

# Banks and Hedge Funds. A Side By Side Comparison

|                      | Banks  | Hedge Funds   |
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| Capital              | <ul style="list-style-type: none"> <li>· Banks have permanent equity capital and long term hybrid capital.</li> </ul>  | <ul style="list-style-type: none"> <li>· Hedge funds have variable capitals. Equity can be redeemed although there may be lock ups, gates and low redemption frequency to stabilize equity capital.</li> <li>· Lock ups and gates have been controversial. Some investors dislike them while others appreciate the stability they bring.</li> </ul>   |
| Price discovery      | <ul style="list-style-type: none"> <li>· Bank equity and capital trade on open markets and price discovery is achieved through demand and supply.</li> </ul>   | <ul style="list-style-type: none"> <li>· Equity is subscribed and redeemed at Net Asset Value.</li> <li>· Secondary market remains small and specialized.</li> </ul>  |
| Leverage (size)      | <ul style="list-style-type: none"> <li>· Banks are typically leveraged anywhere from 10X to 50X.</li> <li>· Banks are allowed to apply risk weights to assets for the purposes of calculating their leverage.</li> </ul>   | <ul style="list-style-type: none"> <li>· Hedge funds are typically leveraged between 2X to 5X although some strategies are more leveraged than others.</li> <li>· No risk weighting of assets. Everything counts.</li> </ul>  |
| Leverage (structure) | <ul style="list-style-type: none"> <li>· Banks issue across the spectrum from hybrid capital to senior, secured, bonds as well as secured and covered bonds.</li> <li>· An important source of banks' funding is deposits. Bank deposits are a source of duration mismatch.</li> <li>· Some banks rely on short term, wholesale funding such as interbank, commercial paper and repo markets.</li> </ul> | <ul style="list-style-type: none"> <li>· Hedge funds rely on prime brokers for their leverage. Prime brokers are usually the large investment banks.</li> <li>· Hedge funds not only borrow money but also borrow securities for shorting, leading to de facto if not financial leverage.</li> <li>· Cash and securities lending is usually on a short term basis and can be recalled.</li> </ul> |

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| <p>Business</p>        | <ul style="list-style-type: none"> <li>· Banks lend to households, businesses, and governments. When they do so they make money by taking credit risk.</li> <li>· Banks provide services to clients earning fee income.</li> <li>· Banks engage in trading activities. This has been substantially reduced post 2008 as regulation has been introduced to reduce systemic risk and taxpayer bailouts.</li> </ul> | <ul style="list-style-type: none"> <li>· Most hedge funds make money from trading and investment.</li> <li>· Some hedge funds provide financial services and earn fees but this is usually in conjunction with assuming some market or credit risk.</li> <li>· Some large hedge funds are significant lenders providing credit not only through bond investment and underwriting but in private loans.</li> <li>· Many hedge funds were spin outs of bank proprietary trading desks. As heavier capital requirements weighed on banks capacity for trading more traders left to join or establish hedge funds.</li> </ul> |
| <p>Investor base</p>   | <ul style="list-style-type: none"> <li>· Equity is publicly traded and bought by institutional investors, retail investors, mutual funds, and institutional funds.</li> <li>· Other claims are variously traded by investors of varying sophistication.</li> </ul>   | <ul style="list-style-type: none"> <li>· The offer of hedge funds is usually restricted to sophisticated investors.</li> </ul>  |
| <p>Operating costs</p> | <ul style="list-style-type: none"> <li>· Borne by shareholders.</li> </ul>   | <ul style="list-style-type: none"> <li>· Investors pay management and performance fees, ostensibly 2% p.a. for management and 20% of profits. Actual management fees are lower as institutional investors obtain discounts.</li> <li>· Investment manager bears the operational costs which are paid out of the management and performance fees they collect.</li> </ul>  |
| <p>Asset Valuation</p> | <ul style="list-style-type: none"> <li>· Banks have some discretion on whether assets are marked to market or not depending on whether the bank deems them to be Held To Maturity, Trading, or Available for Sale.</li> </ul>  | <ul style="list-style-type: none"> <li>· Almost all hedge funds mark all their assets and liabilities to market. The market convention is that long positions are market to bid and short to offer.</li> <li>· Typically an independent administrator is involved in the valuation of individual assets and the calculation of NAV.</li> </ul>  |
| <p>Regulation</p>      | <ul style="list-style-type: none"> <li>· Regulated internationally (e.g. BIS), regionally (e.g. EBA, ECB), and nationally (e.g. local central bank.)</li> </ul>  | <ul style="list-style-type: none"> <li>· Largely unregulated although AIMFD in Europe is an attempt at better regulation.</li> <li>· Increased regulation if they seek wider distribution such as retail investors.</li> </ul>  |

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| <p>History of Instability</p> | <ul style="list-style-type: none"> <li>· Bank runs have been recorded since banks were invented.</li> <li>· A record of banking crises exists from 1763 with roughly one crisis per decade.</li> <li>· Over-leverage and a concentration in one area of collateral appear to be factors.</li> </ul> | <ul style="list-style-type: none"> <li>· Hedge funds have not had as long a history as banks but the frequency of systemic failures has not been as frequent as in the banking industry.</li> <li>· 2008 was the last time hedge funds faced forced closure en masse. Their demise was closely related to the failure of a number of investment banks which were prime brokers, notably Lehman Brothers, but also Merrill Lynch and Bear Stearns.</li> <li>· The last systemic crisis in hedge funds occurred 10 years earlier when LTCM failed as a result of over leverage and over dependence on theoretical models. A number of Wall Street banks were called upon to bail out the fund. Bear Stearns and Lehman did not participate.</li> </ul> |
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