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Plenary 4

The Rapidly Evolving Activities of Hedge Funds

Mr. Paul Wright

Head of International Department,
Financial Services Authority of the United Kingdom

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FSA review of prime brokerage

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Financial Services Authority

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Phase 1

Jan-May 04

- Context of industry changes
- Need to review progress vs LTCM recommendations
- Participation
- Risk identification
- Conclusions

Phase 2

Jun-Dec 04

- Survey objectives
- What data do we have access to already?
- Participation
- Template design
- Practical problems
- Compilation of data
- Conclusions

Phase 3

Jan 05-

- Obtain counterparty names
- Clarify purpose, objectives to firms
- Agree any changes to the template
- Agree frequency, future participation

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Conclusions from Phase 1

- **Some positive impressions, but also some concerns, including:**
  - Prime brokerage is often part of an attempt to provide a range of services to hedge funds – could create conflicts and fudge credit risk awareness
  - Some uncertainty about firms' ability to aggregate exposures to hedge funds where they have relationships with desks other than prime brokerage
  - Hedge funds' use of leverage could expand rapidly and lead to increased volatility; greater sophistication of margining techniques, including cross-margining, may contribute to this
  - Lack of consolidated oversight could mean liquidity adjustments to collateral requirements may not be adequate for a fund serviced by several prime brokers; whole fund data may not always be an adequate mitigant
  - New client procedures may place too much reliance on track record of individual managers

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Phase 2

- Objective: to obtain data on hedge fund exposures in aggregate, by strategy, and for the largest counterparties
- But firms experienced some problems:
  - Aggregation of prime brokerage and other exposures proved difficult for some firms
  - Distinction between management information and UK-legal entity basis of our survey
  - Liaison between business units sometimes laborious
  - Manual categorisation needed (e.g. hedge fund strategies)
  - *"The whole process took us considerably longer than we anticipated"* – quote from a participant

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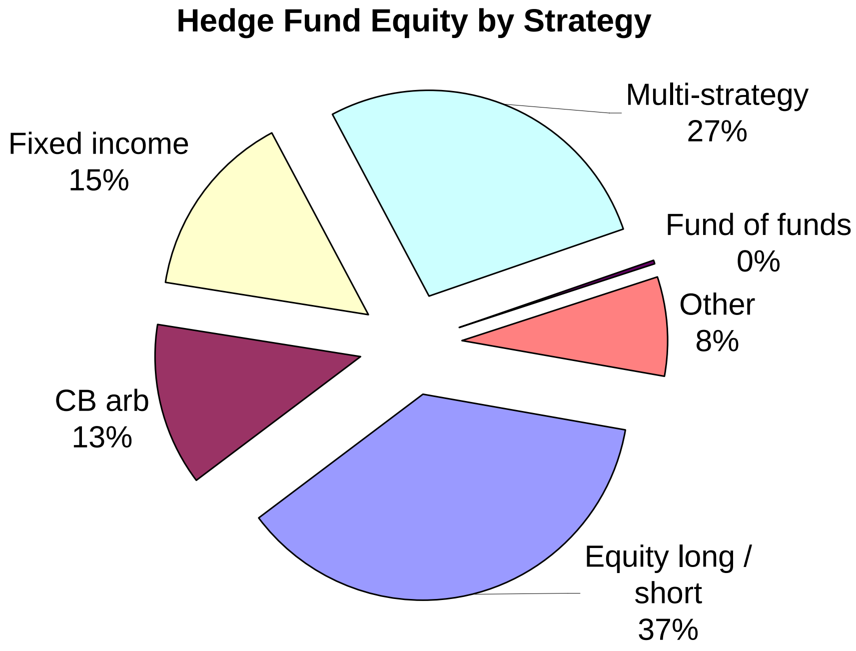
Survey results – strategy breakdown

- Equity long / short strategies the single most popular strategy by equity
- Multi-strategy next: mainly convertible bond (CB) strategies
- Fixed income 15%
- Dedicated CB arb 13%
- FoF financing relatively immaterial



