Submission By:

Sydney Futures Exchange

To:

House of Representatives
Standing Committee on Economics,
Finance and Public Administration

Inquiry into the International Financial Markets Effects on Government Policy

EXECUTIVE SUMMARY

The participation of large leveraged managed funds in a number of Australia's financial markets potentially enhances the contribution which efficient financial markets bring to the economies in which they operate.

This needs to be recognised in policy responses to any adverse side effects of the manner in which hedge funds have participated in financial markets.

In particular, there needs to be a two-pronged response:

- Continued active Australian participation in the international forums in which risks to financial stability are being addressed; and
- Continued domestic focus on leveraging Australia's success at withstanding pressure on our institutional framework into a bigger share of global financial activity.

A simultaneous focus on both types of response will serve as a useful discipline against too ready acceptance of proposals to unilaterally adjust our domestic institutional arrangements to cope with financial market volatility.

FOCUS OF SUBMISSION

The Sydney Futures Exchange Limited provides facilities for trading various financial risks to which participants are exposed or seek an exposure. The Exchange is also a co-regulator, with the Australian Securities and Investments Commission, of users of the markets provided by the Exchange.

These dual commercial and regulatory functions give the Exchange valuable experience from which to draw lessons relevant to the Committee's terms of reference.

That experience does not lead us to suggest any particular modification of current macro-economic policies to cope with volatility in financial markets (being the subject of the Committee's first term of reference), or to suggest new information requirements for stable and efficient operation of financial markets (being the subject of the Committee's second term of reference).

The committee's terms of reference mention the possibility of requiring "highly leveraged institutions" to provide more information in order to assist the functioning of financial markets. The Committee, when announcing the inquiry, made it clear that this was intended to encompass hedge funds.

The Exchange has noted that one of the outcomes, which the Committee hopes to ensure, is a better understanding of the issues by the Australian community as a whole. The Exchange's submission has been provided to assist the Committee achieve this outcome.

Although some of the larger global hedge funds participate from time to time in our own markets, this involvement has not to our knowledge, been accompanied by activities that would bring into question the integrity of the markets[1] or the capacity of the intermediaries through which they traded to meet their financial obligations.

Indeed, to the extent that consideration is being given within international forums to the impact of hedge funds on market integrity and credit risks faced by the counter-parties to hedge funds, the focus appears to be primarily on currency markets rather than on any exchange-based markets.

Accordingly, the Sydney Futures Exchange's interest in the issues being considered by the Committee does not stem from any concern about the involvement of hedge funds in its own markets.[2] The Exchange simply has the same interest as other participants in ensuring a balanced response to the emergence of concern in some quarters about the involvement of large highly leveraged institutions in financial markets generally.

The prospects for growth in the Australian economy may be set back if excessive constraints were to be placed on the capacity of well managed financial institutions to incur responsible exposures to funds that use leverage. Accordingly, all sectors of the economy, not just the financial markets, have an interest in the outcome of debates in international forums about the benefits and risks of leverage.

IDENTIFYING THE CAUSES OF ECONOMIC DISRUPTION

As many countries have learnt, painfully, one of the consequences of globalisation is that the benefits to an economy of inflows of capital come at a price: if the suppliers of capital change their minds as to the attractiveness of a particular destination for their investments, they will withdraw those funds and are in a position to do so rapidly.

The economic distress experienced by several countries in the region justifies the considerable global effort which has been, and continues to be, expended on analysing the causes and searching for ways of preventing a repetition.

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[1] "Market Integrity" refers to the degree of certainty that the market price is a true reflection of fundamental determinants.

[2] Of course, the Exchange has a keen interest in ensuring that no single customer – whether a hedge fund or anyone else – accumulates such a large position relative to the size of the market that either it could influence the behaviour of others in the market or could threaten the capacity of an intermediary to meet its financial obligations.

Each market disruption tends to have some new element (such as the involvement of hedge funds) which, at least for a short period, has the potential to deflect attention away from what are later seen to be the most relevant issues. It took some time, for example, after the rescue of Long Term Capital Management (LTCM) for something approaching consensus to emerge in official circles (at least within the major western financial centres) that the key issue was not so much what to do about hedge funds, but whether there was scope for enhancing the capacity of, and incentives for, other institutions (particularly those who are prudentially supervised) to make sound counter-party credit assessments.

Policy makers in the US, for example, have acknowledged that hedge funds do not appear to have played a significant role in precipitating financial market crises.[3]

Similarly, the revelations about the extent of leverage used by some hedge funds have, over time, been put in perspective. It has been revealed by banking supervisors in the US that the large financial institutions with the greatest exposure to the most highly leveraged funds did *not* have exposures, which seriously threatened financial viability of the former class of financial institution.[4]

At the same time, there are a number of systemic issues, which need to be considered, irrespective of whether there is a causal link between the activities of hedge funds and the hardship experienced by a significant proportion of our regional neighbours.

These include:

- a default by a large institution can cause losses to counter-parties beyond their direct exposure to the defaulting institution (eg declines in stock prices due to rumours); and

- a default by one institution can cause a contraction of capital market activity generally.

