BANK FOR INTERNATIONAL SETTLEMENTS

Regulatory framework for hedge funds and private equity

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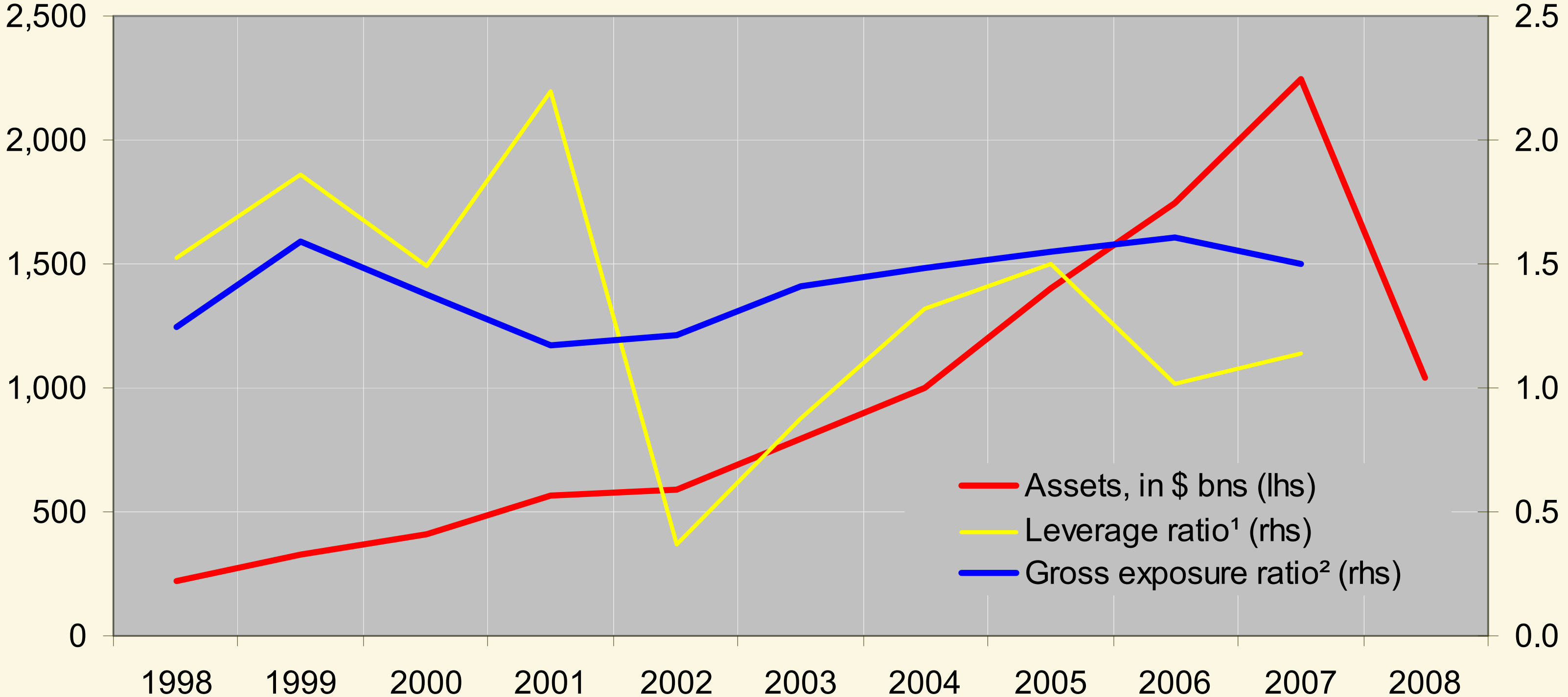
Current crisis was preceded by a substantial increase in assets managed by unregulated, leveraged investors.

