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Healthy Hedge Funds, Sick Banks

By Peter J. Wallison

The last eight months have been tumultuous for banks, as the subprime meltdown worked its way through the balance sheets and income statements of some of the world's largest financial institutions. Yet, at the same time, the hedge fund industry has continued to grow—and, from all appearances, to prosper. This must present something of a paradox for those who have always believed that regulation is necessary to produce stability for a financial industry. In a period of major market turmoil, a huge unregulated industry that engages regularly in transactions with banks and other financial counterparties has shown few, if any, significant problems. This suggests two possible conclusions: that market discipline is more effective than regulation in maintaining an industry's stability, and that regulation itself must be significantly improved in order to be effective in overcoming the moral hazard it fosters.

We are now at least eight months into a period of market turmoil in which many of the world's major banks have announced substantial losses, spreads in interbank lending have reached historic levels, and yields on U.S. government securities have fallen substantially as investors rushed to quality in the face of significant market risk. The market value of all U.S. bank stocks has declined by about 20 percent during this period, and the share prices of European banks have declined even more (see figure 1 on the following page). Banks that were heavily involved in the subprime mortgage or other securitization markets, which includes most large institutions in both Europe and the United States, have suffered share price losses that are substantially larger than the industry as a whole.

Yet throughout all this turbulence and uncertainty, little has been heard about one part of the financial sector that was the focus of attention—and the source of much hand-wringing—before the huge losses in subprime mortgages diverted everyone's attention to the banks. Although problems may still come to light, hedge funds seem to have weathered the storm reasonably well. While there are no share price figures for the privately held hedge funds, the indexes published for the industry show substantial gains in virtually every month during 2007.

This is surely a paradox for those who believe that government regulation of financial markets is necessary to protect consumers and achieve stability. But it should come as no surprise.

Hedge Funds and Banks

Alarm in the political class about hedge funds is typified by an October 2006 letter from Senator Charles Grassley (R-Iowa), then chairman of the Senate Finance Committee, to Treasury Secretary Henry M. Paulson:

> Today, the hedge fund industry is comprised of over 9,000 hedge funds that manage over $1.1 trillion in assets. In spite of this major presence in our financial markets and our economy as a whole, hedge funds are not subject to disclosure and transparency rules that apply to other financial intermediaries, and are permitted to operate almost completely unfettered by government oversight or regulation.[1]

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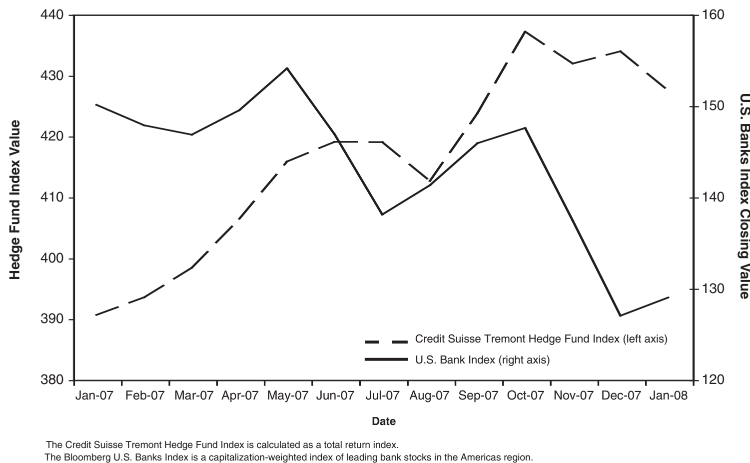
FIGURE 1
CREDIT SUISSE TREMONT HEDGE FUND INDEX VS. BLOOMBERG U.S. BANKS INDEX JANUARY 1, 2007, TO FEBRUARY 15, 2008



SOURCE: Index data compiled by AEI research assistant Karen Dubas.

The assumption underlying this statement is that regulation is the only way to protect the public from the risks associated with financial activity. In light of the fact that the most heavily regulated industry in our economy—banking—has encountered significant financial difficulties in recent months, this assumption deserves a critical second look.

