

ZENTRALER KREDITAUSSCHUSS

MITGLIEDER: BUNDESVERBAND DER DEUTSCHEN VOLKSBANKEN UND RAIFFEISENBANKEN E.V. BERLIN · BUNDESVERBAND DEUTSCHER BANKEN E. V. BERLIN
BUNDESVERBAND ÖFFENTLICHER BANKEN DEUTSCHLANDS E. V. BERLIN · DEUTSCHER SPARKASSEN- UND GIROVERBAND E. V. BERLIN-BONN ·
VERBAND DEUTSCHER PFANDBRIEFBANKEN E.V. BERLIN

Public Comment on the Hedge Funds Oversight: Consultation Report OICV-IOSCO

April 2009

The ZKA¹ welcomes the opportunity to comment on the consultation report and agrees with IOSCO that hedge funds are very important in the international financial markets and that therefore regulation in this area should be globally coordinated as far as possible, as the G20 summit called for. We would like to comment specifically on the questions as follows:

Item 44: Do you believe that the FSF work will sufficiently cover the remuneration/ compensation issues / risks?

Item 63: Do you believe that Chapter 1 appropriately identifies and describes the relevant risks / issues associated with hedge funds and their operations?

Section 1 contains a description of the theoretical risks and efficiency-enhancing effects that accompany the activities of hedge funds in capital markets.

Nonetheless, the empirical finding should be taken into account that hedge funds have proven to be robust in the current financial crisis and that they have not substantially intensified or accelerated the crisis. Hedge funds that got into difficulties were closed without disturbing the market.

Regardless of this, the ZKA agrees with IOSCO that inadequate separation of responsibilities between investment management and the other corporate functions leads to increased risks. The ZKA therefore supports the demand to separate these areas of responsibility.

Likewise, the ZKA supports the calls for reliable valuation techniques and sound risk management.

Furthermore, the ZKA sees the principal agent issue rooted in hedge funds, with its particular peculiarity in the remuneration of the fund managers.

Finally, the ZKA recognises that with increasing leverage, the stability of the financial markets decreases, though this phenomenon is not limited to hedge funds.

¹

The ZKA is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public-sector banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks financial group, and the Verband deutscher Pfandbriefbanken (VdP), for the mortgage banks. Collectively, they represent more than 2,200 banks.

Thus, overall the ZKA concedes the necessity for additional transparency in order to better assess the systemic risk emanating from hedge funds and to be able to control it.

Item 118: Do you share the views that this type of information should be obtained from hedge fund counterparties? Do you support the call for strong risk management controls at these entities?

The ZKA agrees with IOSCO on the evaluation of the immense importance of the prime brokers. However, there are no indications that the risk management of the prime brokers was inadequate in the past. On the contrary, the development of the hedge fund sector over the past twelve months indicates that the prime brokers made adequate provisions for possible loan defaults. Prime brokers should therefore continue to monitor their lending to hedge funds on the existing basis. In turn, the supervisory authorities should monitor the lending practices of the prime brokers as well as their risk management systems.

The interest of the supervisory authorities in information about the exposures of the hedge funds is understandable. However, the ZKA believes that it cannot be the task of the prime brokers to supply the information specified in Section 117 to the supervisory authorities, as they could not be always completely informed about all of the items in the list. The hedge fund managers themselves are much better sources of the information desired here.

While existing information from prime broker relationships should be used by regulators in a consistent way, the regulatory burden of new information requirements should be put mainly on the hedge funds or the hedge fund managers. This is in line with the G-20 goal to ensure, that all relevant actors and all types of financial instrument are subject to appropriate regulation and oversight, and the recommendation of the High-Level Group on Financial Supervision (chaired by Jacques De Larosière), to 'extend appropriate regulation, in a proportionate manner, to all firms or entities conducting financial activities of a potentially systemic nature'.

In our opinion, the reporting duties of the banks should be uniformly regulated subject to bank supervisory requirements and not according to special criteria, as proposed here. For the rest, the ZKA believes that appropriate banking supervisory regulations already exist for the business with hedge funds. Finally, we wish to point out that this paragraph does not differentiate between depositaries and prime brokers with regard to the scope of reporting obligations, which however would be useful and necessary in view of the restricted duties of the former.

Item 119: Is direct regulation of hedge fund managers the best approach to addressing investor protection and systemic risk concerns raised by hedge funds?

