The Financial Economists Roundtable Statement

on

Long-Term Capital Management and the Report of the President?s Working Group on Financial Markets

October 6, 1999

In April 1999 the President?s Working Group on Financial Markets released its report on "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (hereafter referred to as the Report). The report describes the near-failure of the hedge fund Long-Term Capital Management (LTCM) in September 1998 and provides an analysis of the events which surrounded that episode. LTCM received worldwide press coverage because of the unusual actions taken by the Federal Reserve in facilitating a $3.625 billion creditor-rescue of LTCM and because of the apparent breakdown in fixed-income markets in August and September 1998 that precipitated LTCM?s collapse, as liquidity in those markets all but disappeared everywhere. In justifying its actions, Federal Reserve Chairman Greenspan suggested that, had the Federal Reserve not acted swiftly, the bankruptcy of LTCM "... could have potentially impaired the economies of many nations, including our own." Not surprisingly, the Federal Reserve?s having to intervene to facilitate the rescue of LTCM has put all hedge funds and their activities at center stage, and has raised questions about the regulation of both hedge funds and the banks and securities firms that deal with them. In particular, the large amount of credit extended to LTCM by large banks and securities firms has raised questions about the risk management practices of banks and securities firms and about the effectiveness of the regulation of those institutions.

The Financial Economists Roundtable finds that the Report sheds almost no light on the events surrounding LTCM?s collapse. The extraordinary role of the Federal Reserve in the LTCM episode is not even mentioned in the Report, and there is no analysis of the causes of the perceived breakdown in fixed-income markets that the Federal Reserve feared would turn the failure of LTCM into a worldwide financial and economic disaster. The Report also does not provide an informative analysis and assessment of the risk management practices of banks and securities firms, and does not tell us whether there was an aberrant breakdown in the regulation of these institutions or whether current regulations are intrinsically flawed and need be to recast. Even more disturbing, the Report provides no new information or data about either LTCM or the banks and securities firms which were LTCM?s creditors and derivatives counterparties. In the absence of such information it is nearly impossible for outside observers to make an independent assessment of the exposures that these institutions had to LTCM in the event of its default, and about whether the current regulation and supervision of these institutions is sufficient.

The Report chooses to focus on the dangers of excessive leverage as the main policy lesson to be drawn from the LTCM debacle. It says: "The principal policy issue arising out of the events surrounding the near collapse of LTCM is how to constrain excessive leverage." (Cover letter to the Honorable Al Gore, April 28, 1999). Thus, its chief policy recommendations, not surprisingly, are measures which it believes will, if adopted, ... "constrain excessive leverage." However, the Roundtable finds that the Report is exceedingly vague on exactly why it considers leverage to be a systemic concern, on what it means by "excessive" leverage, and even on how leverage should be measured. It seems obvious that the Report does not mean to suggest that high leverage per se is a systemic concern. The failure of a small but highly-leveraged firm, hedge fund or other financial institution would clearly not pose a threat to the financial system. For leverage in financial institutions to constitute a systemic concern, large size must also play a role. Finally, the Report is unclear whether its concern is with excessive leverage by hedge funds or with excessive leverage by all large financial institutions, such as the banks and securities firms which were LTCM?s creditors and counterparties. The Report, for example, fails to point out that leverage in most hedge funds is generally much less than is true for most large banks and securities firms.

Thus, the Roundtable believes that, while the high leverage used by LTCM certainly contributed to LTCM?s near-failure, the Report?s emphasis on "excessive" leverage as a systemic concern is unsupported. It fails to make a case that excessive leverage is a systemic concern, that private markets fail to constrain hedge fund leverage adequately, and that additional regulatory steps are needed to assure that in the future hedge fund leverage will not be excessive. Even assuming that a case can be made (which the Report does not make) that excessive leverage was the primary culprit in the LTCM collapse, this single event cannot by itself be the basis for the claim that leverage is in general excessive in either the hedge fund industry or the financial system as a whole.

The Report recommends increased disclosure requirements for hedge funds as a way to enhance private market discipline and constrain excessive leverage. But this recommendation also is unsupported. It is premised, in the first instance, on the Report?s unsubstantiated allegations that hedge fund leverage is generally excessive, and that such leverage, were it to exist, would pose a threat to the financial system. More generally, while additional (or better) hedge fund disclosure would undoubtedly help investors and outside observers like academics to better assess the performance of hedge funds, there is no obvious public policy objective to be served by instituting mandatory hedge fund disclosure laws. The law already requires that hedge fund investors be wealthy and sophisticated investors, and hedge fund creditors are typically large financial institutions which are already highly regulated. All of these parties have a strong incentive to protect themselves from losses that can flow from excessive risk-taking. There is, therefore, no obvious public policy rationale which supports additional regulation to protect hedge fund investors and creditors from their own mistakes in not demanding adequate disclosure from hedge funds. It is hard to think of a market environment more conducive to allowing private markets to determine market disclosure practices than the hedge fund industry -- an intensively competitive industry with sophisticated investors and creditors. In these conditions it seems reasonable to leave the determination of hedge fund disclosure practices and requirements to private parties and to the workings of the private market, rather than setting them by government mandate. Indeed, we expect that an important fallout of the LTCM episode will be a greater demand by investors and creditors for better hedge fund disclosure.

