Case 2
Long Term Capital Management’s
Big Loss

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Too Big to Fail?

Long-Term Capital Management and the Federal Reserve

Synopsis

In September 1998 the Federal Reserve organized a rescue of Long-Term Capital Management (LTCM), a very large and prominent hedge fund on the brink of failure. The Fed intervened because it was concerned about possible dire consequences for world financial markets if it allowed the hedge fund to fail. The Fed’s intervention was misguided and unnecessary because LTCM would not have failed anyway, and the Fed’s concerns about the effects of LTCM’s failure on financial markets were exaggerated. In the short run the intervention helped the shareholders and managers of LTCM to get a better deal for themselves than they would otherwise have obtained. The intervention also is having more serious long-term consequences: it encourages more calls for the regulation of hedge-fund activity, which may drive such activity further offshore; it implies a major open-ended extension of Federal Reserve responsibilities, without any congressional authorization; it implies a return to the discredited doctrine that the Fed should prevent the failure of large financial firms, which encourages irresponsible risk taking; and it undermines the moral authority of Fed policymakers in their efforts to encourage their counterparts in other countries to persevere with the difficult process of economic liberalization.

Introduction

In September 1998 the Federal Reserve organized a rescue of Long-Term Capital Management, a very prominent U.S. hedge fund on the brink of failure. The Fed intervened because it was concerned about the possibility of dire consequences for world financial markets if it allowed the firm to fail. The Fed’s rescue of LTCM was misguided.

The intervention was not necessary to prevent the failure of LTCM. The firm would not have failed, and even if it had, there would not have been the dire consequences that Federal Reserve officials feared. Indeed, letting LTCM fail might well have had a salutary effect on financial markets: it would have sent a strong and convincing signal that no financial firm—however big—could expect to be bailed out from the consequences of its own mismanagement.
The rescue of LTCM also has a number of detrimental consequences. It encourages more calls for the regulation of hedge-fund activities, which would be pointless at best and counterproductive at worst. The rescue also implies a massive and open-ended extension of Federal Reserve responsibilities, without any congressional mandate. In addition, the rescue implies a return by the Federal Reserve to the discredited doctrine of “too big to fail”—the belief that the Fed will rescue big financial firms in difficulty—for fear of the possible effects on financial markets of letting big firms fail. Too big to fail encourages irresponsible risk taking by financial firms, which makes them weaker and financial markets more fragile. Finally, the rescue of LTCM does a lot of damage to the credibility and moral authority of Federal Reserve policymakers in their efforts to encourage their counterparts in other countries to persevere with the necessary but difficult process of economic liberalization.

**What Are Hedge Funds?**

Hedge funds are private investment funds that aim to make profits for their shareholders by trading securities. Hedge funds vary enormously but fall into two main classes. The first is macro funds, which take speculative (i.e., unhedged) positions in financial markets on the basis of their analyses of financial and macroeconomic conditions. They bet on exchange-rate devaluations, changes in macroeconomic policies, interest-rate movements, and so on. Macro funds are thus “hedge” funds in name only. They make their profits from speculation, and their portfolios are often highly risky. Most macro hedge funds are also highly leveraged—that is, the amounts invested in their portfolios, the firms’ assets, are much greater than their share capital, with investments in excess of capital being financed by borrowing.

Leverage increases the potential profits of shareholders, but it also increases their risks: the greater the leverage, the bigger the profit to shareholders if investments are successful and the bigger the loss to shareholders if they are not. A highly leveraged fund can therefore make very high profits but also runs a relatively high risk of going bankrupt. Macro funds are highly leveraged relative to most other institutional investors and typically have asset bases five to nine times greater than their capital.

The other main class of hedge funds is relative-value, or arbitrage, funds. Those funds use sophisticated models to detect arbitrage opportunities—differences in the prices of nearly equivalent securities or portfolios—in financial markets. Having detected such opportunities, those funds construct arbitrage trading strategies to profit: they buy securities that are underpriced and sell those that are overpriced, while simultaneously taking offsetting positions to hedge against any risks involved and lock in their arbitrage profits. Financial-market arbitrage is a relatively low-risk activity,
so relative-value funds often operate with much higher leverage than do macro funds. In the United States, hedge funds with fewer than 100 shareholders are exempt from regulation under the Securities Act of 1933, the Securities Exchange Act of 1934, and the Investment Company Act of 1940. Most U.S. hedge funds therefore restrict the number of their shareholders to fewer than 100. Overseas hedge funds are also usually subject to little or no regulation, particularly those operating from offshore centers, such as the Bahamas and the Cayman Islands. The hedge-fund industry is thus largely unregulated.