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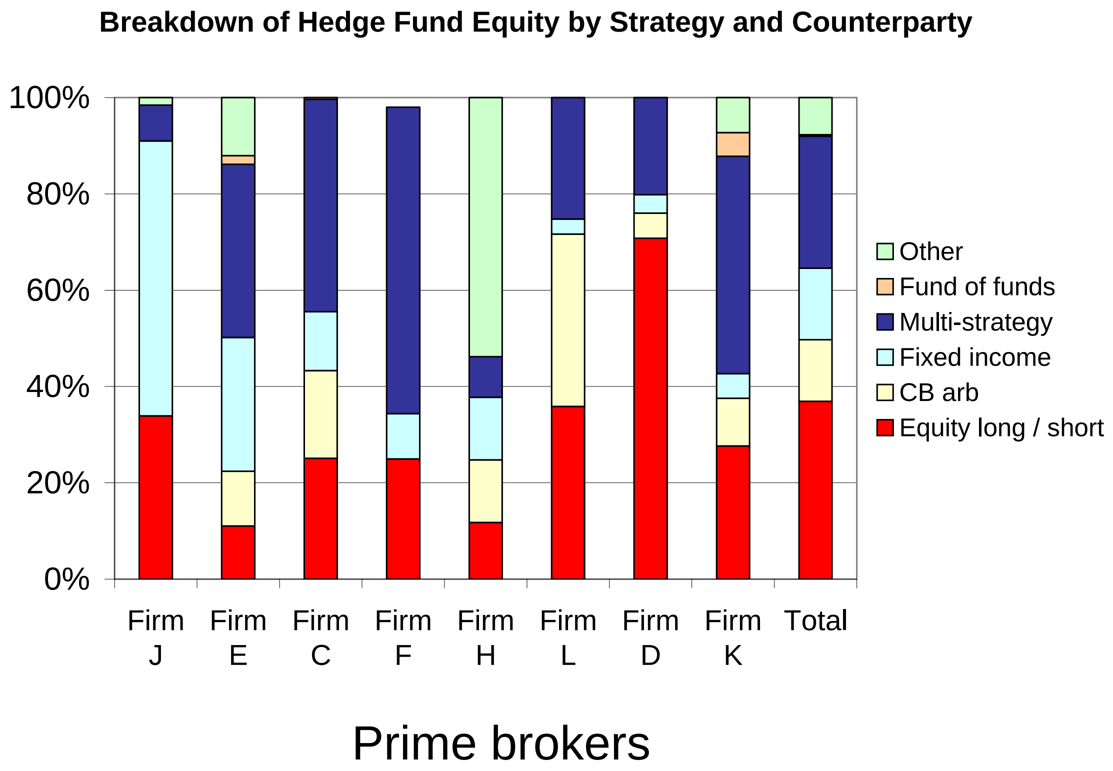
Strategy mix financed by prime brokers

