SENATE STANDING COMMITTEE ON ECONOMICS QUESTION

(Supplementary Budget Estimates 20 October – 21 October)

Question: SBT165

Topic: Hedge Funds

Senator Cameron asked:

Senator CAMERON—I am asking, in relation to your response to me that you look at exposure to hedge funds 'on a case-by-case basis': how many hedge funds have you looked at?
Mr Jones—I cannot say how many we have looked at. We look at them within the context of each particular fund.
Senator CAMERON—Can you take that on notice?
Mr Jones—We can do that.
Senator CAMERON—I am sure you must be able to tell me if APRA has had a look at hedge funds—
Mr Jones—I am not sure, but we will take it on notice.

Answer:

Response to Questions on Notice from Budget Estimates

APRA's supervision of superannuation funds and their investments

Our supervision approach aims to enable APRA to make an assessment of each superannuation fund's current and potential risk profile, and assess the adequacy of the risk management and controls in place. As part of our supervisory approach we review fund investment portfolilios on a case by case basis.

The scope of this review may cover the entire portfolio of the fund, or be targeted to address our concerns relating to particular investments (e.g. unlisted investments, overseas equities or hedge funds) and/or aspects of their investment management framework.

Rather than focussing on the superannuation industry's aggregate exposure to hedge funds, APRA aims to identify investment trends and common issues arising from fund investments in hedge funds. The awareness and knowledge of these trends and issues help strengthen the quality of our supervision and oversight of the industry.

What is critical is the level of exposure of individual superannuation funds to specific investments – including hedge funds. Survey results1 indicate that, on average, superannuation funds that do invest in hedge funds have a 3% exposure, across a variety of strategies. Specific superannuation funds, however, may have very different exposures and this is what APRA focuses on, the exposure at the entity level. It is also important to note that 'hedge funds' as a generic asset class are far from homogeneous – they vary from highly leveraged to very conservative.

Coverage of hedge fund investments in a prudential review

At a high level, APRA's review of hedge fund exposures in funds typically covers (in addition to general investment assessments):

- the role of hedge funds in the portfolio;
- the current and potential exposure to hedge funds;

[1] '*Hedge Fund Survey of Australian Superfunds 2010'* by AIMA and Australian School of Business UNSW. March 2010.

- the hedge fund strategies being pursued;
- the investment structure of the hedge fund; and
- the nature of the underlying assets.

It is important to note that APRA undertakes similar analysis of any other asset class/investments held by the fund if we consider the structure or the underlying assets of the asset class/investment to be complex, high risk and/or to expose the fund to risks that are difficult to capture. Generally, APRA will examine more closely the trustee's investment management framework for private market and alternative assets given the nature and greater complexity of those assets.

Investment and hedge fund related issues identified recently

Recent examples of hedge fund specific issues include:

- the strategic fit of such investments for the superannuation fund;
- the due diligence process;
- the trustee's oversight of the operations of the investment vehicle;
- the reporting received from underlying managers; and
- the consideration of exit strategies.

Again some of these concerns are equally applicable (or the same in essence) to other types of investments as they reflect to some extent the trustee's attitude to investment risk management, albeit the significance of these issues will differ between asset classes.

Additional focus on the unique features of hedge funds

APRA recognises that there are unique features of hedge funds which require additional risk management attention. For example, hedge funds can include strategies to short securities to generate returns or hedge exposure; use leverage to magnify returns; adopt a wide range of strategies; and utilise very concentrated strategies.

Although returns of hedge funds are generally uncorrelated with other asset classes, market behaviours in a crisis can cause assets that do not normally correlate to behave similarly very quickly on the downside. This poses the risks that traditional risk measures cannot capture the volatility of hedge fund assets; stress-testing scenarios may not reflect the worst case scenario; and valuations can become questionable in stressed markets given the reliance on models for valuation.

APRA would expect trustees to demonstrate how they address these risks, particularly with respect to:

- due diligence;
- risk measurement;
- assessing the adequacy of returns given the risk assumed;
- gaining an understanding of the underlying exposures; and
- having appropriate reporting.

While these risk issues arise in relation to hedge funds, they are driven by the nature and characteristics of hedge funds. In principle, these issues are relevant to any investments that are opaque, contain significant leverage, or are in thinly traded or illiquid markets.