# Hedge Funds and the Collapse of Long-Term Capital Management

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In the fall of 1998, the losses and credit exposure of one particular hedge fund, Long-Term Capital Management (LTCM), were so far-reaching that the U.S. Federal Reserve Board (Fed) felt compelled to organize LTCM's rescue. The author examines the hedge fund industry and reviews events that led to the collapse of LTCM. He questions the prudence of the Fed's actions and considers the policy and regulatory issues raised by the intervention. The author also suggests that current risk-management policies at financial institutions do not fully capture market risks and that regulatory policies need both updating and improvement.

The author describes the legal structure of hedge funds and outlines how and why their managers have greater latitude than other managers in pursuing investment strategies. He also reviews fee structures and the types of investors that typically invest in these funds. Using data from Managed Accounts Reports, the author examines the size of the hedge fund industry, returns, correlations, and risks. In addition, he reviews the primary classifications of hedge funds and considers how hedge funds achieve their performance.

The author describes the history of Long-Term Capital Management (LTCM) and reviews the performance and size of its assets under management. He describes the positions that the fund had and the events leading to its collapse in August 1998. He reviews how the U.S. Federal Reserve Board (Fed) organized a 16-member

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creditor consortium that contributed $3.6 billion (in exchange for 90 percent ownership) to bail out the fund.

Three policy implications from the LTCM rescue are considered. First, did the Fed act prudently? Second, why were banks and securities firms so vulnerable? And third, should hedge funds now be more heavily regulated?

The author believes that the Fed acted because of the fragile condition of the markets and the desire to prevent a formal LTCM default, which could have threatened world economies through a series of chain-reaction defaults. He also states that, although the Fed did not explicitly intervene, it is difficult to believe that the central bank's role was only incidental and not implicitly coercive. By organizing the rescue, the Fed used its safety net to include not only banks but also their customers. Such actions can create a moral hazard problem by encouraging excessive risk taking. Ultimately, this type of policy is expensive, as evidenced by what happened with the savings and loan industry, making markets more fragile in the long run.

LTCM had extensive leverage and derivative positions; banks and securities firms either did not require LTCM to disclose this information or elected not to use it. Either way, a disturbing prospect arises; nobody—owners, depositors, or regulators—kept banks from taking imprudent risks. The author suggests that more-effective regulation is necessary for key players in certain markets, especially those that include off-exchange derivatives. Greater accountability and improved transparency of derivative exposure are minimal starting points. In addition, the author challenges the validity of certain risk models that fail to incorporate problems that arise in crisis situations. The author also suggests changing the capital requirements of banks to increase monitoring by investors.

The author suggests that competition among the more than 3,000 hedge funds is the best way to encourage better disclosure. Greater regulation is justified only if significant negative externalities are associated with hedge fund activities. For example, some individuals believe that large hedge fund speculators caused the collapse of certain Asian currencies in 1997, but no consensus exists regarding whether speculation is destabilizing.

The author concludes that criticisms related to hedge funds' lack of disclosure, leverage, and fees are diversions from the real focus. The structure of hedge funds is determined by those with whom they do business—counterparties, lenders, and investors. Rather than suggesting increased regulation, these groups can effectively implement any necessary adjustments by prudently choosing or avoiding their business partners. Those who make poor business decisions should bear the losses. The LTCM collapse should serve as a wake-up call. Risk-management at financial institutions is inadequate, and bank regulation is not current with respect to market developments.

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