

Hedge funds slammed by banks' margin calls

Lenders are quick to react when clients run into trouble

BY CARRICK MOLLENKAMP
AND SERENA NG

After surviving most of the financial crisis in decent shape, hedge funds and other investors are facing a mounting threat: The banks that lent them money are asking for it back.

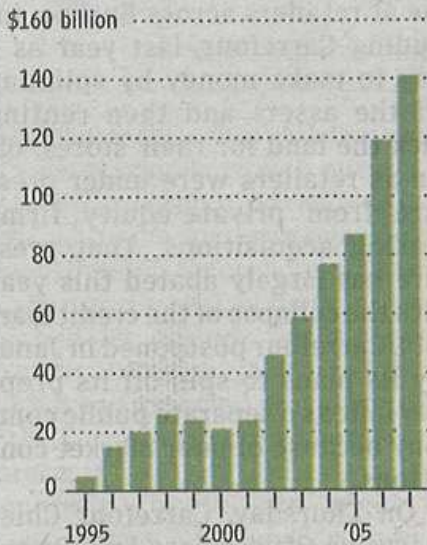
Loans from banks and brokers have allowed hedge funds, which manage some \$1.9 trillion in clients' money, to amass many times that amount in various investments, from Swiss stocks to mortgage bonds. But as the value of some of those investments has plummeted in recent weeks, the lenders are demanding more collateral to protect themselves against losses. The demands, known as margin calls, are pushing cash-strapped funds to the edge, and could leave the banks holding a lot more of the same hard-to-sell securities that have already cost them some \$140 billion in write-downs.

The issue came to the forefront yesterday as Carlyle Capital Corp. Ltd., a fund of Washington-based private-equity firm Carlyle Group, said it had failed to meet margin calls on loans backing part of its \$21.7 billion portfolio of highly rated securities issued by U.S. housing agencies Fannie Mae and Freddie Mac.

The Carlyle news comes only a week after margin calls triggered

Pressure point

Credit-oriented global hedge funds, among the hardest hit as banks pull back on lending, have seen their assets under management rise sevenfold in the past decade.



Note: Assets under management do not include borrowed money

Source: Hedge Fund Research Inc.

the implosion of London hedge fund Peloton Partners LLP, which analysts estimate could leave the funds' 14 lenders—including Deutsche Bank AG, Goldman Sachs Group Inc., Lehman Brothers Holdings Inc., Merrill Lynch & Co., Morgan Stanley and UBS AG—holding as much as \$17 billion in problematic mortgage securities.

Prices on even the safest of mortgage bonds slid sharply yesterday amid fears that the problems could spread, as tighter lending standards force investors—particularly those that used the most borrowed

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Carlyle Group, KKR fuel mortgage fire; bid to calm investors

BY PETER LATTMAN

Private-equity firms have their hands full these days, not with deals but with debt.

Two such firms, Carlyle Group and Kohlberg Kravis Roberts & Co., are reeling from turmoil in the mortgage markets.

Yesterday, Carlyle Capital Corp., a listed investment company managed by Carlyle Group, added to worries about forced liquidations of residential mortgage-backed securities after failing to meet margin calls on its \$21.7 billion portfolio.

Also yesterday, Standard & Poor's slashed its ratings on KKR Financial Holdings LLC commercial paper backed by "high-quality mortgages." Late last month, KKR Financial, affiliated with the private-equity firm of similar name, said it was having difficulty selling those mortgages backing the commercial paper, which helps fund KKR Financial's operations.

In an effort to extend their brands and diversify into other areas, both Carlyle and KKR formed funds to buy mortgage securities and later took them public. Carlyle Capital was started in 2006 and listed shares on the Euronext Amsterdam exchange last summer; KKR Financial was founded in 2004 and listed shares on the New York

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Hedge funds feel the pressure of margin calls

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money, or leverage—to sell all kinds of securities, pushing down prices and triggering still more margin calls.

“It feels incredibly bad,” says Gregory Peters, a credit strategist with Morgan Stanley in New York. “The current environment is already very skittish and that’s feeding upon itself.”

