Chapter 6: Executive Summary

Hedge Funds in the Aftermath of the Financial Crisis

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Background

The available data show a remarkable diversity of management styles under the "hedge fund" banner. Hedge funds are major participants in the so-called shadow banking system, which runs parallel to the more standard banking system. Hedge funds have the ability to short sell assets, which allows them to use leverage, and leverage means that their equity value, absent limited liability, can go negative. Hedge funds add value to the financial system in a number of ways: (i) by providing liquidity to the market; (ii) by correcting fundamental mispricing in the market; (iii) through their trading, by increasing price discovery; and (iv) by providing investors access to leverage and to investment strategies that perform well.

Hedge funds have certainly been in the thick of the current financial crisis. For example, it was the collapse of two highly levered Bear Stearns hedge funds that initiated the collapse of the subprime-backed collateralized debt obligations (CDOs). But hedge funds didn't cause the growth in the subprime mortgage market, or make housing prices collapse so that subprime loans would default, or force financial institutions (GSEs, commercial banks and broker-dealers) to hold $785 billion worth of CDOs on their books. In fact, there is very little evidence to suggest that hedge funds caused the financial crisis or that they contributed to its severity in any significant way. That being said, hedge funds, or subsets of hedge funds, may still generate systemic risk that imposes externalities on the financial system. A fund that is sufficiently large and levered (like Long Term Capital Management [LTCM] in 1998) could generate systemic risk.

The Issues

Hedge funds are, for the most part, unregulated.

At first glance, not regulating hedge funds seems patently unfair, as it allows them to take advantage of regulatory arbitrage, namely the ability to offer intermediation services in direct competition with regulated institutions like banks. However, this ignores the substantive advantage that banks have through either the explicit guarantee of deposit insurance or the implicit "too-big-to-fail" guarantee.

The immediate policy issues are the following:

- Should hedge funds be exempted from any of the financial system regulations aimed at managing the systemic risk in the financial system (and the associated externalities)?
- Under what circumstances should hedge funds be subject to additional regulation?
- What forms should the additional regulation (if any) take?

Policy Recommendations

1. By the proprietary nature of their trading, hedge funds are not very transparent to the market. Lack of transparency of financial institutions can magnify financial crises due to counterparty concerns. A minimal condition would be that, in order to help regulators measure and manage possible systemic risk, **hedge funds (of sufficient size) should be required to provide regulators with regular and timely information about both their asset positions and leverage levels.**

2. Since hedge funds do not receive guarantees from the government and so are not subject to the moral hazard problems associated with such guarantees, any additional regulation of hedge funds over and above that advocated above is in general not warranted. The exception is when hedge funds impose externalities on the financial system. For example, **if a hedge fund falls into the class of large complex financial institutions, then that fund needs to be treated as a systemic institution to be regulated (and taxed) as such.** We also make several suggestions for cases in which a subset of funds ("systemic-risk" subset) together imposes externalities on the financial system.

3. Managed funds (mutual funds, money market funds, SIVs, and hedge funds) are subject to bank-like runs on their assets. These runs can trigger systemic liquidity spirals. In the current crisis, both the commercial paper market (in August 2007) and money market (in September 2008) seized up when a managed fund in these markets stopped redemptions due to exposures to subprime AAA-rated CDOs and Lehman Brothers' short-term debt, respectively. **Hedge funds in a systemic-risk subset may need regulation that discourages investors from withdrawing funds after bad performance**, since bad performance (and lack of transparency) by a fund may lead to a run on the fund's assets under management. Any such regulation would impose costs on the hedge fund investors, which must be balanced against the benefits obtained from the systemic risk reduction. We propose a market-oriented solution that weighs this balance.

4. A more controversial question is whether special regulation is needed for hedge funds with respect to public transparency of asset positions and leverage (e.g., along the lines of more Form 13F-like filings). This decision involves balancing the benefits and costs to hedge funds and investors. The largest concern relating to transparency is counterparty risk, and these counterparty issues are most relevant with OTC derivatives. It may be that by fixing the cracks elsewhere in the system, e.g., creating a clearing house/exchange structure for large OTC derivative markets, **the transparency goal can be reached without having to impose onerous regulation on the hedge fund community**.