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Functionality of Banks and Hedge Funds and Contagion Between Financial Institutions

ABSTRACT

The paper studies crises and contagion effects in the framework of two financial institutions: a bank and a hedge fund. System dynamics models of a hedge fund and a bank are formulated. The concept of contagion is discussed in the framework of these two financial institutions. The goal of the paper is to understand conditions under which each of the financial institutions can fail and determine when a failure in one financial institution can trigger a contagion effect that leads to the failure in another financial institution. Both models and the concept of contagion are validated and discussed within established financial frameworks. The paper provides conclusions and policies how to avoid or mitigate the effects of financial crises and contagion.

INTRODUCTION

Section 1 gives an overview of the general structure of hedge funds and banks as well as background for these financial institutions. Section 2 provides a framework for a generic model. A generic model is made to account for both bank and hedge fund structure. Appendix A provides equations for the running model. Section 3 (along with Appendix B-E) provides the reasons behind financial crises in each of the financial institutions. The issues of contagion between a bank and a hedge fund are discussed in Section 4. Section 5 explains how validation and calibration of the model should be done. Recommendations and conclusion follow.

The goal of the paper is to understand conditions under which each of the financial institutions can fail and determine when a failure in one financial institution can trigger a contagion effect that leads to the failure in another financial institution.

Section 1

Hedge Funds

Since 1990s there has been a growing awareness about hedge funds. Hedge funds are often called alternative investments because hedge fund managers are not restricted to any particular type of investments. Hedge funds have the ability to buy (long) or sell (short) securities which they do not hold. They are not restricted to plain "buy and hold" strategy. Hedge funds' activities are usually not transparent to investors and to the government. Hedge funds have the capability of leveraging - borrowing against their existing assets. In 1990 there were about 70 hedge funds. There are about 50,000 hedge funds in 2000. The hedge funds also grew in size of assets under management. Currently, there are about \$8 to \$15 trillion dollars invested in these alternative investments. Despite spectacular growth and performance in double digits of various hedge funds, there have been many horrifying collapses and bankruptcies of hedge funds such as Granite Capital, Global Systems fund, and LTCM.

The current form of most U.S. hedge funds is a limited partnership, or a limited liability company established to invest in public securities. However, there is no

common definition of a hedge fund. Hedge funds are defined by their freedom from regulatory controls stipulated by the Investment Company Act of 1940. The controls limit fund leverage, short selling, holding shares of other investment companies, and holding more than 10% of the shares of any single company. However, the laws are relatively lax, especially compared to the laws that mutual funds have to abide by. Like mutual funds, hedge funds are actively managed investment portfolios holding positions in publicly traded securities. However, unlike mutual funds, hedge funds have a bigger flexibility in the kind of securities they can invest. Hedge funds can invest in domestic and international debt and derivative securities. They can take undiversified positions, sell short, and level up the portfolio.

Hedge funds seek to generate above-average returns to their investors. Most hedge funds use the following strategies:

- Short selling. The strategy involves the sales of borrowed securities hoping the price of these securities will go down. A hedge fund manager should have sufficient skills and expertise to identify overvalued securities and being able to cost-efficiently borrow the overpriced stocks.
- Hedging. The strategy involves decreasing risk inherent in hedge fund's portfolio. The risks might be the following: political, economic, company, interest rate and market risks. Hedging can use the combination of derivatives and short sales. Hedge fund managers should be able to use efficient hedging techniques. For example, it is very costly and not efficient to hedge by shorting a share of a stock for every share held long in the portfolio. It might be more economical to short contracts or shares of different assets which are highly correlated with the underlying asset.
- Arbitrage. The strategy involves finding any price inefficiencies or discrepancies between securities or markets. The strategy is risk-free; however, in current efficient markets it is very hard to find any price inefficiencies. Even if such inefficiencies are found, they do not last. Therefore, fund managers tend to use leverage in order to enhance returns due to such minuscule short-term opportunities.
- Leveraging. The strategy involves either borrowing money, to increase the size of the portfolio; or assigning cash or securities as down payment, collateral, or margin for a percentage of the position one seeks to establish.

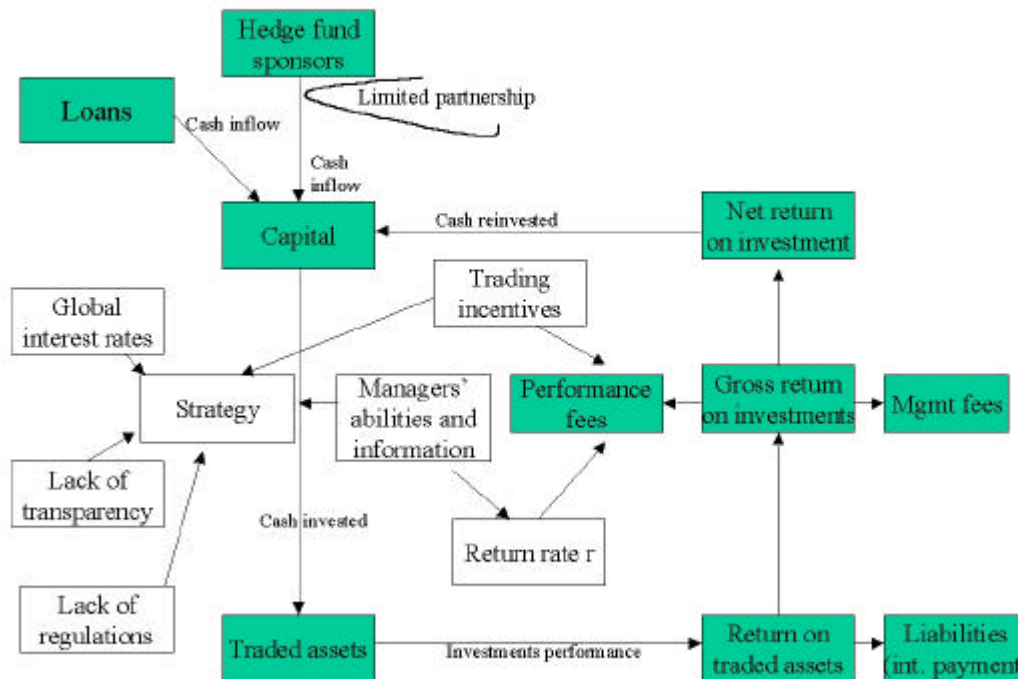
- Synthetic positions or derivatives. The strategy involves using derivative contracts to establish certain positions or strategies in the hedge fund.