The impact is not limited to hedge funds. This week, mortgage lender Thornburg Mortgage Inc. said it had failed to meet part of some \$500 million in margin calls, a default that could prompt its lender, J.P. Morgan Chase & Co., to seize and sell billions of dollars in mortgage loans into an already struggling market. One impetus was sharp market price declines in recent weeks on bonds Thornburg owns in its investment portfolio that are backed by so-called Alt-A mortgages, which are considered less risky than subprime mortgages.

The difficulties highlight the growing repercussions as banks, facing hundreds of billions of dollars in further losses on investments gone bad, seek to conserve cash and shy away from risk. Their efforts are straining the traditionally cozy relationship between banks and hedge funds, in which banks reaped fees for providing services to the funds, and the funds received the financing they need to magnify the returns they can earn on their clients’ investments.

Typically, banks and brokers provide financing to funds through so-called repo transactions, in which a hedge fund turns over securities as temporary collateral for a loan. The fund later buys back the securities at a higher price that includes interest on the loan. The top banks and brokers in the U.S. alone—including Morgan Stanley, Goldman Sachs and Bear Stearns Cos.—had some \$4.4 trillion in repo loans outstanding as of Feb. 20, according to the Federal Reserve Bank of New York, though only a fraction of those would be to hedge funds.

Now, banks and brokers are scaling back on their exposure both by tightening standards on repo loans and being quick to react when clients run into trouble. A bank, for example, might lend 97 cents against the collateral of a high-quality mortgage security with a market value of \$1—a difference known as a “haircut” that insures the lender against losses. In recent months, as the value of all kinds of securities, particularly highly rated mortgage bonds, has fallen sharply, banks have been increasing the haircuts and issuing more margin calls. Because repo loans often last only one day, hedge funds can find themselves in trouble literally overnight.

“The mandate of any prime broker or repo trader requires that they hold sufficient collateral that can be liquidated with a high degree of certainty within a tight time frame, even next day,” says Glen Mif-

sud, head of Credit Suisse Group’s fixed-income prime services in London, which works with hedge-fund clients.

In a well-functioning market, the borrower might sell assets to come up with the cash. But as fretful investors shun a widening range of securities, funds often can’t find

Carlyle’s problems extend the crisis to a previously unaffected class of securities.

willing buyers—a situation known as a lack of liquidity. That forces banks and brokers to seize the collateral, leaving them holding the troubled securities at the root of the hedge funds’ problems—holdings that analysts say could require the banks to take billions of dollars in further write-downs.

The investors facing the biggest pressures are those that own fixed-income securities, particularly funds that use a lot of leverage. The Carlyle fund managed only \$670 million in client money, but used borrowings to boost its portfolio of bonds to \$21.7 billion, meaning it was about 32 times levered. Peloton used borrowings to boost its portfolio by four to five times. Many credit hedge funds “were trying to pick up eighths and quarters

from a lot of small mispricings in the debt markets and were levering up their returns significantly. Now they are facing that once-a-lifetime event that they thought would never happen,” says Brad Alford, founder of Alpha Capital Management, an investment-advisory firm in Atlanta.

In a sign of the increasing tensions between banks and their lenders, Carlyle Chief Executive John Stomber issued a statement yesterday complaining that the margin calls demanded by the funds’ lenders had been excessive. “Unfortunately, this disconnect has created instability and variability in our repo financing arrangements,” he said.

Carlyle’s problems are of particular concern, because they extend the crisis to a previously unaffected class of securities—bonds issued by Fannie Mae and Freddie Mac, agencies that investors have perceived as having the full backing of the U.S. government. Amid fears of forced selling, the difference between the interest rates on these bonds and yields on ultrasafe Treasury securities—a measure of investors’ appetite for risk—has risen sharply in the last few days to what some analysts say are record highs.

“The fact that this is happening in top-quality agency paper is really worrying,” says Tim Bond, a strategist at Barclays Capital in London. “It’s marking an extension of this stress into the group of players who only invest in the safest mortgage-backed stuff.”