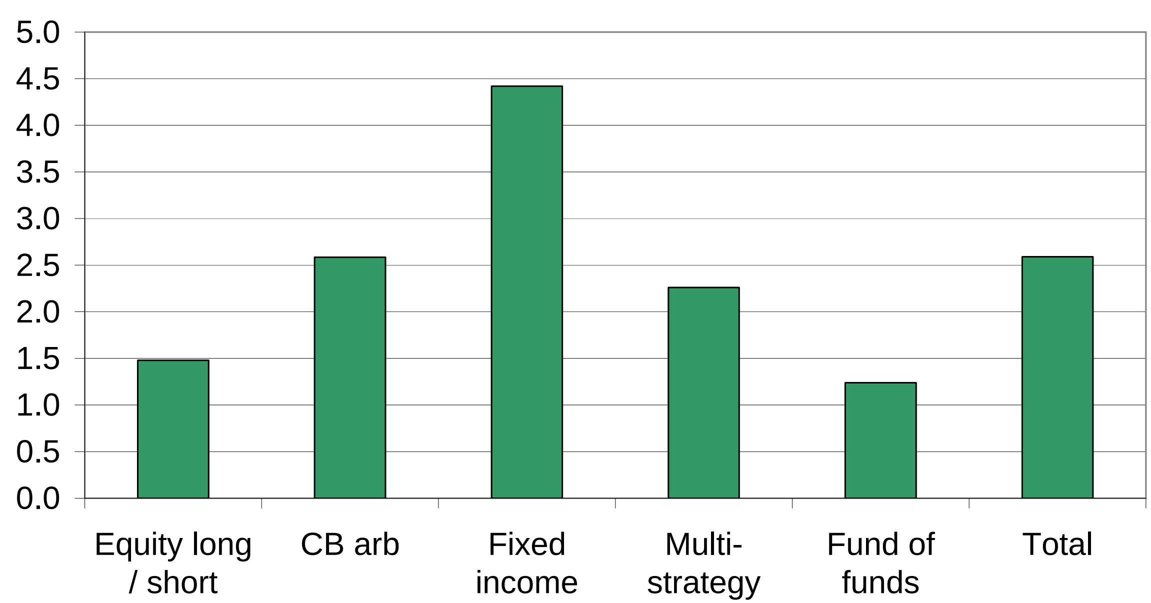
- Considerable variation in mix of strategies
- Some prime brokers dedicated to financing one main strategy
- Others more mixed



Leverage employed by hedge fund clients

- Long leverage: just one measure of risk
- Considerable variation
- As expected, most nominal leverage in fixed income
- Less in equity long / short or FoF

Aggregate LMV / Equity



Note: LMV = Long Market Value – mark-to-market value of long positions financed

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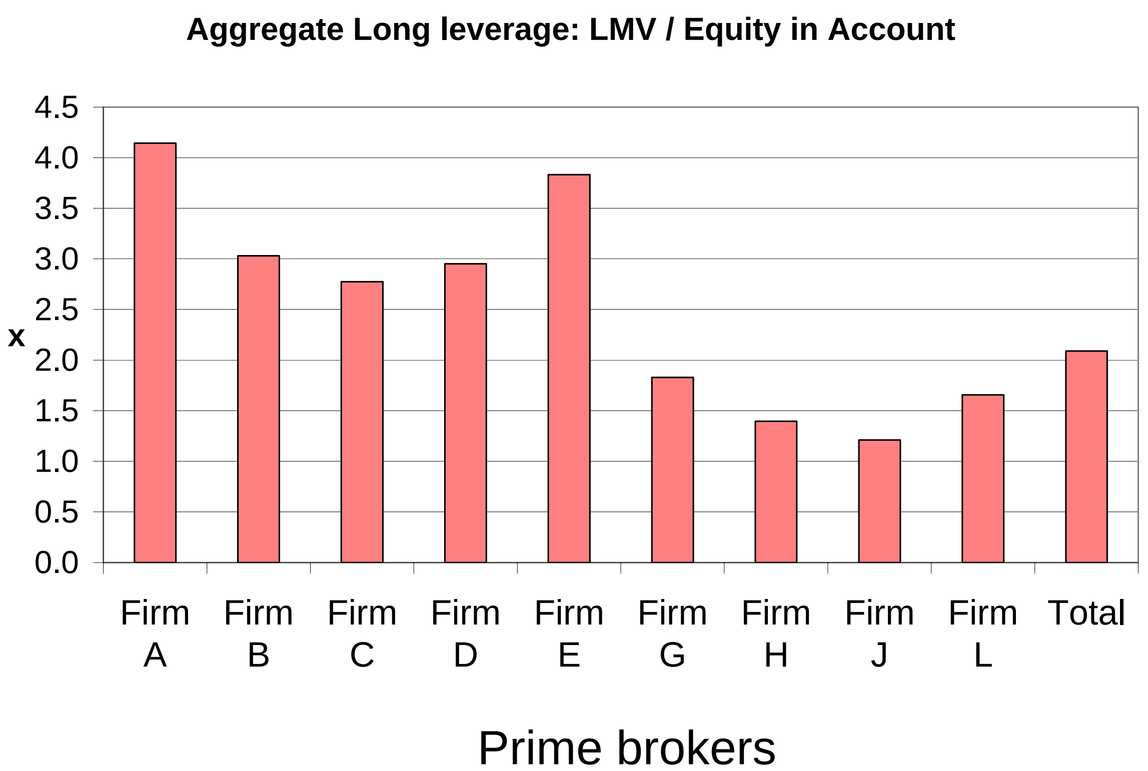
Leverage employed by hedge fund clients

