CONSTRAINTS AND OPPORTUNITIES OFFERED BY THE INVOLVEMENT OF HEDGE FUNDS AND PRIVATE EQUITY

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I. MONEY BASICS

A. What is Money?

Money is the mechanism that connects value and liquidity.

Money is supposed to be a stable and honest way to (a) keep score of profit and loss, and (b) foster commercial exchanges of value and liquidity.

B. What The Fed Does

The Fed's Stated Mission: to control money, value, and liquidity to foster maximum employment and stable prices.

Necessarily, the Fed's actions often work as a blunt instrument, which can create both liquidity and value distortions.

C. Where the Money Goes

Money created by the Fed flows first into the regulated banking system and from there into the unregulated "shadow banking system" of hedge funds and private equity.

All financial entities make money by finding disparities between perceived and actual value and liquidity.

Sometimes these disparities are caused by how regulated and unregulated systems inter-relate, and the different ways they reward and punish.

When the distortions become too great, the systems become unsafe and unsound. The 2007-8 financial crisis is the latest example.

Since 2009, the biggest consumer of new money – *i.e.*, the liquidity flood of the last eight years created by Quantitative Easing – has been the hedge fund and private equity world. Few other sectors of the economy have had their appetite for debt and risk.

II. HOW DO BANKS AND HEDGE FUNDS DIFFER?

A. They operate by different rules

Banks are heavily regulated by the Comptroller, the Fed, and state banking authorities.

Hedge funds are corporate entities not subject to the regulation of banks, but only to general corporate and securities law.

B. They recoil from different threats

Banks fear capital loss, since their ability to do business diminishes in tandem with capital shrinkage; there are structural and regulatory incentives to cut losses quickly.

Hedge funds do not have built-in stop-loss mechanisms at the deal level and are ready to ride a much longer cycle to end up with a profit.

C. They have differing financial underpinnings

Banks are funded by equity investors, depositors, the commercial paper market, and the Federal Reserve. Especially the Federal Reserve.

Hedge funds are funded by investors and bank loans. Especially bank loans, which allow them to leverage their capital.

D. They have different goals

Banks make money by lending to businesses and being repaid.

Hedge funds make money by buying or conducting business with mostly borrowed money, selling assets to pay off loans, and then selling the remainder of the entity for profit.

E. Different forces destabilize them

Bank disrupters:

Industry downturns and macroeconomic changes
Changes in the money supply
Changes in regulatory policy
Sloppy loan underwriting

Hedge fund disrupters:

Insufficient deal flow.
Too many hedge funds chasing too few deals.
The current deal-scarce environment causes funds to overpay, which impairs or destroys profitability.
Dissatisfied investors withdrawing capital.
Funds remaining stuck with assets for which they overpaid.

F. Different Goals in Bankruptcy Court

1. Banks

Regulatory pressure pushes banks to early resolution of problem loans, generally by forcing a sale through Section 363 or a Plan, and hits to capital are dealt with promptly.

2. Hedge Funds:

Lack of regulatory scrutiny leaves hedge funds subject only to their investors' pressure when a deal goes sour. Instead of recognizing the loss and getting out of the deal, the hedge fund tries to find a way to gain control of the entire situation through: cutting liability to other creditors and retaining ownership itself, or receiving securities under the plan or sale that can be laid off to other unsuspecting suckers at a later time. Hedge funds are allergic to bankruptcy's short deadlines. The last thing they want is to force a solution on a tight time frame, because they believe that the longer the time available to fix a problem situation, the better they are likely to do.

Title search: Constraints and Opportunities Offered by the Involvement of Hedge Funds and Private Equity

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