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Restricting Bank Funding for Hedge Funds: Paul Volcker Does Not Go Far Enough

While Alan Greenspan has been busy denying any blame or foresight into the financial crisis, Paul Volcker has been working to dissociate the speculative risks of hedge funds from banking. While certainly a step in the right direction, this new rule dubbed "The Volcker Rule," does not go far enough.

In today's business model, hedge funds are purely speculative to various degrees depending on their structure and management. The fact that hedge funds now rely entirely on bank funding as part of their prime brokerage relationship puts a huge burden on the banks' balance sheets that I estimate at $ 1.5 trillion. That is neither necessary, nor helpful and won't fully be addressed in the new regulation.

I suggest that hedge funds get most of their funding from capital markets. Doing so would transform the model in significant but virtuous way:

1. Since this would free up some liquidity on the bank balance sheets, banks will be better positioned to grant more loans to SMEs and consumers.

2. By transferring their hedge fund exposure to the capital markets, banks will not need to increase their capital, even under the Bale III new rules, since they will have deleveraged their balance sheets.

3. Hedge funds are fundamentally well placed to issue bonds on the fixed income markets and, once established, can find most of their funding from that source.

4. In order to achieve their results hedge funds would need to be rated - this could shed some light on their true creditworthiness and show that not all hedge funds are as strong as others.

5. The rating process and the capital market rules will force hedge funds to publish significant information on their risks, not only to the rating agencies, but to the institutional investors who should be the only ones authorized to buy and hold those bonds.

While it is clear that hedge funds cannot operate only on bond financing, some rules can be set up to allow them to up to 25 % of their needs from banks. At the same time, the equity allocation to the assets held by banks on hedge funds should reflect their different ratings. The riskier would imply more equity.

Last but not least, banks should not be able to have more than, 5% of their assets exposed to hedge funds. They can manage and distribute the bonds and participate to the structuring of their clients' financial needs as part of their prime brokerage activities. They can also own such bonds within the limit of their exposure to the industry.

This solution will limit the exposure of the banking sector against the specific risks of hedge funds. They in turn will discipline their funding and transparency in a way that will, hopefully, avoid some of the excesses and allow all of us, even Fed Chairman, to minimize and see any future problems before they rise to crisis levels

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