- Long leverage by prime broker also varied considerably
- Generally correlated with strategy bias



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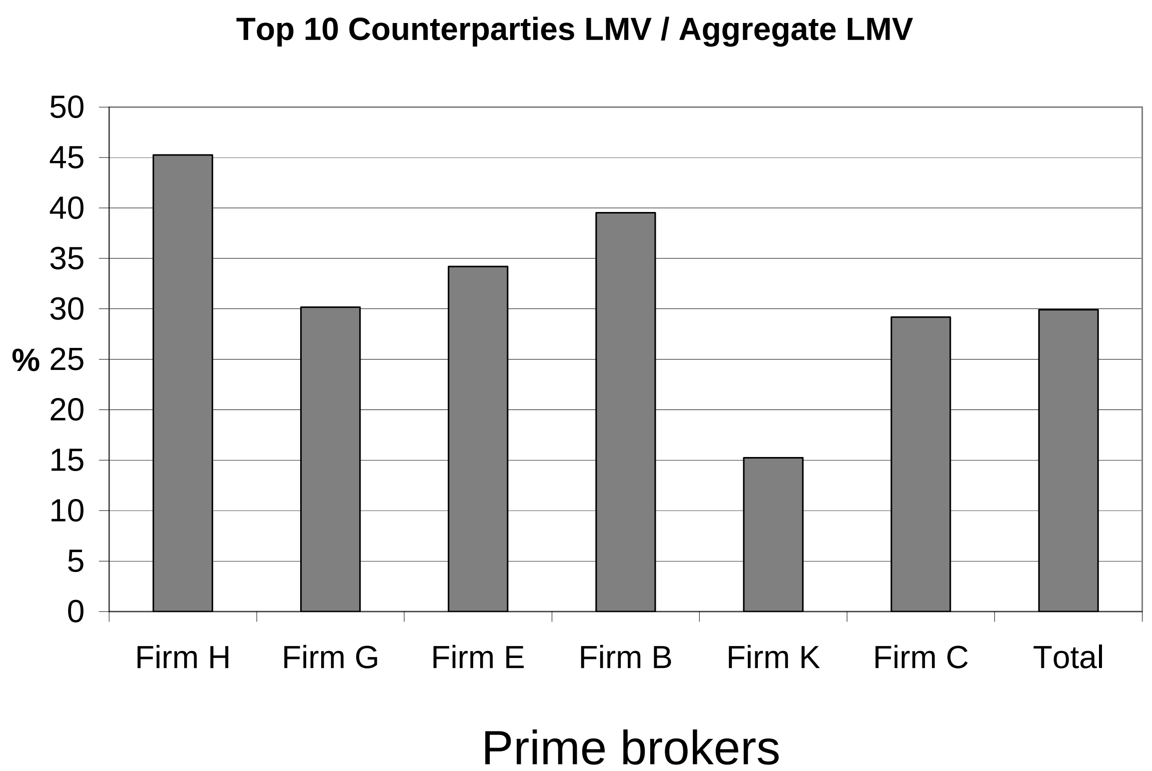
Concentration of business

- Also varies by prime broker
- On average, exposures seem well spread
- Top 10 LMV = 30% of aggregate
- 45% for one prime broker, less for others



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Conclusions (1)