Any consideration of this question would have to begin with the remarkable fact that U.S. financial history provides only two examples of whole industries suffering something close to a meltdown—the banking industry during the Great Depression and the savings and loan (S&L) and banking industries in the real estate collapse of the late 1980s and early 1990s. Although the regulation of banks before the adoption of the federal deposit insurance system in 1933 was less comprehensive than it is today, there was state and federal regulation that involved safety-and-soundness examination and restrictions on entry and branching. Regulation in this era seemed intended to foster stability by reducing "cutthroat" competition and, in the case of interstate branching, was continued until the 1990s. After the reforms of the 1930s, both banks and S&Ls took insured deposits, and both were still heavily regulated when they suffered near-collapse half a century later. The banking industry's problems in the Depression and more recently were not unique. As my AEI colleague Charles W. Calomiris notes, "Nationwide [banking] panics in U.S. history include 1819, 1837, 1857, 1861, 1873, 1884, 1890, 1893, 1907, and the three successive waves of contraction from late 1931 to early 1933."[2]

In other words, the banking industry—under the supervision of state and federal governments before and after the Depression—has shown remarkable instability throughout much of its history. The question addressed in this *Outlook* is whether regulation allowed an industry that is inherently unstable to function with a reasonable degree of stability or whether the regulation itself is responsible for the instability that has historically afflicted banking. The apparent stability of the hedge fund industry in a time of troubled financial markets may point to an answer.

Stability, Risk-Taking, and the Regulation of Banks

There is a school of thought that views banking as inherently unstable and thus inherently in need of government regulation.[3] The analysis underlying this view focuses on the foundational observation that banks take deposits that may be withdrawn on demand but make loans that can extend over many years. Thus, a bank is always subject to failure—the consummate instability—because there is a critical mismatch between its assets (the loans) and its liabilities (the deposits). For the purposes of this *Outlook*, this may be viewed as a key distinction between banks and hedge funds. Hedge funds may invest in riskier assets than the commercial and other loans that are made by banks, but their liabilities—that is, their financing—are not subject to withdrawal on demand like bank deposits.

That, however, may not be as important a distinction as it seems. Despite the fact that hedge fund financing is not as short-term as bank deposits, it is likely to be susceptible to withdrawal should the hedge fund suffer a severe decline in asset values. Almost all hedge fund financing is collateralized, and a serious decline in collateral values will usually give the lender the opportunity to call the loan or demand more collateral. Accordingly, while there are not likely to be visible "runs" on hedge funds, a severe decline in the value of a fund's assets could result in a termination of credit lines and demands for immediate repayment, leading to collapse. So the questions remain: why are regulated banks suffering a bout of instability and market

turmoil at this point while unregulated hedge funds seem to be stable and even prospering, and what does this say about regulation?

It is important to note that regulation of banks has improved markedly over the last quarter century. Historically, there were three reasons for bank instability:

- Banks were confined by regulation to specific geographic areas—often as unit banks—and thus could not diversify to avoid the troubles of the local economy.[4]
- Banks (through the Glass-Steagall Act) and S&Ls (because of their legislatively required focus on mortgage lending) were limited in the assets they could hold and thus could not diversify their portfolios.[5]
- State and federal deposit insurance programs created moral hazard by leading depositors and other creditors to believe that deposit insurance and regulation obviated the need for them to be wary creditors and exert market discipline.[6]

In recent years, greater sophistication about the economics of banking has led to the gradual elimination of the first two elements above. Banks have been allowed to branch—contributing to their stability—and to diversify their assets into securities and other financial activities. But along with these favorable trends has come an increased willingness by regulators to use their powers to prevent instability and the consequent losses to the public, and that has led to increased moral hazard and a corresponding reduction in market discipline. These regulatory efforts do not always extend to direct bailouts of distressed institutions, but rather to actions that will relieve the difficulties of a troubled group of institutions in order to forestall either a liquidation (in which uninsured depositors and other creditors might not be protected) or a bailout (in which they would).

A recent example is the series of actions by the Fed when it was confronted with the severe losses of the large banks involved in the subprime loan meltdown. This was a serious problem, but it did not affect all, or even most, banks. Instead, a few banks suffered severe losses while others were largely unaffected. Nevertheless, the initial reaction to impending subprime losses caused a panicked reaction among the major international banks, which were no longer sure of the financial condition of their counterparts. On August 1, 2007, the overnight London Interbank Offer Rate (LIBOR)—the rate at which banks lend to each other—was an unusually high 6 percent. The high rate for overnight loans reflected deep concern among banks about the financial condition of their bank counterparts. The Fed acted quickly. As Congressional Budget Office director Peter R. Orszag testified to the Senate Finance Committee on January 22, 2008:

> One important reason that undue risk-taking occurs is that market discipline has been reduced by moral hazard—the sense among investors and depositors that in the end the government will rescue banks and other private sector institutions from the consequences of their own errors.

