

Hedge funds: changing

Spurred by new guidelines from the Basle Committee on Banking Supervision, investment banks have seized the initiative and are changing the way they conduct prime brokerage and other business with hedge funds. Jane Locke reports

A change in the way banks deal with hedge funds has been long overdue. One hedge fund manager at a leading US investment bank active in prime brokerage jokes that, before last year's hedge fund crises, banks would ask more questions before lending \$100,000 for a personal mortgage loan than they would before risking millions with a hedge fund.

Last month saw the publication of new guidelines that banks dealing with highly leveraged institutions (HLIs) must follow. Issued by the Basle Committee on Banking Supervision and produced by Jan Brockmeijer of the Dutch central bank, the new rules are the culmination of a study commissioned following the Fed-sponsored bailout of Long-Term Capital Management (LTCM) in September 1998 amid fears of a systemic crisis.

The report can be set against a backdrop of calls for greater regulation of hedge funds, with their reputation for being over-leveraged and too secretive. The report concludes, however, that – because hedge funds tend to be domiciled offshore – in practice, any regulation would be hard to enact. The way forward, it says, is in the hands of the banks.

Risk has gained exclusive access to a review of the industry by Bradley Ziff and Noel O'Reilly of Arthur Andersen in New York, which suggests that banks have already taken many of these ideas on board. According to Ziff, bank providers of prime brokerage services, credit lines and derivatives structuring have begun to modify their approach to hedge funds. In some cases, they are withdrawing from doing business with them altogether.

Ziff says that many second-tier banks that tried to capture hedge fund clients last year are reconsidering their original decision to enter the market. They will be the first to exit the hedge fund business, he says, potentially after the first or second quarter of 1999. Just last month, for example, Rabobank, the Dutch investment house, parted company with hedge fund supremo Ron Tannenbaum, who was previously global head of hedge fund coverage at UBS. It had originally hired Tannenbaum last August to raise its profile with hedge funds.

Those that continue to act as derivatives counterparties for hedge funds and

provide financing will be taking a tougher line, particularly in terms of credit lines and rules about disclosure. In fact, banks have already substantially reduced the amount of credit they are prepared to make available to hedge funds, says Sarah Street, managing director and funds team executive at Chase Securities in New York. Street structures trades and financing for hedge funds as part of Chase's global investment bank. "The events of last year changed things quite a lot, and not just for hedge funds. There has been an across the board change in the bank loan market," she says.

Haircuts – the additional collateral demanded by the lender over and above the loan being collateralised – are higher all round, according to Irene May, head of hedge fund relationships at JP Morgan in New York. And the firm has taken steps to implement more rigorous demands for collateral in instances where they were not previously in place. Previously, banks

did not impose haircuts when US Treasuries were put up as collateral and now they are charging about 1% (ie, the borrower must put up 101% collateral against the loan), while haircuts on emerging market debt, which were at 5-10%, are now in the 10-20% range, says May. And CSFB is ensuring that its collateral management unit is much closer to the business than it was prior to last year's crisis. Previously, says Ben Weston, head of CSFB's leveraged capital services group in New York, this was largely a back-office task. The bank is also trying to apply much more science to the way it calculates collateral requirements. "We are trying to be refined about it and recognise that both funds and instruments have different degrees of risk and require different amounts of collateral," he says.

Moreover, says Ziff: "It is no longer the case that banks are involved in a series of one-off transactions with hedge funds to make the spread on a trade." Instead, they now want to ensure that those hedge funds it deals with are "a good fit with the firm". For example, a bank that does not have an interest in emerging credit markets should be questioning the value of having a hedge fund that specialises in credit derivatives transactions as a client.

Prime numbers

According to Ziff, there are now only nine banks that provide hedge funds with a full derivatives and prime brokerage service – including the provision of credit lines, brokerage services and stock lending, and repo. Before last September's crisis there were 20 to 25 banks competing for this business. The remaining big league providers are: Chase Manhattan, Citigroup, Credit Suisse First Boston, Deutsche Securities, Goldman Sachs, JP Morgan, Merrill Lynch, Morgan Stanley Dean Witter and UBS. But some dispute that all of these are still committed to hedge fund clients. In addition, there are still some niche players that specialise in providing hedge funds with specific instruments. For example, Toronto-Dominion structures credit derivatives for hedge funds, but it is not a full-service provider.

