme Wins 'Encouraging' Support", *Global Risk Regulator,* Vol. 4, No 7, July/August.
9 See also comments on this proposal by B. S. Bernanke (2006), "Hedge Funds and Systemic Risk", a speech at the Federal Reserve Bank of Atlanta's 2006 Financial Markets Conference, 16 May.

reports for any other HLI to which it has an exposure. This twist again highlights the issues of risk aggregation and access to gathered information.

Notwithstanding the sheer complexity of practically implementing the proposal for an international HLI position register, it is noteworthy that some of its useful features could perhaps be, and in some cases already are, provided by private market participants.[10] An illustrative product concept with associated information flows and reporting options is depicted in Figure B5.1. This figure shows that a hedge fund could supply information to an independent service provider, which would furnish customised aggregated information packages to various recipient groups based on their access level. The current market standard is at monthly reporting frequency, but hedge funds with liquid strategies would need to report on at least a daily basis. However some institutions administering investable hedge fund index platforms argue that even daily reporting is not sufficient in terms of providing full risk transparency of dynamic hedge fund strategies (e.g. to detect a strategy drift) and, therefore, information needs to be collected on every intraday transaction. Different parties may be allowed to see different information, although a substantial proportion of large hedge funds provide the same monthly risk reports

10 See, for example, C. Davidson (2005), "Clear Thinking Needed", *Risk,* March, pp. 18-20.
11 See Mercer Oliver Wyman (2006), "Risk Taking and Risk Management in the Hedge Fund Industry: Review of Market Practices", July.

Figure B5.1 Risk aggregation and monitoring services: Information flows and possible reporting options



to both their investors and counterparties.[11] Investors could also be offered diversification analyses of their portfolios of reporting funds. To achieve all of this, the requirements for the risk aggregation and monitoring service provider would be enormous and, among others, would include historical and real-time data feeds, flexible software systems, up-to-date valuation methodologies, sophisticated risk calculation models and otherwise keeping abreast of financial and technological innovations. This is also an important reason why it is preferable, to the extent possible, to entrust such a task to competing private market participants.

If banks were to request their hedge fund clients to subscribe to such risk aggregation and reporting services, then they would be able to monitor the whole portfolio of a hedge fund and would perhaps be in a better position to detect some potentially risky concentrations of large exposures among and across their hedge fund clients. However, in order to ensure a level playing-field and to obtain a truly global picture, banks themselves would also need to report their positions. Then all service providers would essentially become position registers and would need to be encouraged to report regularly standardised market concentration data, perhaps with some coordination provided by the public authorities.

To sum up, enhanced transparency on the risk profiles of hedge funds is a necessary precondition for ensuring that efficient market discipline is applied by hedge fund counterparties. It could prove a viable alternative to direct regulation, especially if it were supported by undistorted incentives which prevent market discipline from occasionally breaking down. Of all the alternatives, an international HLI position register would theoretically offer the best solution for tackling the portfolio problem related to the lack of timely aggregate risk information on a hedge fund and hedge funds as a whole. However, it is also the most complicated measure. This notwithstanding, there are already some market products available which have features similar to a HLI position register and which could potentially evolve into market-based solutions.