> On August 9, the Federal Reserve injected $24 billion in temporary reserves into the U.S. banking system, a larger-than-usual amount, by accepting greater-than-normal amounts of mortgage-backed securities as collateral. That and subsequent injections temporarily lowered the federal funds rate below the 5.25 percent target the Federal Reserve set on August 7. . . . On August 17, the Federal Reserve narrowed the spread of the discount rate (the rate at which depositories can borrow from the Federal Reserve) over the target federal funds rate from 100 to 50 basis points.
>
> The Federal Reserve has continued to act since then. With money market conditions still under stress in the fall of 2007, the Federal Reserve reduced the target federal funds rate three times in September, October, and December to its current level of 4.25 percent. In December, the Federal Reserve also created a Term Auction Facility (TAF) to auction $40 billion of short-term financing to depository institutions that are eligible to borrow from the Federal Reserve's discount window. The Federal Reserve has scheduled two additional auctions this month [January 2008], each of $30 billion in short-term credit. These actions, plus possible further reductions in the federal funds rate over the next few months, may stabilize financial

> institutions and markets enough to obviate the need for changes in discretionary fiscal policy.[7]

The effect of these actions has been to return some degree of stability to the interbank market, with the overnight LIBOR now a little above 3 percent. However, policy actions such as these do not discourage future risk-taking. If anything, they increase the likelihood that a bank management, saved from the consequences of their earlier missteps, will engage in even more risk-taking to return the price of a bank's shares to the higher levels they enjoyed before a crisis. For the moment, banks have tightened their lending conditions for commercial loans, in large part because of capital constraints. At some point, the banks will have to recapitalize. Many observers believe more losses will be recognized in the future, not only because of write-downs on portfolio holdings of downgraded securities but also because of declines in revenue from securitization. Once these losses have been recognized and recapitalization completed, banks will seek to replenish their earnings stream. It is likely that supervisors on their own are not going to be able to prevent bank managements from taking greater risks to replace lost revenues.

This is not to say that the Fed was wrong to act. It is functioning within a system that includes a history of policy actions already in place—the Fed was expected to act. Moreover, there was a genuine crisis of confidence in the banking industry, and that crisis might have resulted in real economic losses if it had continued. The question addressed in this *Outlook* is why the risk-taking occurred in the first place, and why regulation was not sufficient to prevent it. One important reason that undue risk-taking occurs is that market discipline has been reduced by moral hazard—the sense among investors and depositors that in the end the government will rescue banks and other private sector institutions from the consequences of their own errors. When that attitude takes hold, it may overwhelm the efforts of bank supervisors to control risk-taking. It is ironic that the Fed's action in this case was both a result of the moral hazard created by its past actions and the reason additional such actions will be necessary in the future.

The Persistence of Moral Hazard

One of the most difficult problems for government is establishing its own credibility. The Treasury Department routinely promises that if either Fannie Mae or Freddie Mac should default on its obligations, neither of them will be bailed out. Investors do not believe this. When both government-sponsored enterprises (GSEs) were unable, because of accounting failures, to file any financial statements with the Securities and Exchange Commission for several years, the spread of their debt over Treasuries—including their subordinated debt—actually *declined*. Obviously, investors were looking at the government's past record of GSE and bank bailouts and concluding that the government would do the same again if either of the GSEs had financial difficulties.

Unfortunately, the government has a poor record of avoiding bailouts. Prior to the adoption of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991,[8] it was the established policy of the FDIC and the Federal Reserve to bail out the uninsured depositors of banks. Between 1979 and 1989, for example, 99.7 percent of all deposit liabilities—involving roughly 1,100 failed commercial banks—were fully protected by the FDIC.[9] FDICIA mandated a "least-cost resolution" policy that in most cases required the FDIC to bail out only the insured depositors—those with deposits of $100,000 or less. FDICIA left open the possibility, however, that all depositors and creditors could be bailed out in extreme or special circumstances, and it established a set of procedures for the FDIC to follow before doing so.[10] Nevertheless, although the percentage of bank failures in which the uninsured depositors were protected declined between 1986 (before FDICIA) and 2000, the uninsured depositors of seventy-four banks that failed between 1991 and 2000 were still protected.[11]

