

RISK MANAGEMENT IN A POST-CRISIS WORLD

SABRINA LEACOCK AND JESSICA WORMALD OF APPLEBY DISCUSS HEDGE FUND RISK MANAGEMENT BEFORE AND AFTER THE 2008 FINANCIAL CRISIS



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Risk management within the hedge fund industry, particularly counter-party risk and rehypothecation risk, were not particularly emphasised factors in hedge fund management prior to the 2008 financial crisis. While most managers ascribed to the theories behind counter-party and rehypothecation risk, very few saw either as a priority and even fewer gave enough credence to these theories to implement effective risk management strategies.

PRE-2008 RISK MANAGEMENT

To put pre-2008 hedge fund risk management into context; there had never been a significant broker-dealer failure within the hedge funds industry. No global power house custodian or prime broker had ever experienced such a collapse as was evidenced by Bear Stearns and Lehman Brothers.

Hedge fund managers governed their funds accordingly and over time had greatly reduced the risk rating allocated to custodians and prime brokers. The situation was compounded further by the fact that there were only a few truly global players in the custodial and prime brokerage arenas so that most large hedge fund managers maintained only one or two brokerage and custodian accounts and relationships with these firms.

THE IMPACT OF 2008 ON RISK MANAGEMENT

The collapse of Lehman Brothers in September 2008, following closely on the heels of the collapse of Bear Stearns, sent hedge fund managers into furious risk management reviews. Coming out on the top of the list of required changes was the need for multiple prime brokers and custodians to allow for a spread of risk, increased transparency for improved investor confidence and reduced rehypothecation for risk attenuation.

But when it became time to implement these changes, many hedge fund managers were shocked by just how long the appointment of a second prime broker could take. It could take weeks, sometimes months, to get a new prime broker signed up and for those funds with only one prime broker, real trouble was just around

the corner. Easily overlooked during the flourishing times of pre-2008 was the fact that funds with only one prime-broker could not easily move their assets. Without a second prime broker, the fund was stuck leaving their assets with their current custodian and hoping, literally, for all they were worth, that their broker was not going to be the next to fail.

Reducing rehypothecation risk was also not as simple as it seemed. Many fund managers had agreements with their custodians allowing for full carte blanche rehypothecation, which meant that even if those hedge funds

were not actively borrowing or utilising leverage, their broker may have pledged the assets of that hedge fund to secure their own borrowing, making the return of those assets more problematic.

Hedge funds managers across the board learned in true detail the dangers of rehypothecation when the assets some hedge funds held at Lehman Brothers in London were frozen by administrators. All assets, including cash, became ensnared by the Lehman Brothers administration even in circumstances where hedge funds had attempted

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to segregate their assets.

These factors specifically, and the financial crisis and failure of several main brokerage firms generally, saw a dramatic modification to the way in which hedge fund managers chose and worked with their prime brokers. Particularly in areas such as spread of risk, transparency and rehypothecation.

MULTI-PRIME, INCREASED TRANSPARENCY AND REDUCED REHYPOTHECATION

Suddenly having multiple brokers and custodians became a very real risk management strategy and marketing platform for managers. Even those hold-out managers who continued to maintain their singular brokerage or custodian accounts found themselves being held accountable by institutional investors who demanded a multi-prime environment. Most managers discovered that, even without their risk strategies indicating they should be using more than one broker, marketing any single-prime fund was nearly impossible. The market

all but dried up in 2008, the number and size of investments dwindled and on the back of the crisis investors became more demanding and knowledgeable about their investments.

From investors the message was clear, no road show would have any success unless issues like multi-prime, increased transparency and reduced rehypothecation were addressed.

