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SPECIAL POLICY BRIEF 30

HEDGE FUNDS AGAIN: A RESPONSE TO DEREGULATION

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The publication format of the Special Policy Brief was not intended as a travel log. But on some occasions the setting somehow creeps into the content as context. Like the previous Brief,¹ the following addresses, once again, the alarming complacency regarding the lack of an adequate regulatory framework for hedge funds.

Like last time, the setting conference was in Berlin but this time it was organized by the NGO called WEED.² So being back in Berlin and again listening to an important official – this time from the German finance ministry and a participant in high level discussions at the Financial Stability Forum – carrying forth on the virtues of hedge funds and the dangers of attempting to regulate them, one is reminded of the comment attributed to Hegel that history, in repeating itself, occurs the first time as tragedy and the second time as farce.

¹ Special Policy Brief 29. On The Hedge Fund Question: A Program of Reckless Complacency, available at www.financialpolicy.org.

² The acronym for World Economy, Ecology and Development, viewable at <http://www.weed-online.org/themen/english.html>.

If neglecting the public interest by failing to adopt prudential regulation of hedge funds is the makings of a tragedy, then presenting unfounded claims about how unregulated hedge funds improve the safety and soundness of financial systems is the makings of a farce.

Given that Germany's Merkel government has sought to put hedge fund regulation on the agenda at the next meeting of the G8, one might have expected a senior official from the Finance Ministry to give a thoughtful look into the role of hedge funds in the economy. Any such illusions would have been shattered by the official's following two statements.

- There is nothing important to know about hedge funds that was not included in the Financial Stability Forum's 2000 study of the subject.
- Hedge funds in fact are a tremendous improvement to financial stability because they disperse risk.

Consider the first statement. There are many new things to learn about hedge funds since the report was published in 2000 (and likely written well before prior to that date). Prior to 2000, hedge funds were viewed largely as unregulated investment companies financed by super wealthy individuals that pursued high risk, and often highly complex, investment strategies. The colossal failure of Long Term Capital Management in late 1998 illustrated this nature and this danger.

Today, the number of hedge funds is estimated to have reached 9,000. That is about a thousand higher than last year, and so given the ones that failed or closed it represents a large number of new funds. More quantity does not equate with more quality. One public interest concern raised by the proliferation of these investment companies is that, as one prominent market commentator put it, it is now "amateur hour" in the hedge fund industry.

This proliferation of unregulated, high yield investment companies brings to mind a comment made about the influence of the Velvet Underground on rock and roll music. Brian Eno quipped that although the Velvet Underground never sold many records, everyone who bought one started a band. Unlike the challenge of turning large amounts of capital into larger amounts of assets, the public danger from bringing forth art produced more by inspiration than talent is likely limited to hearing loss and public embarrassment later in life.

In addition to the number of funds, the size of the hedge fund market, measured by the amount of capital invested in the funds, was \$221 billion in 1999 before growing by over 450% to exceeds \$1.22 trillion today.³

The composition of the capital raised by hedge funds has also changed significantly since the 2000 report was drafted. In 1999, 55% of hedge fund capital came from individuals compared to 40% today. Meanwhile, the amount of capital that is channeled to hedge

³ Sometimes this is referred to as assets under management, but since some hedge funds use leverage then the amount of assets – not to mention derivatives – can be many times the amount of the capital raised from investors. Data comes from Hennessee Group release of December 5, 2006, and Greenwich Associates.

funds from ‘funds of funds’⁴ has risen from 19% to 28%, and that from corporations and ‘institutions’ from 10% to 15%. The share from pension funds and endowments is roughly the same as six years ago – although the share of capital from ‘funds of funds’ is itself not broken out and may represent growth from pension funds or endowments. Of course maintaining a constant share of a market growing that fast means that pension funds and endowments today have \$232 billion of their assets – plus an unknown share of funds channeled through funds of funds – invested in hedge funds. Hedge fund allocations among U.S. endowments is now 12.3% of their total assets according Greenwich Associates.⁵

Today, hedge funds are major participants in other important financial markets. Market reports claim that 18%-22% of all trading volume on the NYSE and 30% to 35% on the London Stock Exchange is by hedge funds. Similarly, 75% of actively traded convertible bonds are held by hedge funds. Hedge funds account for 45% of trading volume in emerging market bonds, 47% in distressed debt, and 25% of high-yield bonds.

In derivatives markets, hedge funds account for 55% of the credit derivatives trading volume. Their trading in interest rate derivatives rose 49% last year, while that in credit derivatives rose 50%. According to Greenwich Associates, "In many cases, the credit derivatives market now drives the pricing of the actual underlying corporate bonds and some real money managers have complained to Greenwich Associates that this new dynamic is increasing volatility in corporate bond pricing." "In many ways, they have become the market," stated Peter D'Amario of Greenwich Associates.⁶

There are other important changes underlying the fact that the economic importance of hedge funds is different today. For instance, they are raising capital in public securities markets – Citadel is raising over \$2 billion in a public debt offering.

