: February 2017 | No 2

Swiss Finance Institute
Practitioner Roundups

The Beneficial Ties between Hedge Funds and Financial Conglomerates

Regulation that seeks to sever ties between hedge funds and financial conglomerates may have serious implications for liquidity provision and market stability. A new paper suggests that recent regulation should be rethought.

Following the global financial crisis, a new wave of regulation has aimed to curtail proprietary trading carried out by systemically important financial institutions. In the US, the Volcker Rule prohibits “banking entities from engaging in proprietary trading and from acquiring or retaining any equity, partnership, or other ownership interest in or sponsoring a hedge fund or a private equity fund”.[1] The Liikanen Report and the Vickers Report recommend similar or even tougher initiatives in the EU and in the UK, respectively. Consequently, hedge funds that are sponsored by financial conglomerates (i.e., financial-conglomerate-affiliated hedge funds, henceforth FCAHFs) could cease to exist, even if they are funded mostly using capital that does not originate from the parent company.

> “The very funds that might face being outlawed are currently contributing to the smooth functioning of financial markets.”

The proposed rules, however, could have unintended consequences, because hedge funds contribute to the smooth functioning of financial markets by providing liquidity and correcting mispricing. In a new empirical paper, SFI’s Francesco Franzoni and coauthor Mariassunta Giannetti test the hypothesis that FCAHFs are better suited than other institutions, including non-affiliated hedge funds, to stabilizing the market in periods of financial turmoil. The authors start from the premise that FCAHFs are likely to rely on a more stable investor base. In particular, FCAHFs benefit from the reputation and visibility of the financial conglomerate to which they belong. Therefore, they are likely to enjoy more trust from their clients, who have reason to believe that the parent company will provide a financial backstop should funding conditions in the market become tighter. In addition, the parent company can use its marketing power and exert moral suasion to convince the clients of the affiliated hedge funds not to jump the boat in rough waters and to persuade the hedge fund’s creditors to ease the funding conditions.

Not only can these factors directly lead to lower redemptions from FCAHFs during periods of financial turmoil or following weak performance, they can also exert an indirect retention effect on the funds’

[1] The Volcker Rule, from which this is an excerpt, refers to Section 619 of the Dodd–Frank Wall Street Reform and Consumer Protection Act. On December 10, 2013, the necessary agencies approved regulations implementing the Rule, which were scheduled to go into effect April 1, 2014. On January 14, 2014, after a lawsuit filed by community banks, revised final regulations were adopted. On December 18, 2014, the Federal Reserve extended the Volcker Rule’s conformance period for “legacy covered funds” (i.e., hedge funds and private equity funds) until July 21, 2017. Recently, Wall Street banks asked the Fed for five more years to comply with the Volcker Rule. Further uncertainty on the implementation of the Rule results from recent statements made by the incoming administration regarding its intention to repeal parts of the Dodd–Frank Act.

About the Authors

Francesco Franzoni
Francesco Franzoni is Full Professor of Finance at the Università della Svizzera Italiana (USI Lugano) and holds an SFI Senior Chair. He obtained his PhD in Economics from MIT. He studies institutional investors, such as hedge funds and ETFs, and their effect on asset prices. His work has been published in top academic journals and has been featured in the financial press, including the FT and the WSJ.

Mariassunta Giannetti
Stockholm School of Economics, CEPR, and ECGI.

The full paper can be found at http://bit.ly/2kUojeL.

clients. According to recent research by Chen, Goldstein, and Jiang (2010), the fact that some investors in a fund are more likely to redeem their capital increases the probability that all investors in the fund run for the exit, analogous to what happens during bank runs. Because the clients of FCAHFs are on average less likely to withdraw their capital, it is possible that FCAHFs are less exposed to runs on their assets.

Less volatile funding and a more established reputation may in turn affect asset managers' investment strategies. For example, some research argues that a lower sensitivity of flows to performance is expected to make fund managers more inclined to provide liquidity, especially when this implies taking a long-term view on investments. To investigate these issues, the authors assemble a novel data set of international hedge funds that cater to US investors, using regulatory filings with the SEC. In the data, the parent companies of affiliated hedge funds can be banks (14 percent), insurance companies (7 percent), or broker dealers (79 percent).

The first empirical result of the paper is that FCAHFs experience fewer redemptions during periods of financial turmoil. Furthermore, their flows are less sensitive to performance, especially following low returns. FCAHFs also offer investors more favorable contractual terms. In particular, FCAHFs impose weaker restrictions on redemptions—that is, they require a shorter lockup period and redemption notice period. These features probably reflect the fact that FCAHFs do not have to force their existing clients to remain invested because they have easier access to funding.

"When others are divesting, affiliated funds increase their exposure, providing much needed liquidity and playing a stabilizing role."

The authors then explore FCAHFs' strategies and risk taking. A stable funding structure is an important source of comparative advantage when it comes to holding assets that are vulnerable to transitory price movements. Indeed, the authors find that affiliated hedge funds increase their exposure to the market during downturns, when other investors are exiting. Consistent with liquidity provision in bad times, FCAHFs buy illiquid and volatile stocks and they avoid massive liquidations. Finally, thanks to their long-term stance, FCAHFs earn a liquidity premium, which materializes when the market rebounds. Overall, FCAHFs seem to perform a stabilizing function during periods of market stress. On average, however, the risk-adjusted returns of affiliated funds are lower than the returns of non-affiliated funds, by about 6 basis points per month. This finding can be explained by the lower sensitivity of flows to performance. If investors do not monitor performance closely, fund managers have lower incentives to deliver good returns. Why then are investors loyal to affiliated hedge funds in spite of the lower returns? Possibly investors may be willing to trade weak performance for looser redemption restrictions. Indeed, the literature suggests that the option to redeem capital easily is of great value to hedge fund clients. Hence, the authors conclude that FCAHFs offer valuable liquidity transformation services.

"Too strict regulation of affiliated funds in various financial centers creates opportunities for others, which—like Switzerland—have refrained from following this particular regulatory trend."

The policy implications of this research are far-reaching. Regulations, such as the Volcker Rule, may remove an important actor from financial markets. Recent anecdotal evidence suggests that traditional market makers, such as banks, are withdrawing their liquidity provision in the corporate bond market because of tighter capital requirements and limits on their risk taking. Severing the ties between financial conglomerates and hedge funds, as the Volcker Rule demands, can further inhibit liquidity provision, especially at times of market stress. It is fortunate that Switzerland has not followed this regulatory trend. Indeed, the tightening of regulation in other jurisdictions can represent an opportunity for Switzerland to harbor hedge funds that are sponsored by financial conglomerates. Although, of course, it would be important for regulators to strike the right balance between the desirable flexibility of allowing banks and other financial institutions to sponsor hedge funds and the need to limit the potential risks that these funds can entail for the sponsoring institutions.

Key Words
Hedge funds
Liquidity provision
Proprietary trading
Volcker Rule

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SFI Knowledge Center
knowledge@sfi.ch
www.sfi.ch/knowledge