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Hedge Funds, Financial Intermediation,
and Systemic Risk

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Hedge Funds, Financial Intermediation, and Systemic Risk

John Kambhu, Til Schuermann, and Kevin J. Stiroh

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Abstract

Hedge funds are significant players in the U.S. capital markets, but differ from other market participants in important ways such as their use of a wide range of complex trading strategies and instruments, leverage, opacity to outsiders, and their compensation structure. The traditional bulwark against financial market disruptions with potential systemic consequences has been the set of counterparty credit risk management (CCRM) practices by the core of regulated institutions. The characteristics of hedge funds make CCRM more difficult as they exacerbate market failures linked to agency problems, externalities, and moral hazard. While various market failures may make CCRM imperfect, it remains the best line of defense against systemic risk.

Key words: banks, counterparty credit risk management, liquidity

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1. Introduction

Financial economists and policy-makers have historically focused on banks as prospective channels of systemic distress through, for instance, bank runs and the concomitant reduction in the supply of credit. This “special” attribute of banks has been the classic policy rationale for regulating them. The ongoing shift toward financial markets, arms-length transactions, and active trading, however, has shifted focus to the potential impact of a hedge fund-led disruption on financial institutions, markets, and the broader economy.¹

Financial intermediaries, of course, have many ways to reduce their exposure and mitigate the impact of financial market shocks. The first line of defense is the intermediary’s counterparty credit risk management (CCRM) system. Banks establish limits, implement risk reporting infrastructures, and define haircut, margining and collateral policies, all designed to assess credit risk and limit their counterparty exposure. Effective CCRM is obviously needed for any counterparty, but hedge funds differ in important ways such as their use of complex trading strategies and instruments, leverage, opacity, and convex compensation structures, all of which increase the challenges to effective CCRM.

This paper examines how the nature and characteristics of hedge funds may generate “market failures” that make CCRM for exposures to hedge funds intrinsically more difficult to manage, both for the individual firm and for policy-makers concerned with systemic risk. We put forward no specific new policy proposals, however, because we believe CCRM remains the appropriate starting point for limiting the potential for hedge funds to generate systemic disruptions.² By laying out the issues and highlighting the specific linkages from hedge funds to systemic risk, we hope to highlight areas for further research to better understand when and how markets may fail to yield a desirable outcome.

2. Hedge Funds 101

We begin by describing the difference between a hedge fund and other asset management vehicles such as mutual or pension funds, then discuss the traditional role of

¹ See, for example, McCarthy (2006), President’s Working Group (PWG, 2007), and the papers in the Banque de France (2007) special issue devoted to hedge funds. In addition to the financial system implications, there are also concerns about investor protection and market integrity issues, which we do not discuss.

² Supervisors, of course, have other tools such as direct regulation or disclosure requirements that may mitigate the potential for systemic disruptions. We discuss these in Section 5.

counterparty credit risk management, and present some stylized facts about the hedge fund industry.

2.1. What is a hedge fund?

Hedge funds, in short, are largely unregulated, private pools of capital. Hedge fund managers can invest in a broad array of assets and pursue many investment strategies such as global macro, market neutral equity, convertible arbitrage, or event-driven.³ While strategies and individual hedge funds are quite heterogeneous, we believe it is useful to focus on four broad characteristics that distinguish them from other types of money management funds.

First, hedge funds are not restricted by the type of trading strategies and financial instruments they may use. In particular, hedge funds can and do make use of short selling, derivatives, and options, all of which are complex and potentially nonlinear in payoffs. Second, hedge funds make liberal use of leverage, be it directly through the use of debt or indirectly through leverage embedded in derivatives. This freedom is possible because hedge funds in the United States largely fall outside of the regulatory umbrella by virtue of being open only to accredited investors and large institutions.⁴ Of course, hedge fund investors and counterparties impose some discipline on the amount of leverage actually employed. This discipline, however, may be limited by the third key characteristic - opacity to outsiders - which again is in large part due to their unregulated nature. Finally, hedge fund managers are typically compensated based on both scale and absolute performance through a dual fee structure, e.g., the “2-and-20” set-up where managers retain 2% of the net asset value of the fund and 20% of returns in excess of some benchmark.

The first two traits - the use of complex, nonlinear financial instruments and leverage - make hedge funds somewhat unusual in the asset management world, but not unique among financial intermediaries.⁵ Mutual funds, for example, do have limited ability to short-sell.⁶ By contrast, both of these strategies are available to commercial and investment banks, and

³ See the useful overviews by Fung and Hsieh (1999), McCarthy (2006), Hildebrand (2007), and Stulz (2007).

⁴ The regulatory scope of the SEC is restricted to protecting small, retail investors. The term “accredited investor” helps define what is in and out of scope. See <http://www.sec.gov/answers/accred.htm>.

⁵ There are other investment vehicles which make use of some of these strategies such as private equity and vulture funds.

⁶ See Almazan et al. (2004) for a description of the regulations that govern how mutual funds may behave in terms of issuing shares, distributing dividends, reporting, and investment restrictions such as the use of leverage and short-selling.

many have proprietary trading units that emulate hedge fund investment strategies. This is important as those firms act as counterparties to hedge funds, and likely have experience with the range of financial instruments and strategies, and should therefore be able to adjust their risk management practices accordingly. It is precisely this flexibility, however, that allows hedge funds to play their critical role in terms of price discovery, arbitrage, and increased market efficiency.

Opacity also is not unique to hedge funds as financial institutions generally, and banks especially, are thought to be more opaque than firms in other industries.⁷ Financial firms, however, often have traded instruments such as equity shares or bonds outstanding, so they are subjected to further scrutiny by market participants. By contrast, hedge funds, due to their unregulated and private nature, are not subject to such wide scrutiny unless they chose to issue public securities. Moreover, the success of a hedge fund often depends on proprietary trading strategies which, if made public, can be used by others to trade against them. Investors know this and are thus willing to tolerate a degree of opacity not seen in the mutual fund industry in the hope of securing particularly rich returns.⁸

Finally, the compensation structure of hedge funds differs markedly from other institutional investors such as mutual funds. In particular, hedge fund traders and managers tend to be compensated more on absolute return and scale, while their brethren in institutional investing typically have their compensation tied to performance relative to some benchmark such as the S&P500.⁹ In addition, hedge fund managers have added optionality in the form of hurdle rates (no incentive fee if returns are below the hurdle rate) and high water marks (incentive fee only on new profits, i.e., after past losses are made up), making payoffs potentially very convex and therefore asymmetric: gains and losses are treated differently (Ackermann, McEnally, and Ravenscraft 1999).¹⁰ This convex payoff structure provides strong incentives for hedge fund managers to take on risk and leverage. Although incentive

⁷ Morgan (2002) shows that rating agencies disagree more about financial firms than nonfinancials, a sign of opacity, although Flannery et al. (2004) present an opposing view.

