

Press release

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FSF makes recommendations to address potential financial system risks relating to hedge funds

The Financial Stability Forum (FSF) today issued a report recommending action by financial authorities, counterparties, investors and hedge fund managers to strengthen protection against potential systemic risks relating to hedge funds and other highly leveraged institutions (HLIs).

Activity by hedge funds has expanded rapidly since the FSF's 2000 report on HLIs. Their activities have generally been a spur to continuing financial innovation and, by absorbing risk, have provided greater depth and liquidity to financial markets. Over the same period, a small number of core intermediaries have come to play an increasingly important role in some key areas of wholesale financial markets. The relationships between these core intermediaries and hedge funds, through prime broking and counterparty relationships, have thus become more central to the robustness of the financial system.

Since the Long-Term Capital Management crisis, risk management practices and capacity at core intermediaries have been substantially enhanced. Risk management capacity at the largest hedge funds also has improved. But, while risk management techniques and capacity have been improving, products and markets have become more complex, posing heightened risk measurement, valuation and operational challenges for all market participants.

There recently have been some signs of erosion of counterparty standards that reflect the strength of competition for hedge fund business and which complement other signs of complacency about risk taking in financial markets. This heightens the importance of strengthening market discipline, buttressed by supervisors and regulators setting expectations regarding stronger counterparty risk management practices.

Effective market discipline requires that counterparties and investors obtain relevant information from hedge funds and act upon this information. Through such market discipline, counterparties contain leverage and its adverse effects on market dynamics. And rapidly changing products, rising trading volumes and closer market integration underscore the importance of continuing attention to infrastructure improvements. The FSF welcomes recent and ongoing public policy and private initiatives to address these issues.

Given the importance of strengthening protection against systemic risks, the FSF makes the following five recommendations to support and where relevant build upon ongoing supervisory and private sector work:

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

2. Supervisors should work with core intermediaries to further improve their robustness to the potential erosion of market liquidity.
3. 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.
4. Counterparties and investors should act to strengthen the effectiveness of market discipline, including by obtaining accurate and timely portfolio valuations and risk information.
5. 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.

The FSF underscores the importance of ongoing cooperation among financial authorities in taking forward these recommendations and in spreading good practices. It also notes the importance of authorities' market surveillance activities and of their continuing dialogue with a range of market participants and actors to keep abreast of innovation and to assess the adequacy of practices and policy approaches in addressing risks to financial stability.

The FSF will monitor work on these recommendations, as well as other areas relevant to the potential systemic risks associated with hedge funds. It will report to the G7 Finance Ministers and Central Bank Governors on the progress made, new developments and any judgements that the FSF makes about the need for further updates of its overall assessment and recommendations.

Notes to editors

The report published today follows a request by the G7 Finance Ministers and Central Bank Governors at their meeting in Essen in February for the FSF to update its 2000 report on HLIs. The present report provides a re-assessment of the financial stability issues and systemic risks posed by hedge funds. It does not address the investor protection issues associated with institutional or retail investments in hedge funds.

The FSF's original report on HLIs in 2000 set out a range of recommendations to address the systemic risks posed by highly leveraged institutions. The FSF published subsequent assessments of the progress made in implementing these recommendations in 2001 and 2002. These reports are available at www.fsforum.org/publications/publication_21_25.html . Since then, the FSF has continued to follow these issues closely.

The FSF brings together national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. It was established by the G7 finance ministers and central bank governors in 1999 to promote international financial stability through enhanced information exchange and international cooperation in financial market supervision and surveillance. The FSF is chaired by Mario Draghi, Governor of the Bank of Italy. The FSF's Secretariat is based at the Bank for International Settlements in Basel, Switzerland.

For further information on the FSF, its membership and other publications, visit the FSF website at www.fsforum.org.