The Report also calls for more hedge fund disclosure to government regulators. The Financial Economists Roundtable sees no overriding government interest in additional hedge fund disclosure. There should be no government guarantee of either hedge fund investors or creditors. They, of all people, are able to bear their own losses. Indeed, given the extraordinary events surrounding the LTCM episode, it is important that government regulators, and especially the Federal Reserve, make it crystal clear that hedge fund investors and creditors will have to bear the full costs of their mistakes or misjudgments. Hedge fund losses should be borne by hedge fund investors and creditors, and not by other market participants or taxpayers, either directly or indirectly.

That the Report does not analyze or attempt to justify the unusual actions of the Federal Reserve in engineering a creditor-rescue of LTCM is, at best, a curious omission. The Working Group may have thought it unnecessary to address this issue out of a belief that there was no federal "bailout," contrary to widespread public perception. In facilitating the rescue of LTCM the Federal Reserve did not explicitly commit any federal monies and does not appear to have extended any promises or guarantees to any participants. However, any Federal Reserve intervention that changes the market outcome from what would otherwise have occurred has the clear potential to exacerbate the moral hazard problem in financial markets. The Federal Reserve?s actions clearly raise a question about what its "lender-of-last-resort" policy is, and about whether in the future it intends to extend the Federal safety net that underpins financial markets to all financial institutions deemed "too large to fail." The prospect of receiving federal assistance in times of market stress has the potential to affect private incentives in undesirable ways and to create additional moral hazard risk in the financial system. This concern provides an overriding public interest in the actions taken by the Federal Reserve in assisting LTCM , and the absence of any discussion of this event in the Report constitutes a glaring omission that needs to be corrected. At minimum, the Federal Reserve itself should have to demonstrate publicly that its actions in organizing LTCM?s rescue were a necessary and appropriate response to unusually disorderly market conditions, and that alternative solutions were not available or would have proved inadequate. Unsubstantiated assertions of "systemic risk" are not a sufficient justification.

A useful aspect of the Report is the attention it gives to inconsistencies in the U.S. Bankruptcy Code that appear to have interfered with a private market resolution of LTCM?s debt problems and derivatives contracts. To the extent that current bankruptcy procedures are in fact not conducive to private market solutions in complex situations involving both standard loan contracts and derivatives contracts, these procedures need to be fixed. A major function of government is to provide a legal and institutional environment within which private market solutions can be found to episodic institutional or market failures, such as LTCM. Further, to the extent that inadequacies in the

Bankruptcy Code made necessary the Federal Reserve?s intervention in the LTCM episode, this argument needs to be spelled out in greater detail.

In summary, the Financial Economists Roundtable considers the Working Group Report to be a disappointingly uninformative analysis of the events surrounding the collapse of LTCM, and of the interplay between those events and the regulation of financial markets and institutions. Hopefully, a more detailed and thorough analysis of those events will follow at some point in the future, when all of the facts are in and can be disclosed to the public. Until then, any recommendations for additional regulation and market reforms based on the analysis in the Report of the President?s Working Group should be greeted with a healthy degree of skepticism.

FER MEMBERS SIGNING STATEMENT
(Affiliation shown for identification purposes only)

- Rashad Abdel-Khalik, University of Florida
- Edward I. Altman, New York University
- George J. Benston, Emory University
- Gerald O. Bierwag, Florida International University
- Marshall E. Blume, University of Pennsylvania
- Richard Brealey
- Willard T. Carleton, University of Arizona
- Andrew Chen, Southern Methodist University
- George Constanidies, University of Chicago
- Elroy Dimson, London Business School
- Franklin R. Edwards, Columbia University
- Julian Franks, London Business School
- Lawrence Fisher, Rutgers University
- Martin J. Gruber, New York University
- Nils Hakansson, University of California, Berkeley
- Edward J. Kane, Boston College
- George G. Kaufman, Loyola University Chicago
- Alan Kraus, University of British Columbia
- Dennis E. Logue, Dartmouth College
- Stewart C. Myers, Massachusetts Institute of Technology
- Eduardo S. Schwartz, University of California at Los Angeles
- Kenneth E. Scott, Stanford University
- Lemma Senbet, University of Maryland
- William F. Sharpe, Stanford University
- Seymour Smidt, Cornell University
- Robert A. Taggart, Boston College
- Seha M. Tinic, Koc University (Turkey)
- James C. VanHorne, Stanford University
- Ingo Walter, New York University
- Richard West
- J. Fred Weston, University of California at Los Angeles