Americans for Financial Reform Education Fund

May 7, 2021

The Honorable Dr. Janet L. Yellen
Secretary of the Treasury
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Jerome Powell
Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, DC 20551

Dear Secretary Yellen and Chair Powell:

We write to you today to express concerns over what has been revealed by the blow-up of the Archegos family fund. This incident reveals both the dangers of excessive leverage at private funds, and the failure of banking regulators, including the Federal Reserve, to properly regulate bank interactions with such funds. To address these issues, the Federal Reserve must investigate its own regulatory failures in this case and publicly disclose the lessons learned from this investigation, and must also work with the Financial Stability Oversight Council to address the risks of excessive leverage at private funds.

The Board warned about the risks of excessive leverage for years, including in its 2019 Financial Stability Report.[1] The 2020 report noted a marked increase in the concentration of leverage at hedge funds, with the top 25 hedge funds accounting for half of the industry's borrowing as of Q2 2019. The Board also noted, in a particularly prescient passage, the risks that leverage can inflict on funds, banking institutions, and the market overall:

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[1] Board of Governors of the Federal Reserve System, Leverage in the financial sector, Financial Stability Report (November 2019), https://www.federalreserve.gov/publications/2019-november-financial-stability-report-leverage.htm.

> “The increase in leverage concentration has occurred over the past several years as dealers have reportedly given preferential terms to their most-favored hedge fund clients. Market participants have raised concerns over this concentration because distress at a few large hedge funds with disproportionately high leverage can have outsized effects, as they may have to sell large amounts of assets to meet margin calls or reduce portfolio risk during periods of market stress.”

Archegos, as a family office that managed tens of billions, created just such a period of market stress when it received a margin call on one of its many Total Return Swaps that it couldn’t meet. Archegos’ oversized presence in eight separate stocks created liquidity problems when many of the nation’s largest banks needed to unload the same basket of stocks all at the same time. Yet Archegos is only one fund. Many hedge funds also operate similar strategies that could be susceptible to the same problems and surprises if the markets suddenly move against them.[2] The Board also had warned that this kind of combination of a lack of liquidity and extreme leverage could “result in rapid deleveraging when volatility spikes, which could, in turn, contribute to further market volatility.”

Given the Fed’s warnings about a situation that so closely mimics Archegos, we were surprised by Chair Powell’s comments last week, which acknowledged failures in banks’ internal controls, but downplayed the risks to the system. Chair Powell said “Archegos risks were not systemically important or were not of the size that they would have really created trouble for any of those institutions.” He also defended the Fed’s bank supervisors in the press conference, stating “[w]e don’t manage their companies for them.” He did not point to the broader issues the Archegos implosion made clear.

While the 2021 Financial Stability report acknowledges that the Archegos incident “highlights the potential for material distress at [non-bank financial institutions] to affect the broader financial system,” it also claims “broader market spillovers appeared limited.”[3] It also focuses more on data gaps in the reporting hedge funds do to the SEC than on the Fed’s own ability to control the liquidity that finances hedge fund leverage and the kind of big bets firms like Archegos could make. The data gaps are important and should be addressed,[4] but there is much the Federal Reserve Board should do as well.

Minimizing the gravity of the Archegos incident does not make sense. The significance of this incident does not lie in whether it led to the immediate failure of a bank, but in what it reveals about inadequate regulation of prime brokerage, securities lending, equity derivatives

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[2] Detrixe, John. How many hedge funds are a margin call away from Archegos-style implosion? Quartz (March 2021),
https://qz.com/1991073/how-many-funds-are-a-margin-call-away-from-failing-like-archegos/

[3] Board of Governors of the Federal Reserve System, Leverage in the financial sector, Financial Stability Report (May 2021),
https://www.federalreserve.gov/publications/files/financial-stability-report-20210506.pdf

[4] Americans for Financial Reform, Letter to Acting Chair Alliosn Lee (March 2021),
https://ourfinancialsecurity.org/2021/03/letter-to-regulators-in-the-wake-of-archegos-the-sec-should-end-13f-loopholes/.

