Banks and Hedge Funds. A Side By Side Comparison

	Banks	Hedge Funds
Capital	· Banks have permanent equity capital and long term hybrid capital.	· Hedge funds have variable capitals. Equity can be redeemed although there may be lock ups, gates and low redemption frequency to stabilize equity capital. · Lock ups and gates have been controversial. Some investors dislike them while others appreciate the stability they bring.
Price discovery	· Bank equity and capital trade on open markets and price discovery is achieved through demand and supply.	· Equity is subscribed and redeemed at Net Asset Value. · Secondary market remains small and specialized.
Leverage (size)	· Banks are typically leveraged anywhere from 10X to 50X. · Banks are allowed to apply risk weights to assets for the purposes of calculating their leverage.	· Hedge funds are typically leveraged between 2X to 5X although some strategies are more leveraged than others. · No risk weighting of assets. Everything counts.
Leverage (structure)	· Banks issue across the spectrum from hybrid capital to senior, secured, bonds as well as secured and covered bonds. · An important source of banks' funding is deposits. Bank deposits are a source of duration mismatch. · Some banks rely on short term, wholesale funding such as interbank, commercial paper and repo markets.	· Hedge funds rely on prime brokers for their leverage. Prime brokers are usually the large investment banks. · Hedge funds not only borrow money but also borrow securities for shorting, leading to de facto if not financial leverage. · Cash and securities lending is usually on a short term basis and can be recalled.

Business	· Banks lend to households, businesses, and governments. When they do so they make money by taking credit risk. · Banks provide services to clients earning fee income. · Banks engage in trading activities. This has been substantially reduced post 2008 as regulation has been introduced to reduce systemic risk and taxpayer bailouts.	· Most hedge funds make money from trading and investment. · Some hedge funds provide financial services and earn fees but this is usually in conjunction with assuming some market or credit risk. · Some large hedge funds are significant lenders providing credit not only through bond investment and underwriting but in private loans. · 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.
Investor base	· Equity is publicly traded and bought by institutional investors, retail investors, mutual funds, and institutional funds. · Other claims are variously traded by investors of varying sophistication.	· The offer of hedge funds is usually restricted to sophisticated investors.
Operating costs	· Borne by shareholders.	· 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. · Investment manager bears the operational costs which are paid out of the management and performance fees they collect.
Asset Valuation	· 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.	· 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. · Typically an independent administrator is involved in the valuation of individual assets and the calculation of NAV.
Regulation	· Regulated internationally (e.g. BIS), regionally (e.g. EBA, ECB), and nationally (e.g. local central bank.)	· Largely unregulated although AIMFD in Europe is an attempt at better regulation. · Increased regulation if they seek wider distribution such as retail investors.

History of Instability	· Bank runs have been recorded since banks were invented. · A record of banking crises exists from 1763 with roughly one crisis per decade. · Over-leverage and a concentration in one area of collateral appear to be factors.	· 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. · 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. · 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.