⁸ This increased managerial discretion does result in higher risk-adjusted returns, as found by Agarwal et al. (2007).

⁹ Relative returns do matter to the extent that capital flows toward better performing hedge funds. That is, high water marks compensate absolute returns only to the extent that capital under management is fixed. As discussed later, hedge fund capital does have some mobility.

¹⁰ Agarwal, Daniel and Naik (2006) report that over 60% of funds have hurdle rates and over 80% have high water mark provisions. Note that these authors find that funds with high water marks do earn higher returns – about 20% higher – as they should, but hurdle rates have no effect on fund performance.

fees also play an important role in the mutual fund industry, they are required by law to be symmetric in the U.S. (Elton, Gruber and Blake, 2003).

The combination of opacity and highly convex compensation structures has the potential to create excess risk-taking, which may make investors reluctant to commit capital. As a result, investors prefer hedge fund managers with a significant fraction of their personal wealth invested in the fund, i.e., “skin in the game,” but information on manager stakes is difficult to come by and is generally known only to the largest and most sophisticated investors. Consequently, a hedge fund’s ability to raise and retain capital may be particularly acute in periods of stress when investors may try to withdraw capital from hedge funds.

To be sure, these characteristics are relevant for many types of financial firms such as the proprietary trading desks at regulated financial institutions. Hedge funds are arguably different in degree but not kind, so that any preventive measures or policy discussion should not be limited to hedge funds alone. We now turn to traditional tools to reduce exposure.

2.2. Counterparty credit risk management (CCRM)

Hedge funds interact with regulated financial institutions and intermediaries in many ways including prime brokerage relationships, where regulated intermediaries provide services such as trading and execution, clearance and custody, security lending, technology, and financing through margin loans and repurchase agreements.¹¹ An important part of this relationship is the extension of credit to the hedge fund, so the financial institution is exposed to counterparty credit risk. As a result, traditional counterparty credit risk management (CCRM) systems are the first line of defense between unregulated hedge funds and regulated financial institutions.

An integral part of CCRM is margining and collateral practices, which are designed to reduce counterparty credit risk in leveraged trading by providing a buffer against increased exposure to the dealer providing the financing or derivatives contract. In general, a financial institution may be willing to extend credit to the hedge fund against the posting of specific collateral that is valued no less than the amount of the exposure. This reduction in settlement

¹¹ Revenues for prime brokerage services alone accounted for about \$8bn in 2005, with total hedge fund related business revenue estimated at \$26bn, about two percent of their total asset under management (*Financial Times* 8/9/2006, Richard Beales and Joana Chung, “Banks Take to a Supporting Role as Hedge Funds Flourish,” p. 7).

risk in leveraged trading increases confidence and thereby promotes active financing of leveraged trading.

To be precise, variation margin is the amount of collateral or cash provided to a dealer to cover past changes in the value of the counterparty's position (current exposure). As market prices move and evolve, for example, the mark-to-market of the position may deteriorate and trigger a margin call. Initial margin, in contrast, is an additional amount of collateral designed to cover potential future changes in the value of the contract (potential future exposure). Variation margin and initial margin together ensure that collateral held by the dealer is sufficient to cover the current replacement value of the contract if the counterparty defaults, and also the potential change in value of the contract between the time of the default and the time at which the trading position can be liquidated. Initial margins vary by financial instrument and are usually set to cover changes in the contract's value up to a certain probability, typically 95% to 99%, over a particular horizon, typically one day to two weeks. See Box #1 for an example.

Other forms of traditional CCRM include the development of a broad set of risk metrics including internal ratings; ongoing monitoring and evaluation of exposures such as stress testing on a consolidated basis over a range of suitably stressful scenarios; due diligence to understand the strategies and history of the counterparty; limits on specific trades, exposures, or concentrations; and well-defined processing arrangements and settlement protocols. All of these help control exposure and reduce risk of the financial institution dealing with a hedge fund counterparty.

Our discussion so far has focused on the CCRM imposed by the financial intermediaries that interact directly with a counterparty such as a hedge fund. Of course, investors also play a critical role in disciplining hedge fund behavior and reducing excess risk-taking. It is clearly in the interest of individual investors to understand and evaluate the objectives, strategies, fee structures, and history of the particular funds in which they invest, but the same factors that make CCRM difficult also increase the challenges associated with investor market discipline.

A recent industry study, however, reported improvements in risk management practices in the global hedge fund industry and noted in particular that 87% of dealers surveyed were actively negotiating credit terms specifically to increase transparency and

disclosure.¹² Moreover, the invested capital of the hedge fund managers and the managers' desire to maintain the franchise value of the fund also provide clear incentives to improve risk management.

******* Box #1 - Determination of Initial Margins *******

By way of example, consider the initial margin standards of exchanges such as the Chicago Mercantile Exchange (CME) or the Chicago Board of Trade (CBOT). Specifically, the March 12, 2007 initial margin requirement for JPY/USD futures contract is \$1350.¹³ These contracts are sold in units of ¥12,500,000 each. On March 12, 2007, the exchange rate was \$1 = ¥116. The annual volatility for this exchange rate is measured to be about 8.4%. Then one-day 99% VaR turns out to be very close to the initial margin requirement:

$$\text{VaR} = 2.33 \times \left(\frac{8.4\%}{\sqrt{252}} \right) \times \left(\frac{12,500,000}{116} \right) = \$1300,$$

where the annual volatility is converted to a daily volatility using the standard approach of normalizing by (the square-root of) the number of trading days in a year. This exercise makes clear that risk-based initial margin requirements depend on market conditions, here the exchange rate and its volatility. If market conditions worsen, the initial margin would be too low and additional margin would be called for.

The level of initial margin can be more sensitive to volatility and market conditions in over-the-counter (OTC) markets where trading terms are more flexible than on futures exchanges. Nevertheless, even in OTC markets, margin locks are being adopted to provide more predictability of initial margin requirements. In a margin-lock a dealer will commit to freeze the initial margin terms (e.g. the volatility term in the formula above) for a specified time period, say three months. This practice reduces the liquidity risk for the trading counterparty – though at the cost to the dealer of having fixed initial margin terms at a time when the volatility of exposures may be rising. Note, however, that margin locks do not preclude the dealer from collecting variation or maintenance margins.

¹² Source: Mercer Oliver Wyman (MOW), June 2006, available at http://www.mow.com/en/Files/Press/MOW_Hedge_Funds_Risk_Press_Release_6202006.pdf. Their sample of broker-dealers constituted 90% of global business banks do with hedge funds.

¹³ This example is adapted from Jorion (2007). Margin information for the CME can be found at <http://www.cme.com/html.wrap/wrappedpages/clearing/pbrates/PBISHomePage.htm>.