exposures, and other areas of bank regulation which may conceal even larger risks. The Fed is tasked with being a prudential regulator over banking institutions and their capital plans. The fallout from Archegos led to over $10 billion in losses across major banking institutions.[5] Credit Suisse has lost $5.4 billion to date, and Morgan Stanley's losses are near $1 billion. Credit Suisse's losses were so substantial that they wiped out five years of profits in the investment banking division.[6]

More importantly, bank risk models supervised by the Federal Reserve clearly totally missed the Archegos risks, and may be missing other risks associated with leveraged exposure to equity markets now at record highs. To take the most egregious examples, Credit Suisse risk models measured only about $25 billion in *total* counterparty credit risk across all areas of the bank, corresponding to only about $2 billion in capital reserved for potential counterparty credit losses.[7] Yet the single Archegos case caused almost $5 billion in losses to the bank, two and a half times capital reserved for all counterparty risks. This comes two years after Credit Suisse effectively failed the qualitative portion of its 2019 stress test, pointing to issues that have evidently not been resolved.[8]

Failure on such a scale calls for a comprehensive investigation and reporting to the public on the general issue of whether bank risk models are adequate to spot potential risks in areas such as prime brokerage, securities lending, and equity derivatives. With asset values reaching new highs seemingly every week, there are large profits to be gained by bank financing of hedge fund speculation. Banks are identifying growth in prime brokerage business as a strategic priority even in light of the Archegos blow up.[9]

We are lucky that Archegos did not create fallout sufficient to damage the financial system broadly. But in the future, unforeseen risks due to bank financing of highly leveraged hedge funds could very well create systemic damage to banking institutions and the economy overall.

In order to address this ongoing risk, we call on the Board and the Treasury to:

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[5] Leo Lewis and Owen Walker, Total bank losses from Archegos implosion exceed $10bn, Financial Times (April 2021), https://www.ft.com/content/c480d5c0-ccf7-41de-8f56-03686a4556b6.

[6] Christiaan Hetzner, 'Unacceptable': Credit Suisse reveals further mega losses from the disastrous Archegos trade, Fortune, (April 2021), https://fortune.com/2021/04/22/unacceptable-credit-suisse-mega-losses-archegos/.

[7] Credit Suisse Q4 2020 Pillar 3 disclosures, available at https://www.credit-suisse.com/about-us/en/investor-relations/financial-regulatory-disclosures/regulatory-disclosures/pillar-3.html

[8] Kiran Stacey and Robert Armstrong, Credit Suisse singled out over 'weakness' in Fed stress test, Financial Times (June 2019), https://www.ft.com/content/27fb9696-9912-11e9-9573-ee5cbb98ed36; and Federal Reserve, Comprehensive Capital Analysis and Review 2019: Assessment Framework and Results, (June 2019), https://www.federalreserve.gov/publications/files/2019-ccar-assessment-framework-results-20190627.pdf. ("weaknesses in the assumptions used by the firm to project stressed trading losses that raise concerns about the firm's capital adequacy and capital planning process")

[9] See e.g. Goldman Sachs April 14, 2021 Earnings Call. https://www.fool.com/earnings/call-transcripts/2021/04/14/goldman-sachs-group-inc-gs-q1-2021-earnings-call-t/

- Comprehensively investigate the failure of risk models to properly identify the risks in the Archegos case and whether this failure has implications for the modeling of risks from prime brokerage, securities lending, and equity derivatives more broadly. The results of this investigation should be released to the public and should include recommendations for any regulatory enhancements necessary;
- Enhance supervision of bank holding companies with prime broker relationships;
- Ensure the newly re-started hedge fund working group at the Financial Stability Oversight Council is looking at leverage used by all private funds;
- The working group should also examine if regulators and bank risk managers currently have sufficient data to understand the effective total leverage at banking institutions' hedge fund clients, and if not, make recommendations for how to eliminate any data gaps; and
- Work closely with the SEC, which gathers hedge fund leverage through its Form PF, on identifying potential areas of risk.

The Archegos situation reveals the real and present risk of over-leverage in the financial system, and the very grave potential consequences of banking institutions' failures to have adequate capital plans in the event of drastic trading losses. The Board and the Treasury should use this opportunity to closely examine how the next Archegos can be prevented, rather than downplaying the risks it highlighted.

Sincerely,

Americans for Financial Reform