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Round Two: Challenges for Hedge Funds in the financial crisis

Bradley Ziff, Partner in Oliver Wyman, says that as the world's largest banks and corporate giants are whipsawed by a never-ending series of shocks and traumas in the financial markets, the alternatives sector has been taking its own beating as well. Hedge funds, with \$2 TN in assets and a growing base of diverse institutional investors worldwide, had predicted some of this wild ride at the outset of the year, and in some instances were well prepared. For many, given the unpredictable nature of the crisis, even that foresight was insufficient. As the US, European, and Asian Central Banks put in place new proposals and regulations to address the credit and liquidity crunch, hedge funds and their equals are tackling a whole slew of challenging questions going forward. How will they navigate in a new dealer landscape? Will the ongoing process of de-risking sufficiently restore lenders' faith? How will the inevitable increase in overall regulation affect them? Will investor withdrawals continue? How can firms make sense of new legal and governance structures? And how can they assess counterparty risk? The ability of hedge funds to address these issues will in large part determine the scope of their long-term success.

A new dealer landscape

The recent crisis has dramatically redrawn the 'dealer map'. Bear Stearns and Lehman Brothers are gone. Merrill Lynch was acquired by Bank of America, and hedge funds are unsure of its status given the latter's unclear commitment to capital markets. JP Morgan has always been a substantial counterparty for hedge funds, but it too is currently consumed with operational integrations related to its purchases of Bear Stearns and Washington Mutual. As a result, the onus of providing liquidity will fall on a select group of commercial banks, most prominently Deutsche Bank and Credit Suisse, both of whom have played major roles in recent months in assuring needed liquidity to clients, albeit at higher costs. Nevertheless, even the largest commercial banks are facing balance sheet constraints of their own. These constraints have forced them to reassess the creditworthiness of certain funds and to re-evaluate their appetite for hedge fund business more generally.

For the largest hedge funds (with assets above \$1 or \$2 BN) the toughest challenge is deciphering this new landscape—selecting and identifying which firms can be relied on to provide liquidity and what level of consistency in risk appetite will be available in the months ahead. While these large funds have made progress in determining who their allies are, many other hedge funds are in the midst of working through these issues with counterparts and will be doing so until year-end.

As the US Treasury's Troubled Asset Relief Program (TARP) and some equivalent efforts abroad begin to address the liquidity and credit issues facing banks and other financial services companies, hedge funds will monitor these changes with special interest. Hedge funds have been amongst those most severely affected by the crisis, and while they may eventually see some benefits from Treasury's liquidity infusions, in many cases these benefits will arrive a bit too late to address the concerns noted above.

De-risking

Hedge funds have been 'de-risking', or taking risk off their books, for most of the past year. Funds that were more heavily leveraged have been decreasing leverage dramatically. Less leveraged funds have also been decreasing risk, not by de-leveraging, but rather by contracting the size of their positions and focusing on more liquid sectors and less sophisticated products (i.e. without

associated optionality or volatility). Funds have also increased transparency in order to highlight the decreased risk of their books. Nevertheless, their actions have not necessarily generated any greater level of comfort among investors and counterparties. In this environment, everyone is sharing the pain. Financial institutions everywhere are refusing to reward transparency and de-risking with more generous credit limits or terms. They are also not enhancing trading lines or allowing much slippage on their agreements to meet collateral calls. Like every other market participant, hedge funds will be forced to wait for liquidity to work its way through the system.

Tighter regulation

An additional challenge for hedge funds is the prospect of tighter regulation across the financial services industry. On balance, most funds recognize that, because of the enormous focus and scrutiny that their industry received throughout 2007 and 2008, they are unlikely to receive additional regulatory focus in the near future while more pressing issues receive attention. In the US, the Federal Reserve and the Treasury have already agreed that hedge funds will follow the guidelines of the President's Working Group on Financial Markets with implementation loosely set for the end of the year. In the UK, the Financial Services Authority and other regulators in Europe (Bank for International Settlements and the Financial Stability Forum) have already endorsed the approaches of the Hedge Fund Standards Board in addition to the voluntary efforts of the Alternative Investment Management Association (AIMA) and others. As a result, with the mounting difficulties facing banks and the need for regulatory oversight of specific product sets, hedge funds are unlikely to face additional regulatory scrutiny soon.

On the other hand, hedge funds do expect increased oversight on the financing benefits they receive from the broker-dealer community. It is likely that funds will not be able to access the same financing and credit terms to which they have grown accustomed. In that sense then, the *de facto* effects of regulation will impact the industry, if not the immediate direct effects.

Investor withdrawals

Perhaps the most pressing topic for hedge funds, that will draw attention through the end of the year, is how the community will handle substantial investor withdrawals. The current financial

challenges could not have happened at a less opportune time for the market—just as hedge funds are striving to preserve their investor base. Through late October, tens of billions of dollars have been withdrawn from the sector, and some projections suggest that those amounts could multiply by year-end. A number of these estimates may be exaggerated. A portion of these redemptions are for longer-term money, and once performance figures are published and institutional investors can reconsider their options, some of that capital could easily be re-deployed.