There are many hedge fund types. The list of hedge fund types is the following:

- Macro funds
- Special-situation funds
- Pure equity funds
- Convertible arbitrage funds
- Funds of funds
- Market-neutral funds
- Commodity trading advisor funds
- Private equity funds
- Risk arbitrage funds
- Long or short funds
- Emerging market funds
- Event risk funds
- Restructured or defaulted security funds

The structure of a typical hedge fund is provided below. Hedge funds increase capital by borrowing from wealthy investors, taking loans from the bank and reinvesting net return on investments. The diagram below describes both material as well as information flows. For example, capital can only be increased or decreased by material flows. However, performance fees can be adjusted to past performance fees, track performance, the effort exerted by managers, managers' skill and other parameters. Investment performance depends both on assets invested as well as on the skill of hedge fund managers.

Hedge Fund - Functional Diagram



Banks

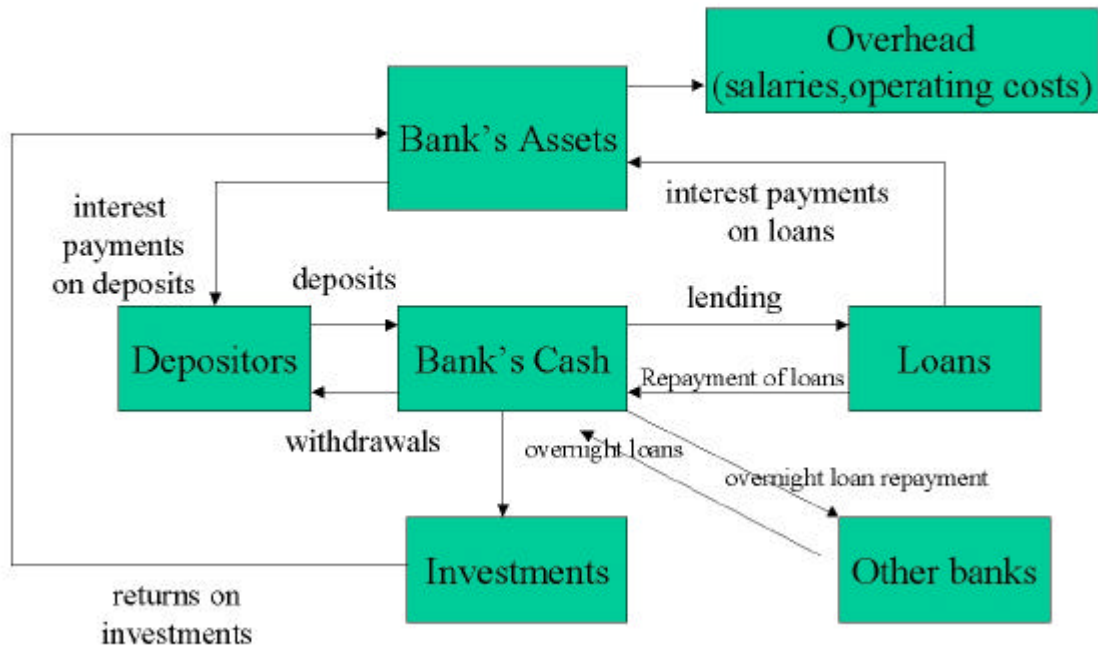
Banks have been in the USA since the 19th century. They should promote depositor safety and economic stability. Federal Reserve is supposed to make emergency loans to commercial banks. Banks by law have to keep 10 % reserve requirement. They cannot invest all of their money like hedge funds. Banks primarily make money by taking deposits and lending money as loans. Interest rates charged on loans are much greater than the ones promised to depositors. However, banks can also invest some part of their assets into more riskier assets. Banks are financial institutions whose main purposes are the storing and lending of money. Banks, like most large companies, are owned by stock holders. These stock holders elect the individuals who run the operations of the bank, the board of directors. The stock holders also reap the benefits of the profits that the bank makes. Banks make it desirable for customers to store their money thereby offering both security and also profit for the customer in the form of interest on deposits. The security inherent in a large financial institution is enhanced by federal protection of

the depositors' funds, in the form of the Federal Deposit Insurance Corporation (FDIC). A bank invests the money it holds, reaping profit on the earnings from these investments. Another service offered by banks is the lending of money to individuals and institutions. Customers take advantage of these loans for things ranging from mortgages to car purchases to business expansions. These loans are repaid to the bank with interest, and it is on this interest that the bank makes a significant portion of its profit.

The net profit made by a bank is a balance between the profit due to the returns on investments and the interest paid to the bank on loans and the expenses due to the operating costs (salaries, buildings, etc.) and the interest paid to customers on their deposits. A bank will often delve into other areas of financial business. Many banks offer credit cards, mutual funds, insurance and currency exchange. Banks occupy a very important niche in the economy. When a bank lends money it allows a business or an individual to borrow against their future income in order to accomplish things they otherwise couldn't. Further, it allows businesses and individuals to store, and make profit on, their wealth with minimal risk.

A simple diagram based on banks' functionality is drawn below.