Positives

- Greatly enhanced picture of an important feature of the UK financial market
- Impressionistic view of the distribution of leverage and risk
  - By strategy and by firm
  - By (unidentified at this stage) counterparty
- Some insight into firms’ abilities to aggregate and assemble information from a wide range of business lines
- May have stimulated senior management interest and enhancement of internal risk processes

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Conclusions (2)

Negatives

- Lack of named counterparties limits the value of the exercise
- Lack of time series makes some judgements more difficult
- Some differences in interpretation and completeness limit extent of comparability
- Differences in legal entity coverage
- Resource-intensive – both for firms and for us
- Potential for ‘moral hazard’

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Why are we keen to repeat the exercise in the future?

- Competition in the prime brokerage industry continues to increase and net inflows into hedge funds are rising
- We have obtained useful information on differences in the peer group, on strategic risk, risk profiles, and systems and controls
- We only have a ‘snapshot’ of exposures as at summer 2004 – a time series is needed to assess developments
- Continued concerns about finance providers’ ability to aggregate exposure data
- Can’t reach conclusions (yet) for individual funds in the absence of counterparty names – we are now obtaining these
- Sub-group of firms now working on improvements to the survey template for future use – keen to work with the industry

Questions

Have previous FSF recommendations on HLIs been implemented? If not, why not?

Recommendation/issue **(from 2000 report)**	**2004 assessment**
Overall risk management framework	Greater competition could be putting pressure on margin terms Potential/latent leverage has probably increased in recent years Diversification away from 'traditional' equity prime brokerage – models less well tested Better terms may be available for some counterparties outside prime brokerage platforms Potential conflicts via 'bringing the firm' Standard margin schedules usually in place; deviations generally seem to be well thought out (and audit trail documented)
Credit assessment and ongoing monitoring	Some firms do not conduct on site visits for all hedge fund counterparties prior to take-on Many firms found it difficult to aggregate PB and non-PB data Heavy reliance on investor newsletters for NAV/VaR data, too focused on historical data More funds are securing margin lockups
Exposure measurement	Some anecdotal evidence that PFE techniques have continued to improve (complexity / time horizons) but details not tested Stress testing used widely, mainly for monitoring purposes; some use this to determine haircuts
Limit setting	'Concentration' of business varies among the main players Many US-managed hedge funds obtain financing through the UK subs of Wall St firms to avoid regulatory restrictions on leverage (Regs T and U)
Senior management reporting	Reassuring – have seen examples of daily management reporting on portfolio changes, exceptions, clients on call etc)
Improvements in market practice	Anecdotal evidence that some prime brokers are paying less attention to establishing common dealing terms across clients
Transparency/disclosure	Limited progress; investor letters provided as standard, conference calls becoming more popular No progress on public disclosure initiatives

Questions

Is competition among prime brokers for hedge fund business leading to easier terms? Is desire for this business compromising risk management processes in regulated entities?

- Competition is clearly increasing
- Prime brokers are not necessarily competing aggressively for all types of business (i.e. by strategy or fund size)
- Most firms make good profit margins, but some new entrants may have underestimated barriers to entry
- No evidence of unsecured exposures to hedge funds, or funds being able to post zero initial margin
- Most firms have standard margin schedules in place, although terms can be negotiated
- Ambiguities remain about the scope of margin requirements; competition could be leading to easier terms in some cases

Questions

Does hedge fund engagement of multiple prime brokers undermine counterparties' ability to assess whole fund risk profiles, or the overall system's exposure to individual funds? Can large conglomerates aggregate their total exposure to hedge funds across the organisation?

- Growth of multiple prime brokerage relationships an inevitable consequence of the increased maturity of the market
- Smaller players have benefited from the trend towards multiplicity
- Multiple prime brokerage arrangements could lead to margin requirements proving insufficient where a large illiquid position is spread in what appear to be individually 'liquid' chunks
- Broad range of trading activities conducted by hedge funds means that counterparty exposures to funds arise across a large number of desks within a firm
- Survey work suggests that some firms found it difficult to aggregate total exposure to hedge funds across the business