

Box 14

LARGE EU BANKS' EXPOSURES TO HEDGE FUNDS

Over the last couple of years, the hedge fund industry has expanded rapidly. Because of the important role that hedge funds play as participants in financial markets and as counterparties to financial institutions, especially banks, it has become increasingly important to monitor their activities and to assess the implications for financial stability. Against this backdrop, the ESCB Banking Supervision Committee decided to investigate the links between EU banks and hedge funds. This Box reports on the main findings of this survey.¹

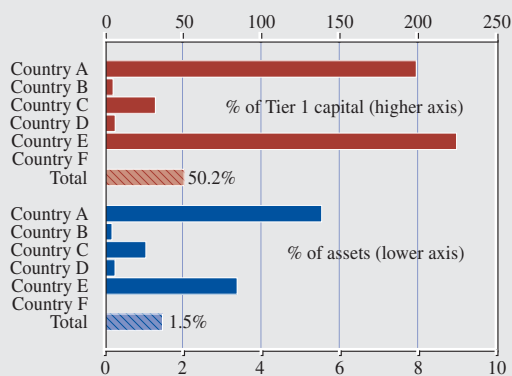
The survey excluded subsidiaries and branches of non-EU banks, some of which, primarily US ones, were leading global financing and trading counterparties of hedge funds. More than 40 EU banks from 14 countries provided qualitative comments and sometimes quantitative data on their connections with hedge funds. Based on the provided coverage information, 35 surveyed large banks (including 11 smaller banks with mainly investment exposures) as a group constituted around 1%, 55% and 38% of respectively the total number, consolidated assets and Tier 1 capital of all eligible banking groups in these countries. Some quantitative data was supplied by 22 large banks from seven EU Member States.

Regarding banks' *financing exposures*, at the end of 2004, for the 14 large banks from six countries (AT, DE, ES, FR, NL and SE), the absolute amount of cash lending to hedge funds collateralised with securities (e.g. via reverse repurchase agreements) totalled almost €100 billion, and large banks from two countries clearly dominated in the sample (see Chart B14.1). For the smaller sample of five banks from four countries, which also provided 2003 data, lending increased 1.5 times in 2004. In general, banks extended either no or only negligible

¹ ECB (2005), *Large EU banks' exposures to hedge funds*, November.

Chart B14.1 Cash lending to hedge funds collateralised with securities

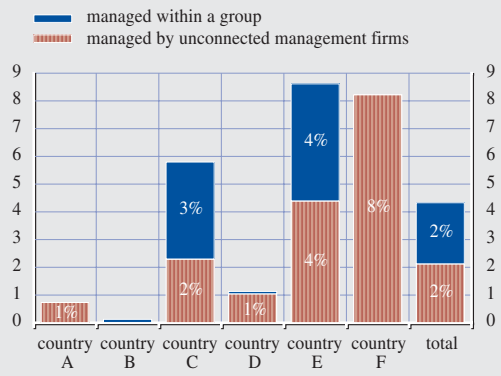
(end-2004, % of Tier 1 capital and assets)



Source: Banking Supervision Committee.
Note: Based on a sample of 14 large banks from six EU Member States.

Chart B14.2 Investments in hedge funds

(end-2004, % of Tier 1 capital)



Source: Banking Supervision Committee.
Note: Based on a sample of 16 large banks from six EU Member States.

amounts of unsecured lending, and many banks had policies completely forbidding unsecured credit exposures to hedge funds. A number of banks indicated that lending spreads had declined over 2004, especially for lending to larger hedge funds, as competition in this segment was the most intense.

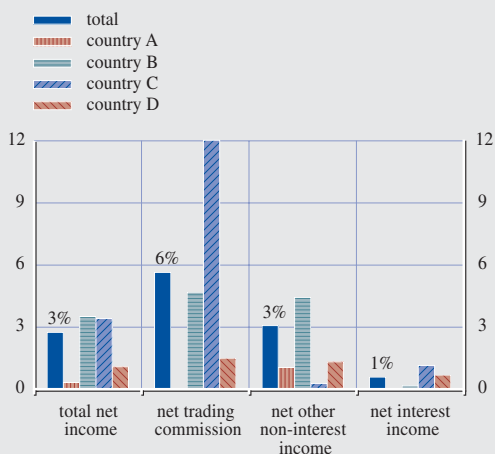
In many EU Member States *investments* in (funds of) hedge funds were the major and sometimes the only form of direct links with the hedge fund industry. Banks saw such investments as a way of gaining attractive risk-adjusted returns and improving the diversification of their investment portfolios. At the end of 2004, the total amount of investments in hedge funds by 16 large banks from six countries (AT, DE, ES, FR, NL and SE) exceeded €9.4 billion, although most of these investments were made by large banks in two countries (see Chart B14.2). In 2004, total investments by the smaller sample of five banks from four countries that also provided 2003 data increased by 52%, and allocations to unconnected hedge funds grew more rapidly.

