The Australian hedge funds sector and systemic risk

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Introduction

Today I am pleased to release our report, *The Australian hedge funds sector and systemic risk*, setting out the findings of our 2012 survey into the systemic risk posed by local hedge funds. This is our second such survey: the first was in 2010.

The report gives a general overview of the size, makeup and performance of the sector, to contextualise our findings. It explains how we came to conduct these surveys, how our work fits into a bigger international initiative, ways hedge funds might cause systemic risk and how the data we collect informs our deliberations.

Much of the benefit of these surveys comes from repeating the exercise, as a time series will allow trends to be seen. To help understand the 2012 data, and where useful comparisons can be drawn, we have included data from our 2010 survey.

I will conclude with some remarks about changes we propose to make to how we define hedge funds for the purposes of excluding them from the shorter PDS regime.

Hedge funds and systemic risk

Can hedge funds pose systemic risk? Our starting premise is that they may.

We understand systemic risk to mean a disruption in financial services caused by an impairment to all or some part of the financial system which is capable of negatively impacting the wider economy.

Fortunately, there are no Australian examples of hedge funds causing this kind of risk, but there are overseas. The collapse of Long Term Capital Management (LTCM) in 1998, where the Federal Reserve Bank of New York had to orchestrate a bail-in by its investment bank counterparties is the most famous.[1] This is an example of a hedge fund raising systemic risk through the channel of credit risk. Ten years later, Morgan Stanley faced the simultaneous blows of massive withdrawals of hedge fund assets from custody while having to satisfy contractual rights to provide uncollateralised loans to other hedge funds. This led to tri-party repo (repurchase agreement)

[1] LTCM pursued a relative value arbitrage strategy, investing mainly in government bonds. In August 1998, it held US$125 billion in assets against only US$4.1 billion in equity (i.e. leverage of 25:1). A market crisis led to risk spreads and liquidity premiums rising, confounding LTCM's risk management models. As other markets were impacted, LTCM's positions were found to be more correlated than had been supposed. With the fund's liquidity evaporating and its capital collapsing, the Federal Reserve Bank of New York sponsored talks between its principal counterparties, which led to a consortium of 14 buying into LTCM. Thereafter, the fund's positions were unwound: refer Report of the President's Working Group on Financial Markets, *Hedge funds, leverage and the lessons of long-term capital management,* April 1999.

lenders questioning its credit and to the firm applying to become a bank holding company.[2]

Hedge funds may also contribute to systemic risk through the market risk channel – for example, where their activities lead to a liquidity problem or mispricing in a particular market for securities or futures. Examples include the distorting impact of Amaranth Advisors' investing over the northern summer of 2006 in US natural gas futures for the 2006–07 winter,[3] and the shorting and resulting short-squeeze of Volkswagen stock in 2008 which distorted the German equity indexes over several days.[4]

There is another important advantage in this survey. As hedge funds can take highly leveraged and concentrated market bets, they can be severely impacted by ripples far out along the risk curve, long before a wave may appear further down that curve. Harbingers of the last crisis were the collapse of the Bear Stearns Asset Management funds in the United States in June 2007, and the freezing of our own Basis Capital Funds the following month. Both were undone by synthetic collateralised debt obligation (CDO) exposure.

The international dimension of our hedge fund survey

ASIC's 2010 and 2012 surveys were undertaken in coordination with other members of the International Organization of Securities Commissions (IOSCO), which created a Task Force to consider the proper supervision of hedge funds and to monitor the systemic risk they may pose.

The survey template was agreed by the Task Force, as was the survey date (30 September). It was also agreed to only survey single-strategy funds to avoid double counting. The template has two parts. The first seeks quite general information from managers across all of their hedge fund holdings. The second seeks very detailed asset category level data in respect of their largest, 'qualifying' funds. After consultation with the Reserve Bank of

[2] *The financial crisis inquiry report: Final report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*, 2011, pp. 360–363.

[3] Amaranth collapsed in September 2006. Throughout that summer, it dominated the trading in natural gas contracts on the New York Mercantile Exchange (NYMEX) and the IntercontinentalExchange (ICE) (controlling as much as 40% of the outstanding contracts on NYMEX for natural gas in the 2007 winter). Its trading led to significant price rises over summer but, in the face of stable supply (and ample reserves), these positions could not be sustained by late summer. From late August through mid-September, the fund lost US$2 billion, leading to liquidation of its US$8 billion portfolio. During this process, gas prices collapsed: refer Staff report of the Permanent Subcommittee on Investigations of the US Senate, *Excessive speculation in the natural gas market*, 2007.

