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Clinton administration opens debate on hedge fund controls

by William Engdahl

Almost two years to the day after George Soros, Julian Robertson, and Louis Bacon—the three most aggressive hedge-fund managers in the world—launched their attack on the Thai currency, the baht, and set into motion a chain-reaction collapse of global dimensions, the Clinton administration unveiled a set of proposals to hem in such speculative unregulated funds.

On April 29, U.S. Treasury Secretary Robert Rubin presented to Congress and the public the report of the President's Working Group on Financial Markets, titled "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management" (LTCM). The working group consists of Rubin, Federal Reserve Chairman Alan Greenspan, Securities and Exchange Commission head Arthur Levitt, and Commodity Futures Trading Commission head Brooksley Born.

Notable about the proposals, which the administration will submit to Congress as proposed law, is the very fact of its intention to curb one of the most dangerous areas of unregulated global capital markets: the ability of offshore hedge and other investment funds, operating with off-balance-sheet secret credit lines from large international banks or investment banks, to pool billions of dollars, leverage the risk sometimes by as much as 100 times the original (as in the case of the collapsed LTCM hedge fund), and unleash speculative attacks which destroy entire national economies within days.

The 'Basel Loophole'

Since 1988, large international banks of the Organization for Economic Cooperation and Development (OECD) countries, have been bound by the so-called Basel Accords on Capital Adequacy, which were agreed upon by the central banks of the Basel-based Bank for International Settlements. Then, for the first time, international banks had to agree on a common minimum capital base or reserve set-aside, comprising 8% of the bank's total traditional loans outstanding. That meant, for example, if Citicorp loaned $100,000 to a small business customer to purchase new equipment, the bank had to set aside 8%, or an $8,000 reserve. If a bank's total "BIS ratio" fell below 8%, it was in danger of being banned from international lending, as has occurred with some Japanese banks.

The new Basel rules, which took effect only in 1992, were aimed at reining in some of the most highly leveraged, unsecured lending of the speculative bubble years of the late 1980s, especially by Japanese banks. However, when the rules were first debated, back in 1987-88, central bankers left in what has come to be known as the "Basel Loophole." In 1987, financial derivatives—interest rate swaps, stock index derivatives, and such—were in their infancy. Most European banks, as well as those of Japan, had little knowledge of their dangers, or their potentials for huge gains—or losses. As a result, no risk set-aside was required for certain off-balance-sheet lending by a bank to finance derivatives positions of hedge funds or similar clients. Moreover, the credits could be effectively hidden from regulators, or buried in a catch-all declaration of liabilities.

The threat of one hedge fund, Long Term Capital Management of Greenwich, Connecticut, to trigger a meltdown of the global financial system last September, forced an unprecedented direct intervention by the Federal Reserve to "persuade" a group by 14 creditor banks to step in with $3.5 billion in new cash, to prevent liquidation of LTCM's estimated $1 trillion in derivatives positions in every major world market. Until a Sept. 23 meeting at the New York Federal Reserve, chaired by New York Fed president William McDonough, none of the LTCM's 14 creditors was aware of the other 13 banks' degree of lending. It was all "off-balance-sheet."

Important first steps

The latest administration report is an attempt by U.S. regulators to try to prevent future LTCM debacles. As such, it is a mix of compromise, combined with a few important first steps.

The most notable omission is that the report proposed no direct regulation of hedge funds. According to an article in the April 29 *Washington Post* by Kathleen Day, "Treasury officials favored regulating hedge funds, but Levitt and Greenspan were staunchly opposed and succeeded in steering the group to a less radical approach."

Despite this omission, which Rubin made clear could be changed should the other measures prove inadequate, the proposals take several significant steps. First, the SEC would issue new rules requiring any publicly traded company to reveal any significant lending exposure to hedge funds. Bank and financial securities regulators would demand new reserve

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provisions against losses at banks and Wall Street firms lending to hedge funds. This is an attempt to close the "Basel Loophole," of secret bank loans to hedge funds disguised as "margin accounts."

The proposed legislation would also require hedge funds to file financial information every quarter to indicate its degree of gross risk, although this does not include specifics on the fund's trading positions. As well, Congress should pass a proposed law on contract "netting," settling a contested gray area of ultimate derivatives exposure, in the event that one party to a contract fails. Further, bank secrecy havens offshore—such as the Netherlands Antilles where Soros, Robertson, and Bacon all base their funds, or the Cayman Islands, where LTCM hid from regulators—would be pressured to require more compliance with international regulation standards in supervising resident hedge funds.

The proposals have been applauded by one of the loudest critics of unregulated hedge funds, U.S. mutual fund managers. Unlike hedge funds, mutual funds are "onshore" and subject to Federal regulations. Generally, they are banned from building derivatives positions. John Brennan, chairman of Investment Company Institute, the mutual fund association, called the proposals "great news." "I didn't think the recommendations would be as concrete," he said.

Not everyone is happy with the failure of the report to propose active regulation of hedge funds, however. At a May 3 financial conference in Manila, Hong Kong Monetary Authority head Joseph Yam called for "greater monitoring and perhaps even regulation of highly leveraged investors." Yam told the Hong Kong-based *South China Morning Post* that "hedge funds manipulated Hong Kong's stock exchange and banking system" last year when devaluation threatened to spread the Asia crisis to Hong Kong and China. "You can detect a certain back-pedalling on the part of the larger markets on the need to do anything," he said.

Japanese Finance Minister Kiichi Miyazawa, speaking at the same Manila conference, noted that government authorities in several Western nations "feel that hedge funds have to do very much with the occurrence" of the 1997-98 "Asia crisis." "So we are now thinking about what hedge funds can do in the future," he said.

One good place to begin might be to put the international spotlight on the one government in the world which exercises ultimate legal jurisdiction over most offshore bank secrecy havens where hedge funds are based—Tony Blair's Britain. From the Channel Islands to Gibraltar, to the Cayman Islands, to the Bahamas, the British are the undisputed kings of offshore havens, used by everyone from Colombian drug lords to hedge funds to escape government scrutiny. That loophole in the global financial architecture would indeed be worth closing. It would also put the United States in a state of de facto war with Great Britain, once more in its history.

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