Another source of moral hazard is discount-window lending by the Federal Reserve. This central banking function was originally intended to prevent banks from having to sell good assets at distress prices in order to meet deposit withdrawal demands. Discount-window lending is supposed to enable the Fed to lend to otherwise healthy banks by taking as collateral—that is, discounting—good assets, such as U.S. government securities. The mechanism is well-founded in theory, but in practice it is very difficult for the Fed to determine whether a bank that is offering good collateral at the discount window is in fact healthy. Lending to a weak bank may simply keep the bank afloat while the uninsured depositors and other creditors get out. If this occurs, it is another form of bailout and moral hazard. In August 2007, the Fed offered discount window access to just about every bank, particularly those that were having liquidity difficulties. As noted by Orszag, the

Fed even set up an auction process for discount-window access, abandoning entirely the idea that the discount window was supposed to be available only to banks in sound financial condition that needed temporary liquidity.

There is also a strong tendency on the part of regulators to bail out uninsured depositors and other creditors. If the bank is very large, there can be serious concern that its failure would have spillover effects on other banks—directly through correspondent deposit arrangements and indirectly through a general loss of confidence in the banking system—and this spillover might have dire systemic effects. In this case, regulators face a choice: they can deny assistance and risk the possibility of a serious financial crisis arising on their watch, or they can create long-term problems for their successors by bailing out uninsured depositors and other creditors, with the resulting moral hazard and reduction in market discipline. Only the strongest and most principled regulator could resist taking the short-term course of providing a bailout whenever there is a more than remote chance that a bank failure will have knock-on effects. The same incentives are present when the Fed is confronted with a discount-window request. Meeting the request may increase moral hazard, but refusing it may result in a financial crisis and an embarrassing congressional investigation.

Banks can expand and take more risks than would ordinarily be allowed by those who supply their funds.

In the current financial turmoil, as detailed in Orszag's testimony, the Fed acted exactly as one would expect. When it appeared that the largest U.S. banks would suffer substantial losses in the subprime collapse, raising doubts about their financial health, the Fed took steps to demonstrate its support for their continued liquidity. Taken together, these actions seem finally to have calmed the interbank market sufficiently for spreads in interbank lending to decline. This is undoubtedly considered a policy success at the Fed, and, in light of the favorable result, it can certainly be viewed that way. But the unasked question is whether the Fed's willingness to shore up the banks adversely affected by the subprime collapse has simply created more moral hazard and increased the likelihood that another similar crisis will result in the near future. After all, if depositors and creditors in a bank can be reasonably sure that they will not suffer losses should a bank meet financial reverses, they will be much more willing to lend to the bank—at an interest rate that does not reflect the full scope of the risk involved. With this history, it will be very difficult for regulators to persuade investors and creditors that any large institution will be allowed to fail.

Regulation and Risk

If only a few people ask whether the Fed should have taken the steps it did to restore confidence in the banks, almost no one is asking whether regulatory policies such as this were what allowed the banks to take substantial risks in the first place—and thus lay themselves open to significant losses. Yet that is a plausible idea that deserves examination. The experience of hedge funds, at least thus far—even in this time of market turmoil—suggests strongly that market discipline is a powerful mechanism for controlling risk. Indeed, the hedge fund industry seems to recognize this. The Managed Funds Association, the business association of the hedge fund industry, recently published a new edition of its manual, *Sound Practices for Hedge Fund Managers*.[12] The book contains recommendations on matters such as risk management, relationships with counterparties and prime brokers, and—recognizing the significance of market discipline—a checklist for investors. The Bush administration has also come to realize that regulation is often not the answer in dealing with industries that have grown up without regulatory intervention. In a landmark pronouncement in February 2007, the Treasury Department and the other members of the President's Working Group on Financial Markets put themselves squarely on record in favor of market discipline as the mechanism that would control the risk-taking of hedge funds and private equity funds.[13] Until market discipline is shown to be ineffective, that is likely to remain government policy, which accounts for the attention to market discipline displayed by the Managed Funds Association.