[4] On 26 October 2009, Porsche announced it had lifted that stake in Volkswagen (VW) to 42.6% and had cash-settled call options to raise its stake to 74.1%. Many hedge funds, assuming Porsche was not going to take over VW and that VW's business would decline in the recession, had shorted 12% of VW's stock. With a free float of less than 6%, funds rushed to close out their shorts and the price of VW stock skyrocketed, making it briefly the most valuable company in the world on 28 October. After Porsche made some stock available, the price fell by week's end to 20% of its Tuesday peak. The DAX significantly over-performed and then under-performed world indices over the week: The Economist, *Squeeze money*, 30 October 2008; FT.Com, *Watchdog on alert after Volkswagen shares plunge*, 30 October 2008.

Australia (RBA), Australian Prudential Regulation Authority (APRA) and the Alternative Investment Management Association (AIMA) in 2010, and again last year, ASIC customised the survey questionnaire for our market.

As the survey involves much work for ASIC and industry, we decided to only require managers with more than US$500 million in assets under management (AUM) across all their hedge funds to complete the first part of the survey. The Task Force agreed in 2012 that managers need only complete the detailed questions in the second part for *each fund* with more than US$500 million in AUM.

In November 2012, the survey was dispatched and responses were received before the end of December. Sixteen managers completed the survey and detailed responses were provided in respect of 12 qualifying funds.

The data was aggregated and sent to the compiling IOSCO Task Force members who will report the global data and findings to the Financial Stability Board later this year. We analysed the local data and reported it to the Australian Treasury, the RBA and APRA back in May. The report we are releasing today is an edited version of that May report.

Australia’s hedge fund industry

Before I tell you what we went looking for and what we found, let me give you some context to where we looked.

Using information from various data providers and research houses, we have identified 603 active single-strategy hedge funds and funds of hedge funds operating in Australia. This number has been quite stable over the last couple of years, with only 11 new fund launches recorded in 2012, down from a peak of 75 new funds in 2006.

Based on self-reported AUM by 370 hedge funds, sector AUM stood at $66 billion in September last year, comprising $51 billion in single-strategy funds and $15 billion in funds of funds. As some funds’ AUM is not reported, we know sector AUM will be higher, but probably not much higher, as the bigger a fund gets the more radar screens it gets picked up on. And, for obvious reasons, it is the biggest funds we focus on when considering systemic risk.

It is important to understand, when considering the systemic significance of the sector, that identified hedge funds only account for about 3% of the $2.1 trillion in assets held by the Australian managed funds industry in total.

The 16 managers we collected general data from managed US$33 billion in AUM in 76 single-strategy hedge funds – or about 65% of known assets in single-strategy funds. The AUM of the 12 large funds we collected detailed data from represents 42% of known single-strategy hedge fund assets.

So what were we looking for?

Apart from sector size, the impact factors we were most concerned to consider in forming a view on the potential systemic risk posed by local hedge funds were:

- the market footprint of funds in terms of their gross (rather than net) assets,[5] concentrated positions and levels of holding and trading in categories of assets
- the depth and liquidity of the markets in which they invest
- any mismatch between the duration of funds' assets and their liabilities
- funds' investor base – to understand where any loss would fall and their capacity to assess risk and absorb loss
- sources and types of borrowing – again, to understand where losses may fall, but also to identify any worrying concentration of exposure
- levels and distribution of leverage – as this indicates vulnerability to sudden shifts in prices
- collateral requirements – as these protect counterparties and are an indicator of risk appetite among finance providers
- levels of rehypothecation – which indicate vulnerability to liquidity crunches.

Results of the survey

So what did we find?

Nearly 90% of investors in these 12 funds were wholesale, with superannuation funds the largest investor source at 41.1%. This is heartening, because sophisticated or professional investors are better placed than retail investors to assess and bear the risks of these types of investments.

Nearly half of the 16 surveyed hedge fund managers' net asset value (NAV) is invested in Australia, with North America and other Asia Pacific markets both at about 18.5% of NAV.

Excluding interest rate and foreign exchange (FX) derivatives (due to their being measured by their large notional values), the 16 surveyed fund

[5] We have focused on gross rather than net asset footprint as hedge funds often gain enhanced exposure, over and above their net asset value (NAV), to markets through the use of leverage.

managers' funds' biggest exposures by gross market value (GMV) was to listed equities. The next largest exposures, in the US$8–6 billion range, were equity derivatives, G10 sovereign bonds and cash. Differences between 2010 and 2012 include a big increase in the short value of equity derivatives – we assume to hedge the equities exposure – and a big decrease in exposure to financial institution bonds with increased exposure to G10 sovereign bonds.

The 16 managers' funds' share of the markets in which they trade was not significant. For instance, their holdings of Australian equities was just 0.4% of the market capitalisation of the All Ordinaries Index. Their holding of interest rate derivatives was just 0.15% of that market.