The history of fraud, embezzlement and market trading abuses is longer and deeper since the 2000 report. The third largest bankruptcy in US history occurred after it was discovered that Refco was using transactions with a hedge fund to hide massive debts. The recent failure of Amaranth set a new record for losses – over \$6 billion – and that just followed by a few weeks the \$300 million loss by Mother Rock. Hedge funds were caught late-trading and market timing mutual funds. The practice inflicted damaging costs on many mutual fund investors and severely embarrassed the whole industry. There are allegations and charges of insider trading, market price manipulation, naked short selling, and exercising undue control over corporate governance and credit committee to drive down company values where the funds hold large net short positions.

Credit derivatives markets – the acclaimed gift from hedge funds to financial stability – were a relatively small market at the end of 1999. In fact, the BIS did not even start collecting data on these markets until 2004. However, some indication of the change in

⁴ A ‘fund of funds’ is an investment company that earns a management fee by placing investor capital into one or more hedge funds or by advising investors on making such investments on their own.

⁵ Greenwich Associates, press release of May 17, 2006

⁶ Greenwich Associates, press release, September 14, 2006.

the market can be gleaned from data from US bank regulators. US banks held \$278 billion at the end of 1999, and their holdings have since grown by 2,654% through the third quarter of 2006. Applying the same growth rate to the global market means that back in 1999 the credit derivatives markets were about 3.6% of their current \$26 trillion.⁷

In sum, the world of hedge funds is very different today than only six years ago. Hedge funds are more numerous, have more capital, manage more assets and derivatives, operate at higher levels of leverage and play critical roles in many major financial markets.

Yet, we regulate them as if they were so many child-operated lemonade stands, but in fact they are playing an economic role more like McDonalds. Our understanding of the public interest in the growing role of these financial institutions should be keeping pace with their growth and development. Dismissing these changes leads to ignoring the potential dangers that they pose.

BREAKING UP RISKS

Next consider the second statement that hedge funds make the system safer by helping banks break up risks and disperse them throughout the economy.

While it is indeed useful to avoid concentrations of risk as well as to diversity risk, it is neither the case that hedge funds are needed for this type of risk management nor that they in fact participate significantly in this activity.

Even the premise of the argument needs further investigation. Most risks in the financial system are not that 'lumpy' but rather are already sufficiently granular to facilitate risk shifting. Certainly stocks and bonds are sufficiently granular that their ownership can be disbursed widely – and in fact that is the case. Regarding loans, risk shifting most often involves aggregating – not disaggregating – loans through various types of mortgage backed securities and other asset backed securities. These securities are then sold to a wide array of investors and this disperses risk. Even large loans are not necessarily lumpy because they are issued by a syndicate in which many lenders participate by taking shares of the loan. All these vehicles for risk management are used in large volume, and they have been used in large volume for some time. They do not depend upon the participation of hedge funds even if hedge funds often participate in those markets.

The market for credit derivatives does involve hedge funds, and that begs the following two questions. The first is whether they are necessary for that market, and the second, is whether it is indeed an improvement to financial stability that unregulated, highly leveraged investment companies without formal credit ratings are being used to off-load credit risk from our core regulated financial institutions – namely the major banks and broker dealers.

⁷ Data from ISDA.

Regarding the first, there should be enough interest in credit risk shifting amongst banks, other regulated financial institutions and institutional investors to support the market. They hold the vast majority of credit risk and have the greatest incentive for risk shifting, and so there should be more than enough opportunities to make an efficient market amongst these entities. After all, they have the greatest knowledge of credit risks and have the greatest potential gain from diversifying across such risks. If the credit derivatives markets cannot exist without large scale participation by speculators adding to their existing risks, then it implies these markets are not really generating the economic benefits they are claiming.

Yet, as the Hennessee Group stated, “However, Hennessee is concerned that many funds are inexperienced within the [credit] derivatives markets and may be using them in inappropriate ways.”⁸ Moreover, the claims of improving pricing efficiency and other market improvement must be weighed against how these unregulated entities harm market integrity. The SEC is investigating the use of credit default swaps to speculate on corporate merger activity after observing 30 instances of significant price movements in credit default swaps prior to the announcement of takeover efforts – these 30 included four of the largest LBOs in 2006.⁹ So not only is their necessity in question, but also whether they – a few or many – are not playing a disruptive role.

The second question pertains to the economic desirability of effectively reducing the capital required by banks and broker-dealers through trading credit derivatives with hedge funds. The question is analogous to asking whether it is prudent to buy homeowners insurance from a homeless person or buy auto insurance out of the trunk of a car in a parking lot?

