Letter from the Editors

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LTCM: TOO BIG, TOO COMPLEX, TOO SMART, TOO BAD

I did not bailout THAT hedge fund! Actually what Alan Greenspan said in his testimony to Congress on October 1st, 1998 was, "On September 23, the private-sector parties arrived at an agreement providing a capital infusion of about $3.5 billion in return for substantially diluting existing shareholders' stake in LTCM. . . .This agreement was not a government bailout in that Federal Reserve funds were neither provided nor ever even suggested. Agreements were not forced upon unwilling market participants".

Representative Jim Leach R-Iowa disagrees with Chairman Greenspan on the matter of the hedge fund Long Term Capital Management (LTCM). "Last month, with the rescue of LTCM, a corollary appears to be in the making that "some financial firms are too big to liquidate too quickly." The application of the "too-big" doctrine for the first time beyond a depository institution raises troubling public policy questions. . . .From a social perspective, it is not clear that "Long-Term Capital", or any other hedge fund, serves a sufficient social purpose to warrant government directed protection. . . . .By acting as it [The Fed] did, however, it preserved an institution that in a free market economy would normally have been allowed to fail". (October 12, 1998 105th Congress, 2nd Session, Vol. 144, No. 144, The Failure of Long-Term Capital Management: A Preliminary Assessment)

Both Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve System and William McDonough, President of the Federal Reserve Bank of New York believed that the collapse of LTCM would have disrupted capital and money markets to an extent that not only LTCM's counterparties but segments of the economy not contractually connected to LTCM could have suffered significant losses in wealth and productive capability.

Too big to fail does not imply that equity will not be lost, it implies that an institution will be kept afloat so that contracts and commitments can be offset, liquidated or closed in an orderly fashion so that losses are contained to the owners and uninsured creditors of the distressed institution. Bank supervisors have an incentive to control the fall of large financial institutions not for the benefit of owners but rather for the benefit of society. The same was true of LTCM. The question Alan Greenspan was contemplating in September of 1998 was not the social value of hedge funds but the social cost of LTCM's collapse.

The difference of opinion between Representative Leach and Chairman Greenspan is significant because moral hazard arising from the government's rescue of a private investment fund may skew capital allocation and compound future economic losses by leading private investors to expect that their investments in hedge funds will be supported by government funds.

Politicians may find it convenient to misinterpret the facts but in doing so they create the effects of moral hazard that they argue were promoted by the Federal Reserve's handling of the LTCM affair. Rather than creating an environment where investors would continue to generously extend and leverage bets to unregulated financial institutions, the near collapse of LTCM has reduced the flow of capital to hedge funds by causing regulated financial institutions to internalize the costs of doing business with highly leveraged institutions.

The following excerpt from J.P. Morgan's 1998 10-K is one example of the steps many banks are taking to limit and control their exposure to hedge funds in the aftermath of the LTCM affair.

"Volatile market conditions in the third quarter of 1998 created significant losses and severe liquidity concerns for many hedge funds.

As a result of these concerns, we reassessed our policies and exposures related to hedge funds and made a number of improvements. They included:

- Updating due diligence on our hedge fund client base and screening out the least creditworthy counterparties
- Strengthening margin agreements to include up-front margin requirements that take into account liquidation considerations

• Reviewing all documentation
• Increasing information monitoring requirements
• Reviewing daily exposure changes and their correlation with market parameters."

Certainly LTCM has forced financial market supervisors to take a closer look at the activities of hedge funds and the risks they pose to the operation of financial markets and payment systems. This increased attention from market supervisors will also increase the caution with which financial institutions engage highly leveraged institutions (HLIs).

The Bank for International Settlements in a January 1999 report, "Banks' Interactions with Highly Leveraged Institutions", analyzes the risks banks face when dealing with HLIs, current shortfalls in bank management of risks associated with doing business with HLIs and policy recommendations for monitoring and measuring bank exposure to HLIs. The BIS report defines highly leveraged institutions as "large financial institutions that are subject to very little or no direct regulatory oversight as well as very limited public disclosure requirements and that take on significant leverage". One topic discussed in the report is "secondary exposures".

"Secondary exposure" is the possibility that collateral that is adequate at a point in time may be inadequate when a counterparty becomes distressed and it is quite clear that an HLI can become distressed very quickly with little warning. What is adequate collateral for a position that can be liquidated immediately such as a futures contract is not adequate for a OTC derivative contract that must be liquidated into a thin and evaporating market. For example J.P. Morgan reports in its 1998 10-K "The net amount J.P. Morgan was owed by hedge funds under derivative and foreign exchange contracts on a mark-to-market basis was approximately $1.3 billion at December 31, 1998. Substantially all of this amount was secured by cash and U.S. Treasury and agency securities under daily mark-to-market collateral agreements". If their exposure to hedge funds is fully collateralized and marked-to-market daily, why the concern when it became apparent that LTCM's equity was burning up? Why didn't the Federal Reserve System stand aside and let the banks work out their positions with LTCM, rebalance their portfolios and liquidate their collateral?

The language found in J.P. Morgan's filing is typical of the information offered by other banks with exposure to hedge funds. Focus is placed on collateral and the fact that positions are marked-to-market daily. Secondary exposure relates to unsecured exposure that can result from the delay between calling for and receiving margin, the time it takes to liquidate collateral and the time it takes to offset positions.

In his testimony to Congress on October 1st, 1998, William J. McDonough explained that the multibillion dollar losses that LTCM counterparties would have experienced had LTCM been "suddenly put into default", was not the concern of the Federal Reserve. Working for a solution that would keep LTCM afloat was motivated by the Fed's concern that bankruptcy of LTCM would have had serious contagion effects. It was feared that financial markets would have been disrupted as counterparties sought to liquidate collateral, close positions and rebalance their portfolios.

The "best and the brightest" got burned as the capital of LTCM was consumed by the markets. We have lost some money at the backgammon table by throwing double sixes twice in a row an event with a probability of .007716. We have not revised our game strategy to take this event into account yet when we play we don't bet all our risk capital on the chance that this outcome will not occur. In the late summer of 1998, security values across a number of markets began moving in directions and at speeds that hedge fund managers had thought very unlikely, the markets had tossed double sixes consecutively.

Financial disasters not only destroy wealth, they increase the cost of creating new wealth. Temporary effects of September 1998 are an increase in the cost of capital to hedge funds and a decrease in the value of Ph.D's in Greenwich. A more lasting effect is that hedge fund activities will be supervised more closely. We say temporary because who is left on Wall Street that remembers David Askin's "market neutral" Granite Funds except for the lawyers who have been in court since 1994 when the funds blew up as interest rates were increased by the Fed. Of course that was long ago in 1994 and David Askin didn't have a Nobel Prize in economics. In fact part of Askin's defense was that he was a dupe for the brokers. One lesson the current population of bankers has probably learned is that no one is "too smart" to lose it all.

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