Another break or a blow to investments in equity-related hedge funds?

Japanese commercial banks have been making sizeable investments in hedge funds that invest in stocks. This is due, at least in part, to the fact that banking regulations as well as anti-trust regulations on such investments had been relatively lenient for Japanese banks. However, under the new capital adequacy rules, Japanese commercial banks may now be facing some changes in the current climate.

Historically, Japanese banks long had a significant amount of direct investments in stocks. During the lost decade of the 1990s to the mid 2000s, banks gradually reduced their direct stakes in stocks. However, due in part to the long-lasting extremely low interest rate environment, banks also needed to increase the amounts of their investments in equity-related hedge funds, resulting in indirect investments into stock markets, where the regulatory rules were quite lenient on such investments. From March 31 2007 Japanese banks’ investments in equity-related hedge funds face a change in their regulatory environment as the new capital adequacy guidelines promulgated by the Financial Services Agency of Japan (the FSA), which implement the Basel II Accord, became effective.

The treatment of investments in funds by banks taking the standardized approach (the vast majority of Japanese commercial banks including some of the major banks) under the stipulated capital adequacy rules is not clear. The uncertainty has had a chilling effect on banks to some degree. Answering the banks’ demands for a clearer rule, the FSA gave some guidance by publishing its interpretation of the rules in December 2006 (although it still does not provide answers to all of the questions raised).

According to the interpretation by the FSA, under the new rules, the most basic principle for risk-weight calculations of investments in funds by standardized approach banks is the look-through principle, which is the same principle as that for internal ratings based approach banks. This requires aggregation of the risk-weights of credit exposures for each asset constituting the fund. Different rules apply for standardized approach banks and internal ratings based approach banks for funds where it is not possible to look-through. For banks taking the standardized approach, the greatest risk-weight is applied to the uncertain portion of the fund (for example, if the assets constituting 60% of the fund are unknown, and if that portion could be invested in a securitized product, then that portion would be calculated as if all of it is invested in the non-rated subordinated securitization product which calls for capital deduction. If the fund also has no ability to invest in a securitized product, then that portion could be deemed as having investments in nonperforming loans (over 90-days nonperformance) which calls for a 150% risk-weight).

In comparison, rules for an internal ratings based approach are more complicated. If the assets comprising the fund are not transparent, the first question would be whether more than half of the assets comprising the fund are equity-related investments. If so, then the adjusted simple majority approach, which calls for the application of a 400% risk-weight or 300% risk-weight (only if the equity-related investments are all listed stocks) to the entire fund, will be applied. If more than half of the funds’ assets are not equity-related, then the second question will be: whether the fund’s investment policy is transparent, in which case an approach called the mandate approach, which essentially assumes that the investment policy has been complied with in a manner calling for most amounts of risk-weight, will be applied. If the mandate approach
cannot be taken, then the VaR approach might be taken if the mark-to-market price for the fund is available on a daily or weekly basis. Furthermore, if the VaR approach cannot be taken, then it would be the simple approach, which calls for the application of a 1250% risk-weight or 400% risk-weight (but only if the bank can verify that there is no high risk exposure such as a securitized product included in the fund) to the entire fund.

In addition, on May 9 2007, the FSA provided its interpretation on the capital adequacy rules concerning leveraged funds with long/short positions. According to the FSA's interpretation, when a fund is leveraged, the basic principle is to add up the risk-weights of credit exposure as to all of the assets constituting the fund; and basically, 8% (for international banks; 4% for domestic banks) of the sum will be the required regulatory capital in respect of the bank's investment in such fund. Moreover, it has been clarified that the FSA's intention is not to net any short position that a fund may have but rather simply to ignore the short positions and to add up all of the long positions.

In evaluating the guidelines described above, the following should also be noted: for banks taking the standardized approach, the risk-weight to be applied to direct investments in stocks is a mere 100%; For banks taking the internal ratings based approach, the existing portfolio of stocks will be grandfathered and assigned a 100% risk-weight for the first ten years. For stocks that will not be grandfathered, banks will either calculate on a PD/LGD method similarly to debts (with LGD deemed as 90% and maturity being deemed as five years) or on a mark-to-market basis, in either case a 200% risk-weight basically being the floor for listed stocks (300%, if non-listed).

Whether the new capital adequacy rules are a blow to investments in hedge funds (especially equity-related) by Japanese commercial banks, or whether it should be viewed that, to the contrary, the FSA has given banks another break by setting a more-lenient-than-envisioned rule remains unanswered. We will have to see how banks cope with or react to the rules. However, it is quite clear that banks are now required to be more cautious in making investments in hedge funds, as direct investments in stock markets or other markets could be less costly in terms of regulatory capital, depending on the terms and conditions of funds.