The IMF-FSB Users Conference

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Topic: What are best practices in monitoring systemic risks arising from hedge funds and other large unregulated non-bank financial institutions?

Intro

Good morning Ladies and Gentlemen,

It is a honor and a privilege to be here today participating in this very important and timely conference. The topic I have been asked to speak on-what are best practices in monitoring systemic risks arising from hedge funds and other large unregulated non-bank financial institutions -requires us to first identify what these risks are. However, prior to doing that I would like to offer a brief overview of the Cayman Islands' regulatory regime for hedge funds.

Despite the topic's inclusion of hedge funds among unregulated financial institutions, the Cayman Islands is one of the few jurisdictions that actively regulate the fund itself, rather than its Adviser or Manager, as is done, or is proposed to be done, in most onshore jurisdictions. Therefore, when we are considering the risks, we are also looking at the funds themselves.

The Mutual Funds Law (2007 Revision) ("the Law" or "MFL") identifies three categories of regulated funds: Licensed funds, Administered funds and Registered funds. The Law and supporting rules and regulations also makes a distinction between private funds and public or retail funds, which are marketed more generally to the public at large.

The regulatory requirements for public funds are far more onerous than private funds, but that is not to say that private funds escape regulation. Instead, promotion of separate regulatory frameworks for non-public funds and the public or retail funds seeks to allow greater innovation, flexibility and creativity for the traditional hedge funds to prevail. This makes for more expeditious registration and launching of these funds, while also allowing access to funds of hedge funds by retail investors to progress under a more prescriptive, rule based, regulatory regime.

The Registered Funds mentioned previously, is the category of funds most commonly used by hedge funds. The MFL provides for two types of hedge funds to be known as registered funds: those with minimum investment of US$100K and those listed on a stock exchange. The vast majority of funds registered in the Cayman Islands fall into the category of private hedge funds, which in practice have minimum investment levels of over US$1 million.

For these Registered Funds, the overriding regulatory objective is to compel proper disclosure by fund operators (Directors, General Partners or Trustees) so that investors are not misled about the nature of the risk taken. This is achieved primarily by requiring these funds to prepare and file offering documents that describe the equity interests in all material aspects and provide other information as is necessary to enable a prospective investor to make an informed decision whether or not to subscribe for or purchase the equity interests. These funds are also required to advise the Authority promptly of any material changes affecting any information in the offering document or prescribed details of the offering document filed with the Authority.

Notably, recent reports issued by various international regulators and standard setters express doubt that a single fund could pose a systemic risk because it would require that this entity be very large and heavily invested in numerous markets to be able to seriously adversely affect other players in the markets in the event of its collapse.

While it could be argued that this was the case for Long Term Capital Management, this case is the exception rather than the rule. Collectively however it is possible that by their sheer number, total asset holdings by the industry and international structure, a large number of funds together can pose a systemic risk.

Identifying Risks

In considering this we sought to look at what risks posed by hedge funds could potentially be systemic. The primary areas identified were liquidity, leverage and investment strategy, with the availability and reliability of information in these areas being the largest obstacle to risk mitigation.

The inability to ascertain the value of portfolios held by hedge funds, based on the illiquid positions held by most, was alleged to be one of the primary causes of the current credit crisis. A compounding factor was the imposition of redemption suspensions or gates in some funds which left investors unable to redeem. This negatively contributed to the market wide liquidity shortage experienced during the crisis. As such, getting more information about funds' liquidity -on an individual and aggregate basis- over time could provide valuable data that will allow regulators to determine whether regulatory measures would be appropriate.

It is often said that funds' use of leverage is a prime reason why these entities pose a higher level of risk than other institutions. However recent studies done, such as the Turner Report published in March 2009, seem to belie this notion, as leverage in funds has consistently been less than that used by large, regulated institutions such as investment banks; a factor highlighted by the credit crisis and the recent failure of large, big-name institutions.

It is necessary to recognize that these institutions are the counterparties to funds in many instances. Therefore their use of leverage, combined with the fund's use of leverage can reach unsustainable levels and ultimately cause a collapse of financial markets.

It is important to note that these counterparties are regulated entities in many if not most jurisdictions and are already subject to limits on lending and large exposures. Banks withdrawing loans from funds in difficult market conditions can exacerbate the distress of funds facing difficulties. Leverage is therefore a factor that should be monitored over time to identify leverage trend creeps or spikes and, if appropriate, impose regulatory measures.

