

# Leverage and the LTCM rescue<sup>1</sup>

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A number of economists have blamed the depth and persistence of the Great Depression in the USA on collapsing credit markets. Could similar mechanisms have played a role in ending the East Asian economic miracle – and in creating fragility in global financial markets? Consider land-holding property companies and their vulnerability to adverse shocks – like the end of a property price bubble or a fall in the exchange rate, as in Thailand. Even when substantial margins are held, the initial drop in net worth may be followed by powerful ‘knock on’ effects in the scramble for liquidity if companies are forced to sell land to satisfy collateral requirements – possibly leading to wholesale financial collapse.

But the practice of collateralised lending by highly-leveraged financial institutions is not confined to property companies in Thailand: it is a characteristic of off-shore investment funds such as Long-Term Capital Management (LTCM), the hedge fund that was saved from collapse in late September 1998. In that case, the leverage and exposure involved was phenomenal. The Independent newspaper (10/10/98) quoted a report by the North American credit-control department of UBS on LTCM as saying “leverage was very high: on-balance sheet 27.2 times, off-balance sheet was not disclosed but we assume leverage 250 times”: with a capital base of around \$4 billion this implies assets under management of \$125 billion – and a ‘potential exposure’ of over a trillion dollars.

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<sup>1</sup> Extracted from “ASSET BUBBLES, LEVERAGE AND ‘LIFEBOATS’: ELEMENTS OF THE EAST ASIAN CRISIS” by Hali J. Edison, Pongsak Luangaram and Marcus Miller. This paper can be down-loaded from <http://www.warwick.ac.uk/fac/soc/CSGR/current.html>.

Could adverse shocks to the global economy exert powerful effects on asset prices via the effects of leverage? If so, should monetary authorities take actions to limit the knock-on effects? The near-collapse and officially-orchestrated rescue of LTCM by a lifeboat of private financial institutions in late 1998, led by Goldman Sachs, Merrill Lynch, and J.P. Morgan, suggests affirmative answers to both questions.

Why did the central bank intervene? In his Congressional testimony, Federal Reserve Chairman Alan Greenspan (1/10/98) explained that – “rather than let the firm go into disorderly fire-sale liquidation following a set of cascading cross defaults” – the FRBNY helped to arrange an orderly resolution “not to protect LTCM’s investors, creditors, or managers from loss, but to avoid the distortions to market processes caused by a fire-sale liquidation and the consequent spreading of those distortions through contagion”. LTCM was, evidently, judged, “too big to fail”.

So why was it not taken over by the creditors as a going concern, “lock, stock and barrel”? The reason is that the ‘technology’ of managing a hedge fund is “idiosyncratic”, i.e. it involves the inalienable human capital of the owner/managers (--including that of two recent Nobel prize-winners in economics!) . As Chairman Greenspan explained: “The private creditors and counterparties in the rescue package chose to preserve a sliver of equity for the original owners – one tenth – so that some of the management would have an incentive to stay with the firm to assist in the liquidation of the portfolio. Regrettably, the creditors felt that, given the complexity of market bets woven into a bewildering array of financial contracts, working with the existing management would be far easier than starting from scratch.” To keep existing management at work may have solved incentive problems inside the firm; but what of the moral hazard problems facing global financial markets if managers of gargantuan hedge funds (aka masters of the universe) are “too smart to be fired”?