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Hedge fund investment by financial institutions under Basel II

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Under the Basel II regulatory regime, in effect in Japan since 31 March 2007, hedge fund investments require an increased risk weighting if the hedge fund does not adequately disclose its asset holdings. This change has prompted considerable interest in financial institutions' hedge fund investment activity. A recent AIMA Japan survey reveals that financial institutions finished adjusting their hedge fund allocations in response to Basel II in FY07 and have now entered a new phase of hedge fund investment in pursuit of improved returns.

Basel II's impact on hedge fund investment

As of 31 March 2008, the new Basel II capital adequacy regulations[1)] have been in effect in Japan for one year. Basel II revised how financial institutions measure their credit risk.

For financial institutions that invest in investment funds (e.g., hedge funds, investment trusts), a key issue is measuring the credit risk of funds that lack transparency with respect to their asset holdings, rendering inapplicable the so-called "look through" approach for lower risk capital requirement[2)]. Many hedge funds in particular refuse to disclose detailed information about their investment strategies to investors. This practice caused concern that hedge fund investments' risk weightings would increase under Basel II in comparison to Basel I.

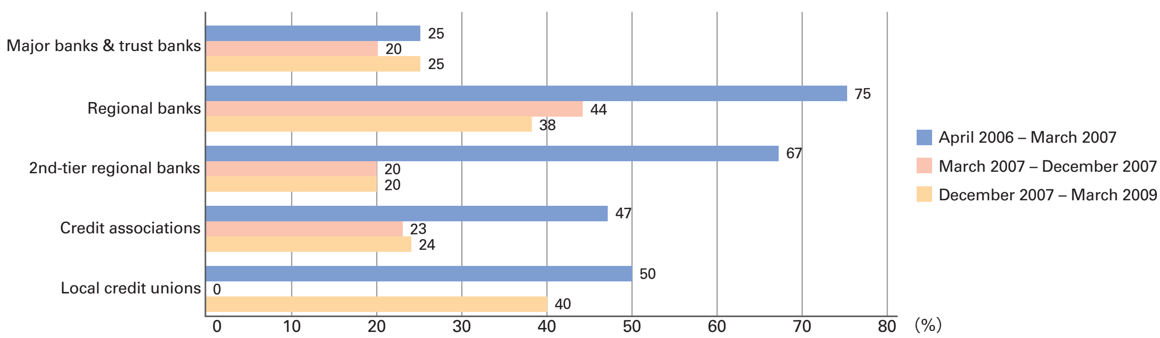
Hedge funds differ from conventional securities in terms of the sources of returns that they offer, enabling financial institutions to pursue risk diversification vis-à-vis their existing securities holdings. Financial institutions have increasingly invested in hedge funds in recent years[3)], but it remained to be seen whether they would continue to do so once risk weightings and, in turn, regulatory capital requirements increased under Basel II.

To shed light on Basel II's impact on hedge fund investment and how financial institutions have responded, AIMA Japan[4)] conducted a survey of Japanese financial institutions in late January[5)].

Financial institutions are already done adjusting their hedge fund investments in response to Basel II

The graph below plots the percentages of financial institutions by type that have reduced their assets invested in hedge funds before and after Basel II took effect. It yields three notable observations. First, a large percentage of financial institutions, chiefly regional banks and second-tier regional banks, reduced their assets invested in hedge

Exhibit. Percentages of financial institutions that reduced their assets invested in hedge funds before and after Basel II took effect



Source: Post-Basel II Hedge Fund Investment: Present and Future (AIMA Japan, March 2008) funds before end-March 2007. Second, the percentage of financial institutions that reduced (or plan to reduce) their assets invested in hedge funds decreased substantially after Basel II went into effect. Third, the percentage of institutions that reduced their assets invested in hedge funds was much smaller for major banks than for other types of financial institutions.

Excluding major banks, a majority of banks reduced their assets invested in hedge funds before Basel II went into effect. When queried about their rationale for reducing exposure to hedge fund investments, many survey respondents cited reasons related to Basel II (i.e., "increased risk weightings" and "uncertainty about how bank examiners' treatment of hedge fund investments").