Functional Diagram of a Bank



Section 2

Research Question

The proposal is to study the ways a generic hedge fund can fail. Under which conditions a generic hedge fund might fail? It is imperative to find the leverage points in the hedge fund's structure and decision points which lead to the collapse of the generic hedge fund. (Note, as was mentioned in the introduction, we are building a model of a generic financial institution, and then calibrate it to a specific one. For this paper, a model was calibrated to a hedge fund. That's why we will often make references to a model of a hedge fund.)

Method

In finance, the following saying that is true - the past does not guarantee the future. If a hedge fund failed due to one cause, it does not mean that other hedge funds

will fail only due to this cause. It is true that a huge leverage of LTCM in 1998 was the main factor which led to the almost bankruptcy of the fund. Other hedge funds that had similar structure as LTCM had to go down. However, other factors should be included in the equation in order to predict the possibility of a hedge fund to go down. In order to address the problem of hedge fund failures, it is imperative to study a generic hedge fund structure thoroughly. It is important to identify all stocks and flows which are the backbone of an operational hedge fund. After this is done, major effects which lead to the change in flows should be identified and measured. To illustrate, a fund's value is called the net asset value (NAV). NAV is going to be a dependent variable. NAV is the sum of cash, total investments less liabilities.

$$\text{NAV} = \text{Cash} + \text{Total Investments} - \text{Liabilities}$$

NAV is a function of hedge fund's leverage, reputation, return, risk of positions, skill and other factors. Of course, there are many more variables that affect NAV. However, it seems that leverage, return, risk of positions and skill are the most important to study. They vary a lot with NAV and they are the answer why hedge funds can fail. The skill of managers is a huge factor that determines NAV. A skillful manager can deliver above average returns; therefore, increasing NAV of the fund. New investors, who are aware of the skillful manager, are eager to invest with this manager. Leverage is one of the defining elements of a hedge fund's operations. It is an important component which affects returns and the additional benefits or value added they bring to investors. By allowing managers to increase the size of the hedge fund portfolio due to leverage, hedge fund managers are able to magnify their returns. Since many hedge fund managers are paid on the basis of performance, the greater the leverage, the greater the fund's potential returns and performance fees. Leverage is an important factor for the study of hedge funds collapse. Overleveraging to boost fees is a common temptation faced by many hedge funds. Excessive leverage is the major cause of hedge fund losses in volatile or falling markets. For example, LTCM collapsed in the summer of 1998 due to the use of high leverage ratio which magnified relatively minor but unexpected negative price moves during that time. Risk of positions is an important factor in looking at NAV.

Investors tend to stay away from risky funds which have high volatility stocks with negative returns. However, they are more eager to invest with funds which have risky positions in instruments which bring positive returns. Return of a fund is of course, an important variable. Investors will fly away from funds which consistently bring negative returns or less than expected returns (compared to their peers or to the indices).

We are interested in finding the exact dependence of NAV on the independent variables. Therefore, the problem is to find "f", where

$$\text{NAV} = f(\text{leverage, return, risk of positions, skill}) + E$$

The equation below is wrong and oversimplified. NAV is not linearly dependent on the following factors. Hedge fund operations has many implicit feedback loops which do not lead to a simple linear dependence. The model in the following section is going to fully address needed feedback loops.

$$\text{NAV} = b_1 * \text{leverage} + b_2 * \text{return} + b_3 * \text{risk of positions} + b_4 * \text{skill} + E$$

Where $b_1..b_4$ are regressors of NAV on leverage, return, risk of positions, and skill respectively. E = is the error.

Estimation of Variables and Problems in Finding Data

It is very hard to find data on all independent and even dependent variables. The hedge fund industry lacks transparency. Hedge funds are heavily dependent on intermediaries devoted to matching buyers and sellers who have every reason to limit the flow of information to the public. These intermediaries charge substantial commissions for their efforts, and are eager to limit the distribution of information to investors in order to maintain their roles. Fund managers are also interested in maintaining the lack of transparency because they are engaged in arbitrage strategy and are not interested in revealing positions or order flows. However, with the growth of hedge funds, recent collapses of huge hedge funds and the push from international regulators, a growing

number of publications and sources now offer hedge fund data. Laws are also changing. For examples, the U.S. Securities and Exchange Commission ruled in 1997 that hedge funds could distribute data using an Internet subscriber service, provided only "qualified investors" have access to this information.

A hedge fund's prospectus contains information on the fund's investment strategy, philosophy, as well as its track record. Track record of the fund is another important source. A hedge fund track record is simply the historical presentation of the fund's historical returns as measured by the changes in its value over time. The track record tells how NAV has changed over time.

NAV

It is important to realize that NAV (dependent variable) which is quoted in the track record might have errors associated with it. The sources of such errors are the following:

- The Relevance Problem. Some funds present *pro forma returns* - theoretical returns what the fund could have made in the past had such a methodology, manager, or asset composition been used. *Pro forma* statements are particularly commonly used by funds of funds, new hedge funds and system-following commodity trading advisers. In general, since these returns have not been validated by actual market events, *pro forma* track records should not be considered in evaluating NAVs.
- The Consistency Problem. Usually, the longer we have returns for a manager, the better and more precise is our evaluation of the manager and his fund. However, the longer we have returns for a manager, the higher is the probability that the manager uses other managers to run the fund or he combined several funds into one fund. The data should be adjusted for the radical change in strategy, markets, leverage and any change in management structure in order to evaluate the correct NAVs.
- Fees. All fees should be subtracted from overall earnings in order to get consistent estimates of NAVs.
- Valuations. NAV requires that the assets and liabilities of a fund be valued at a prevailing market price. However, there are different techniques for calculating NAVs which are reported in funds' track records. The prevailing techniques are the

following: marked to spot, marked to model, and marked to market. Marked to market should be always used.

