Christian Noyer: A central banker’s personal perspective on hedge funds

Introductory speech by Mr Christian Noyer, Governor of the Bank of France, at Conference on hedge funds, Washington DC, 15 April 2007.

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Thank you all for coming. It's a pleasure and a privilege to have you all here to day. Special thanks to the IMF and John Lipsky for organizing this event for us and with us.

The purpose of our meeting is to present the special issue of our Financial Stability Review on hedge funds. So I want to say a few words on why we embarked on such a project and how we did it.

As you noticed, this issue of our Review is mostly based on external contributions. Some authors are with me to day and I also want to thank them. We are very happy that we could assemble such an eminent roster of contributors.

Let me say from the outset that we did not intend to reach a conclusion at this stage. The international community is working on this issue, in particular in the framework of the FSF. The main question is: how can we best reconcile keeping the positive inputs of this activity for financial markets functioning and innovation, while keeping the risks that may be generated for financial stability to a minimum.

This is why there is a debate on hedge funds, which we think, is legitimate. We think it is our role as Central Banks to foster this debate, because we have that ultimate responsibility for financial stability.

This being said, I may give some personal perspective and make, as an introduction a few remarks.

Why are we having this debate at the moment? If we look back five or six years ago, we can see at least three major changes that have contributed to a renewed interest in hedge funds activities :

First, the sheer size and very fast growth of their activities and portfolios which have made them major participants in financial markets (40% of the turnover of some major stock exchanges; between 25% and 50% of credit derivatives turnover according to various estimates).

Second, retail investors (as opposed to high net worth individuals) have – directly or indirectly – **got increasingly exposed** to hedge fund type investment, and, of course, risk. Sometimes, such exposure might be not even known to the individual investor (e.g. through pension funds). I was surprised to learn that, in my own country, more than 20 billions euros are to day invested in Funds of hedge Funds or similar instruments.

And third, **fast and far reaching structural changes** have taken place in credit and capital markets, with hedge funds playing a major role in the process. It's fair to say, for instance, that credit derivatives would not have expanded at the same pace and with so high innovation without strong hedge funds involvement.

What do those evolutions mean for the future? Financial innovation is good and healthy for our economies. Changes that have occurred in the last years strongly contribute to market efficiency and overall increase the resilience of our financial system. By allowing wider spreading of risk through credit derivatives, in particular, hedge funds bring an important contribution to market efficiency and liquidity.

At the same time, the implications of those changes for financial market dynamics might be more complex and far reaching than before. New instruments have been developed in a very benign environment. Liquidity in many market segments has not been tested in period of stress. How these instruments would behave in periods of stress is a major question for market participants and authorities alike.

In such an uncertain environment, securing the full benefits of the structural shifts in the financial system does put a premium on risk management. Everybody would agree, I think, that the first mitigant against the risks associated with hedge funds is robust internal risk management systems, both in hedge funds themselves and at their prime brokers. These are the basis for an efficient market discipline and a condition for financial stability. Strong and rigorous implementation of sound principles for risk management seem essential. You have noticed the reference, in yesterday's G7 communiqué, to the Paulson's task force (Presidents Working Group).

Beyond that, there may be some additional questions to consider which, for the sake of argument and in order to launch the debate, I will put on the table rather in a provocative mode, but are dealt with in more detail and balance in my own (and some other) contributions to the Review.

First question: what are the conditions to ensure an appropriate level of investor protection, and in particular, what are the consequences of the increased "retailization" of hedge funds?

A second question is the future of the hedge fund industry. It is the nature of technological progress to spread in a way that the profits it creates to be competed away. Replicating hedge funds strategies – at lower costs – seems to be expanding. M. Hsieh will tell you more about it during the panel discussion.

A third and important issue relates to the evolving relationship between banks and hedge funds. This relation is complex and multi-faceted. **It is at the heart of the concept of indirect regulation.**

Finally, we have an ongoing debate about "transparency", on which I am sure that members of the panel will tell you more in a few minutes.

By nature, hedge funds are secretive investors. They do not publish information about their positions and strategies. On the one hand, for markets to be fully efficient, some investors must be able to hold proprietary information and make profits on this basis.

On the other hand, financial market participants and public authorities responsible for financial stability require information to monitor the risks related to the hedge fund sector.

On those remarks, I leave the floor to the panelists, and first to Jaime Caruana, who has kindly accepted to kick start the panel.