***** End Box #1 *****

2.3. Overview of industry

By the end of 2006 the global hedge fund industry had about \$1.43tr in assets¹⁴ under management, spread out over more than 11,000 funds, one third of which are fund-of-funds (ECB, 2006). However, because hedge funds are not required to register with any financial regulator or supervisor, these numbers can only be estimated. As we illustrate in Figure 1, the industry has grown enormously: in 1990 hedge funds had less than \$400bn in assets under management, and the one trillion dollar mark was passed just two years ago. Hedge funds are grabbing an increasing share of investable assets when compared to mutual funds, where in 1993 their assets under management were less than 4% of mutual fund assets, increasing to more than 10% by 2005 (Stulz, 2007).

Hedge funds are also dominant players in several markets: in 2005 by one estimate they accounted for 89% of the U.S. trading volume in convertible bonds, 66% in distressed debt, 33% each for emerging markets bonds and leveraged loans, 20% of the speculative grade bond volume, and 38% in credit derivatives.¹⁵ By early 2006 their estimated share of credit derivatives trading had increased to 58% (Greenwich 2006). As these figures show, hedge funds are now engaged in a broader range of activity than in the past, especially in the trading of credit instruments.

Hedge funds come and go. Estimates of hedge fund survival rates vary between 85% and 95% (attrition rate of 5-15%) per year, depending on the year and the style of fund. In their literature review, Chan et al. (2005) report that 30% of funds do not make it past three years, and 40% of funds do not survive past the fifth year. These survival rates are much lower than in the mutual fund industry where average one-year attrition is less than four percent (Carhart et al. 2002). Although attrition rates are high for hedge funds, death by undercapitalization does not seem to be the main reason. Gupta and Liang (2005) report that nearly 90% of dead funds in their study were adequately capitalized at the time of closure.

¹⁴ Source: Hedge Fund Research.

¹⁵ Source: *Wall Street Journal* 7/27/2006, Henny Sender and Anita Raghavan, "Private Money: The New Financial Order," p. A1.

3. Systemic Risk

3.1. Defining Systemic Risk

Amid the rapid growth and innovation in global capital markets, financial stability and systemic risk have emerged as top policy concerns around the world. The Reserve Bank of Australia, the Bank of England, the Bank of Japan, the Norwegian Norges Bank, the Bank of Spain, the Swedish Riksbank, the Swiss National Bank, the Financial Stability Forum, the ECB, and the IMF, to name a few, now all publish regular reports on global financial conditions and financial stability issues.

Systemic risk, however, is not always defined and remains somewhat nebulous, so it is useful to be precise about what we mean by systemic risk. In their exhaustive survey, DeBandt and Hartmann (2002) describe a “systemic crisis” as occurring when a shock affects:

“a considerable number of financial institutions or markets in a strong sense, thereby severely impairing the general well-functioning (of an important part) of the financial system. The well-functioning of the financial system relates to the effectiveness and efficiency with which savings are channeled into the real investments promising the highest returns (p. 11)”

and define “systemic risk” as the risk of experiencing a systemic event.

Bordo et al. (1998) offer a similar description of systemic event as a situation where:

“shocks to one part of the financial system lead to shocks elsewhere, in turn impinging on the stability of the real economy (pg. 31)”

while the Counterparty Risk Management Policy Group (CRMPG, 2005) describes a financial shock with systemic consequences as one with:

“major damage to the financial system and the real economy (p. 5, emphasis in original)

In our view, an essential feature of systemic risk is when financial shocks have the potential to lead to substantial, adverse effects on the *real* economy, e.g., a reduction in productive investment due to the reduction in credit provision or a destabilization of economic activity. Indeed, it is the transmission of financial events to the real economy that is the defining feature of a systemic crisis, and which distinguishes it from a purely financial

event.¹⁶ As discussed in more detail below, these real effects might occur if credit provision is interrupted through shocks to the banking sector or through capital market disruptions.

This view also seems to reflect the thinking around the intervention during the collapse of Long-Term Capital Management (LTCM) in the fall of 1998. FRBNY President McDonough, in his 1998 congressional testimony after the LTCM collapse, stated:

“there was a likelihood that a number of credit and interest rate markets would experience extreme price moves and possibly cease to function for a period of one or more days and maybe longer...Most importantly, this would have led to further increases in the cost of capital to American businesses.”

Presumably, the increase in the cost of capital would lead to a reduction in credit provision and real activity would have suffered. FRBNY President McDonough’s testimony explicitly stated that financial losses associated with asset price declines or failed trading strategies were not enough to motivate an intervention, but rather the concern was for “other market participants -- investors who had no dealings with Long-Term Capital.” This type of impact, either through direct exposures of particular intermediaries or broader disruptions to financial markets, provides a useful framework for discussing systemic risk as an “externality,” which is a classic rationale for government intervention.

An important point is that the optimal level of systemic risk is not zero. A regulator, in principle, could eliminate all systemic risk by imposing sufficiently stringent limits on things like leverage and balance sheet linkages or by imposing severe operating restrictions on key financial intermediaries, but this would unduly curtail the efficient activities of the financial sector and would be sub-optimal from society’s perspectives. Without a fully developed model of the benefits of financial markets and the costs (and origins) of systemic risk, we obviously cannot determine the optimal level of systemic risk here, but it should be stressed that concern should be for “inefficient” systemic risk that exceeds the socially optimal level.¹⁷ As discussed below, the idea of inefficient systemic risk is closely linked with market failures in counterparty credit risk management.

¹⁶ Bordo et al. (1998) label events that only lead to asset price declines and wealth losses without impinging the real economy “pseudo-systemic risk” and conclude that “wealth losses are not synonymous with real systemic risk (pg.33).” CRMPG (2005) make a similar distinction between a financial “disturbance” and a financial “shock,” where only the latter has broad effects on the real economy.

¹⁷ A simple model with diminishing marginal returns to financial intermediation and increasing marginal costs, for example, generates an optimal level of systemic risk that is not zero.

3.2. The Real Effects of Financial Intermediation

If a meaningful definition of systemic crisis involves a potential impact on real economic outcomes, the next step is to identify precisely the linkages between the financial sector in general, and hedge funds more specifically, and the real economy. This connection has historically been made through the “special” role that financial intermediaries, particularly banks, play in resolving information problems in the provision of credit. We begin with a discussion of this channel, and then broaden our perspective to consider the role of hedge funds as a potential source of systemic risk.

The traditional story of why banks matter for real economic activity rests on the assumption that borrowers (firms and entrepreneurs) are risky, but banks have unique skills that allow them to effectively screen lending opportunities, *ex ante* before investing, and then to monitor borrowers *ex post*. As it is inefficient for each saver to do this individually, banks become the “delegated monitor” that produce the critical information to facilitate the efficient allocation of credit. If bank lending activity becomes disrupted, due to insolvency or capital shocks for example, socially productive relationships are severed and critical information is destroyed. As a result, some viable investment projects go unfunded and economic activity is reduced; ample evidence shows that bank lending affects real outcomes.¹⁸ Note that this type of pure informational problem tends to reduce the supply of credit (credit rationing). Later, we discuss how agency problems may reverse this and generate excess risk-taking.