As these risks are essentially risks created by uncertainty as to the actual extent of various parties' exposures, it is natural that increased transparency should have become one of the broad directions of international efforts to address financial stability concerns.

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3 Report of the President's Working Group on Financial Markets, April 1999, p2; *Hedge Funds Leverage, and the Lessons of Long-Term Capital Management.*
See Barry Eichengreen et al., *Hedge Funds and Financial Market Dynamics*, Occasional Paper No. 166 (Washington D.C.: International Monetary Fund, 1998); and Stephen J. Brown, William N. Goetzmann, and James M. Park, *Hedge Funds and the Asian Currency Crisis of 1997,* NBER Working Paper No. 6427 (February 1998).

4 The April 1999 Report of the President's Working Group on Financial Markets, at Appendix D indicated that "the estimated notional value of derivative contracts with hedge funds at money centre banks with significant trading activities represents less than four percent of the total $27 trillion in total notional value of derivative contracts at these institutions……… Collateral held against current hedge fund exposures resulted in negligible net current credit exposure".

TRANSPARENCY

An important issue in a globalised market – in which there are limits to the capacity for individual nations to chart an independent course – is who determines what disclosures are needed to reduce systemic risks.

It is becoming more widely more recognised that direct regulation of large institutions such as "hedge funds", whose owners may not perceive a net benefit in making particular disclosures, is fraught with difficulty when those institutions can easily re-locate offshore. Hence, imposing controls directly on hedge funds has generally not been seen as the most viable means of addressing the potential consequences of excessive leverage. Instead, the focus has been on:

- regulating some aspects of hedge funds' activities indirectly through controls on certain domestically based institutions which have an exposure to those funds; or

- encouraging greater awareness on the part of investors in other companies that, through such investments, they may have an exposure to hedge funds or other highly leveraged institutions.

We note that, for example, the Report of the President's Working Group on Financial Markets,[5] released in April 1999 made recommendations in general terms about the scope for more frequent and meaningful information to be made public. Those recommendations appear to be predicated on the capacity for such disclosures to produce a tightening of credit standards. The recommendations included:

- that "more frequent and meaningful information on hedge funds should be made public"; and

- that "public companies, including financial institutions, should publicly disclose additional information about their material financial exposures to significantly leveraged institutions, including hedge funds".

[5] Report of the President's Working Group on Financial Markets, April 1999, p2; *Hedge Funds Leverage, and the Lessons of Long-Term Capital Management.*
See Barry Eichengreen et al., *Hedge Funds and Financial Market Dynamics,* Occasional Paper No. 166 (Washington D.C.: International Monetary Fund, 1998); and Stephen J. Brown, William N. Goetzmann, and James M. Park, *Hedge Funds and the Asian Currency Crisis of 1997,* NBER Working Paper No. 6427 (February 1998).

The underlying assumption linking these recommendations appears to be that public companies, particularly regulated financial institutions, will be less likely to undertake dangerous levels of exposure to other highly leveraged institutions if shareholders and other investors in such companies have greater awareness of the extent of those companies' exposures to highly leveraged institutions.

A number of difficulties in implementing this approach have already been identified. They include:

- excessive reliance on the quarterly or other snapshot of a public company's exposures – such snapshot may not be representative of the exposures existing at the future time when consideration is being given to varying investment in the particular public company; and

- the difficulty of couching disclosure obligations in terms which avoid requiring disclosure of proprietary information to competitors.

Suggestions which have been put forward as to the type of information that counter-parties could demand without involving any disclosure of proprietary data include:

- broad concentrations to countries or types of product;

- availability of liquid unsecured assets (to meet possible increases in margin calls under adverse conditions;

- assumptions used to calculate value at risk; types of stress tests conducted and other indicators of risk management capabilities.

Whilst the Exchange has a keen interest in how these issues are worked through[6], it does not have a central role in their resolution. These are issues for financial institutions to work through with their lead prudential supervisors, with the benefit of any consensus emerging from relevant international forums.

We simply note that Australia does not have the freedom to address these issues independently of the work being pursued in global forums[7].

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6 Only if the capacity of a number of significant clearing members to meet margin obligations were simultaneously compromised by their exposures to highly leveraged institutions, would the prospect arise of defaults that could have systemic consequences. This unlikely scenario provides the principal practical rationale for the existing regulatory framework relating to supervision of clearing houses for exchanges.

7 Those forums include the Basle Committee on Banking Supervision, the Financial Stability Forum and the Joint Forum.

Furthermore, even assuming that Australian prudential supervisors continue to adopt any emerging international consensus in their treatment of financial institutions which they lead regulate, globalisation of financial markets means that most substantial participants in wholesale financial markets will be lead regulated by a prudential supervisor based outside Australia.

Accordingly, it will be the adoption of those international standards by prudential supervisors in other countries, as much as the steps taken by Australia's prudential supervisors, that will ultimately provide protection for Australian customers dealing with intermediaries in Australia's financial markets.