Those banks that have decided to stay in the hedge fund business are being much more rigorous in terms of demanding disclosure and transparency. JP Morgan's May says: "The first priority is

Bradley Ziff, Arthur Andersen: banks are reviewing their decision to enter the market



the rules of the game



Jan Brockmeijer, chairman of Basle's hedge fund committee. The guidelines are intended to act as a kind of benchmark

to make sure we have a better sense of the risks embedded in their portfolios.”

“It is all about transparency,” says Ron Rosenberg, head of the global leveraged strategy group at Merrill Lynch in New York. “Transparency may have become a buzzword, but it is very important. Before the crisis last year, banks were not aggressive in getting information.”

The Basle report highlights several deficiencies in some banks’ risk management practices with respect to certain HLIs. It states that hedge funds pose “particular challenges to the risk management process, given the relative opaqueness of their activities”, and adds that risk management is often compromised due to the strongly competitive environment between creditors.

Banks’ due diligence processes were inadequate, the report states. Too often, credit limits were set according to the reputation of the fund. Many dealers agree that Wall Street became too entranced by LTCM’s John Meriwether, and his Nobel Prize winning colleagues, Myron Scholes (who announced he was leaving LTCM last month) and Robert Merton. Banks also relied too heavily on collateral management systems for ongoing exposure monitoring, ignoring secondary market exposures.

The Basle Committee report on hedge funds makes a number of recommendations. Those banks that have dealings with HLIs, it says, should:

□ establish clear policies and procedures for interacting with HLIs as part of the

overall credit risk management environment;

□ employ sound information-gathering, due diligence and credit analysis practices that address the specific risks associated with HLIs;

□ encourage the development of more accurate measures of exposure resulting from trading and derivatives transactions;

□ set meaningful credit limits for HLIs;

□ link credit-enhancement tools, including collateral and early termination provisions, to the specific characteristics of HLIs; and

□ closely monitor exposures to HLIs, taking into account their trading activities, risk concentration, leverage and risk management processes.

No way back

Institutions with exposures to HLIs have already put in place many of these increased safeguards, the report acknowledges. According to Jan Brockmeijer, chairman of the Basle working group, the purpose of issuing the guidelines is to establish a kind of benchmark such that, once gained, there can be no backsliding into the old-style practices. The banking community accepts that, in the rush to secure lucrative hedge fund clients, many banks had let basic standards slip in terms of margins, haircuts and transparency. Merrill Lynch’s Rosenberg says: “Before the fall, Wall Street was a little too aggressive in competing on credit terms, and the crisis caused a kneejerk aversion to risk. Now the industry seems to have found an optimal equilibrium.”

Last year many banks had an “over-reliance on collateralisation of mark-to-market exposures”, the report says. But last year’s events proved that collateralising a trade does not insure against losses, as the value of the collateral does not necessarily move in line with the size of the exposure. It also stresses that banks must develop more meaningful measures of potential future exposure, which should give an accurate picture of the extent to which banks are involved with their counterparty in relation to their overall activities – incorporating netting, portfolio effects across products, risk factors and maturities – and be analysed across multiple time horizons.

Banks must develop more effective measures for assessing the unsecured risks inherent in collateralised derivatives positions, says the report. Potential delays in the collateral process can create a significant unsecured credit exposure



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Ben Weston, CSFB

in a volatile market. According to the report, banks should obtain comprehensive financial information about an HLI, covering both on- and off-balance-sheet positions, to understand the overall risk profile of the institutions, as well as standard due diligence information such as credit references. And such information should be updated regularly, particularly when there are any changes in trading activities, profit and loss developments, significant changes to leverage, alterations to risk management procedures or the risk measurement process, and shifts in key personnel.