Bank lending, however, is not the only information-intensive form of credit provision and other forms are rising in relative importance. According to the U.S. Flow of Funds, bank credit accounted for 39% of outstanding credit market instruments for nonfarm, nonfinancial corporations in 2005, down from 52% in 1985, which reflects the growing importance of alternative sources of credit such as corporate bonds and commercial paper. These capital market instruments also rely on specific knowledge about borrowers’ creditworthiness, so a financial disruption in these markets could also limit the provision of credit and have real economic effects.¹⁹

¹⁸ Ashcraft (2005) shows that the FDIC-induced failure of healthy banks in the 1980s led to persistent declines in relative income levels. A bank failure could also have real, adverse consequences if depositors are not made whole so wealth is lost or if credit-constrained depositors lose liquidity, although deposit insurance and prompt resolution of failures limit these effects.

¹⁹ Santos (forthcoming) shows the importance of information as a determinant of access to the corporate bond market, especially during recessions when signals of firm quality may be noisy.

Financial intermediaries in this world may not fund as much credit directly on their balance sheet, but act as underwriters, originators, and distributors of credit, and also as traders in the secondary market. Hedge funds, in particular, are active traders and contribute to increased market efficiency and liquidity through their frequent trading and ability to exploit arbitrage opportunities. This activity is generally stabilizing and provides considerable benefits in terms of greater market liquidity, lower volatility, and more stable relationships in the relative prices of financial assets. This should promote an efficient allocation of capital and improve real outcomes.

3.3. Hedge Funds and Systemic Risk

How, then, might hedge funds generate systemic risk? If systemic risk is fundamentally about financial markets linkages to the real economy, then hedge funds create systemic risk to the extent that they can disrupt the ability of financial intermediaries or financial markets to efficiently provide credit. The President's Working Group (PWG, 1999), for instance, identified the potential for the liquidation of a highly leveraged institution to lead to volatility and sharp asset price declines that "heighten uncertainty about credit risk and disrupt the intermediation of credit...heighten the risk of a contraction in real economic activity (p. 23)." A hedge fund link to the real economy might occur through banks' direct exposures to hedge funds, disruptions to capital markets that hinder credit provision or allocation, or indirect effects as bank problems feedback into the broader financial markets. We take each point in turn and end with a discussion of what makes hedge funds particularly prone to exacerbating financial shocks.²⁰

Commercial banks and securities firms are directly linked to hedge funds through their counterparty exposures, e.g., short-run financing for leveraged positions, prime brokerage activity, and trading counterparty exposures in OTC and other markets. If a bank has a large exposure to a hedge fund that defaults or operates in markets where prices are falling rapidly, the bank's greater exposure to risk may reduce its ability or willingness to extend credit to worthy borrowers. Collateralizing the credit exposures may not be enough to mitigate the risk. A sudden decline in asset prices, triggered, for example, by the unwinding of a highly

²⁰ See McCarthy (2006) and Hildebrand (2007) for a discussion of the transmission mechanism from hedge funds to financial stability that focuses on the direct link between an intermediary and a hedge fund counterparty.

leveraged hedge fund, can reduce the value of that collateral, or generate liquidity risk and further price declines via variation margining as investors sell into the falling market to meet margin calls. Such declines in collateral values, if sharp enough, can cast doubt on the assumptions relied upon in stress testing and risk management and cause dealers to become more risk averse in their credit decisions. See Box #2 for further discussion. Moreover, according to the “financial accelerator” model popularized by Bernanke and Gertler (1989), a fall in asset values may reduce collateral values and thus the ability of firms to borrow, which amplifies the impact of the initial shock.

To the extent that bank-dependent borrowers cannot access alternative sources of funding, investment and economic activity will be curtailed until new relationships are formed and information recreated. This mechanism parallels the concern in the early 1990s that bank loan losses in commercial real estate and the need to raise capital combined to create a “credit crunch” that exacerbated the U.S. recession in 1990-91. The concern now, of course, is that worrisome bank exposure is to hedge funds and capital markets, rather than commercial real estate.

Discussions of this type of direct linkage from hedge funds to real economic activity through the banking system are common, e.g., PWG (1999), Financial Stability Forum (2000, 2007), Chan et al. (2005), Garbaravicius and Dierick (2005), Bernanke (2006), McCarthy (2006), and Hildebrand (2007). While the magnitude of this exposure remains unclear, BIS estimates that banks’ direct exposure to hedge funds has been growing proportionately with the hedge fund industry itself.²¹ It should be noted, however, that banks’ current exposures to hedge funds are heavily collateralized and the Financial Stability Forum (2007) estimates that both the current and potential exposure net of collateral of core firms to hedge funds are quite modest in the aggregate (p. 12). Moreover, each bank has a clear self-interest to manage and mitigate the risk of these exposures, although, as discussed in Section 4 below, market discipline through counterparty credit risk management is not a panacea.

A second mechanism is if hedge fund difficulties disrupt broad financial market activity, interrupt the efficient functioning of the capital markets, and hinder the broader provision of credit. It was feared, for example, that the market disruption surrounding the collapse of LTCM might impair the functioning of the credit and interest rate markets, and

²¹ See Garbaravicius and Dierick (2005).

thus impede the provision of credit (McDonough, 1998). This disruption of capital markets fundamentally reflects the loss of confidence of investors and a reduced ability or willingness to bear risk through the provision of credit (CRMPG, 2005). To the extent that this truly reflects an issue of investor confidence and not underlying fundamentals, it suggests an opportunity for policy intervention to shift market participants from a “bad” to a “good” equilibrium.

We emphasize that it is precisely the defining characteristics of hedge funds discussed earlier that create the potential for a substantial market disruption. For example, their opacity and incentive structure may increase the likelihood of such an event as managers turn toward high-risk strategies with substantial tail-risk. Leverage, in turn, may amplify the impact of a given shock and result in larger and wider losses as in the classic example of LTCM in the fall of 1998. Indeed, the PWG (1999), Chan et al. (2005), and others highlighted excessive leverage as the key issue driving systemic concerns from hedge funds. Finally, the complexity and heterogeneity of the instruments may make unwinding positions more difficult, which would impede a timely and efficient workout and exacerbate the market impact.

A third systemic mechanism operates indirectly through the banking system. As discussed earlier, large commercial banks and broker/dealers provide substantial liquidity to the hedge fund sector in the form of absorbing of counterparty credit exposure of trading positions, collateralized financing, providing contingent credit lines, and direct equity stakes. A hedge fund-induced shock to a commercial bank could have knock-on effects if that bank (or other banks) reduces the provision of liquidity to other hedge funds or to other banks, and so further disrupts financial markets and credit provision. Shin (2006), for example, argues that interlinkages of bank balance sheets create complex dynamics that can amplify an initial price shock.