In the case of banks, on the other hand, where regulation and past and current efforts to maintain stability have created moral hazard and seriously reduced market discipline, regulation is the only available path. As long as the government is backing bank deposits, market discipline will not work. Why this is true seems fairly straightforward, as described by Alan Greenspan:

> Since the sovereign credit of the United States ultimately guarantees the stability of the banking system and the claims of insured depositors, bank creditors do not apply the same self-interest monitoring of banks to protect their own position as they would without discount window access and

> deposit insurance, and they demand lower interest rates on their deposits and loans because they perceive the risk to be lower than it actually is.[14]

In the absence of market discipline, risk is supposed to be controlled by regulation. It appears, however, that regulation is not effective. If anything, by lulling investors and creditors into the belief that regulators understand the risks the banks are taking, regulation may enable risk-taking rather than effectively control it. Bank managements are probably more inclined to take risks because they are not receiving signals from the market—in the form of rising interest rates—that normally indicate investor concern about risk-taking. The result is that banks can expand and take more risks than would ordinarily be allowed by those who supply their funds.

Thus, the problem seems to be circular: the more regulation, the less market discipline; the less market discipline, the greater the incentive to grow; the larger the bank, the more reasonable it seems that the bank will not be allowed to fail; the smaller the probability of failure, the more latitude for risk-taking the bank gets from its depositors and other creditors. That seems to be the mechanism that created the current paradox—unregulated hedge funds seem stable but heavily regulated banks do not.

Undoing the Paradox

Banks are probably not inherently unstable, despite the fact that they offer demand deposits. Deposit banking has been around for over five hundred years. It developed as a business because it served an economic purpose, and it still does today. It is not logical to believe that banking has always been on the verge of financial collapse. If banks were not government-regulated, and if they were allowed to diversify their geographic and product range, market discipline would likely prevent excessive risk-taking. Banks would be required to hold more capital, to share more information with depositors and creditors about their activities and portfolios, and to bear higher funding and capital costs if they expand too quickly or engage in risky activities. This, however, is a counterfactual. We do not know what the banking system would look like without regulation. Calomiris notes that "[i]n principle, the lessons are straightforward: the United States should move to an uninsured, interstate branching system with broad powers for banks . . . [but] in practice there are many obstacles."[15]

The most important of these obstacles is the existence of deposit insurance, which is intended to provide a safe and stable savings vehicle for the American public. Until this objective is met in some other way, deposit insurance will be around, and, since it seriously impairs market discipline, regulation will be required to substitute for market discipline in controlling bank risk-taking.

As Greenspan has noted, the desire for stability reflected in deposit insurance directly impairs market discipline:

> As a society we have made the choice to create a safety net for depository institutions, not only to protect the public's deposits but also to minimize the impact of adverse developments in financial markets on our economy. Although we have been successful in doing so, the safety net has predictably created a moral hazard: the banks determine the level of risk-taking and receive the gains therefrom but do not bear the full cost of that risk; the remainder is borne by the government.[16]

That regulation is often ineffective—as shown by the fact that large numbers of our most important banks have suffered substantial losses despite comprehensive government supervision—should lead policymakers to search for a way to supplement and improve it. After all, as long as there is deposit insurance, regulation must exist. One such idea would be a subordinated debt requirement for the largest banks—those that are so large that their failure might cause significant financial turbulence and affect the economic system as a whole. For that reason, they are also the banks for which market discipline is weakest because depositors and creditors believe that they are so big that the regulators will not allow them to fail.

What is necessary is the reintroduction of a form of market discipline wherever it has been impaired or chased away by a combination of deposit insurance and the notion that some of the very largest institutions are too big to fail. In 2000, the Shadow Financial Regulatory Committee, of which I am a member, proposed an idea for a subordinated debt instrument that would have this effect.[17]

- It would be subordinated to all liabilities of the bank and could not be insured by any government agency, backed by any credit enhancement device, collateralized, or converted into equity. As an extra measure, the FDIC and other

government agencies would be prohibited by law from providing any financial assistance to the holders of the debt, either as part of a "too-big-to-fail" bailout or as a least-cost resolution of the bank.

- It would count as equity ("Tier 1 capital" in the current supervisory lingo), but only if it has at least one year remaining until maturity, and if the aggregate principal amount outstanding is equivalent to at least 2 percent of the issuing bank's assets. It could not be redeemed by the bank, but could be exchanged for a new issue of subordinated debt with substantially the same terms, other than its interest rate.