The willingness to transfer credit risk through credit derivatives to hedge funds illustrates the logical extension of how interest rate swaps can lower the cost of borrowing to otherwise poorly rated borrowers. The borrower can receive a better credit rating for variable rate than fixed rate debt,¹⁰ and so it can lower borrowing costs by borrowing at variable rates, then trading into a fixed rate swap and ending up with lower fixed rate debt payments than if they had issued a fixed rate bond or loan. The economic reason is that they can be treated as AA credit risk for the purposes of the swap and thus get the same fixed rate on the interest rate swap as any other eligible counterparty. This favorable credit rating is justified because as a swap counterparty they are only responsible for the expected difference between the fixed and floating rates. This amounts to a significantly smaller credit exposure than on the entire debt principal itself. In other words, they can be considered AA for small credit exposures even if they are junk for the purposes of large exposures.

⁸ Hennessee Group, press release, October 30, 2006.

⁹ Hennessee Group, press release, October 30, 2006, which cited a report by Credit Derivatives Research.

¹⁰ There is questionable economic reasoning for why this is the case, but nonetheless it persists in credit markets and so can be taken as a matter of fact. While short-term debts are naturally less risky than long-term debts, it should not follow that debts of similar maturity should offer lower credit spreads if tied to short-term rates than if structured by long-term rates. If anything, the long-term rates offer the borrower less market risk and might thereby justify lower instead of higher credit spreads.

While this makes economic sense with respect to the small credit exposure on interest rate swaps (and this can be further reduced through the posting of collateral), it is dangerous to extend this logic to apply to credit derivatives. Why? The credit exposure on interest rate swaps is most likely small in comparison to the notional value of the swap. The credit exposure is roughly the expected capital gains or losses on a Treasury security of a similar maturity. Thus the credit exposure is only on the gain and not the larger notional principal.

This however is not the case with credit derivatives. While on a normal day there are merely gains or losses arising from changes in the market price of the derivative as it reflects changes in market perceptions of the creditworthiness of the underlying debt. Yet if the underlying debt were to fail to perform, i.e. trigger a credit event, the derivatives counterparty would suffer a loss equal to the entire notional value of the contract if the protection buyer delivered the worthless debt against the contract. For example, selling credit risk on Enron through a credit default swap would have ended up with the protection buyer delivering the worthless bond to their derivatives counterparty. It would be a loss equal to the full notional value. Hence the question, if the credit exposure on the derivative per se could be as great as a similar amount of debt, then why treat the credit risk on the derivative better than the credit rating on the counterparty?

Perhaps the counterparties to these credit derivatives make up the difference with collateral? This is impossible to know with any certainty but consider the following observations on the use of collateral by hedge funds. Greenwich Associates and Hennessee Group report higher hedge fund leverage. Greenwich cites the proportion of hedge funds in Europe with leverage ratios greater than three rising from 23% in 2004 to 49% in 2005. Hennessee Group looked at gross market price exposure and stated that it was at an all time high.

Reports from the repo market¹¹ show that dealers are lowering their standards for collateral with hedge funds in order to attract their business. Greenwich Associates reports that the percentage of dealers accepting below sovereign grade bonds from hedge funds rose from 45% in 2004 to 70% in 2005, while the percentage of dealers listing below-investment grade bonds as the lowest quality of acceptable collateral rose from 11% in 2004 to 38% in 2005.¹²

This would make it uneconomical to buy credit protection on an A rated debt from a B rated – much less a C rated – derivatives counterparty. But that is precisely what the major banks are doing by trading credit derivatives with hedge funds. And what is so disagreeable is to find senior government officials arguing that this indeed a good thing and stating that it should be encouraged and not even possibly discouraged by the introduction of prudential regulation. Nero might have fiddled while the fires burned, but at least he didn't distract himself by distributing gasoline.

¹¹ See Financial Policy Forum Primer on repurchase agreements. They have many similarities with derivatives.

¹² Greenwich Associates, press release for January 24 2006.

CONCLUSION

Like architecture and automobiles, the design of public policy should heed the dictum that form should follow function.¹³ In the case of hedge funds, their function in the financial system and, in turn, the overall economy should be reflected in their regulatory treatment. If they are important to markets and the economy, then their place in the regulatory framework should be important. If they play critical roles in credit markets, then they need appropriate standards for capital and the use of collateral. If they are taking large positions in securities and derivatives markets, then they should be subject to large trader positions reporting requirements that are prudently used elsewhere in financial markets. If they are not proving themselves incapable of effective self-governance, then the regulatory framework should provide for market supervision and market surveillance.

In order to better understand the function of hedge funds in the economy, officials and other students and analysts need to engage in serious, thoughtful discussion and not be dismissive or complacent in their thinking. This Special Policy Brief is intended as a contribution to that effort.

¹³ See the late L.J.K. Setright' 1976 volume on *The Designers: Great Automobiles and the Men Who Made Them*.