Risk of Positions

Generally, the higher a fund's standard deviation, the greater its risk for an investor. Standard deviation of the fund is going to be used as a metric for measuring the risk of the fund's positions. However, it should be noted that the standard deviation of the fund's returns is not perfectly correlated with the general risk of the fund for an investor. The correlation coefficient is 1 only when returns are normally distributed. If returns are normally distributed, thus symmetrical, ranking funds by means of average returns and standard deviation will give meaningful results. However, if returns of the fund are skewed, then results should be adjusted. The presence of skews means that it is imperative to distinguish between positive and negative standard deviations and volatility. Real-world investors are more sensitive to losses than to gains. They prefer positive volatility (positive returns greater than the fund's average returns). Investors seek to avoid negative volatility (negative returns greater than the fund's average returns). Therefore, all other things being equal, a fund with high positive volatility will always be more attractive to an average investor. (Prospect Theory). It is important to adjust for the skews because in reality the assumption of normality in the distribution of hedge fund returns is generally incorrect.

Returns

It is incorrect to assume a normal distribution of returns for a typical hedge fund. In a simulation model where sometimes returns are deterministically or stochastically used as an input to the model in order to test the effect of returns on NAV, it is imperative to make the correct assumptions about returns. For example, most hedge funds have the loss "tail" in the distribution of returns. It is more frequent than should have been predicted by a normal distribution. Also, all the distributions have a positive skew; that is, the frequency of positive returns is to some degree greater than should have been the case under the normal distribution. Positive skews might be explained by the skills of hedge fund managers. Hedge fund managers charge enormous fees and higher the best

people in the industry in order to deliver better than average positive returns. Therefore, the more skillful the managers, the less likely their returns will be to conform to a normal distribution. These skillful managers tend to hold on to assets with positive volatility and sell assets with negative volatility. Hedge funds' returns can be found in investment track records of hedge funds.

Skill

Manager's skill depends on prowess and risk management strategy. Prowess is the ability to identify and capitalize on situations that have high reward and lower risk than perceived by the market. Risk management is the manager's ability to cut losses and let winners run. In a way, a good hedge fund manager has a linear utility function compared to average investors who have convex utility functions when faced with losses, and concave utility functions when faced with the possibility of future gains. A skill is usually hard to measure since this variable is often dependent on many other factors. It is also dynamic in nature. A hedge fund manager's skill can be decreased or increased over the life span of the fund. The following metric is proposed for the estimation of the hedge fund manager's skill. It is called D ratio.

D ratio = Abs D/U, where

D= number of positive returns

U= number of negative returns

Abs = absolute value

The D ratio will have a value between 0 and infinity. A D ratio of 0 is a distribution of returns that have no downside. A D ratio of 1 is a perfectly equal distribution of returns around 0. A D ratio of infinity signals that managers have a low skill and cannot deliver any positive returns to their investors.

Leverage

Leverage is the value of assets or positions a fund has over and above its capital. The larger the market value of a fund's positions over its investor supplied capital, the greater the fund's leverage. The following statistic can be used to calculate leverage:

$$\text{Leverage} = (\text{Total Investments}) / (\text{Total Investments} - \text{Liabilities})$$

Another proxy is a Debt Ratio:

$$\text{Debt ratio} = \text{Liabilities} / \text{Assets}$$

It is important to have the correct leverage ratio in order to make the right assessments of the impact of leverage on the NAV. Many fund managers do not disclose leverage. Only one-third of the fund's leverage can be readily determined on the basis of its bank borrowings. The remainder of the fund's leverage is "hidden" by being contained in the structured note it is holding in its investment portfolio. Sometimes, only after the collapse of the fund, the leverage of 50:1 come as a surprise to many of its investors who did not realize that the manager of the fund used such a high leverage ratio.

Model

There are three important accounting variables that should be represented in the model: "Assets," "Liabilities," and "Equity." According to the accounting identity:

$$\text{Assets} = \text{Liability} + \text{Equity}$$

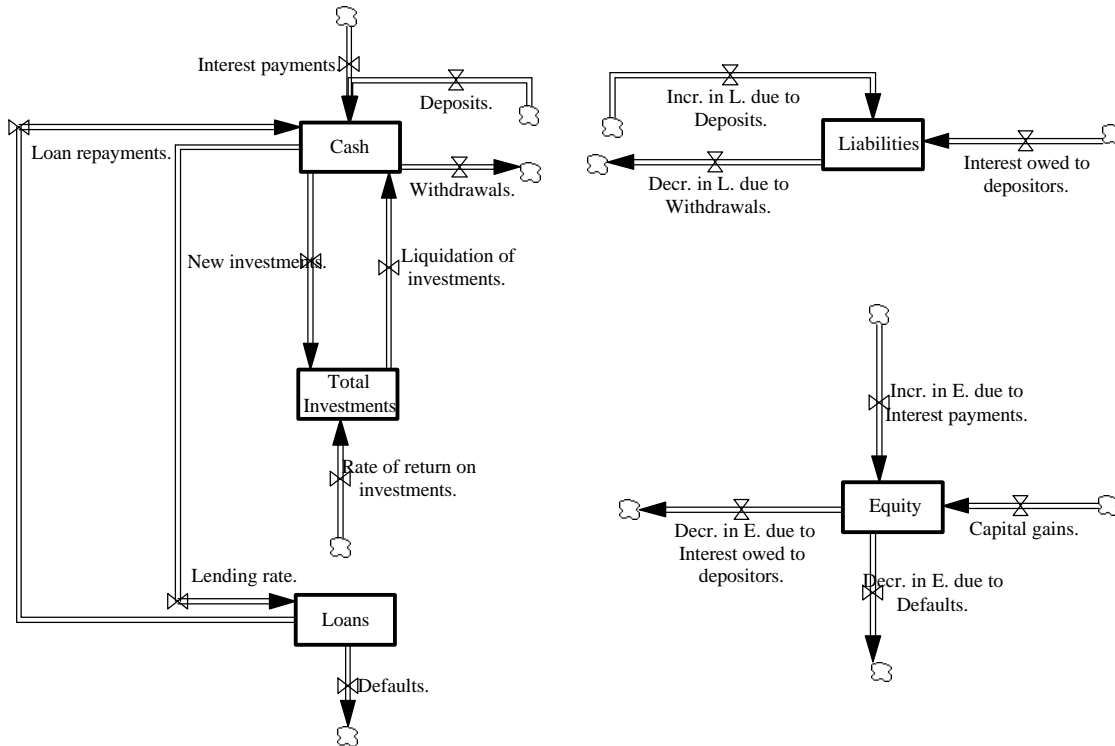
Each financial institution has three types of assets: "Cash," "Total Investments," and "Loans." Each of these types of assets is presented as a stock in the final model. These stocks are the operational stocks of a generic fund. They were inferred from operational description of hedge funds.