Yes, at least it is the initially practical way to approach regulation of hedge funds. The process of creating greater transparency for hedge funds was begun long before the onset of the financial crisis. The results achieved in the meantime should not be ignored. In particular, the effect of the codes of conduct must be taken into account. Regulations already exist for the prime brokers. Insofar as regulatory measures appear necessary beyond these, direct regulation of the hedge fund managers is the right approach. Direct regulation of hedge fund managers is needed:

- in order that regulatory institutions and prime brokers get aggregate information on leverage and the use of debt of hedge funds,
- to aggregate standardised information on general strategies and developments.

Based on such information, regulators could then formulate limits on leverages.

Information which enables monitoring of systemic risks arising from hedge funds and should be collected in a standardised manner encompasses:

- the 20 largest items of a hedge fund on a nominal and risk-adjusted basis
- cash position
- liquid assets (i.e. debt of G-7 countries)
- leverage on a nominal and risk-adjusted basis.

This and further standardised information should be collected in a uniform manner to create a global information database. This could be part of the global “risk map” as proposed by the German "Issing Group". This early warning system could be located at the IMF/ the Financial Stability Board) or the BIS and could be combined with already available data on systemic risks arising from hedge fund business

- such as the regular information the British FSA collects on the activities and credit relationships of the large prime brokers and the insights from the ongoing exchange of information with hedge fund managers
- and the information contained in national credit registers.

In such a system, not only banks and prime brokers would be data suppliers, but also the hedge funds themselves. The information then could be seen by all market participants with a justified interest – at least in aggregated and anonymised form.

In addition to investor protection and systemic risk concerns, market integrity, i.e. the avoidance of market abuse, fraud, abuse of shareholder rights and the protection of public trust in the capital markets should be a further important objective of the regulation of hedge fund managers.

Item 121: Do you support the need for progress towards a consistent regulatory approach to hedge fund managers?

The ZKA supports this process.

Item 122: Do you agree with such a risk-based approach? What should determine whether a fund manager (or their underlying funds) are systemically important?

We agree on the system-oriented regulation approach and accordingly feel that a de minimis regulation is appropriate.

However, it may be difficult in practice to determine which hedge funds are systematically relevant and which ones are not. The assets under management or leverage alone are inadequate guidelines for this. This ignores the fact that hedge funds operate in different markets with various market mechanisms. From the point of view of the ZKA, further investigations are necessary to find a practical definition of a systemically relevant hedge fund.

Item 126: Do you agree with the proposed list of information to be provided at authorisation/registration?

We agree on the hedge fund information to be disclosed to the supervisory authorities.

Item 127: Do you agree with the proposed approach to ongoing supervision?

We agree on the proposed general principles of hedge fund monitoring. However, it must be noted that many hedge funds are relatively small. A certain proportionality of requirements should be preserved. With regard to the key requirements, the need should be mentioned that outsourcing of management functions should conform to the usual standards.

Item 128: Is direct regulation of hedge funds the best approach to addressing investor protection and systemic risk concerns raised by hedge funds?

What do you see as the benefits of direct regulation of the hedge fund itself? What requirements should apply at this level?

What type of information do you believe the regulator needs to have about the fund itself to allow for adequate oversight? At which frequency should the information be available?

The success of the regulatory approach with direct registration of hedge funds depends in large part on the ability to implement it for the offshore locations for hedge funds as well. Therefore, in principle an approach that covers the hedge funds themselves and not the hedge fund managers would be desirable. In many cases, investment companies delegate their functions to the managers to a large extent. As the goal of the regulation should be greater stability of the financial system, it is doubtful whether regulation of the hedge funds would lead to a qualitatively different result than regulation of the hedge fund managers. The information requirements specified in this consultation paper can be met completely by the hedge fund managers. It is not clear which additional information would be expected from the hedge funds themselves, unless the delegation of the functions to the managers does not take place or is restricted, which would be unusual.

The supervisory authority requires comprehensive insight into business practices and speculation secrets of the hedge fund in order to fulfil the targeted obligation to counteract systemic risks.

Item 131: Do you agree that IOSCO should support that a set of globally consistent industry best practice standards is developed and subsequently monitored? How do you believe the take up / compliance could be monitored?

We agree on a corresponding binding and globally coordinated obligation of hedge funds to comply with best practices and regard monitoring via the FSF as possible.

Item 134: Do you have any comments on the proposals made?

No further comments.