Subprime Losses Fell Hedge Funds, Threaten Pensions

by Paul Gallagher

Warnings of a leveraged-debt or hedge fund-triggered systemic financial blowout—including one from a U.S. Treasury official and another in the Bank of England's first-quarterly report—are multiplying as U.S. long-term interest rates rise. Lyndon LaRouche has forecast a "financial disintegration" in the U.S. banking system, and declared that U.S.-based banks will have to go through writedown of assets and bankruptcy reorganization, as in 1933, due to the mortgage bubble collapse.

Asserting that he is a strong believer in the possibility of an event that could deal a serious blow to the broader economy, such as the failure of a financial institution, Anthony Ryan, Treasury's Assistant Secretary for Financial Markets, said on June 11, that hedge funds play no small part in perpetuating this danger. Ryan was addressing the Managed Funds Association's Forum 2007 in Chicago. His warning was strong enough, that ten days later, at a hearing of the House Financial Services Committee, chairman Barney Frank (D-Mass.) pressed Secretary Henry Paulson repeatedly, on whether Ryan's speech had meant that Treasury was now waiting for a systemic shock to hit the financial markets.

Ryan cited the fact that hedge funds account for 30-60% of all trading activity, depending on the asset class and instrument. The surge in liquidity has brought down lending standards, with investors exposed to more leverage than ever. Correlation among hedge fund strategies and returns is on the rise, Ryan said, increasing the concentration of risk, while much hedge fund debt is concentrated among a few large institutions.

The Bank of England (BoE), in its June 17 quarterly review, concentrated on leveraged corporate buyouts, which skyrocketed in the first quarter—globally, but especially in the United States—to levels which are dwarfing even the all-time record buyouts of 2006. The bubble of corporate debt in the OECD nations has exploded from 55% of GDP less than 20 years ago, to nearly 85% now. The BoE warned that the collapse of a single major equity deal, could trigger a general economic crisis.

The report highlights the fact that the debt markets which fund U.S. leveraged-takeover deals by private-equity groups, have come to be dominated by so-called "covenant-lite" loans. These loans, often in the multibillions, lack the basic bond covenants which define default on the debt, and which have characterized all sound corporate bonds for over a century. This is the result of banks and hedge funds lowering standards in order to make high-interest loans into the big leveraged buyouts. The banks make these loans and then sell them to investors, knowing just how bad they are. The loans include "toggle" clauses allowing them to be turned into balloon notes—with still higher interest rates—at the request of the indebted firms, whenever they have trouble paying the debt service.

The BoE report warns that, "such developments mean that the underlying value of a bought-out firm could be allowed to deteriorate far longer, before its creditors can intervene." BoE says that, "In this scenario, a large and pervasive shock might cause asset markets to adjust quite sharply as required-risk premia increased." One of the likely triggers for this crunch "could be the failure of a large leveraged loan deal [to go through], leaving the lead intermediaries [lending banks] with unexpectedly large commitments," and causing the value of existing debt to fall suddenly across the entire high-yield, or "junk" bond markets.

The Bank notes that "the U.S. subprime mortgage market may provide a useful case study of how lax lending behavior and deteriorating fundamentals can test the structure of a market."

Some Big Failures

As a result of the U.S. subprime mortgage meltdown—now joined by housing-bubble crises in Spain and the U.K.—some big hedge funds have started to fall. Beginning with a UBS bank-managed hedge funds (shut down in April) and another, Global Alpha, run by Goldman Sachs (major losses since January), the contagion is becoming more deadly: Two Bear Stearns hedge funds collapsed June 15-21, the larger one operating with $6 billion. A desperation $4 billion sell-off of its mortgage-backed securities (MBS) on June 14 failed to save the "High-Grade Structured Credit Strategies Enhanced Leverage Fund," which had borrowed heavily from Merrill Lynch, Goldman Sachs, and JPMorgan banks. The double failure will likely cause the shutdown of another unit of Bear Stearns, Everquest Financial, which was about to offer an IPO on the stock market!