In the model, a financial institution can invest in three types of investments: low-risk, medium-risk, and high-risk. For example, when a hedge fund invests in a treasury bond, it invests in a low-risk security; however, when a bank invests in a hedge fund, it

invests in a high-risk security. All these relationships are mapped out in the model. Loans can be short-term or long-term. Note that since we are trying to model a generic financial institution, the term loans does not apply to all financial institutions, hedge funds, for example. Hedge funds, by definition, are not able to make loans.

“Cash” can be increased by “Interest Payments,” “Deposits,” “Loan Repayments,” and “Liquidation of Investments.” It can be decreased by “New Investments,” “Withdrawals,” and “Lending Rate.” “Total Investments” is increased by “New Investments” and “Rate of Return on Investments.” However, it is decreased by “Liquidation of Investments.” “Loans” are increased by “Lending Rate” and are decreased by “Loan Repayments” and “Defaults.” The variable “Liabilities” has two additive components: “Increase in Liabilities due to Deposits” and “Interest Owed to Depositors.” “Liabilities” is decreased by the rate “Decrease in Liabilities due to Withdrawals.” Finally, “Equity” is increased by “Capital Gains” and “Increase in Equity due to Interest Payments.” “Equity” is decreased by “Decrease in Equity due to Interest Owed to Depositors” and “Decrease in Equity due to Defaults.” Negative equity stock means that a financial institution failed.

The diagram below shows a stock and flow structure of a generic financial institution.



Formulation for the Rate of Return

- Lognormal distribution of returns
- r_{it} are continuously compounded single-period returns, IID normal
- Single-period gross simple returns R_{it} are distributed as IID lognormal variates
- Three types of returns are used: low risk, medium risk and high risk

Rate of Return: Calculation

$$r_{it} \square N(\mathbf{m}_i, \mathbf{s}_i^2)$$

$$r_{it} = \log(1 + R_{it})$$

$$R_{it} = e^{r_{it}} - 1$$

$$E[R_{it}] = e^{\mathbf{m}_i + \frac{\mathbf{s}_i^2}{2}} - 1$$

$$Var[R_{it}] = e^{2\mathbf{m}_i + \mathbf{s}_i^2} [e^{\mathbf{s}_i^2} - 1]$$

Rate of Return on Investments

• I_{it} is the rate of return on investments [\$/year]

• T_{it} is the total investments [\$]

• L_{it} is the total net losses [\$]

$$I_{it} = R_{it} T_{it}$$

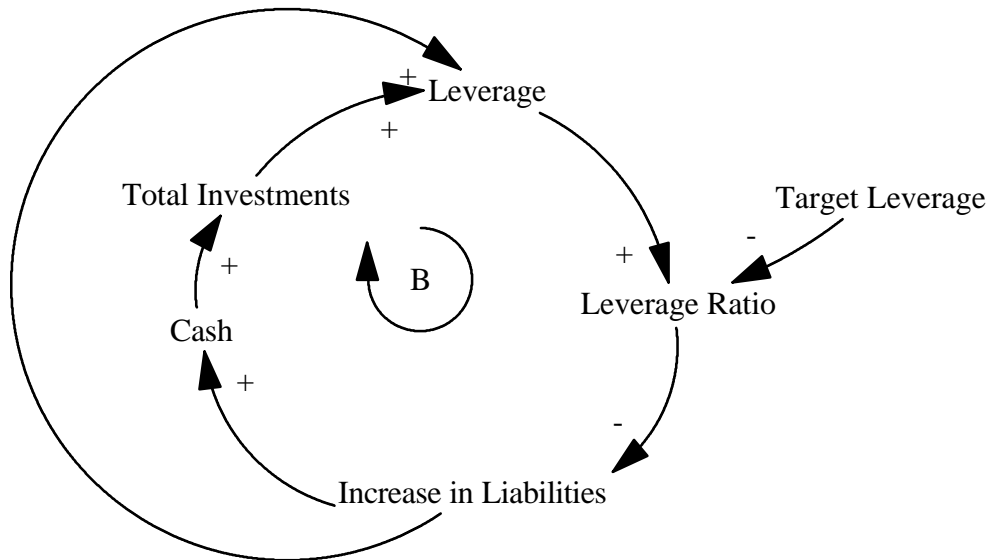
$$L_{it} = \int -I_{it} dt$$

Hypotheses for Collapse of a Financial Institution:

HYPOTHESIS 1: Effect of Leverage on Liquidation, Deposits, and Withdrawals

The following hypothesis is going to be tested: Hedge funds decide on target leverage based on their peer group, their own strategy or the current market conditions. If their current leverage is below the target leverage, they increase their liabilities, therefore, increasing the cash and total investments of the hedge fund. However, the combination of the increase in cash, total investments and liabilities leads to the increase in leverage. Therefore, leverage is increased until the target leverage is reached. This loop is very important in the study of crises in hedge funds. If hedge funds have a very high target leverage such as 50:1, they might end up magnifying small decreases in the market, thus, increasing their exposure to losses. However, if target leverage stays within the boundary of a sustainable one, then the hedge fund might prevent its collapse. The diagram below describes the decision of the increase of leverage based on its target leverage. "B" stands for a balancing loop. It means, that the increase in leverage is balanced by the target leverage. The leverage will not be increased beyond its target value. "+" means that an increase in one variable leads to an increase in another. For example, an increase in leverage leads to the increase in the leverage ratio. "-" means that an increase in one

variable leads to a decrease in another. For example, increase in leverage ratio leads to the decrease in the increase in liabilities.