According to Merrill Lynch's Rosenberg, some of the bank's hedge fund clients already fully disclose the positions in their portfolios to Merrill Lynch's credit department. Rosenberg stresses that

there are "Chinese walls" in place between the credit department and the rest of the bank; in other words, the credit department is watertight.

But CSFB's Weston says pushing the Basle guidelines through may not be all plain sailing. Irrespective of the number of positions it holds, or the amount of capital it has under management, a hedge fund may not be a large business – it may have few back-office personnel, unfamiliar with regulatory reporting or what would be required administratively to meet the guidelines' requirements. Weston says: "I think this is a real opportunity for prime brokers and other fund information providers to put together standard comprehensive disclosure packages for their hedge fund clients. In this way, a standard market will evolve." He adds, however, that in such a competitive market it only takes one bank to break ranks to bring the whole process to its knees.

But hedge funds do not have much choice, because they need the banks more than the banks need them, says Arthur Andersen's Ziff. Chase's Sarah Street says there is a direct correlation between the degree of transparency hedge funds provide and the business Chase is willing to do with them. "Our view is that the more they tell us about their business, the more we can help them achieve. Otherwise, we are limited in what we can do with them," she says.

Disclose to survive

In the main, hedge funds accept the need to disclose more information about their trading activities, the banks say, and most have been co-operative. But Leon Metzger, executive vice-president of Paloma Partners, a Connecticut-based hedge fund, expresses the real concern that Chinese walls at banks between the trading floor and credit departments might be breached. John Meriwether, the chairman of LTCM, interviewed for the *New York Times* recently by Michael Lewis, author of the book *Liar's Poker*, complained bitterly that information about LTCM's positions leaked into the market and banks put on copy-cat trades through their proprietary trading desks.

Paloma Partners' Metzger raises another objection. Bank counterparty credit departments are unlikely to be able to understand the strategy implied by a complex set of positions held by a sophisticated hedge fund, he says. So even if the fund does disclose full details of its activities, the credit departments will not necessarily understand them. Ensuring that fund disclosures are meaningful will be difficult, says CSFB's Weston. For instance, at what point do details about a fund's changing exposure cease to be-

come useful information for a bank? Weston says one hedge fund manager he spoke to revealed that he would bombard his bank with every last detail on a daily basis to obfuscate his fund's positions and trading strategy.

In general, the Basle Committee's report has been well received, allaying fears in the market that regulators would attempt to extend their jurisdiction to cover hedge funds. But if the guidelines it has laid down for banks should prove insufficient to alleviate systemic risks caused by HLIs, the committee has made it clear that it would consider a more direct approach. "If deemed appropriate, direct regulation could take a number of forms, including licensing requirements, fit and proper tests, minimum capital standards and minimum standards for risk management and control," the report says. But the working group acknowledges that imposing such controls would be difficult as many funds are domiciled offshore, so any legislation would have to extend to these jurisdictions.

Paloma Partners' Metzger believes the committee has taken the right approach in curbing banks' activity rather than trying to control hedge funds. "It is far more efficient and effective to regulate the banks' lending practices than to regulate highly leveraged institutions' borrowing practices," he says.

Chase's Street hopes that hedge funds will take on board the lessons of last year in terms of refinancing risks. Many relied heavily on overnight repo and short-term financing from prime brokers and their counterparties. In effect, the funds were granting the banks the option to cut their financing lines over night. "The smart funds realised how relying on short-term funding can cost them a lot of money in times of market crisis," she says. If a bank pulls back on such a credit line overnight, funds have no choice but to liquidate their positions at fire sale prices if this coincides with a major market dislocation. This was exactly the situation that plagued Ellington Capital Management, a hedge fund operating out of Old Greenwich, Connecticut. Over the past six months, Street has seen funds try to find more committed forms of financing and thus having to accept more credit restrictions than in the past. "Refinancing risk has been way underestimated for years and funds have overestimated the value of Wall Street relationships," she says.

It remains unlikely that hedge funds will have to give banks as much information as ordinary mortals when applying for credit, but banks are unanimous when they say that after enduring such a period of strain, their relationships with hedge funds will be much stronger and healthier. ■