Regarding *trading exposures*, for five large banks from three countries (DE, FR and SE) the estimated gross market value of OTC contracts outstanding with hedge funds in derivatives made up 2.7 % of all outstanding banks' OTC contracts in derivatives at the end of 2004. In the case of OTC interest rate derivatives, the share was 2.4%. Based on banks' comments and some quantitative evidence, it seems as if hedge funds were not key banks' counterparties in credit risk transfer markets and probably, on aggregate, were net credit protection buyers from banks.

Finally, on banks' *income exposures*, according to the quantitative data from nine large banks from four countries (AT, FR, NL and SE), banks earned nearly €0.8 billion from hedge funds in 2004. However, the share of net income derived from hedge funds was not high in relation to total net income and its sub-components, although proportions were higher for net trading commissions (see Chart B14.3). Across countries, net trading commissions made up the largest share of total net income derived from hedge funds. Moreover, for the smaller sample of four banks from three EU Member States that also provided 2003 data, the growth of total net income and its sub-components derived from hedge funds was much faster than the net income

Chart B14.3 Share of net income derived from hedge funds

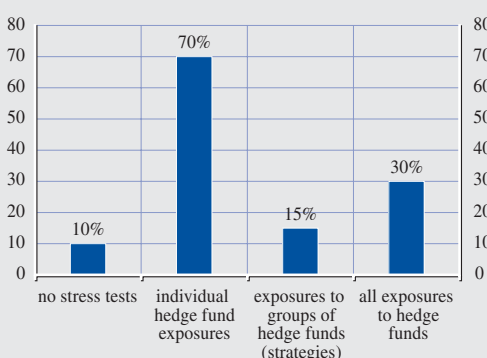
(2004)



Source: Banking Supervision Committee.
Note: Based on a sample of eight large banks from four EU Member States.

Chart B14.4 Scope of stress testing

(% of banks, answers not mutually exclusive)



Source: Banking Supervision Committee.
Note: Based on a sample of 20 large banks from seven EU Member States.

growth from all activities in 2004. This positive contribution may further intensify banks' efforts to foster hedge fund-related business and to attract more hedge fund clients, most likely putting further pressure on applied price and non-price credit terms.

With respect to risk management practices, most banks that extensively dealt with hedge funds had specific guidelines for this interaction as well as advanced risk management systems, or were in the process of further enhancing them. Surveyed banks generally had stringent requirements for exposures to hedge funds, with a strong emphasis on collateralisation. Nearly all cash-lending exposures to hedge funds were collateralised. Moreover, many banks with higher financing and trading exposures used sophisticated potential future credit exposure (PFE) measures to calibrate the expected downside risks of their hedge fund exposures that arise from the interaction of market, credit and illiquidity risks. Most banks also reported that they used stress tests to evaluate the potential effects of volatile or illiquid markets on their exposures. Regarding recent developments, banks did not see any systematic increase in risk-taking, as leverage levels across hedge fund clients seemed to be moderate and lower than in 1998, even though funds of hedge funds were reported to be increasing leverage. It has to be noted, however, that banks generally did not have any information on off-balance sheet leverage arising from trading in derivatives.

The survey also highlighted several areas with scope for further improvement that could become a cause of concern, particularly if the current rather benign market conditions were to change abruptly. These are:

- (i) *counterparty discipline*, as applied by banks, was found to be under pressure owing to highly competitive market conditions. Hedge funds, particularly the larger ones, were successful in negotiating less rigorous credit terms, including, for example, lower lending spreads, higher NAV decline triggers or trading on variation margin only;

- (ii) most *stress tests* applied by banks, particularly the regular ones, included only historical scenarios and often were applied to individual hedge funds only (see Chart B14.4). In addition, the stress testing of collateral was less common and offers further scope for improvement;
- (iii) *aggregation* by banks of their exposures to hedge funds across the entire financial group and/or different business areas/geographical regions was sometimes seen as problematic;
- (iv) hedge fund *disclosures* and *information on leverage* were, despite some progress, lagged and not always adequate. In many cases hedge funds still provided banks with relatively crude measures of leverage, although an increasing number of hedge funds were supplying more advanced risk-based measures of leverage;
- (v) banks' descriptions of their risk management practices also raised questions whether banks were sufficiently taking into account and/or had enough timely *information on the whole portfolio structure of hedge funds*, particularly on the larger ones with financing and trading relationships with several counterparties.

All in all, direct exposures to hedge funds of the large EU banks surveyed varied across countries and generally were not substantial in relation to banks' balance sheets and total revenue. However, even the limited data provided indicated that exposures were growing rapidly, although in most EU Member States these have remained negligible and/or mainly in the form of investments. It is very likely that the absolute and relative size of exposures to hedge funds will increase further in line with the continuing expansion of the whole hedge fund industry, and in particular its European segment. Most of the recommendations that were raised after the near-default of LTCM remain relevant, and banks should further continue to strengthen the risk management of their exposures to hedge funds. Moreover, banks should resist market pressures to lower credit standards applied and should continue to insist on more transparency from hedge funds.