- It would contain a covenant permitting the issuing bank, at the request of its supervisor, to withhold the payment of interest and principal if the issuing bank's capital should fall below a specified percentage of its assets. Such withholding would become mandatory if the bank's capital were to decline further.

- It would be sold in arm's-length transactions to parties unrelated to the bank or its holding company.

Subordinated debt with these properties would go a long way toward providing bank supervisors with a market-based signal about bank risk-taking that is roughly equivalent to what the market would do in the absence of government regulation. If the market perceived excessive growth or risk-taking, the interest rate on the subordinated debt would rise—just as it would for any company that seeks financing without government backing. It would also have other salutary effects. In order to lower the interest rate on its subordinated debt, a bank would have incentives to take two important steps. First, it would have to increase its equity capital to the optimal level necessary to reassure the holders of its subordinated debt, thus replicating to some extent how a bank would have to respond to its depositors and other creditors in the absence of government intervention. Second, it would be obliged to disclose information about its risks in sufficient detail to satisfy its subordinated-debt holders, its supervisors, and the market generally.

A subordinated-debt requirement could also be integrated into the prompt corrective action and early closure regimen required by FDICIA. Thus, if the yield on a bank's subordinated debt falls to junk levels, the bank could be treated as undercapitalized under FDICIA, no matter what its actual capital level. This would bring into play some of the regulatory restrictions on operations that are required for prompt corrective action. FDIC insurance premiums could be raised and an examination required. The market-based signal provided by subordinated debt will offer to supervisors an otherwise unobtainable comprehensive signal about bank risk-taking. Because of the moral hazard created by regulatory policies and past actions, a supplement of this kind seems essential.

AEI research assistant Karen Dubas worked with Mr. Wallison to produce this Financial Services Outlook.

Notes

1. Senate Finance Committee, "Grassley Seeks Multi-Agency Response on Lack of Hedge Fund Transparency, Expresses Alarm at Risk to Pension-Holders," news release, October 16, 2006, available at www.senate.gov/~finance/press/Gpress/2005/prg101606.pdf (accessed February 4, 2008).

2. Charles W. Calomiris, *U.S. Bank Deregulation in Historical Perspective* (Cambridge: Cambridge University Press, 2000), 3–4, available through www.aei.org/book272/.

3. See, for example, Jonathan Macey, "Commercial Banking and Democracy: The Illusive Quest for Deregulation," *Yale Journal on Regulation* 23, no. 1 (2006).

4. Ibid., 7–42

5. Ibid., 227–35.

6. Gary H. Stern and Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts* (Washington, D.C.: Brookings Institution Press, 2004), 100–101.

7. Peter R. Orszag, "Options for Responding to Short-Term Economic Weakness" (testimony, Senate Finance Committee, January 22, 2008), 3, available at www.cbo.gov/ftpdocs/89xx/doc8916/MainText.4.1.shtml (accessed February 15, 2008).

8. *Federal Deposit Insurance Corporation Improvement Act of 1991*, Public Law 102-242, U.S. Statutes at Large 105 (1991): 2236.

9. Gary H. Stern and Ron J. Feldman, *Too Big to Fail: The Hazards of Bank Bailouts*, 12.

10. U.S. Code 12 § 1823(c).

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12. Managed Funds Association, *Sound Practices for Hedge Fund Managers* (November 2007), available at www.managedfunds.org/downloads/Sound%20Practices%202007.pdf (accessed February 13, 2008).

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14. Alan Greenspan, "H.R. 10, the Financial Services Act of 1998," (testimony, Senate Committee on Banking, Housing, and Urban Affairs, June 17, 1998) available at www.federalreserve.gov/boarddocs/testimony/1998/19980617.htm (accessed February 13, 2008).

15. Charles W. Calomiris, *U.S. Bank Deregulation in Historical Perspective*, 75.

16. Alan Greenspan, "H.R. 10, the Financial Services Act of 1998."

17. Shadow Financial Regulatory Committee, *Reforming Bank Capital Regulation: A Proposal by the U.S. Shadow Financial Regulatory Committee* (Washington, D.C.: AEI Press, 2000), available through www.aei.org/book215/; and Shadow Financial Regulatory Committee, "Reforming Bank Capital Regulation," statement, March 2, 2000, available at www.aei.org/publication16542/.