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# Progress in Implementing the Recommendations of the FSF Update Report on Highly Leveraged Institutions

*Since May, progress has been made by the official and private sector on initiatives that take forward the FSF's recommendations to address the potential systemic risks associated with hedge funds. Meanwhile, the recent market turmoil has provided a test of risk management that will provide lessons for these initiatives. This note briefly summarises recent developments in the sector and sets out the work underway under the initiatives.*

## I. Recent developments

The robustness of many hedge funds' balance sheets and their risk and liquidity management have been severely tested by the market turmoil of recent months. Some hedge funds, including some high-profile internal investment bank funds, have either failed, required recapitalisation, or been forced to suspend withdrawals. In a few instances, notably the mortgage credit funds managed by Bear Stearns, fund problems contributed to market strains. However, to date at least, hedge fund activities have not been the major source of market instability during the recent turmoil.

Most hedge funds seem to have been able to meet margin calls in an orderly way without fire sales of assets. Counterparties appear to have been able to manage their exposures to hedge funds, albeit with a widening in collateral haircuts and reductions in credit lines. This reflects in part improvements in the robustness of risk management practices in recent years.

It appears that the sector as a whole sustained losses in July and August as the structured credit market problems widened into a reduction in the prices of risk assets more generally. Statistical arbitrage and other quantitative strategies, as well as some macro funds, appear to have suffered rather more than the average as historical statistical relationships broke down and crowded trades accentuated price swings. There has been some deleveraging in these subsectors, mostly in an orderly fashion. The hedge fund sector returned to profit in September as market difficulties eased somewhat.

Investor withdrawals from hedge funds appear to have been moderate. According to one industry survey, investors withdrew a net $32 billion in July, or 2% of total hedge fund assets, and there have been anecdotal reports of further investor withdrawal requests since then. However, the end-September window for investor redemptions passed without reports of major withdrawals. Investor concerns may have been eased by the return to profit of the sector as a whole in September, including for some of the strategies that had performed most poorly in July and August.

There are undoubtedly challenges still ahead for the sector and its counterparties. Liquidity in a number of markets remains low, as does overall market confidence in the valuations of structured instruments. How far hedge funds have recognised losses in mortgage-related structured credit products is not yet clear. Against this background, the recommendations in the FSF Update to strengthen protection against systemic risks and to expand transparency remain as relevant as ever.

## II. Progress on FSF Recommendations

### Recommendations 1 and 2: Strengthening core firms' risk management practices

*Supervisors should act so that core intermediaries continue to strengthen their counterparty risk management practices.*

*Supervisors should work with core intermediaries to further improve their robustness to the potential erosion of market liquidity.*

These two recommendations recognised that the principal channels through which hedge fund activities can pose systemic risk are the direct losses that core banks could sustain on their counterparty exposures to hedge funds, and the indirect losses they could face from market liquidity erosion caused by forced hedge fund liquidation or de-leveraging. Strengthening core firms' counterparty risk management and stress testing practices is therefore the most effective approach to addressing the systemic risks associated with highly leveraged institutions.

Over the summer, supervisors made good progress in their collaborative review of the management of counterparty exposures at the core global financial intermediaries, including as they relate to hedge funds. The first stage of this exercise, reviewing the current state of practice based on a series of interviews with firms, was completed before the summer. The second phase is delving more deeply into a narrower set of issues to identify the scope for enhancements and to formulate recommendations. The issues include:

- senior management oversight of risk management procedures;
- the models and methodologies to capture complex exposures;
- stress testing regimes;
- the measurement of tail risk exposures, exposures to similar risk factors and liquidity risk;
- the ability to aggregate a firm's full exposures to particular risk factors and counterparties;
- the margins and limits regime, including its robustness under stress scenarios;
- the handling of close-out procedures.

The recent market turmoil has provided a demanding test of core intermediaries' risk management practices, including as they relate to hedge funds. The collaborating supervisors have decided to extend their review to include the practical lessons about the robustness of counterparty risk management under stress that can be learnt from this episode alongside the wider lessons of the episode for firms' risk management practices. This will delay by some time the formulation of recommendations from the review but will enhance their value. The overall findings on sound practices and areas for improvement in risk management practices – including liquidity risk, stress testing and valuation practices will then be discussed by supervisors with the group of core intermediaries.

The FSF Working Group on Market and Institutional Resilience will draw on these findings as part of its broader consideration of risk management practices and issues arising from the recent turmoil.