The *Wall Street Journal* called it a potentially troubling sign for the broader mortgage-backed bond market." The kicker is this: If these hedge funds' MBS, being desperately sold off or seized, fall sharply in price, hedge funds and other MBS holders throughout the world will have to write down the value of their mortgage securities, accelerating the "financial disintegration" LaRouche has pointed to.

These hedge funds were leveraged at least ten times; that is, the funds had been buying mortgage securities—now being hit with losses from the mortgage meltdown—not with the assets that had been invested in them, but with 90% funds borrowed against those few assets, which the bank creditors began to seize on June 19-20, effectively shutting the funds down.

As the Bear Stearns funds were failing, other hedge funds, led by the notorious "activist fund" JR Paulson, were suing Bear Stearns and other banks for daring to renegotiate some mortgages rather than foreclose them. This makes clear that these hedge funds, also, are taking MBS losses as the crisis spreads through the markets. They are trying to shove those losses onto the investment banks, by making the banks pay on—literally—"side bets" these hedge funds made, on foreclosures. The hedge funds are trying to use the terms of these mortgage-backed securities, and SEC regulations, to prevent any renegotiation, and let the nationwide flood of foreclosures rise into the millions, in order not to have to declare their MBS losses! Those losses are reportedly mounting above $100 billion. The matter has reached Congress for debate and potential action.

The subprime market was hit with new losses in early June, as revealed June 18 by the index of value of so-called credit derivatives based on subprime mortgages, falling to 61 cents on the dollar (from 72 cents in mid-May), and Moody's Investor Services downgrading more MBS.

The context for these events: The Mortgage Bankers Association reported a record level of delinquencies in the subprime sector in the first quarter: 15.75% of all subprime ARMs are 30 days-plus delinquent, up from 14.44% in 2006's fourth quarter, which was already the highest on record. The subprimes going into foreclosure (usually 90 days-plus delinquent) in first quarter were 3.23%, up from 2.70% the previous quarter, and the highest on record. This survey covers 5-6 million subprime mortgages "worth" about $1.5 trillion.

Fear of Rising Interest Rates

The executive vice president of the world's biggest bond investing fund, PIMCO, on June 20, called the spreading mortgage crisis "a bloodbath" for the economy. Interviewed by Bloomberg, Mark Kiesel foresaw "a two- to three-year downturn that will take a whole host of characters with it, from job creation to consumer confidence. Eventually it will take the stock markets and corporate profit."

Above all, perhaps, it will take the pension funds. According to a June 18 report issued by Greenwich Associates, 25% of all the hyper-leveraged assets managed by hedge funds internationally, now come from private and public pension funds and endowments. Some 40% of the *new* flow of assets into the hedge funds is coming from pensions. And in fact, the overall flow of capital into hedge funds has dropped dramatically—from $40 billion a quarter over January-September 2006, to just $12 billion in fourth quarter 2006, and $20.7 billion in first quarter 2007. In other words, pension fund money in, is allowing "smart" money to get out of the hedge funds.

There can be no more credible claiming that the meltdown of the mortgage bubble is "contained," and not affecting the financial system, though many government officials and economists continue making just such claims, and many in Congress persist in believing them.

The contagion is occurring in part through rising long-term U.S. interest rates—a "credit crunch" hitting vastly over-indebted, over-leveraged financial companies and markets. Mortgage-based assets are 49% of the assets in the entire U.S. banking system. So the mounting MBS losses are hitting the entire U.S. banking system, squeezing interest rates higher. And this self-feeding process is worsening the defaults/foreclosures crisis as all mortgage interest rates go up.

This steady rise in rates has overcome huge money-pumping operations by the Federal Reserve and European Central Bank. *Global Money Trends* newsletter estimated on June 5 that both are printing M3 money supply at a 12% annual rate, the highest since 1995 for the Fed. The Shadow Government Statistics firm in New York estimates that the Fed's money-printing is even higher now, at 14% annual M3 growth rate—the highest since early in Alan Greenspan's term, after the 1987 stock crash.

If Treasury rates keep rising despite this tsunami of money-printing, the Fed will face a more rapid, explosive mortgage-bubble blowout, and start lowering short-term rates to escape it. At that point, if the Bank of Japan is raising rates at the same time, as is likely, look out for an unwinding carry trade—and a collapsing U.S. dollar.