Documentation

Jochen Sanio: Should Hedge Funds Be Regulated?

The following is the advance text of a speech given by Jochen Sanio, president of the German Federal Financial Supervisory Authority, at the "Top Ten Financial Risks to the Global Economy" Conference organized by the Global Markets Institute (Goldman Sachs), and held on Sept. 22, 2005 in New York City. It reflects an ongoing discussion within the banking community which seldom reaches the media in the United States.

It is indeed very interesting that you have asked me, of all people, to comment on whether hedge funds should be directly regulated or not. I have had a clear opinion on this issue since 1998, the year of the LTCM crisis, and I do not think that I will change it in the foreseeable future. I am, and I always will be, an advocate of direct regulation. If you call me a hardliner, I wouldn't be offended. My opinion has nothing to do with the recent highly emotional debate in Germany about "locusts," as hedge funds have been called by certain politicians in my country. I am not an entomologist, I am a supervisor, and as a supervisor my interest is financial stability. And I am deeply concerned about the systemic risk posed by hedge funds. But let me emphasize at the start that today I am speaking purely in a personal capacity. Any views I offer you in this session are entirely my own.

In the relatively short time I am allotted today, I will explain some of my concerns. Hedge funds do handle huge amounts of money, and their highly leveraged business carries enormous risks. Those risks should be reflected in the capital that hedge funds hold. The idea that hedge funds have enough capital today, as an adequate cushion for crisis situations, appears entirely counter-intuitive. If a hedge fund cannot fulfil its obligations, large counterparties could be affected. This has already been pointed out in the LTCM report of the Basel Committee on Banking Supervision, which was published in the Year 2000. The counterparties that are most vulnerable to contagion are prime brokers. There seem to be signs that prime brokers have recently become more aggressive in soliciting hedge fund business which obviously is a growing source of income. It would be rather worrying if the trend towards an erosion of collateral continued. Therefore, it would be foolish to believe that prime brokers are able to replace supervision—even though this idea seems to be very tempting.

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German Federal Financial Supervisory Authority, Jochen Sanio (right), shown here with Chancellor Gerhard Schröder (middle), and Bundesbank Board member Edgar Meister. Sanio said, "We can only get a grip on the systemic risk posed by hedge funds by regulating them directly. . . . The question is not whether hedge funds will cause a disaster; the only question is when."

Indeed, some people seem to think that we can handle the systemic risk posed by hedge funds by simply relying on the industry's will to regulate itself. With all due respect, I beg to disagree. Please don't misunderstand me. I warmly welcome industry initiatives such as the in-depth report of the Counterparty Risk Management Policy Group II chaired by Jerry Corrigan. Its recommendations are valid and should be followed. However, the report's proposal No. 47 concerning hedge funds is not without problems. Simply collecting large-exposure data does not appear to me to be a satisfactory solution—whether it be directly by asking hedge funds to deliver such data to supervisors, or indirectly by making them report to traditionally regulated financial institutions such as prime brokers. Those wishing to follow this line take it for granted that prime brokers would act swiftly after receiving negative information. This is a gamble I would not like to take. We cannot hand over supervision to private parties that are far from being neutral, but are pursuing their own interests. As regards the direct variant of proposal No. 47, let me just note that a supervisor who is relegated to the role of a mere observer isn't a supervisor at all. What use is even the best possible information if we supervisors cannot act on it accordingly? I would not like to be involved in such a process, because our involvement would be very likely to create a false sense of security in the markets which would be dangerous and counterproductive. All in all, the group's proposal No. 47 amounts to privatization of supervision, and therefore doesn't make much sense.

I also have my doubts about the Group's recommendations concerning risk management issues. I do appreciate these standards and I do share the opinion that hedge funds should adopt them, but who will actually enforce them, pray tell? In the case of banks and broker dealers, peer group pressure and regulators will hopefully play a part in ensuring that any gaps will be filled in due course. Will market discipline and peer group pressure do the same job for hedge funds on a stand-alone basis? I think not. Why should hedge funds today feel under pressure to play along? They seem to hold all the aces in this game. Initiatives on a voluntary basis have worked only in particular circumstances. The best guarantee for success is the fear of the legislator.

Ladies and gentlemen, we can only get a grip on the systemic risk posed by hedge funds by regulating them directly. Huge amounts of regulated money are flowing into unregulated hedge funds. This process may even be encouraged by Basel II, because banks' capital requirements for high-risk assets will increase significantly, and the banks may therefore tend to leave their risky assets to other players—such as unregulated hedge funds. We have to stop this massive game of regulatory arbitrage, otherwise the riskiest assets will disappear into black holes, and our chances of controlling them will be nil.

Those who call for regulation must say how this can be done. Today's regulatory answer to systemic risk in the banking area is supervision of capital requirements and risk management. I would propose the same combination to be applied to hedge funds. Risk-sensible capital requirements would be the only appropriate means to eliminate, once and for all, any excessive leveraging. But even if the overwhelming majority of hedge funds already had adequate capital reserves, risk management would still be a very important issue—not only from their own perspective, but also from a regulatory point of view. Adequate risk management is very costly—banks know this—and very often the necessary investment is made only to meet obligatory requirements.

One thing should be clear, though: Regulation of hedge funds will only work properly if we develop internationally consistent and internationally recognized regulatory standards. If we fail to do so, the massive arbitrage game will continue—in a different way—by shifting the business to under-regulated jurisdictions. What we need is a world standard that would have to be implemented even by off-shore centers. But, alas, the international regulatory community lacks drive and, until now, has not shown much interest in drafting international standards for hedge funds. This is nothing new. After the LTCM crisis, the Basel Committee discussed the hedge fund question, and its enthusiasm for regulating them was underwhelming. Things have not changed since then.

But even if I am the voice of one crying in the wilderness, I will insist that the risks of inaction are high. The question is not whether hedge funds will cause a disaster; the only question is when. I will then wash my hands in innocence.