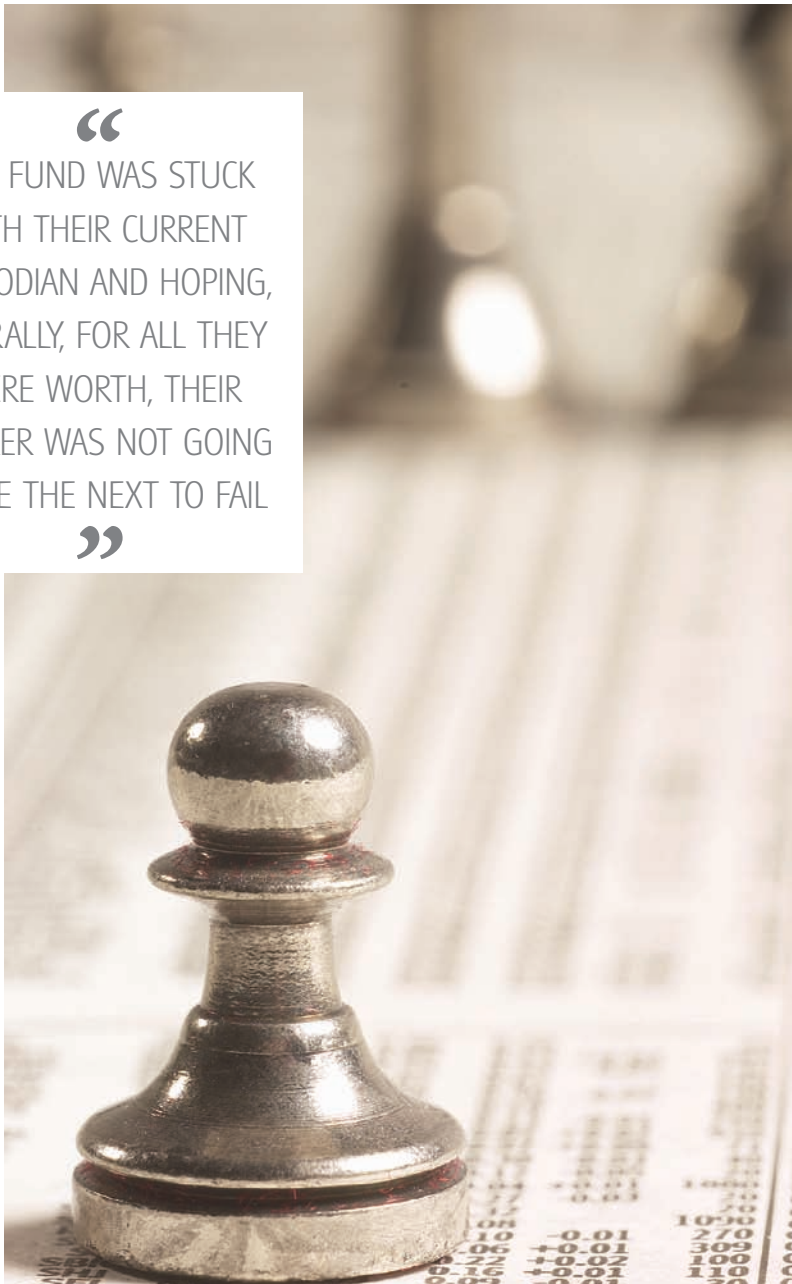
It was not just the need for more than one broker that mattered, but also the type of broker and the way that broker financed itself that investors demanded be addressed. Investors were no longer satisfied with brokers whose main source of financing was the assets they held for other customers. In an environment in which true liquidity was a thing of the past, investors began to demand primes with a stable and diversified reserve of funds.

These increased demands also resulted in a shift in the way brokerage and custodian services were offered to the hedge funds industry. Some larger custodians who were industry leaders began offering brokerage services in addition to their custodian services. A new form of hybrid service provider was created with the custodian side of the business holding and servicing the long positions and the prime brokerage side providing financing and lending for shorter positions. This new hybrid relationship provided greater security and comfort for hedge fund managers and investors alike and opened the way for big names like Credit Suisse to create new tailored products aimed at reducing risk.

Increased transparency also became a highly placed agenda item for investors and, accordingly, a marketing and risk management strategy for managers. Investors wanted greater information on the business dealings, arrangements and agreements between funds and their service providers, especially their prime brokers and custodians.

In particular, investors wanted greater transparency on the use of 'soft dollar' items and the scope of the 'soft dollar' items that were included in the fees paid to custodians or prime brokers. The lack of transparency on the type of items 'soft dollars' cover and the frequency and availability of them became a serious concern for investors causing many managers to reduce the scope of 'soft dollar' items, provide greater transparency in this regard or cease their use altogether.

Finally, investors also became concerned with the practice of rehypothecation and started to pressure their managers into renegotiating the fund's rehypothecation terms. Full rehypothecation rights for brokers are disappearing with managers insisting on percentage caps on the amount of the funds assets that can be rehypothecated. There are still many hedge fund managers battling to retrieve assets frozen due to the Lehman Brothers administration, the impact of which has been felt across the hedge fund industry. Managers are now much less willing to allow full rehypothecation and, in some cases, to rehypothecate at all.



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CONCLUSION

The diversification of counter-party risk, reduction of rehypothecation and increased transparency have become key factors in hedge fund risk management in a post-crisis world. Managers and investors alike are causing a shift in the way prime brokers operate, both in terms of the underlying funding of prime brokers and in terms of the use by prime brokers of client assets to support their own lending. In addition, today, multiple prime broker and custodian relationships are considered best practice in the industry, and a must-have for astute investors. ■