A New LTCM Is In the Making

by Lothar Komp

Seven years ago, the world financial system stood directly on the edge of collapse. On Sept. 23, 1998, the New York Federal Reserve called the heads of the 16 largest banks of the world together, overnight, in order to start an immediate joint rescue operation for the already sunk hedge fund, Long-Term Capital Management (LTCM). LTCM had come to this point by transforming around $3 billion in investment capital, into $100 billion in bank credit, and then issuing further financial bets with a nominal value of at least $1.2 trillion. Other estimations of the derivatives obligations of LTCM place them at up to $3 trillion.

Had one counterparty in all these LTCM two-way financial bets collapsed, this would have brought almost every large financial institution in the world into catastrophe, and the system would have imploded, as Michel Camdessus, then-head of the International Monetary Fund, had to admit at the time.

Today there are many more hedge funds than there were seven years ago, and they move ten times more capital around. On Sept. 22, the president of the German Institute for Financial Services (BaFin), Jochen Sanio, shocked bankers at a conference organized by Goldman Sachs in New York City, by warning that a new derivatives catastrophe, like the LTCM case, was immediately ahead: "It will happen. And nobody at the moment is prepared for it. That is why I am scared as hell."

But according to reports, Sanio's warnings were, once more, essentially written in the wind. The leading bankers themselves are pursuing the expansion of the hedge fund sector, in order to get into high risk ventures at arms' length, without being subjected to financial oversight. Already, on May 19 of this year, Sanio had pointed to the hedge funds as the "black holes of the international financial system." He asserted then that when he had spoken out after the LTCM catastrophe, at the Basel oversight committee, for the regulation of hedge funds, his efforts were systematically thwarted.

The close connection between the major banks and the hedge funds has been documented in a recent study by the European Central Bank, titled "Hedge Funds and Their Implications for Financial Stability." It's an established fact that over the last few years many thousands of leading derivatives traders from the major banks, with the express backing of those banks, have gone "independent," and established their "own" hedge funds. These hedge funds then enjoy the full support of the "mother" banks, including the provision of credit or trading computers.

This new business area of the banks is called "prime brokerage." According to the ECB study, three banks worldwide dominate in this area: Morgan Stanley, Goldman Sachs, and Bear Sterns. Morgan Stanley works at the moment with 398 hedge funds, followed by Goldman Sachs (341), Bear Sterns (299), UBS (98), ABN Amro (72), Citigroup (69), Deutsche Bank (67), Lehman Brothers (60), CSFB (53), Merrill Lynch (39), and Credit Agricole (34).

With regard to the combined capital of these hedge funds, the three American investment banks have the edge: Morgan Stanley with $66 billion, Bear Sterns with $52 billion, and Goldman Sachs with $51 billion. If one takes LTCM as the standard, this puts the valuation of the derivative volumes of these funds at dizzying heights.

No Proposals for a Solution

In the European Central Bank study, the word "LTCM" is mentioned in 33 different places, each time with appellations like "debacle," "crisis," or "near-collapse," but one waits in vain for concrete proposals for regulation. Instead, the report provides an overview of the worldwide "state of the discussion" in the financial establishment, and states that they want no direct regulation of the hedge funds. At best, they want indirect regulation over the current counterparties in derivatives contracts, that is, especially, the large banks. In previous years, there was an effort in Europe to pull down the current regulations on hedge funds, which today have opened up 60% of their headquarters in offshore centers such as the Cayman Islands, to bring them to European financial centers. And the European Commission has made it clear that it will in the forseeable future undertake no initiative for regulation of the hedge funds.

An ever-larger part of the financial system has recently come under the control of the hedge funds, and the financial "bets" they carry out. Even the maintenance of the annual about $800 billion of capital inflows, which are essential for financing of the U.S. trade deficit, is increasingly a matter for hedge fund activity. Thus, the U.S. Treasury reported on Sept. 16 that in the month of July a net $87.4 billion in capital had flowed into the United States. Until then, one would have expected that the Asian central banks, especially those of Japan and China, had provided the lion's share of this net inflow into U.S. government paper, in order to stop their currencies from appreciating too much.

In the meantime, however, the situation has fundamentally changed. More than half of the capital inflow in July—almost $50.4 billion—originated from the City of London ($25.8 billion) and the rest from offshore centers: Bahamas ($8.6 billion), Cayman-Islands ($4.5 billion), and Caribbean Islands ($11.5 billion).

The capital flows out of Asia amounted to only $27.8 billion, led by China ($13.8 billion), Hong Kong ($5.1 billion), and Japan ($4.9 billion).

An Explosion of Credit Derivatives

Next to the speculation on the future price of oil and other raw materials, which decisively determine the actual price consumers must pay, there is another derivatives area that is growing explosively: credit derivatives. In this area, one bets on whether enterprises such as Parmalat, General Motors, or Deutsche Telekom will be able to fulfill their obligations on outstanding bank credits and loans. Also, via the downgrading of these enterprises by the rating agencies, one can win a lot of money through credit derivatives—or lose it.

Only five years ago, credit derivatives were hardly traded. On Sept. 28, the International Swaps and Derivatives Association (ISDA), a private organization of 650 of the most important banks and regular derivatives traders in the world, published its latest semi-annual report. According to this report, the volume of outstanding credit derivatives in the first half year of 2004 had risen from $8.42 to $12.43 trillion, an increase of 48%. In comparison to the previous year ($5.44 trillion) this was a yearly rate of increase of 128%.

The bets with credit derivatives pile up, while at the same time the rating agencies prepare an avalanche of downgradings. Standard & Poor's made known that it has at present a worldwide list of 623 large enterprises with a current rating of "negative outlook" or "credit watch," which corresponds to a worsened outlook. Usually two-thirds of all enterprises, which are rated on this list, must count on a downgrading within a few months. According to S&P, the sectors which show the greatest vulnerability in this regard would be telecommunications, consumer products, and the automobile sector (including suppliers).

In all three sectors, the number of enterprises threatened with downgrading is greater than ever before. A new conflagration among credit derivatives and hedge funds, such as that which broke out after the downgrading to junk of General Motors and Ford in May, could break out very soon.

Within the financial establishment, the word is that the situation is "under control," and that regulation isn't necessary. Also, the head of the Federal Reserve, who is about to retire, hardly misses an opportunity to intone about the positive role of financial derivatives and the hedge funds as the "transmission of risk"—with one exception: Fannie Mae and Freddie Mac. Alan Greenspan wrote in his Sept. 2 letter to U.S. Sen Robert Bennett (R-Ut.), a member of the Senate Banking Committee, that one must very quickly do something to reduce the risk portfolio of the two mortgage financing agencies.

Of course, the housing bubble, gigantic as it is, does not compare to Greenspan's beloved derivatives, in terms of its size or its potential to bring down the world financial system. Unless the Fed's policies are changed, it's only a matter of time before there's a new LTCM.