Big banks hit by investment fund collapse

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Wall Street has been shaken by an event which illustrates the precarious nature of the financial boom fuelled by the provision of ultra-cheap money by the Fed and the willingness of banks to fund ever-riskier operations.

Last Friday there was a massive sell-off in stocks in US media companies, including ViacomCBS and Discovery and Chinese tech stocks, including Baidu and Tencent, amounting to around $20 billion.

The stocks in the media companies had been falling during the week, but on Friday there was a rush for the exits as Goldman Sachs and Morgan Stanley unloaded blocks of shares. Goldman began with a sell-off of $6.6 billion in the morning and then followed it with sales of $4 billion in the afternoon. Morgan Stanley sold off $4 billion worth of shares in the morning followed by another $4 billion worth in the afternoon.

The sales knocked off about $33 billion of the shares of the companies involved.

It quickly emerged that the sales were part of a “forced deleveraging” by Archegos Capital, a private investment firm owned by its founder Bill Hwang. With the fall in the media stocks earlier in the week, Hwang had been subject to a margin call by the major banks that had financed his highly-leveraged bets. It turned out to be possibly the biggest margin call in history.

A margin call is made when banks demand more money as collateral when the price of the asset, in this case shares, begins to fall. If the margin call cannot be met, then the lender sells the securities to try to recoup what it is owed.

On Monday it emerged that the financial backers of Archegos Capital included two of the biggest names in global finance—Credit Suisse and Japan’s largest investment bank, Nomura.

Nomura announced at the start of trading this week it was facing a potential loss of $2 billion and that its profits for the second half of the financial year could be wiped out. Credit Suisse, which was heavily involved in the recent collapse of the UK firm Greensill Capital, said its potential losses could be “highly significant and material to our first quarter results.” The estimate of the total loss is between $3 billion and $5 billion.

The announcement of the extent of their losses sent the shares of both banks tumbling. The shares of Nomura plunged by 16 percent in Tokyo on Monday, its biggest one-day fall ever, and dropped a further 4 percent on Tuesday. The shares of Credit Suisse dropped by 13.8 percent in the biggest decline since the March 2020 market plunge at the start of the COVID-19 pandemic.

The seriousness of the issue was underscored by a report in the *Financial Times* that prior to making an announcement of its losses Nomura had held “emergency talks with Japan’s Financial Services Authority.”

The newspaper reported that bankers in Tokyo had described the sell-off of Archegos assets as a possible “Lehman moment”—a reference to the collapse of the US investment bank that triggered the global financial crisis of 2008.

At this stage that appears to be something of an overstatement, although there may be further shocks in store. There is no question, however, that it is the most serious blow-up of an investment fund since the collapse of the hedge fund Long Term Capital Management in 1998. LTCM had to be bailed out in a $3.6 billion operation organised by the New York Federal Reserve in order to prevent a broader market collapse.

While recent events are not on the scale of 2008, they do recall one of the central aspects of that crisis—the connection of the major banks with outright financial criminal activity.

Bill Hwang, the founder-owner of Archegos, has a record of financial criminality. He previously ran the Tiger Asia hedge fund and in 2012 was forced to return cash to investors when he admitted to fraud in relation to Chinese bank stocks. He paid $44 million in fines to the Securities and Exchange Commission in 2012 over insider trading activities and in 2014 was banned from trading on the Hong Kong exchange.

However, within a year of paying back money to investors, he was back in business, setting up Archegos.

One might have expected that the world's major investment banks would have not touched him with a barge pole. But barge poles appeared from everywhere because of the huge profit opportunities.

With Hwang described as an "aggressive, moneymaking genius," the assets of Archegos grew from $200 million at its launch in 2012 to $10 billion over the course of nine years.

As the *Financial Times* noted: "The fee-hungry investment banks were ravenous for Hwang's trading commissions and desperate to lend him money so he could magnify his bets."

Hwang was able to mask the extent of his dealings through use of a derivative known as total return swaps. These allow investors to pay a fee and in return obtain cash based on the performance of the underlying asset, which is owned by the bank. The use of these swaps enables the investor to expand their holdings in companies without disclosing them which they would have to do if they held equities outright.

Hwang expanded his operations by holding swaps with numbers of banks. The extent of the leverage provided was such that for every stock Archegos bought the bank would lend it seven more. In some cases, the ratio may have been as high as 20. The result was that Archegos did not have to publicly disclose the extent of its indebtedness.

"If you're holding everything as swaps, the reality of what you have to declare to your banks is very little," one hedge fund executive told the *Financial Times*.

There have been claims that banks did not know the extent of the indebtedness of Archegos, but others have dismissed this as "inconceivable." The most likely explanation is that if the banks did not know it was because they did not want to know, as long as the fat fees kept rolling in.

Once the fall in the stocks held by Archegos began there was a rush for the exits. Last Thursday Hwang brought together his major backers, Goldman, Morgan Stanley, Wells Fargo as well as Credit Suisse and Nomura to try to organise an orderly sale. But Goldman, described as being "very exposed," did not commit itself and initiated a sell-off the next morning.

The consensus in financial circles, at least at this stage, is that the effects of the Archegos collapse can be contained. However, there are broader implications. The share market bubble has been made possible by the provision of ultra-cheap money. Notwithstanding the assurances of the Fed that this will continue, financial conditions are shifting.

Yields in the bond markets, which form the base for interest rates in financial markets, are rising on the back of inflation fears and concerns that the market will not be able to absorb all the new US government debt being issued. This has led to a fall in the market value of the high-tech stocks that have been at the centre of the debt-fuelled speculation over the past year.

As the *Sydney Morning Herald* columnist Stephen Bartholomeusz noted in a comment published on Tuesday: "The degree of leverage—indeed the apparent scale of it—inherent in margin calls of such magnitude is by itself disturbing and raises the question of how much more there might be, and where it might lie, within the shadows of the global financial system."