Hedge funds and crisis: A reflection

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Predictions

- Many Pre and Early Credit Crisis Commentators said Hedge Funds would be source of crisis-systemic risk and financial instability-Economist and FT
- Banks, however, have been main source of concern due to lack of liquidity and fears over insolvency
- True in both USA and UK

Were Pundits Wrong?

- View One: Yes, for reasons stated. It is the bank related issues, off balance sheets exposures included, which is primary core issue.
- View two: No, because it was the fact that so many funds were undertaking activities where level of risk could not be understood which was nexus of crisis. Sub-primes re-packaged and sold as cdo's to hedge funds, and counterparty risk of monoline insurers, were crucial; not to mention concern over counterparty risk embedded in ISDA documentation.

Review: Crisis Signposts

- Developing Real Estate Asset price bubble affecting US sub primes and, later, alt-a's
- Bear Stearns Collapse-Too complex to fail?
- Lehman Brothers Collapse-Crisis of confidence despite orderly unwinding of cdo's, and of credit derivatives
- AIG Bailout-Counterparty risk issues at heart of crisis-cross default and cross acceleration for ISDA confirmations; Termination events give rise close out netting of positions in order to find new credit worthy counterparty

Further Signposts

- Freddie Mac and Fannie Mae bailouts
- Fed increases repo activity to provide liquidity , expands eligible collateral definition,
- Reduces interest rates
- Tarp and now Geithner Plan (otherwise known as Hedge Fund Recapitalization and Recovery Act)
- UK-Northern Rock takeover
- Gov’t buys stakes of High Street banks
- Proposes toxic debt guarantee scheme

Hedge funds fallout

- Tremont/CSFB-over 25% of hedge funds assets reduced due to redemptions
- Group of 30 advises on need for greater consolidated supervision of non bank banks
- And greater disclosure generally
- General calls for tighter regulation –G20
- New exchange for clearing and settlement of credit derivative deals
- Increased concern over non-bank banks
- Concern over insolvency of BHC’s as opposed to commercial bank institutions-Relationship to Hedge funds in unwinding

Is this sensible?

- Yes, hedge funds contribute to systemic risk and financial instability
- AIG is core example-although must distinguish between securitization exposure directly and derivatives exposure
- No, system worked-Lehman auction of credit Derivatives was orderly
- Not all hedge funds are the same as to risk
- Ok, but opaqueness is an issue
- Contagion a major concern

What can be done?

- Existing scheme-US funds exempt
- Except those which choose to register pre-Goldstein case
- Valuation issues still troublesome
- Federal Reserve rules require prime brokerage information to be disclosed-but real level of risk is unregulated to large extent (See MFA List of Fed regulations)

UK

- Tripartite system exposed to have many holes
- Light touch is too light-FSA
- Few funds are based in UK-some supervision of brokers is key
- Impact based supervision focuses on key actors-DP 14 Guidance

Current crisis

- US: Fundamental long term issue-How did we allow so many toxic assets to be built up in the financial system in the first place? What is relationship to this and poor SEC oversight (Net asset rule), originate to distribute model, corporate governance for guarantors, etc. Resolution: Not resolved until sell side has incentive to come to market and sell toxic debt to hedge funds
- Hedge Funds –an important issue-but still a sideshow except that it is clear we need more information on risk which is undertaken; problem is this is a probabilistic undertaking, and changes with the market; valuation of securities mark to market is still an issue to be looked at carefully
- UK-wait and see if guarantee scheme works

Broader issues with Hedge Funds dimensions

- Too complex to fail-LTCM, Drexel, and Bear Stearns
- Counterparty risk issues
- Misalignment of incentives for securitized financial products remain key issues to resolve
- Related issues of fraud also present since Madoff
- Need for greater information regarding hedge fund operations directly or indirectly
- One idea: Reporting triggers when potential event of default is to occur such as may trigger cross default to regulators, supervisors as additional early warning system.