Despite its growth in recent years, the industry still is only a very small part of the overall institutional investment sector. A recent International Monetary Fund report estimated that the total amount of capital invested in hedge funds in the third quarter of 1997 was about $100 billion. By comparison, other institutional investors—pension funds, mutual funds, insurance companies, banks, and so on—had a combined capital of well over $20 trillion. Hedge funds therefore account for less than 0.5 percent of the total capital of the institutional investment sector.

Nonetheless, hedge funds have received considerable attention during the last decade, most particularly because of their role in a number of recent exchange-rate crises. Perhaps the best-known example is George Soros’s Quantum Fund, a macro fund reputed to have made more than $1 billion at the British government’s expense by betting against the pound in the European exchange-rate crisis of September 1992. Hedge funds have also figured prominently in more recent crises, including those in Latin America, the Far East, and Russia in the last couple of years. The activities of hedge funds have led to major controversy over their impact on the world financial system and to calls from some quarters that hedge funds be regulated.

**The Story of LTCM**

Long-Term Capital Management was founded in March 1994 by John Meriwether, a former Salomon Brothers trading star, along with a small group of associates, most notably economists Robert Merton and Myron Scholes, who received the Nobel Prize in economics in 1997. The fund initially specialized in high-volume arbitrage trades in bond and bond-derivatives markets but gradually became more active in other markets and more willing to speculate. The fund thus started as an arbitrage fund but gradually became more like a macro fund. LTCM was very successful: by the end of 1997 it had achieved annual rates of return of around 40 percent and had nearly tripled its investors’ money. That track record and the prestige of its associates made LTCM very popular with investors, and the
companies and individuals investing in LTCM “read like a who’s who list of high finance.” LTCM was the darling of Wall Street.

By that stage, it appears that the fund’s assets had grown to about $120 billion and its capital to about $7.3 billion. However, despite that high leverage—an assets-to-equity ratio of over 16 to 1—the management of LTCM concluded that the capital base was too high to earn the rate of return on capital for which they were aiming. They therefore returned $2.7 billion of capital to shareholders, thus cutting the fund’s capital to $4.8 billion and increasing its leverage ratio to around 25 to 1. In effect, the management of LTCM had taken a major gamble: they made the firm much riskier, in the hope of bolstering the returns to shareholders.

**LTCM Gets into Difficulties**

Unfortunately, LTCM’s luck ran out not long afterwards. Most markets were edgy during the first part of 1998, but market conditions deteriorated sharply in the summer and led to major losses for LTCM in July. Disaster then struck the next month, when the Russian government devalued the ruble and declared a moratorium on future debt repayments. Those events led to a major deterioration in the creditworthiness of many emerging-market bonds and corresponding large increases in the spreads between the prices of Western government and emerging market bonds. Those developments were very bad for LTCM because the fund had bet massively on those spreads’ narrowing. To make matters worse, the fund sustained major losses on other speculative positions as well. As a result, by the end of August LTCM’s capital was down to $2.3 billion and the fund had lost over half of the equity capital it had had at the start of the year. By that time, its asset base was about $107 billion, so its leverage ratio had climbed to over 45 to 1—a very high ratio by any standards, but especially in that volatile environment.

As its losses mounted, the fund had increasing difficulty meeting margin calls and needed more collateral to ensure that it could meet its obligations to counterparties. The fund was running short of high-quality assets for collateral to maintain its positions, and it also had great difficulty liquidating its positions: many of its positions were relatively illiquid (i.e., difficult to sell) even in normal times and hence still more difficult to sell—especially in a hurry—in nervous and declining markets.

The fund was now in very serious difficulties and, on September 2, 1998, the partners sent a letter to investors acknowledging the fund’s problems and seeking an injection of new capital to sustain it. Not surprisingly, that information soon leaked out and the fund’s problems became common knowledge.
LTCM’s situation continued to deteriorate in September, and the fund’s management spent the next three weeks looking for assistance in an increasingly desperate effort to keep the fund afloat. However, no immediate help was forthcoming, and by September 19 the fund’s capital was down to only $600 million. The fund had an asset base of $80 billion at that point, and its leverage ratio was approaching stratospheric levels—a sure sign of impending doom. No one who knew LTCM’s situation really expected the fund to make it through the next week without outside assistance.