However, if the balancing loop is absent due to the lack of transparency, management skill or the lack of reporting, then leverage can grow out of a “normal” boundary and lead to a collapse of a fund.

HYPOTHESIS 2: Effect of a Rogue Trader on Net Loss

The following hypothesis is being tested: The presence of a rogue trader can sometimes lead to financial collapse and contagion. The model was run for the following parameters. As it can be seen from the simulation run, the financial institution collapsed in the presence of the rogue trader. The same happened in the Sumitomo bank (Appendix B).

Formulation for the rogue trader:

- If L_{it} is negative, then rogue trader exists with probability P_{it}
- If a rogue trader exists, then

$$I_{it}^{bad} = aL_{it}/t$$

$$I_{it}^{good} = -aL_{it}/t$$

•Where I_{it}^{bad} is a poor investment

I_{it}^{good} is a good investment

a is aggressiveness of a rogue trader

t is time to make a bet

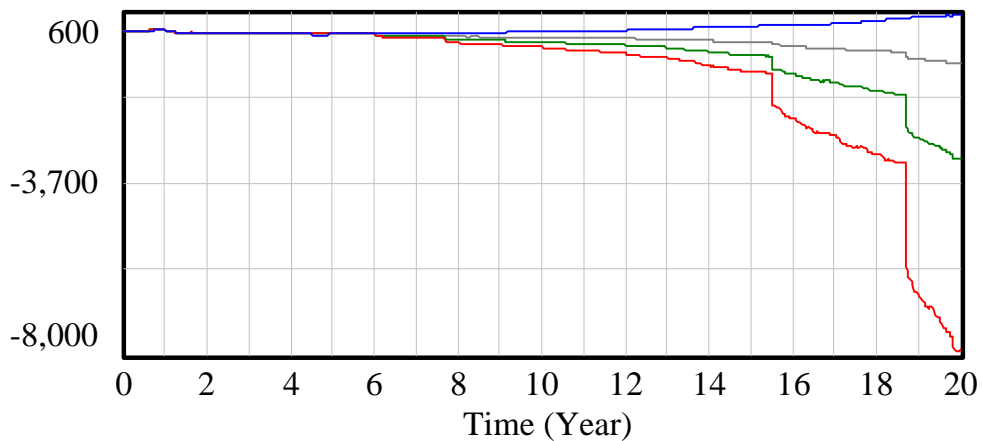
Rate of Return: Rogue Trader is Present

•If a rogue trader is present, rate of return on investments is the combination of the “normal” rate of return and a return on a rogue trader’s bet

•With P^{up} a rogue trader makes a good bet, and $I_{it} = r_{it}T_{it} + I_{it}^{good}$

•With $1 - P^{up}$ a rogue trader makes a poor bet, and $I_{it} = r_{it}T_{it} - I_{it}^{bad}$

Graph for Equity



Equity : a=3_1 ————— Dollars
 Equity : a=3 ————— Dollars
 Equity : a=2 ————— Dollars
 Equity : a=1 ————— Dollars

Section 3

Causes of Banks Going Under

- No capital gains (capital losses)
 - Bank does not make prudent decisions in risky investments
 - Market collapses
 - Hedge fund makes poor investments
- Defaults on principal
 - Hedge fund or another borrower defaults on loans
- Defaults on interest payments

Examples:

1. Financing illiquid assets with short-term deposits
2. Expectation about the behavior of other depositors that drives the behavior of any individual depositor (this causes bank runs)
3. A bank failure can trigger a run on other, solvent banks when bank customers of the solvent bank assume that the value of banks assets are highly correlated with each other.
4. Asymmetric information between banks and their depositors.
5. When a bank is in trouble, bank managers and equity holders have an incentive to gamble for resurrection.

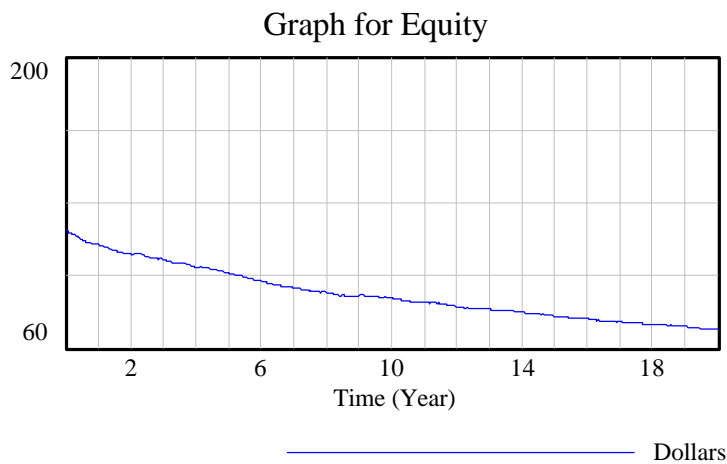
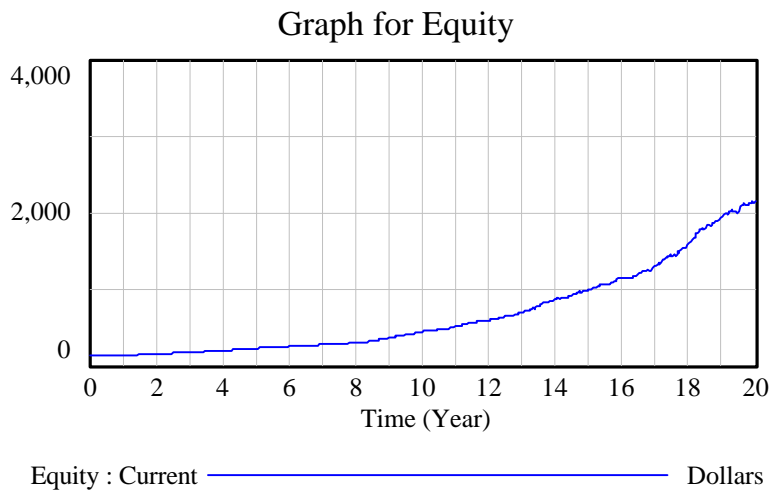
Causes of Hedge Funds Going Under

