MACROECONOMICS

Hedge Funds in the Aftermath of the Financial Crisis

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Chapter in Restoring Financial Stability: How to Repair a Failed System (Wiley, 2009)

Hedge funds have certainly been in the thick of the current financial crisis. The collapse of two highly levered Bear Stearns hedge funds initiated the collapse of subprime-backed collateralized debt obligations (CDOs). But hedge funds didn't cause the growth in the subprime mortgage market, or make housing prices collapse so that subprime loans would default, or force GSEs, commercial banks and broker-dealers to hold $785 billion worth of CDOs on their books.

In fact, there is very little evidence to suggest that hedge funds caused the financial crisis or contributed to its severity in any significant way. That said, hedge funds, or subsets of hedge funds, may still generate systemic risk that imposes externalities on the financial system. A fund that is sufficiently large and levered (like Long Term Capital Management [LTCM] in 1998) could generate systemic risk.

We outline four policy actions.

- Hedge funds (of sufficient size) should provide regulators with regular and timely information about both their asset positions and leverage levels.
- If a hedge fund falls into the class of large complex financial institutions, then that fund should be treated as a systemic institution to be regulated (and taxed) as such.
- Hedge funds in a systemic-risk subset may need regulation to discourage investors from withdrawing funds after bad performance, which may lead to a run on the fund's assets under management.
- Regulators should improve public transparency of hedge fund asset positions and leverage, which may occur organically (e.g., by creating a clearing house/exchange for OTC derivatives).