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Hedge funds on red alert for bank leverage squeeze

Tommy Wilkes and Sinead Cruise, Reuters

Hedge funds are steering clear of the big bets they are famous for, rattled by worries that the lenders who bankroll their most lucrative plays will soon turn the taps off.

With memories of sudden margin calls at the height of the 2008 crisis still fresh, many managers are scrutinising banking relationships and preparing for the likelihood of tighter, more expensive access to credit as several major banks face up to their own funding troubles.

"This is a dynamic we're all very familiar with because it happened a great deal in 2008 and 2009," Benjamin Keefe, investment advisory director at Gamma Finance, said.

"That will have a knock-on effect either in terms of forcing hedge funds to exercise a gate to stop investors redeeming or to sell their more liquid assets to meet recalled leverage lines."

Europe's spreading sovereign debt crisis has virtually frozen lending markets for banks in recent weeks, prompting the world's major central banks to take joint action to provide cheap dollar funding for starved European banks.

Many hedge fund managers will struggle to deliver anything like the strong returns they have become famous for without an ability to amplify the size of their bets, especially in strategies which try to exploit tiny asset price dislocations.

Borrowing was falling before the recent crisis. For every dollar of equity, funds were deploying $1.10 in leverage, down from $1.27 a year earlier, a Hedge Fund Research report published in May showed.

"The banks that can't access long-term capital or can't access it at a competitive rate basically have an unsustainable model because they are pricing the business at a lot less than their cost," one executive in prime broking -- desks which lend money to funds and provide back-office services said.

Worries that banks' own funding positions are in difficulty have returned to the forefront of managers' minds, with the cost of insuring against default for some banks -- a closely watched measure of counterparty risk -- jumping recently.

"Most hedge funds post-2008 opened up multiple PB (prime brokerage) accounts and separate custody accounts ... We have seen a little bit of movement within these relationships, away from European and towards more U.S. or international PBs/custodians," Amos Mwaniki, head of due diligence at Cube Capital, said.

"The diversification of relationships has less to do with sourcing leverage and more to do with safeguarding assets... Hedge funds are keeping a very close eye on counterparty risk."

Around half of managers shift assets between prime brokers (PBs) when one parent bank's credit default swap breaches a certain level, a survey by research house Aksia showed, with more than 70 percent shifting at levels as low as 400 basis points

"(Hedge funds) are always prepared to sweep positions to another broker at the first signs of trouble," Robert Marquardt, CEO of Signet, said.

LOW LEVERAGE

Anticipating a possible squeeze in bank lending, managers are taking steps to reduce their borrowing, so they can avoid a catastrophic bout of firesales if conditions continue to slide.

During the 2008 crisis, managers with big borrowings were forced to sell assets into tumbling markets after banks beset with their own leverage woes retrenched.

"We have seen no moves by prime brokers regarding cost of leveraging or access to leveraging (but) as the wholesale markets seize up and the banks' ratings continue to decline, you have to say it must at some point start becoming an issue for the hedge fund community," one hedge fund manager said.

The average fund is down 8.48 percent this year to Nov. 30, the HFRX Global Hedge Fund Index shows, and with leverage falling many will find it even harder to end 2011 in the black.

The proportion of funds not typically using leverage has grown to around a third, data from Hedge Fund Research showed.

"I think they are very aware that in this environment the last thing you want to do is take significant leverage with so much uncertainty out there," said one London-based prime broker.

Those managers who are still adding leverage say banks are demanding much more collateral -- making it more expensive for them to borrow -- as liquidity for some assets dries up.
Jack Inglis, head of European Prime Services Distribution at Barclays Capital in London, said the average industry margin requirements for some assets such as peripheral euro zone sovereign debt had jumped in recent months.

Hedge funds borrowing against Italian debt, which has been hit hard by worries about the government's ability to repay its creditors, must now post 10 percent in margin, up from the 3 percent it used to share with Gilts, Treasuries and Bunds.

"In essence that makes borrowing more expensive for them, or flipped upside down, it means they can get less leverage than they used to get on the same strategy," Inglis said.
Some managers say the impact of more onerous lending terms is being felt as competitors are squeezed out of bets.

"This deleveraging story is actually explaining why spreads are a bit wider these days because (funds) have to exit their positions," Anne-Sophie d'Andlau, co-founder at merger arbitrage fund Charity Investment Asset Management, said.