- Makes poor investment decisions
- General market conditions are bad
- Banks or other lending institutions decide not to lend (make new deposits), especially in crises times when liquidity is very much needed

The model was simulated under two conditions:

- Current run – investing in securities that on average earn positive returns

- - investing in securities that on average earn negative



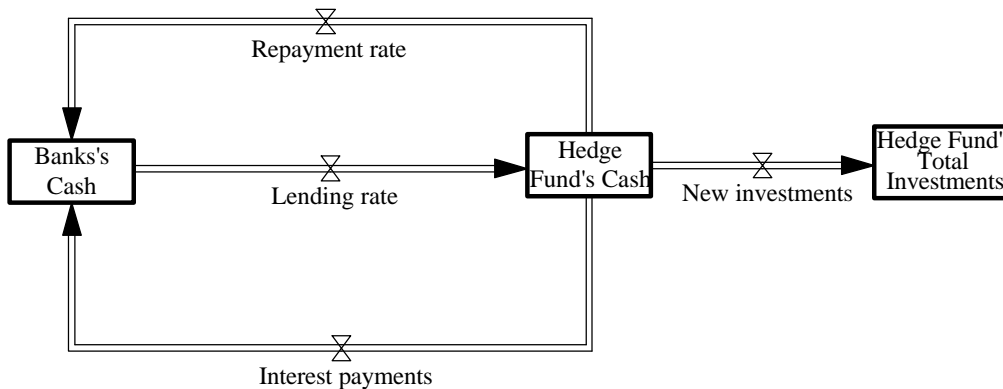
Section 4

Contagion can arise if a bank goes down, then it is possible for the disaster to spread itself into a bank, and vice versa. Of course, contagion only happens under certain structural conditions that are analyzed in the paper. Every day several hedge funds fail; however, not all banks that lend them

assets lent to a hedge fund have to reach some critical number (determined by a mod order for both coupled financial institutions to fail. The section analyzes such couplings

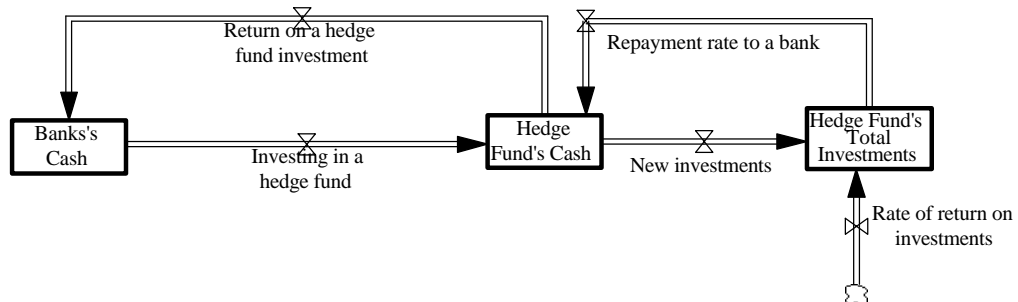
There are two ways for a hedge fund and a bank interact: bank lending to a fund and investing in a hedge fund. When a bank lends money to a hedge fund, the bank

its leverage. It has to pay interest on the money borrowed to a bank. The c describes lending to a hedge fund is depicted below:



hedge fund is shown below. A bank invests in a hedge fund; therefore, it earns interest

A hedge fund receives money from the bank and usually invests right



Section 4

Model Testing

Hypotheses are tested against available data and case studies that have been collected (Appendix B-E). Case studies are studies of individual hedge fund and bank collapses. They encompass reasons behind each collapse, the change in NAV in each case, and the outcome of the crisis. The model is currently being calibrated and checked for validity.

CONCLUSION

In order to fully understand the ways a typical hedge fund or a bank can fail, it is not enough to study past case scenarios and find the reasons behind each collapse. Past case scenarios provide important variables such as manager's skill, return of the hedge fund, risk of its positions, and leverage. These variables are important decision vehicles that impact NAV of the fund. One variable or the combination of these variables might lead to the collapse of the fund. It is imperative to build a model based on the functions of the hedge fund. Once the model is built, all important decision points should be incorporated in the model. The interaction of the feedbacks in the system might lead to potential collapses in individual financial institutions. A good understanding of a model and contagion mechanism leads to comprehending the reasons behind collapse and contagion in different cases.

APPENDIX A
HEDGE FUND MODEL

Assets=

Cash+SUM(Loans[Types of loans!])+SUM(Total Investments[Types of Investments!])

~ Dollars

"Assets - Liabilities - Equity"=

Assets-Liabilities-Equity

~ Dollars

Average time to repay loans[short term]=

1 ~|

Average time to repay loans[long term]=

10*0+1

~ Year

Capital gains[Types of Investments]=

Rate of return on investments[Types of Investments]

~ Dollars/Year

"Capital gains."=

SUM(Capital gains[Types of Investments!])

~ Dollars/Year

Liquidation of investments[Types of Investments]=

Total Investments[Types of Investments]*Normal liquidation fraction

~ Dollars/Year

"Decr. in E. due to Defaults"[Types of loans]=

Defaults[Types of loans]

~ Dollars/Year

"Decr. in E. due to Defaults."=

SUM("Decr. in E. due to Defaults"[Types of loans!])