After Basel II took effect, the percentage of financial institutions that reduced their assets invested in hedge funds decreased sharply. Among regional banks, the percentage fell below 50% in FY07, with less than 30% planning to reduce their assets invested in hedge funds in FY08 or thereafter. In response to a survey question about why they scaled back hedge fund investments after Basel II took effect, many banks cited "poor performance," a reason unrelated to Basel II compliance.

The AIMA Japan's survey also investigated how risk weightings for hedge fund investments have changed since Basel II took effect. Only one-third of respondent financial institutions reported an increase in risk weightings, while 16% reported a decrease. Why did so few financial institutions increase their risk weightings for hedge fund investments, contrary to initial expectations? The survey results offer two explanations. First, financial institutions divested themselves of funds that refuse to disclose asset holdings and increased their asset allocations to funds with relatively low risk weightings (e.g., long-short domestic equity funds). Second, they set up segregated hedge fund accounts[6] compatible with the look-through approach for lower risk capital regirement (nearly 60% of financial institutions with hedge fund investments have done so).

The survey results reveal that regional banks and smaller institutions focused on the look-through issue and adapted their investment behavior to comply with Basel II. Major banks, by contrast, responded very differently. They have not reduced their assets invested in hedge funds by much. We surmise that the major banks did not need to do much if anything to comply with Basel II, given that they now have a somewhat comfortable capital cushion, having finally completed their post-bubble NPL cleanup. Another likely contributing factor is that all the major banks have relatively robust risk management systems with at least two risk managers assigned exclusively to overseeing hedge fund investments, enabling them to easily satisfy bank examiners.

Future issues with respect to hedge fund investment

A surprisingly high 60% of banks have hedge fund investments compatible with the look-through approach, partly reflecting that hedge funds have made their asset holdings more transparent to Japanese financial institutions. Such transparency is a positive from the standpoint of risk management, but what should we make of financial institutions, chiefly regional banks, that have divested themselves of nontransparent hedge funds to avoid increasing risk weightings?

The essential point in terms of risk management is not whether a hedge fund investment qualifies for look-through treatment. When you invest in a hedge fund, your objective should be to diversify risk and enhance and/or diversify returns from securities portfolios by utilizing a fund manager with asset management skills that you do not possess. The most effective way to improve investment returns with accountability is to select asset managers with superior skills without regard to risk weightings and to control risk by imposing investment guidelines that do not undermine their abilities.

For depository financial institutions, accurate assessment of asset managers' abilities is essential to improving returns in compliance with regulatory capital requirements. To comply with the fundamental intent of Basel II, financial institutions should refine their assessment capabilities to better discriminate among hedge fund offerings.

Note

1) Basel II is a comprehensive regulatory framework for financial institutions' risk management.

2) Under Basel II, the two main methods of measuring credit risk are the Standardized Approach and Internal Ratings Based (IRB) Approach. Of the financial institutions that responded to the AIMA Japan survey, 97% use the Standardized Approach. Survey responses should therefore be construed as based on the Standardized Approach.

3) According to a survey conducted by Japan's Financial Services Agency, financial institutions (ex insurers) had approximately ¥5.5 trillion in assets invested in hedge funds at end-March 2006.

4) AIMA Japan was established in 2001 as the Japanese branch of AIMA (Alternative Investment Management Association). A nonprofit trade association with a global membership of over 1,200 companies, AIMA represents the alternative investment management industry. In addition to setting industry conventions and rules, AIMA also lobbies regulatory authorities to promote regulatory regimes that contribute to the industry's development.

5) AIMA Japan sent questionnaire surveys to major banks, regional banks, 2nd-tier regional banks, credit associations, and credit unions based on FY07 Japan Financial Directory listings and received survey responses from 53% of these financial institutions.

6) Such accounts are called managed accounts. The survey did not ascertain whether financial institutions that invest in hedge funds are fully aware of managed accounts.

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