SYSTEMIC RISKS IN EXCHANGE MARKETS HAVE BEEN ADDRESSED ALREADY

From the Exchange's perspective, financial stability is achieved by having a multiplicity of controls which reduce the prospects of any default by one participant in a chain of transactions being transmitted to other participants. The typical involvement of hedge funds in our markets will be through at least two intermediaries: A hedge fund managed out of the US, for example, might lodge an order through the US operation of a globally based futures broker. The US broker, in turn, may route the order through an Australian based affiliate that has access to the Exchange's markets. In assessing whether the Australian affiliate can meet its margin obligations, the Exchange has an interest in whether the US parent/affiliate represents a large proportion of the Australian broker's business. If so, the Exchange would then have an interest in the financial position of the US parent/affiliate. This, in turn, may involve the Exchange considering whether a high proportion of the parent's trades were being effected on behalf of one customer.

From this outline, it can be seen that the question of whether an ultimate customer is large or highly leveraged is relevant to transmission of systemic risk only in the rare event that it gives rise to an excessive concentration of risk to that counter-party on the part of all the intermediaries in the chain.

Accordingly, it is an Exchange's focus on ensuring that its immediate users do not incur excessive concentration risk, rather than a focus on the other end of the transaction chain (whether or not those end customers are large or highly leveraged) that provides the real protection for other users of an exchange's markets.

In any event, as noted above, exposures to hedge funds by globally operating intermediaries (whose stability is important to the financial system) represent a small proportion of these institutions' aggregate credit exposures.

Against this background, it can be seen that credit risks are adequately addressed by the various financial integrity controls built into the structure of exchanges and clearing houses.

This appears to have been implicitly recognised in the fact that the focus of international debate about refining the institutional architecture to address counter-party or credit risk has been on currency markets, rather than on markets in exchange traded instruments.

THE ROLE OF EXCHANGES IN ENSURING MARKET INTEGRITY

The other major category of risk apparently being considered in international forums about the global financial "architecture" is the scope for large market participants to move prices away from values reflecting fundamental determinants.

The various initiatives (discussed above) that have been proposed as a way of reducing the riskiness of hedge funds' portfolios would, if successful, also reduce any potential for systemic disruptions resulting from any attempts by the larger funds to move prices away from fair value.

The need to consider such indirect means of removing scope for manipulation of prices reflects a recognition that creation and enforcement of domestic rules against such manipulation would not be practical in some global markets (e.g. currency markets).

At the same time it needs to be recognised that enforcement of such prohibitions remains a practical option in some other markets that are becoming increasingly global. In particular, it remains a practical option in markets where an exchange provides a sufficient nexus with a particular country for that country to impose prohibitions against market manipulation and give regulatory agencies the necessary enforcement powers.

Indeed, the prevention of market manipulation is one of the key objectives which exchanges and securities commissions are jointly charged with achieving under the existing regulatory framework in Australia.

Having weathered the crises that appear to have prompted considerable discussion about refining the international financial "architecture", Australia is in a good position to retain those aspects of its regulatory framework that are conducive to the creation and maintenance of liquidity.

This, in turn, calls for regulatory structures, which leave considerable room for market participants to rapidly adjust the procedures under which they trade various financial risks so as to remain competitive.

In broad terms, market integrity regulation in Australia exhibits at least as much flexibility for market structures to remain competitive as the regimes operating in most other financial centres. Co-regulation of exchanges, for example, has enabled exchanges to adjust their trading rules and associated procedures relatively easily to meet user demand, whilst preserving the confidence of users in the fairness and orderliness of the markets.

Similarly, over the counter markets would appear to have benefited from considerable flexibility. In modifying the relevant regulatory regimes to achieve other objectives, it is important to retain the elements which have contributed to this flexibility.

CONCLUSION

Financial stability is important. Efforts to promote liquidity are also important.

Hedge funds contribute to the liquidity of a number of Australia's financial markets. Increased liquidity attracts those who would otherwise not participate and helps establish a virtuous circle in which increased capital market activity generates benefits to the broader economy.

Efficient markets in interest rate products, for example, contribute to a lowering of interest rates which is reaped by home owners and industry alike.

It is important not to jeopardise this contribution in addressing perceived risks to financial stability or market integrity posed by the sheer size of some market participants.

Initiatives being discussed in international forums concerned with assuring financial stability include ones directed at reducing the size of entities that are highly leveraged.

Such initiatives would not appear to be necessary in relation to markets in exchange traded instruments. More direct approaches to controlling both counter-party risks and market integrity issues are already in place in well-managed exchanges.

In view of the limited scope for unilateral action by one country in addressing financial stability issues affecting increasingly globalised markets, there needs to be a two-pronged response:

- Active Australian participation in the international forums in which risks to financial stability are being addressed; and
- Continued domestic focus on leveraging Australia's success at withstanding pressure on our institutional framework into a bigger share of global financial activity.

A simultaneous focus on both types of response will serve as a useful discipline against too ready acceptance of proposals to unilaterally modify domestic institutional arrangements that have simultaneously achieved commercial and regulatory objectives.