**Recommendation 3: Improving data on core intermediaries exposures to hedge funds**

*Supervisors should explore and evaluate the extent to which developing more systematic and consistent data on core intermediaries' consolidated counterparty exposures to hedge funds would be an effective complement to existing supervisory efforts.*

While recognizing the inherent limitations of summary data in capturing the complex counterparty exposures of major dealer firms to hedge funds, the FSF asked supervisors to consider whether the collection of systematic and consistent information on major dealer firms' global consolidated exposures to hedge funds would complement supervisory efforts aimed at strengthening counterparty risk management practices.

Supervisors in the largest financial centres are discussing at working level what survey data, both quantitative and qualitative, on counterparty exposures it would be feasible and useful to collect from intermediaries on a consistent basis across jurisdictions. Work in this area is building upon findings from the supervisory review described above, including with regard to measurement of exposure, and is therefore at an earlier stage of development.

**Recommendations 4 and 5: Action by investors and hedge funds to strengthen transparency, market discipline and sound practice standards**

*Counterparties and investors should act to strengthen the effectiveness of market discipline, including by obtaining accurate and timely portfolio valuations and risk information.*

*The global hedge fund industry should review and enhance existing sound practice benchmarks for hedge fund managers in the light of expectations for improved practices set out by the official and private sectors.*

Market discipline by counterparties and investors plays an essential role in containing risks at individual hedge funds and within the system. For market discipline to work effectively, counterparties and investors need accurate and relevant information upon which to base their decisions, including with regard to how far hedge funds meet sound risk management practices and operational controls. Several initiatives are now underway through private sector groups to strengthen hedge fund transparency and enhance sound practices that will contribute to taking forward the goals expressed in these two recommendations.

In June, a working group of 14 leading hedge fund managers based mainly in the UK was formed under the chairmanship of Sir Andrew Large to review best practice by hedge fund managers. On 10 October, the Hedge Fund Working Group issued a consultation document proposing 15 best practice standards covering the following areas:

- Fund governance
- Valuation
- Risk Management
- Disclosure to investors and counterparties
- "Activism"

Amongst other goals, the group's work has sought to address issues about financial stability raised by the G7 and FSF, and the draft standards cover areas – risk management, valuations and disclosure to investors and counterparties – in which the FSF had encouraged action by the global hedge fund industry. The report notes that improved clarity of disclosure to investors and counterparties is at the root of all its recommendations.

The Hedge Fund Working Group aims to publish the final version of its report in January 2008, following the current consultation period with hedge fund managers and others in the financial industry. The standards are voluntary but hedge funds are expected to "comply or explain". In this regard, the working group notes the importance of peer group pressure and demands from the investor community, especially those with a fiduciary responsibility. The group proposes setting up a board of trustees that would assume responsibility for the standards and for updating them in the future, and expresses hope that the standards will be further developed over time to reflect the global dimension, perhaps leading to convergence in some areas with standards published in other countries.

The Hedge Fund Working Group initiative has been welcomed by the Alternative Investment Management Association (AIMA) as complementing its sound practices guide for European hedge fund managers, an update of which it published in May 2007. This followed its March publication of sound practices for hedge fund valuation. In June, AIMA formed an Investor Steering Committee, to offer strategic and practical guidance on the hedge fund industry to investors, including appropriate initial and ongoing due diligence practices. Providing input to the FSF is one of its first projects.

In the US, the President's Working Group on Financial Markets (PWG) announced in September the formation of two private sector groups, one composed of investors and the other composed of asset managers for private pools of capital. The groups will be standing committees, and the first task of each will be to develop best practices related to hedge funds, building on the high-level principles and guidelines regarding private pools of capital issued by the PWG in February 2007.

By developing the guidelines, these two PWG groups aim to foster efforts to enhance market discipline, mitigate systemic risk, augment regulatory standards regarding investor protection and complement regulatory efforts to enhance market integrity. The areas in which the two groups will develop guidelines include information, due diligence, valuation and risk management systems. The work would therefore include the areas in which the FSF had encouraged action under Recommendation 4 and 5. Meanwhile, the Managed Funds Association continues to work towards issuing an updated version of its sound practices guide for hedge fund managers during 2007.

**Concluding observations**

At its recent meeting, the FSF welcomed the ongoing work on the recommendations it issued in May. The events of recent months, though they have not involved hedge funds as the major source of market instability, have provided a test of the robustness of practices that will strengthen the guidance that results. The issuance of draft best practice standards by the UK-based Hedge Fund Working Group, along with a "comply or explain" expectation, is a notable step towards improved transparency and discipline and a recognition by the sector of its responsibilities as a significant force in the financial system. Progress by investors in developing improved due diligence practices for hedge fund investments and in articulating expectations for disclosures by hedge fund managers, while less advanced at this stage, will be an important complement to the above guidance in strengthening market discipline.