Despite these uncertainties, there is a consensus that the bottom of the hedge fund market will collapse, with hundreds of funds likely to close due to outflows and poor performance. From discussions in all three markets (Asia, US, and Europe) there is a consistent view that smaller funds, funds dependent on fund of fund investments, and funds which have lost the confidence of their single prime broker, will not withstand this crisis. The broader question is whether there will be a redistribution of this capital to larger funds that have a more diverse set of strategies and whose returns over time have withstood scrutiny (excluding this year), or whether the investors and their capital will stay on the sidelines. This latest bout of market turmoil will also intensify the debate over ‘sticky money,’ as the more established funds ponder whether they will be able to continue to attract institutional capital with longer lock up periods of 90 days or more. If so, they can then eschew fund of funds money, which is typically redeemed far more quickly due to investors’ impatience with poor returns.

The forthcoming shake-up begs the question: what will the new mix of funds and investors look like in several months? It is reasonably clear that capital will eventually become somewhat more concentrated—firms which have successfully managed strategies through the crisis will see additional investments and larger multi-strategy funds will likely, over time, see that their diversification will pay off. Managers who have over time been successful in managing stressful situations, who are operationally sound, and who can demonstrate that soundness to investors, will prevail. On the other hand, fund of funds that have managed investments on very short, 30-day cycles, may be in for a difficult time. Funds may eschew taking such capital unless absolutely necessary. Investors may not choose to invest in vehicles where they perceive “hot money” is not as reliable. Liquidity providers will encourage funds to have more stable, long-term capital. Even

successful smaller managers may be forced out—the result of insufficient financing from prime brokers and limited capital from their investors in the sorting out process. Ultimately, the hedge fund market will look very different in 2009.

Governance and legal issues

For many in this sector, the most often discussed but least understood problem for hedge funds is the range of complex legal and governance issues that are challenging the industry and require immediate attention. While many of these issues are thought of as “inside industry dialogue”, how they are resolved will be determinative for the continuance of many funds. Two of these issues deserve special attention: disposition of counterparty collateral and re-hypothecation.

First, hedge funds are reviewing the best way to set up independent third parties that can form either a custodial relationship with them or a trusteeship to take ownership of all collateral in their dealings with counterparties. A number of the established hedge funds have quickly re-classified their counterparties according to creditworthiness. Those deemed to be a credit risk have been asked to work with the funds to move their collective collateral to a third party. The exact role that such a third party would play is, however, unclear. Would it be responsible for operational duties (moving the collateral back and forth, settlement, making margin calls, etc.) or simply be playing the role of holding the collateral? This is a critical concern because many funds were unable to retrieve their collateral from Lehman Brothers after the default or are now unclear as to its location between several legal entities. Different responses to this question in different legal jurisdictions may greatly impact hedge fund flows. For instance, funds may now choose to deposit their collateral in what is thought to be the safer confines of the US, as opposed to the UK where both the timeline and the process surrounding the release of collateral are still unclear. Hedge funds seek short-term certainty, and the delayed resolution of these legal processes adds an unnecessary level of stress to an already tension-filled market.

A second concern relates to questions surrounding re-hypothecation. As a matter of market practice dealers have been allowed to re-hypothecate (re-pledge) up to 140% of collateral they receive from hedge funds. Some dealers have been more ‘liberal’ with these commitments. This issue arose in previous hedge fund

crises, for example, with Long Term Capital Management in 1998. With Lehman Brothers default, hedge funds have once again found that much of their collateral has been re-hypothecated, making it uncertain whether that collateral can be reclaimed immediately. For many funds, it is unclear to which legal entity Lehman Brothers has committed this capital, and funds have been challenged logistically to identify where that capital is located. In many instances, they have still been unable to do so. Funds are then forced to sort through their legal agreements to determine whether guidelines are being properly enforced.

Counterparty risk

A final topic for hedge funds is a basic question that has rarely challenged funds before: how do they properly assess counterparty risk, the very risk that has played such a prominent role in the current crisis? The answer to this question will take time to develop, as funds learn from this crisis and consider a variety of ways to properly assess risk and diversify counterparties accordingly. Hedge funds are traditionally astute at identifying and managing liquidity risk, market risk, and trading risk. In recent years, funds have even been given enormous credit for increasing their capabilities in operational and technological risk as they have led the dealer community in their investments and accomplishments. However, the question of counterparty credit risk has rarely challenged them before. How much business can—or should—hedge funds allocate to various counterparties or prime brokers? When should they terminate agreements? At what point do they begin to unwind positions? Are there good models for such assessments available in the market? Can one simply rely on credit derivative swaps (CDS) or bond spreads? Most funds lack answers to these questions. While they may have diversified their counterparts, carefully reviewed all their agreements, and ended or unwound businesses with those counterparties they believe are most risky, the funds may still be vulnerable. There is no good science to this process yet, a fact reflected in the bewilderment and discomfort experienced recently by hedge funds and their counterparts.

Summary

What makes the alternatives space so interesting, both to its participants and to onlookers, is its dynamism. Hedge funds thrive on volatility in markets and capitalize on turmoil. In many ways, these truths have always worried regulators and third parties while also creating the supposed mystery that surrounds hedge funds dramatic success. The current crisis has changed financial markets and will certainly not leave hedge fund participants unscathed. Yet one should not underestimate their uncanny resilience. There will be a shakeup and some funds will disappear. However, others will replace them, at least in part. Standards, guidelines, approaches to thinking about and taking risk will be transformed. Some will be permanent, and some will just be transitory. Nevertheless, a long term view sees the sector coming out of this better for the shakeup—it will find strength in the adversity of the past year, face the issues confronting it, and make changes to suit its creditors and investors.

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