**The Federal Reserve Intervenes**

Wall Street and the Federal Reserve had observed LTCM’s deterioration with mounting concern. Many Wall Street firms had large stakes in LTCM, and there was also widespread concern about the potential impact on financial markets if LTCM were to fail. The Fed felt obliged to intervene, and a delegation from the New York Federal Reserve and the U.S. Treasury visited the fund on Sunday, September 20, to assess the situation. At that meeting fund partners persuaded the delegation that LTCM’s situation was not only bad but potentially much worse than market participants imagined. The Fed concluded that some form of support operation should be prepared—and prepared very rapidly—to prevent LTCM’s failure and to forestall what the Fed feared might otherwise be disastrous effects on financial markets.

Accordingly, the New York Federal Reserve invited a number of the creditor firms most involved to discuss a rescue package, and it was soon agreed that this Federal Reserve–led consortium would mount a rescue if no one else took over the fund in the meantime. However, when representatives of that group met on the early morning of Wednesday, September 23, they learned that another group had just made an offer for the fund and that that offer would expire at lunchtime that day. It was therefore decided to wait and see how LTCM responded to that offer before proceeding any further.

A group consisting of Warren Buffett’s firm, Berkshire Hathaway, along with Goldman Sachs and American International Group, a giant insurance holding company, offered to buy out the shareholders for $250 million and put $3.75 billion into the fund as new capital. That offer would have put the fund on a much firmer financial basis and staved off failure. However, the existing shareholders would have lost everything except for the $250 million takeover payment, and the fund’s managers would have been fired. The motivation behind this offer was strictly commercial; it had nothing to do with saving world financial markets. As one news report later put it: Buffett wasn’t offering public charity. He was trying to do what he preaches: buy something for much less than he thinks it’s worth. Ditto for Goldman Sachs, which made tons of money dealing in bankruptcies, salvaging financially distressed...
real estate. . . . These folks weren’t out to save the world’s financial markets; they were out to make a buck out of Long-Term Capital’s barely breathing body.

Had it been accepted, that offer would have ended the crisis without any further involvement of the Federal Reserve—a textbook example of how private-sector parties can resolve financial crises on their own, without Federal Reserve or other regulatory involvement. But that was not to be. The management of LTCM rejected the offer, and one can only presume that they did so because they were confident of getting a better deal from the Federal Reserve’s consortium. The Fed therefore reconvened discussions to hammer out a rescue package, which was agreed on by the end of the day. The package was promptly accepted by LTCM and immediately made public. Under the terms of the deal, 14 prominent banks and brokerage houses—including UBS, Goldman Sachs, and Merrill Lynch but not the Federal Reserve—agreed to invest $3.65 billion of equity capital in LTCM in exchange for 90 percent of the firm’s equity.

Existing shareholders would therefore retain a 10 percent holding, valued at about $400 million. This offer was clearly better for the existing shareholders than was Buffett’s offer. It was also better for the managers of LTCM, who would retain their jobs for the time being and earn management fees they would have lost had Buffett taken over. Control of the fund passed to a new steering committee made up of representatives from the consortium, and the announcement of the rescue ended concerns about LTCM’s immediate future. By the end of the year, the fund was making profits again.

**Calls for More Regulation**

One of the most immediate consequences of the LTCM affair was calls for more regulation of hedge-fund activities. Among the people calling for more regulation was then–secretary of the treasury Robert Rubin, who called for an interagency study to look at ways of making the activities of offshore hedge funds more transparent. Many others made similar suggestions. However, as one observer wrote, “Many of these calls have been pure reflex actions rather than a carefully considered response to the issues—if any—which hedge funds pose for the world financial system.”

Those calls were met with widespread disbelief offshore. Many people familiar with offshore operations pointed out that there was very little that U.S. regulators could actually do about them. Some pointed out that attempts to regulate U.S. hedge funds might drive more of them offshore where they would be even further out of the reach of U.S. regulators. The skeptics included Greenspan himself: “It is questionable whether hedge funds can be effectively regulated in the United States alone. While their financial clout may be large, hedge funds’ physical presence is small. Given the
amazing communication capabilities available virtually around the globe, trades can be initiated from almost any location. Indeed, most hedge funds are only a short step from cyberspace. Any direct U.S. regulations restricting their flexibility will doubtless induce the more aggressive funds to emigrate from under our jurisdiction…

He concluded: “The best we can do . . . is what we do today: Regulate them indirectly through the regulation of the sources of their funds. . . . If the funds move abroad, our oversight will diminish. Greenspan went on to suggest that the primary defense against the problems posed by the failures of hedge funds is for their counterparties to be careful in their dealings with them (e.g., not extend too much credit).”

Greenspan’s assessment is surely correct. Moreover, since it is also in the interests of those counterparties to be careful, there would appear to be no need for (and no point in) regulating those dealings. In an efficient economy, parties should be free to make whatever deals they want with hedge funds, and it is in their interest not to overexpose themselves to those or any other risky counterparties.