These mechanisms are all conceptual in nature, and there is considerable uncertainty how they might work in practice. For example, recent evidence shows that commercial banks provided considerable stabilization during the market disruption in the fall of 1998 (Saidenberg and Strahan, 1999; Gatev, Schuermann and Strahan, 2006). In particular, when credit spreads rose and commercial paper markets dried up in October 1998, banks were in the position to provide credit, primarily through unused loan commitments and draw-downs

on existing lines of credit, as transaction deposits flowed into the banking sector. Fearing “growing caution by lenders and unsettled conditions in financial markets more generally [were] likely to be restraining aggregate demand in the future,” the Federal Reserve decreased the target Fed Funds rate by 25 basis points on September 29, again on October 15, and once more on November 17, 1998, where it remained for a year.²² In that episode, the Fed’s injection of liquidity combined with normal market mechanisms alleviated the pressure from the short-run disruptions to the capital markets, so that a financial market crisis, driven by a hedge fund collapse, had minimal real effects and did not reach systemic proportions. In crisis, U.S. investors now seem to run to banks, not away from them. It is unclear, however, how effective this substitution of bank credit for capital market credit would be over longer time periods if capital market disruptions persisted.

******* Box #2 - Hedge Funds and Liquidity Risk *******

Hedge funds are typically viewed as being liquidity providers in the capital markets, which helps create market efficiency.²³ Recent reports, however, suggest that hedge funds are moving increasingly into less liquid markets, with structured credit and distressed debt at the top of that list (ECB, 2006, Chan et al., 2005). In the presence of leverage, the combination of relatively illiquid assets and short term financing exposes the hedge fund to possibly significant liquidity risk.

Hedge funds themselves, of course, are well aware of the consequences of their moves into less liquid markets, as are their counterparties. Perhaps as a result, hedge funds are adopting longer lock-up periods on their investors’ ability to withdraw funds, which gives fund managers added flexibility to ride out market fluctuations (ECB, 2006) and MOW, 2006)). MOW (2006) also points out the increased use of gates and notice periods for investor redemption, as well as contractual changes on the part of broker dealers to increase transparency on hedge funds’ liquidity positions. All of these market mechanisms act to reduce liquidity risk for hedge funds.

²² The announcement can be found at <http://www.federalreserve.gov/boarddocs/press/monetary/1998>.

²³ The role of hedge funds as liquidity providers has been documented, e.g., the Agarwal, Fung, Loon and Naik (2006) study of convertible bond market and the Mitchell and Pulvino (2001) study of merger arbitrage both document hedge funds’ role as creators of liquidity

Nonetheless, liquidity management remains an important concern due to the potential impact on market dynamics. Before discussing the concern, it is useful to be precise and distinguish two types of liquidity - “market liquidity” is the ability to trade without affecting market prices, while “funding liquidity” is the ability to acquire funding in the event of credit impairment or other shock. While distinct, these types of liquidity interact in important ways. When funding liquidity is abundant, for example, traders are able to finance positions, trade in higher volume to smooth price shocks, and make markets more liquid. In contrast, weak market liquidity tends to increase volatility, which leads to variation margin and collateral calls that reduce funding liquidity. Market liquidity shocks strain a trader’s ability to fund its positions as additional funds (for instance to meet variation margin calls) can be raised only by selling assets into a falling market.

This mutual dependence creates the potential for market instability.²⁴ Consider the trading losses from a price shock. If the losses are severe enough to seriously erode traders’ capital, then risk management trading limits that are defined relative to capital would compel traders to reduce their trading and market liquidity would decline. At the same time, the increased volatility that typically accompanies price declines can lead to higher initial margin and collateral calls, which raises the cost of maintaining trading positions and reduces funding liquidity (Brunnermeier and Pedersen, 2006). If the shock is large enough, a financially constrained trader will be compelled to sell assets, further depressing prices in the market under stress or transmitting the price shock to other markets as positions in those market are liquidated to meet cash depends. These sales depress prices further, causing a further negative shock to trading positions and setting in motion further assets sales and a downward spiral in asset prices.

A natural question is what market mechanisms or policy responses would halt or reverse a downwards liquidity spiral or bring about a recovery from an illiquid equilibrium. If hedge funds and other traders, who normally smooth out market imbalances and liquidity shocks, are themselves weakened by losses brought on by unusually large market shocks, who

²⁴ Following the 1987 stock market crash, a growing body of research exists on trading driven positive feedback in asset prices and liquidity. Among the earlier papers are, DeLong, Schleifer, Summers, and Waldman (1990), Gennotte, and Leland (1990), and Grossman (1988). Recent examples include Brunnermeier and Pedersen (2006), and Shin (2006). Kambhu (2006) provides empirical evidence on the relationship between funding liquidity and market liquidity in convergence trading in the interest rate swap market.

are the investors that would step in as buyers, and what policies would encourage or promote their stabilizing behavior in a crisis? This is fundamentally a question about the limits to arbitrage and highlights some of the trade-offs that accompany hedge funds' growing role in financial markets.

***** **End Box #2** *****

4. Limitations to Counterparty Credit Risk Management

We now turn to our central question – is counterparty credit risk management (CCRM), particularly by banks and securities firms, sufficient to limit risk-taking of hedge funds and constrain systemic risk to socially efficient levels? The preponderance of financial regulators in the U.S. and abroad have for many years been guided by the principle that CCRM -- not hedge fund regulation -- is the optimal way to control hedge fund leverage and limit systemic vulnerabilities e.g., PWG (1999), Financial Stability Forum (2000, 2007), CRMPG (2005), FSA (2005), Parkinson (2006), and Bernanke (2006). Most recently, PWG (2007) concluded that “market discipline most effectively addresses the systemic risks posed by private pools of capital.”

To assess the question of why CCRM might prove insufficient, it is useful to examine potential market failures (in a textbook sense of deviations from a perfectly competitive, full information economy that efficiently allocates resources) in the provision of credit. These market failures include agency problems, externalities, free rider problems, moral hazard, and coordination failures. We emphasize that these concerns apply more generally to many types of credit provision, but are likely more acute where information problems are most severe, where banks are eager to capture a share of a growing market, and where potential profits are encouraging stiff competition. Hedge fund exposures fit this description quite well, which makes them particularly vulnerable to the erosion of CCRM.²⁵

4.1. Agency Problems

An agency problem exists when participants have different incentives and information problems prevent one party (the principal) from perfectly observing and controlling the

²⁵ See Lacker (2006) for a skeptical perspective on the importance of market failures.

actions of the second (the agent).²⁶ In this case, the agent may act in his own self-interest in a way that is detrimental to the principal. In the case of hedge funds, these agency problems may exist within the dealer/bank, e.g., a trader vs. a risk manager, within the hedge fund, e.g., the hedge fund manager vs. an investor, or in the credit relationship between the bank and the hedge fund.