The largest turnover was in sovereign bonds (at 224x their long market value (LMV)) and equity derivatives (at 135x their LMV). These figures seem large but perhaps represent rollovers of existing positions rather than significant trading activity. By contrast, the turnover of listed equities was 2x their LMV, a decrease of 20% from the 2010 survey, and only 1% of the trade volumes in all Australian listed equities.

Levels of leverage among the 12 qualifying funds appeared low. The biggest source was synthetic leverage at US$10 billion, mainly in the form of interest rate derivatives but, as these were calculated on a notional basis, the figures tend to be large. While the sum of leverage (when derivatives are calculated on a notional basis) appears much higher than in 2010, when measured as gross market value against NAV, leverage only increased from 1.25 to 1.51 by 2012.

The 12 qualifying funds could liquidate 92% of their portfolio in less than 30 days. While 99% of their liabilities could be demanded in the same time period, suggesting potential liquidity problems in a crisis, all the funds can suspend redemptions.

Only US$1.3 billion in assets was posted by the 12 qualifying funds as collateral with counterparties or 12% of total leverage. While half the funds reported their assets could be rehypothecated by prime brokers, only one fund's assets were.

A majority of the 12 funds use multiple prime brokers. The size of funds' exposures to their prime brokers is insignificant to the size of the counterparties.

On average, portfolio concentration for the 12 funds increased since 2010 from 30% to 54%, though five of the nine 2010 respondents reported zero for their top 10 positions as a percentage of their GMV.

Having regard to the following factors about the local surveyed hedge funds:

- they account for a small share of the managed funds industry

- their predominantly wholesale investor base
- the depth and liquidity of the markets in which they have their greatest exposures
- the small share of the markets in which they trade and their low share of the turnover on those markets
- their low levels of leverage
- their ability to liquidate 92% of their portfolios within 30 days and to suspend investor redemptions, and
- the low levels of collateral posted with counterparties, limited rehypothecation of fund assets and the use of multiple prime brokers,

we conclude that hedge funds do not currently pose systemic risk to the Australian financial system or the wider economy.

I should add some words of caution about our data.

Firstly, the circumstances of the 97% of smaller, single-strategy funds we did not collect detailed data from may differ from those of the 12 qualifying funds.

Secondly, not all the questions asked in the survey in 2012 were asked in 2010 so there are gaps in our ability to draw comparisons over the period. Also, there are some other issues we probably should probe but did not – like margin levels.

Finally, we only surveyed funds operating in or managed from Australia. We cast no light on the local investment activity of foreign hedge funds – this may be substantial.

Hedge funds and the shorter PDS regime

You will know that, in June last year, we issued Class Order [12/749] *Relief from the shorter PDS regime*, which defined hedge funds for the purposes of excluding them from the shorter PDS regime.

Following representations from the Financial Services Council (FSC) that the definition captured too many lower-risk funds, we met with 16 of its members to better understand their concerns. Those concerns centred on:

- the complexity of investment structure criterion – which currently is triggered if there are three or more entities between the head retail fund and the ultimate underlying assets – or two or more entities if one of them is offshore
- the use of derivatives criterion and the limited carve-outs for derivatives – particularly as many low-risk funds use exchange-traded derivatives

to maintain market exposure while managing cash moving in and out of a fund through subscriptions and redemptions

- the performance fee criterion – as this indicia was triggered where there was a mere constitutional right to charge performance fees irrespective of whether the fee is charged or not.

There were also concerns on the complex strategy and short selling criteria.

In July, the Commission agreed the definition should be adjusted:

- to amend the complex structure criterion by excluding registered managed investment schemes from the three interposed entity test and certain overseas funds from the two entity test
- to clarify the operation of the complex strategy criterion and to add cash indexes as a category of index to which a fund's strategy could seek to generate a correlated return without triggering the criterion
- to amend the performance fee criterion so that it will only be triggered when a responsible entity has indicated it will levy a performance fee
- to clarify the operation of the derivatives criterion and add a third safe harbour to allow the use of exchange-traded derivatives for any purpose up to 10% of a fund's NAV to be measured on a gross, nominal basis.

We have received some very good feedback on the draft class order from both AIMA and the FSC and expect the final class order, with consequential adjustments to Regulatory Guide 240 *Hedge funds: Improving disclosure* (RG 240), will be released by next week.

Conclusion

Hedge funds have a very important role to play in the Australian financial system and globally, particularly in providing innovative products and strategies to help investors manage their investment portfolios and their risks. Our recent survey work indicates that Australian hedge funds have quite limited levels of leverage and concentration, suggesting that they pose little systemic risk to the financial system as a whole. We look forward to continuing to work with the industry to promote efficient financial markets, and confident and informed investors.