Hedge funds

The counterparty's over

Jun 12th 2008
From The Economist print edition

Brokers may now be a bigger risk

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IT USED to be hedge funds that endangered the existence of banks. In September 1998 Bear Stearns threatened to stop trading with its reckless client Long-Term Capital Management (LTCM). Thirteen days later the Federal Reserve Bank of New York orchestrated a bail-out of LTCM, believing it posed a threat to the financial system. This year the direction of counterparty risk has reversed. Some hedge funds worry they could be dragged down if a bank goes under. After all, Bear Stearns was the industry's second-biggest prime broker (see chart), providing hedge funds with a myriad of services including lending and the custody of assets. As Bear approached bankruptcy, these clients rushed to move their accounts to other banks. Customer balances shrank by one-quarter in the month before JPMorgan Chase came to the rescue.

Hedge funds' concern reflects their symbiotic relationship with prime brokers (investment banks sometimes even provide office furniture to budding George Soroses). If a bank's capital becomes scarce and it needs to tighten its lending terms, it can end up hurting a highly leveraged fund. If a bank goes bust, the effect on its prime-brokerage clients could be fatal. Hedge funds typically park their assets at their prime brokers, which may in turn lend them on to other firms. Retrieving those assets quickly may be tricky if the bank enters receivership. Furthermore, many hedge funds own over-the-counter derivatives written by their prime brokers. How funds would crystallise the notional profits on those contracts if their counterparty went bankrupt is one of finance's great unknowns.

On June 9th the New York Fed and a group of banks and investors embraced reform by agreeing to develop a central counterparty, or clearing house, for credit-default swaps, a hugely popular type of derivative. For hedge funds, trying to protect assets held at prime brokers may be harder. Employing several brokers can diversify a fund's exposure, but since a few investment banks dominate the business, this shuffles overall risk around rather than lowering it. Most types of hedging would not achieve much, since they in turn rely on other counterparties. As a result, says Rick Sopher, the chairman of LCH Investments, a fund of funds, some hedge funds have been poring over their prime-brokerage agreements, seeking ways to ring-fence their accounts and to park spare cash in safer banks.

Even if contracts are rewritten, banks and hedge funds are so intertwined that counterparty risk is a fact of life. Fortunately, since Bear's rescue, a superior form of insurance now exists: an implicit guarantee of big investment banks by the Fed. Even Lehman Brothers, where the balance sheet is under especially close scrutiny, said on June 9th that its prime-brokerage business was doing well. Robert Sloan of S3 Partners, a hedge-fund adviser, thinks the danger now is that the Fed tightens investment-bank regulation in return for its backing. The prime brokers' habit of making cheap loans to hedge funds in return for poor collateral may well be over.