An agency problem is likely to develop within the dealer/bank as a struggle between insiders (those who do the trading or establish the prime broker relationships) and outsiders (those who don't, such as risk managers, owners, or outside creditors). Because of different incentives and internal informational asymmetries, a trader or salesperson at a large dealer/bank may have less risk aversion and shorter horizons than the firm's management as his participation in the short-run upside exceeds the participation in the downside (Allen, 2003).²⁷ The opacity of the hedge fund counterparty is likely to exacerbate these difficulties as it is harder for outsiders who are less informed of the fund's risk profile to determine the appropriate counterparty risk ratings that drive credit terms such as initial margin or limits on the size of business conducted with the fund. These concerns are particularly severe when the normal business practice is to earn fees up-front, while potential losses fall in the future.²⁸ As a result, insiders' incentives will lead to excess risk-taking (from the firm's and society's perspective), which is possible in situations where information asymmetries prevent the outsiders from perfectly observing, understanding, and controlling the actions of the insider (John and John, 2006).

A second type of agency problem emerges between hedge fund managers and the fund's investors due to the combination of opacity of hedge fund strategies and the total-return based structure of hedge fund managers. Rajan (2005) has warned about compensation structures in financial services that are more commonly convex, i.e., increase strongly with good performance, but fall only mildly with poor performance. This convexity creates strong

²⁶ This is a specific type of moral hazard, a situation where individuals maximize their own outcomes at the expense of others. This can occur when they do not bear the full consequences of their actions (insurance) or information asymmetries that prevent complete contracting (loafing on the job while the boss is away).

²⁷ Recent examples include Nick Leeson at Barings and John Rusnak at Allied Irish Bank, both of whom made unauthorized trades that were subsequently hidden from the relevant risk managers (Allen, 2003).

²⁸ This issue of compensation and risk-taking incentives is familiar to bankers who extend long-term loans when performance, including default, may not be known for many years. Indeed, a 1995 SR letter (SR95-36) on Bank Lending Terms and Standards addresses precisely this point in regard to corporate lending. <http://www.federalreserve.gov/boarddocs/SRLETTERS/1995/sr9536.htm>.

incentives to take on risks, and with lower transparency it is easier to hide those risks from both investors and counterparties. Moreover, Rajan points out that the risks that are more easily concealed “are ‘tail’ risks – that is, risks that have a small probability of generating severe adverse consequences and, in exchange, offer generous compensation the rest of the time.” One such example where hedge funds are significant players are credit derivatives.²⁹

Rajan (2005) goes on to say that:

“[m]ost of the time, I will look as if I am outperforming my comparison group for I will have generated returns with no apparent risk. But every once in a while, disaster will strike and the creditor will default. My true risk profile will then be revealed but too late for my investors.”

One might expect the long-run self-interest of hedge fund managers to curtail excessive risk-taking, but there is abundant anecdotal evidence that even managers of failed hedge funds are able to raise capital in subsequent funds. Similarly, traders at regulated institutions that lose their jobs due to trading losses are often able to obtain new employment as traders. The reason for these perhaps surprising facts is the inherent difficulty in distinguishing managers/traders with talent from those without, i.e., to estimate “alpha,” excess returns uncorrelated with market risk.

As a related point, there is a common perception that the convex payoffs from the high water mark contract of hedge fund managers increases incentives for risk-taking and contributes to agency problems. Rosenberg (2006) finds empirical evidence that the volatility of hedge funds’ returns tend to increase as they fall below their high water mark, and that the volatility increase is largest for funds with an incentive fee and high water mark provision. Panageas and Westerfield (2006), however, show that a high water mark need not lead to greater risk-taking *ex ante* if hedge fund managers have a long horizon. Intuitively, the manager takes into account that being under water in the future is costly, increasing his risk aversion today.

In general, any solution to agency problems must balance the proper incentives with appropriate controls that limit excessive risk-taking such as credit risk mitigation practices that attempt to control exposure and loss given default. Practices such as initial and variation margin, collateralization of exposures, trading limits, and internal reporting systems can all

²⁹ John and John (2006) show how such convex compensation structures can indeed increase systemic instability.

serve this purpose. These practices are commonly used by dealers, but the critical question is about how effectively they are implemented and under what conditions they may be waived. For example, a firm's risk managers preferred level of initial margin to be imposed on a hedge fund may be quite different from the level preferred by the trader who owns an implicit option on the income generated by the trading relationship with the hedge fund.

4.2. Externalities

An externality is an impact of one party's action on others who are not directly involved in the transaction. Credit exposure to hedge funds may create externalities in the banking system or broader financial markets in several ways. If the potential exposure amounts to a significant share of bank capital, for example, then a large shock to hedge funds could weaken banks and impair their ability to provide liquidity to the financial system or credit to borrowers. This can be considered an externality as the impact is felt by market participants not directly involved in the original transaction such as a corporate borrower that relies on a bank that suddenly becomes weakened.

A second way in which hedge fund exposures may generate externalities is in the common exposures to market risk factors across hedge funds and the dealers' own proprietary trading activity. The price impact of hedge funds' defensive trading or dynamic hedging after a shock to a position, for example, could further adversely affect the dealer's similar proprietary trading position. This, of course, relies on similarity in the market risk profiles of hedge funds and dealers, which could be aligned or offsetting. To the extent they are aligned, such a shock would potentially magnify the impact beyond the direct effect of the bank's credit exposure to hedge funds.

Whether these are in fact systemic issues depends on the size of the exposures relative to bank capital and the impact on the provision of credit. For large diversified banks, trading risk tends to be small relative to the credit risk in their loan book and small relative to current capital levels. With regard to credit exposure to hedge funds, the Financial Stability Forum (2007), for example, reports that the potential counterparty exposure of core firms to hedge funds is approximately between 3% and 10% of Tier 1 capital and concludes that "the size of direct exposure would not be alarming even if one assumed a wide margin of error (p. 12)."

Jorion (2006) examines the correlation of market risk capital charges and trading revenues across eleven large U.S. banks. Measured in this way these banks turn out to have a fairly diversified exposure profile. O'Brien and Berkowitz (2006), using proprietary trading P&L data, show significant exposure heterogeneity across dealers. Another way to address the question of whether a correlated shock in the hedge fund and trading businesses is material relative to bank capital would be to conduct an integrated stress test across both counterparty exposures and trading exposures at a dealer. A challenge in conducting such a stress test would be the selection of risk factors against which to assess the exposures. Many hedge funds and banks do not take simple directional trades against broad market risk factors. Instead their trades tend to be spread trades between related securities, and these exposures would not be visible unless a stress test were conducted at a very high level of granularity in the representation of positions and risk factors. See the Box #3 for details on correlation risk and hedge funds.

A related idea is the “public good” nature of financial market stability that generates a free-rider problem in terms of CCRM.³⁰ Consider, for example, a large hedge fund that has exposures with many banks, all of whom benefit from the health of the hedge fund. While, in principle, every bank should monitor its exposure and limit excess risk-taking by the hedge fund, each bank also has an incentive to free-ride by reducing its CCRM and enjoying the benefits of the CCRM of the other banks. This is a classic example of “tragedy of the commons” where private markets may under-provide the public good and create a rationale for official sector intervention.