The third area of possible systemic risk is the investment strategy used by funds. The wide varieties of investment strategies provide important benefits to financial markets in normal times, including liquidity, risk distribution and diversification. Moreover, some strategies used by hedge funds have low levels of correlation with equity markets, which allows investors to achieve returns in all types of economic conditions.

While trading strategies are proprietary and not generally disclosed, it is possible that the investment style and strategy of several funds could converge. This poses a potential systemic risk, as all the funds with similar strategies will move en masse, for example liquidating positions after a trigger. This risk caused by the convergence could be amplified if the funds are highly leveraged.

Best Practices

In response to the systemic risks I have highlighted, the Authority examines and considers what information is necessary to know about these funds to better enable effective oversight of these key areas.

One such measure is the ongoing reporting obligations, mentioned previously, for all regulated funds set out in section 4(8) of the MFL. Here it is stated that "any change that materially affects any information in the offering document filed with the Authority or in the prescribed details of the offering document filed with the Authority…" must be communicated within 21 days of such change taking place. This would include information regarding changes to the investment strategy.

In addition, all regulated funds are required to submit annual audited financial statements within six months of the financial year-end via the Authority's web-based portal ("E-reporting"), accompanied by a Fund Annual Return ("FAR"), which provides a snapshot of financial information contained in the audited financial statements and information taken from the offering document. Through this method the Authority is able to gain information on the assets and liabilities of the fund, current investment strategy, subscriptions and redemptions level, etc.

Another valuable source of information for the Authority is the on-site inspection process, which is conducted on licensed mutual fund administrators ("MFA"). During this process, a sample of the MFA's funds under administration is also reviewed, which provides information on the fund's portfolio composition, its pricing methods, etc. Additionally, by improving the onsite inspection process through greater collaboration of worldwide regulators, a new era of sharing supervisory information such as due diligence, fitness and probity, inspection report findings, etc could emerge and reduce systemic risks. This would broaden our overall understanding of the risks and help standardize regulators' requirements on corporate governance, valuation methods and other key aspects of entities' operations.

The Authority recognizes that like many other regulators around the world, we face challenges associated with the information-gathering methods utilized and the timeliness of obtaining pertinent information. Audited financial statements and FAR's are filed annually, arriving a minimum of six months after the financial year-end. Onsite inspections are conducted on a risk-based cycle thereby occurring every one to five years, depending on the MFA's risk profile.

There is also the issue of having on staff the required expertise to accurately decipher the information gained.

Another challenge for regulators is being able to use the information gained from these information-gathering activities. For example, if trend monitoring discloses a build up of systemic risk across the industry it is uncertain what actions are available to a regulator to stop that trend. It is not the regulator's job to either interfere in the course of the markets or manage the investment decisions taken by a fund. Perhaps the only remedy available to a regulator when it has identified this build up of risk is to have at its disposal measures to ensure an orderly wind down of the institution if it does fail.

Cost is also a factor. Regulators are limited in what they are able to do based on budget, which means having to identify carefully the main areas of focus to enable effective regulatory oversight.

CONCLUSION

Despite these common challenges, future best practices must evolve from within the hedge fund community at large. By addressing the issues of liquidity, leverage, investment strategy, and transparency we can collectively make standard a protocol of best practices that enables us to best serve the interest of the international community, our individual jurisdictions and all stake holders.

We at the Cayman Islands Monetary Authority remain committed to ensuring a transparent and robust regulatory regime. We recognize that obtaining reliable data, whether through increased usage of E-Reporting by expanding the FAR data to capture leverage and other relevant information or other identified means, is one of the best ways to ensure this transparency.

The Authority is focused on enhancing international cooperation and maintaining ongoing dialogue with the local industry and international standard setters to identify the information necessary to effectively monitor its funds and further prescribe and implement best practices. It is recognized that improved coordination and exchange of information among regulators should be strengthened, particularly from a cross-border and cross-functional perspective. Ultimately, the sharing of information will be a fundamental tool in enhancing the regulatory oversight of the financial markets in the future, while the building of trust between the regulator and industry players will allow for more understanding of the trends developing. By working together the hedge fund community can collectively build vibrant markets.