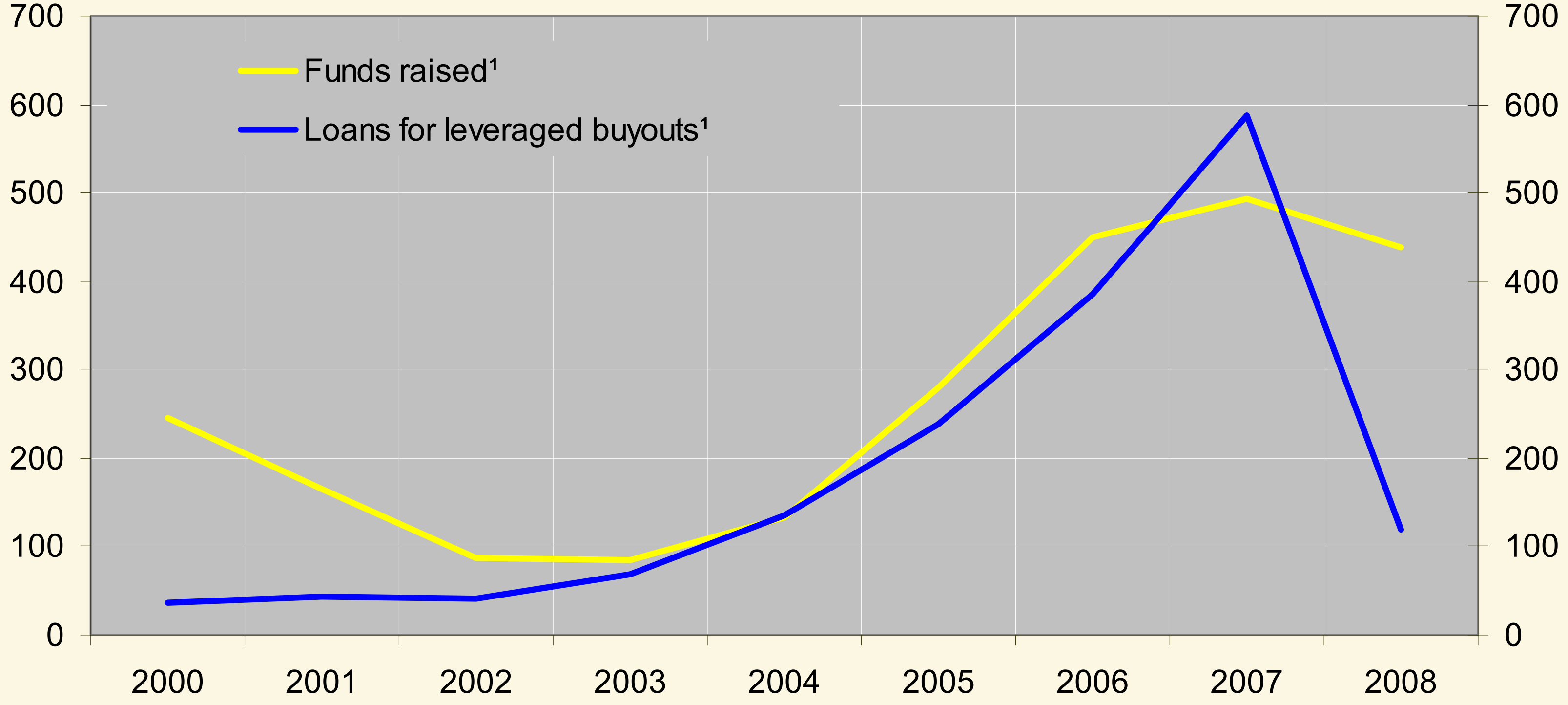
Hedge funds



[1] Derived from fund returns; based on the methodology of P McGuire and K Tsatsaronis, "Estimating hedge fund leverage", BIS Working Paper, no 260, September 2008. [2] Sum of long and short positions, as a ratio of assets.

Sources: Hedge Funds Research; International Financial Services London; McGuire and Tsatsaronis (2008); TrimTabs Research.

Private equity funds



[1] In billions of US dollars.

Sources: Dealogic Loan Analytics; International Financial Services London; Preqin.

Some unregulated, leveraged investors failed in 2007-08, but they were not a major source of systemic risk.

Policy concerns about leveraged investors prior to the crisis

- potential losses to regulated banks
  - direct losses on counterparty exposures
  - indirect losses on banks' trading positions caused by a forced liquidation of hedge funds' positions

Policy concerns about leveraged investors <u>during</u> the crisis

- direct losses?
  - on the internal funds of investment banks
  - on warehoused assets
- indirect losses?
  - important starting in early 2008
- 2007-08 crisis ≠ 1998 LTCM crisis

Standard setters have not (yet) agreed whether to regulate hedge funds and private equity funds.

Initiatives of BIS-hosted organisations

- Financial Stability Forum
  - Report on Highly Leveraged Institutions (May 2007, October 2007)
  - follow up on G20 recommendations to review: (i) private-sector bodies' unified set of best practices for hedge funds and private equity funds, and (ii) the scope of financial regulation
- Basel Committee on Banking Supervision
  - enhancements proposed (in January 2009) concerning: (i) the regulatory capital treatment of trading book exposures, and (ii) Basel II

Consensus about the need to strengthen the framework for addressing risks at the system-wide level.

Financial system is prone to booms and busts

- activities of leveraged investors were symptomatic of the pro-cyclical behaviour of financial institutions
  - prior to the crisis, prices of a wide range of assets were unusually high for an extended period
- tendency for financial decisions to exacerbate macroeconomic cycles

Policies to mitigate pro-cyclicality

- FSF, in cooperation with the BIS, BCBS, CGFS and other international bodies, is examining ways to mitigate pro-cyclicality
  - focus on capital regulations, loan-loss provisioning, interaction of valuation standards and leverage, and compensation practices
- support for the development of a macro-prudential framework to monitor and address the build up of risk in the financial system