This public good concern may be exacerbated by liquidity risk. If very large positions are fundamentally different than smaller ones, for example due to price feedback effects if the position needs to be liquidated in a time of stress, as described in Box #2, then CCRM may not provide enough collective discipline even in the absence of free-riding. This concern is amplified by the ability of a particular hedge fund to boost leverage through interaction with many dealers. While each dealer may have an incentive to monitor and control its own exposure, the opacity of a hedge fund's risk profile means that no particular firm would have

³⁰ A public good is both non-rival (use by one person does not preclude use by others) and non-excludable (available to all). It is related to an externality because one person's provision of the good benefits others.

the ability to control a fund's overall leverage and exposure to risk. In this situation, the competitive equilibrium will not impose enough collective discipline.

******* Box #3 - Hedge Funds and Correlations *******

Are hedge fund returns more correlated than the returns of other asset managers? And if so, does it stem from exposure to common risk factors or some other source of dependence or commonality? And finally, do these correlations get “worse” during periods of market turmoil? Affirmative answers to these questions would cause concern about the unusual effect hedge funds may have on the financial system in adverse market conditions.

As perhaps befitting their name, hedge fund returns tend to be only weakly (linearly) correlated with broad market returns (Fung and Hsieh 1999, and Boyson et al. 2006), although Garbaravicius and Dierick (2005) provide evidence that this correlation has been increasing over recent years. Yet the ECB documents that hedge funds have become more correlated with each other: “the levels reached in late 2005 exceeded those that had prevailed just before the near-collapse of LTCM,” (ECB (2006), p. 134), although Adrian (2007) concludes that this primarily reflects lower overall volatility in the recent period.

The picture becomes somewhat more complex when looking beyond linear dependence. Boyson, Stahel and Stulz (2006) analyze co-occurrences of extreme moves (5-15% tail events), which they call contagion. They find no supporting evidence of contagion from extreme moves in the underlying risk factors – equity, fixed income and currency markets – but they do find evidence of contagion across hedge fund styles. One interpretation is that this simply reflects omitted risk factors such as liquidity risk which are common across styles. Alternatively, these findings may lend support to Rajan's (2005) assertion of herding behavior among asset managers generally, a concern also raised by the CRMPG (2005) in what they call “crowded trades,” but disputed by EDHEC (2006). Overall, however, the conclusion drawn by Boyson, Stahel and Stulz (2006) is worth noting:

“These results imply that systemic risk arising from poor performance in the broad markets is not amplified by contagion to the hedge fund industry (p. 31).”

******* End Box #3 *******

4.3. Moral Hazard

Moral hazard refers to changes in behavior in response to redistribution of risk, e.g., insurance may induce risk-taking behavior if the insured does not bear the full consequences of bad outcomes. In financial markets, the question of moral hazard from conjectural guarantees by the government - the implicit promise to bailout certain bank creditors - may apply to the largest commercial banks, but does not apply to the hedge funds. The resolution of the LTCM crisis, for example, was essentially an informal bankruptcy procedure in which LTCM's stakeholders were largely wiped-out in the recapitalization and ultimate liquidation of the fund by its dealer counterparties. Further, regulators continually disavow any "too-big-to-fail" policy for hedge funds.

For the regulated largest financial intermediaries, however, their central role in the financial system raises the question of how large credit losses would affect regulators' decisions about the regulated firm. As a result, a bank (and bank's counterparties) may arguably have less incentive to monitor, reduce risk, and limit exposure in activities whose current profitability and growth opportunities make them attractive to banks – such as the hedge fund sector. This moral hazard issue for large financial intermediaries is relevant in all of their risk management decisions, however, not just those related to their hedge fund business. Furthermore, the substantial franchise value attributable to large financial institutions should help to mitigate somewhat these moral hazard issues.

4.4. Competition

A final concern about the breakdown of effective CCRM is that the apparent profits to be earned in this business may create competitive pressures that weaken credit risk mitigation practices. Bernanke (2006) and Financial Stability Forum (2007), for example, discuss how competition for new hedge fund business may be eroding CCRM, e.g., lower than appropriate fees and spreads, or inadequate risk controls such as lower initial margin levels, collateralization practices, or exposure limits.³¹

While this is not a market failure per se, the U.S. banking sector has a history of periods where of lax CCRM contributed to substantial credit losses and potential systemic

³¹ This is not a new concern. See PWG (1999) for similar concerns about potentially harmful effects of competition for hedge fund business.

consequences: the LDC debt crisis of the late 1970s and early 1980s; excessive commercial real estate lending in the late 1980s; possibly the weak counterparty credit measures in the 1990s that allowed LTCM to take on enormous leverage in many markets; and most recently in the subprime mortgage market. As mentioned earlier, this deterioration may partially reflect inefficient compensation schemes and short horizons of lenders, although some portion of the adverse outcomes simply reflects the underlying, negative shocks.

A complicating factor, however, is that competition and expected profit typically improve efficiency and erode economic rents by inducing entry. This makes it more difficult for outside observers to assess whether claims of competitive excess are real or the complaint of incumbents whose profits are being eroded by competition. This type of competition may actually be socially efficient if earlier margins, for example, were “too high” and unduly restricted activity.

Little is available in the economics literature on the interaction of competition and risk management discipline on practices such as initial margin levels as the relevant data are not available, e.g., the distribution of dealers’ hedge fund business by counterparty risk class, how it has changed, how measures of hedge fund creditworthiness vary across dealers, and how they relate to potential future exposure and risk mitigation practices such as initial margin. This remains an important question for future research.

5. Implications for Regulation

A typical economist’s view is that market participants enter into transactions with a full understanding of the benefits and costs of their actions. To the extent that participants are well-informed and all the costs and benefits accrue to those making the transaction, a perfectly competitive environment leads to a *laissez faire* level of systemic risk that is socially efficient, so there is no rationale for regulation or intervention. Additional direct regulation would likely reduce social welfare due to less activity, entry deterrence, stifled innovation, limited competition, distorted behavior and regulatory arbitrage, increased moral hazard, and direct compliance costs.

As discussed earlier, however, the text-book description of perfect competition is typically not appropriate in all financial and credit markets where agency problems, externalities, and moral hazard are common. As a result, the *laissez faire* level of systemic

risk may be too high from society's perspective, raising the question of whether regulation may potentially improve outcomes. Indeed, a key lesson from the collapse of LTCM is that market participants may not be sufficiently cognizant of the risks they face and therefore not vigilant enough in constraining counterparty risk.

Since LTCM, however, CCRM has greatly improved. CRMPG (2005), MOW (2006), and Financial Stability Forum (2007), for example, have noted improved risk management techniques by counterparties; improved supervision; more effective disclosure and transparency; strengthened financial infrastructure; and more effective hedging and risk distribution techniques. Moreover, the institutionalization of hedge funds, driven by demands of new investors such as hedge funds of funds and other institutional investors, is increasing discipline and transparency. More research on the role of hedge funds of funds as both a stabilizing force (through increased discipline and reallocation of capital to better performers) and a destabilizing force (as a source of "hot money") would likely be fruitful.

Despite these gains, if systemic risk reflects an externality or public good problem, then by definition, even well-informed market participants will not have an incentive to adequately monitor or limit those risk-generating actions and there is a role for regulation to reduce inefficient systemic risk (PWG (1999) and Bernanke (2006)). Effective policy, however, needs to be able to precisely identify and to quantify the externality in order to determine the appropriate policy (FSA, 2005). Moreover, we have no evidence that externalities relating to hedge funds are unique. Therefore, a second area for research is to examine whether externalities relating to hedge funds are more acute than in other areas of bank lending where stronger CCRM remains the appropriate policy response.

A more forceful alternative – outright regulation of hedge funds such as activity restrictions, required capital, or leverage restrictions – has not received much attention and could have substantial costs. Activity restrictions that dramatically limit trading strategies such as short-selling or use of derivative investments, for example, would likely diminish the beneficial impact of hedge funds on market liquidity and price discovery, thereby reducing the benefits along with the costs. Required capital ratios would be difficult to set optimally and would likely lead to increased regulatory arbitrage as hedge fund managers would find ways to evade the rules and obscure their positions. Outright regulation might be expected to increase moral hazard if it increases the appearance of regulatory approval or simply the shift

the activity to a less regulated jurisdiction. With a heavy regulatory hand there is a risk of hedge funds moving totally off-shore; regulators might go from seeing little to seeing nothing. Finally, the historical policy response to lax CCRM has not been to regulate the borrower, but to increase oversight of the lenders, so regulation of hedge funds would be a significant departure from policy precedents.³²

A second alternative is the mandatory provision of more information to regulators and the investment community. In principle, better informed investors would be increasingly able to monitor and discipline hedge funds, and thus reduce excessive risk-taking. One specific idea raised by the PWG (1999) was improvement in the disclosure of hedge funds' risk profiles to their investors and counterparties. Timely and meaningful disclosures that don't compromise legitimate commercial interests of a hedge fund would help address the information asymmetries related to the market failures discussed above. Another specific idea raised by some is the creation of a large database, maintained by the official sector, that aggregates and records hedge fund exposures on a real time basis. It is not clear, however, how the official sector could effectively analyze the enormous quantity of information or act on it given the heterogeneous nature of positions and exposures, and this would undoubtedly be a very costly exercise (Bernanke, 2006). Moreover, disclosure does not solve the externality problem or all of the agency issues.

A third alternative, discussed by the FSA (2005) and CRMPG (2005), is to encourage through moral suasion "best practice" techniques for risk management and measurement, both within institutions and in terms of market infrastructure. Meaningful best practice efforts spearheaded by the official sector or industry groups can leverage market discipline and encourage institutions to meet generally agreed upon standards in terms of accounting, transparency, and risk management. For market infrastructure issues, the recent work led by the Federal Reserve Bank of New York and other regulators on credit derivatives clearing and settlement shows how market participants may not have adequate private incentives to provide essential "plumbing" that is good for all. This is a classic case of public good that

³² In response to excessive lending to commercial real estate lending in the property boom of the 1980s, regulators established stronger supervisory guidance on property lending, while the banks and property developers developed innovative financing arrangements involving securitization that shifted some of the risk out of the banking sector. Significantly, no one proposed that commercial property developers become regulated institutions.

needs to be provided by the official sector to avoid the “tragedy of the commons,” in this case systemic risk. Other examples may include improved clarity around legal arrangements for prime brokerage activities and valuation standards for complex, illiquid products.

We conclude that the current emphasis on market discipline and CCRM as the primary check on hedge fund risk-taking is appropriate. If systemic risk were to originate through direct banking sector exposures, for example, then the banks themselves have the strongest incentive to monitor those exposures and limit risk. While various market failures may make CCRM imperfect, it remains the best line of defense against systemic risk.

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Total Assets under Management by Hedge Funds, Globally

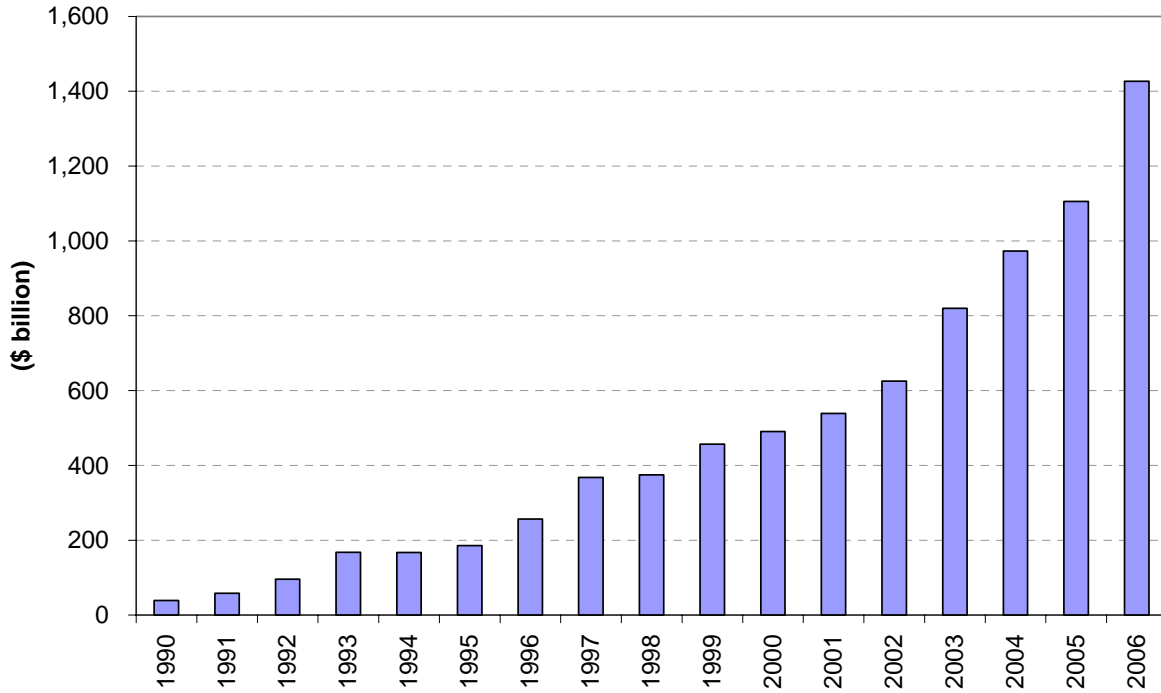


Figure 1: Assets under management by hedge funds, globally. Source: Hedge Fund Research.