~ Dollars/Year

"Decr. in E. due to Interest owed to depositors"=

Interest owed to depositors

~ Dollars/Year

"Decr. in E. due to Interest owed to depositors."=

"Decr. in E. due to Interest owed to depositors"

~ Dollars/Year

New investments[Types of Investments]=

MIN(Cash/TIME STEP,Cash*Weights[Types of Investments]*Normal new investments fraction\

)

~ Dollars/Year

"New investments."[Types of Investments]=

New investments[Types of Investments]

~ Dollars/Year

Defaults[Types of loans]=

Loans[Types of loans]*Normal default fraction

~ Dollars/Year

"Defaults." [Types of loans]=
 Defaults [Types of loans]
 ~ Dollars/Year

Normal liquidation fraction=
 0.3
 ~ 1/Year

Normal new investments fraction=
 0.4
 ~ 1/Year

Rate of return on investments [low risk]=
 Total Investments [low risk] * Returns on individual investments [low risk] ~ ~ |

Rate of return on investments [medium risk]=
 Total Investments [medium risk] * Returns on individual investments [medium risk]

Rate of return on investments [high risk]=
 Total Investments [high risk] * Returns on individual investments [high risk]
 ~ Dollars/Year

"Incr. in E. due to Interest payments" [Types of loans]=
 Interest payments [Types of loans]
 ~ Dollars/Year

"Incr. in E. due to Interest payments." =
 SUM("Incr. in E. due to Interest payments" [Types of loans!])
 ~ Dollars/Year

"Liquidation of investments." [Types of Investments]=
 Liquidation of investments [Types of Investments]
 ~ Dollars/Year

Types of Investments:
 low risk, medium risk, high risk
 ~

Interest owed to depositors=
 Deposits * Interest rate promised to depositors
 ~ Dollars/Year

"Interest owed to depositors." =
 Interest owed to depositors
 ~ Dollars/Year

Interest payments [Types of loans]=
 Loans [Types of loans] * Interest rate [Types of loans]
 ~ Dollars/Year

"Interest payments." [Types of loans]=
 Interest payments [Types of loans]
 ~ Dollars/Year

Interest rate [short term]=
 0.2 * 0 + 0.1 ~ ~ |

Interest rate [long term]=
 0.1
 ~ 1/Year

Interest rate promised to depositors=

0.05
 ~ 1/Year
 Lending rate[Types of loans]=
 MIN(Cash/TIME STEP, Cash*Normal lending fraction[Types of loans])
 ~ Dollars/Year
 "Lending rate." [Types of loans]=
 Lending rate[Types of loans]
 ~ Dollars/Year
 Weights[Types of Investments]=
 Total Investments[Types of Investments]/SUM(Total Investments[Types of
 Investments!])\
 "Rate of return on investments." [Types of Investments]=
 Rate of return on investments[Types of Investments]
 ~ Dollars/Year
 Returns on individual investments[low risk]=
 0.05*0 ~|
 Returns on individual investments[medium risk]=
 0.12*0 ~|
 Returns on individual investments[high risk]=
 0.2*0
 ~ 1/Year
 Loan repayments[Types of loans]=
 Loans[Types of loans]/Average time to repay loans[Types of loans]
 ~ Dollars/Year
 "Loan repayments." [Types of loans]=
 Loan repayments[Types of loans]
 ~ Dollars/Year
 Types of loans:
 short term, long term
 Normal lending fraction[short term]=
 0.25/2 ~|
 Normal lending fraction[long term]=
 0.25/2
 ~ 1/Year
 Withdrawals=
 Deposits+Interest owed to depositors
 ~ Dollars/Year
 Normal default fraction=
 13.75/13-1
 ~ 1/Year
 Cash= INTEG (
 "Deposits."-SUM("Lending rate." [Types of loans!])-SUM("New
 investments." [Types of Investments\
 !])-"Withdrawals."+SUM("Loan repayments." [Types of
 loans!])+SUM("Interest payments."\

[Types of loans!])+SUM("Liquidation of investments."[Types of Investments!]),
 50)
 ~ Dollars
 "Decr. in L. due to Withdrawals"=
 Withdrawals
 ~ Dollars/Year
 "Decr. in L. due to Withdrawals."=
 "Decr. in L. due to Withdrawals"
 ~ Dollars/Year
 Deposits=
 10
 ~ Dollars/Year
 "Deposits."=
 Deposits
 Equity= INTEG (
 "Capital gains."+"Incr. in E. due to Interest payments."-"Decr. in E. due to Defaults."
 -"Decr. in E. due to Interest owed to depositors.",
 50+200/3)
 ~ Dollars
 "Incr. in L. due to Deposits"=
 Deposits
 ~ Dollars/Year
 "Incr. in L. due to Deposits."=
 "Incr. in L. due to Deposits"
 ~ Dollars/Year
 Liabilities= INTEG (
 "Incr. in L. due to Deposits."+"Interest owed to depositors."-"Decr. in L. due to Withdrawals."
 ,
 13*2/2.2)
 ~ Dollars
 Loans[short term]= INTEG (
 "Lending rate."[short term]-"Defaults."[short term]-"Loan repayments."[short term],
 13/2.2) ~|
 Loans[long term]= INTEG (
 "Lending rate."[long term]-"Defaults."[long term]-"Loan repayments."[long term],
 13/2.2)
 ~ Dollars
 Total Investments[low risk]= INTEG (
 "New investments."[low risk]-"Liquidation of investments."[low risk]+"Rate of return on investments."
 [low risk],

```

                200/9) ~~|
Total Investments[medium risk]= INTEG (
    "New investments."[medium risk]+"Rate of return on investments."[medium
risk]-"Liquidation of investments."\  

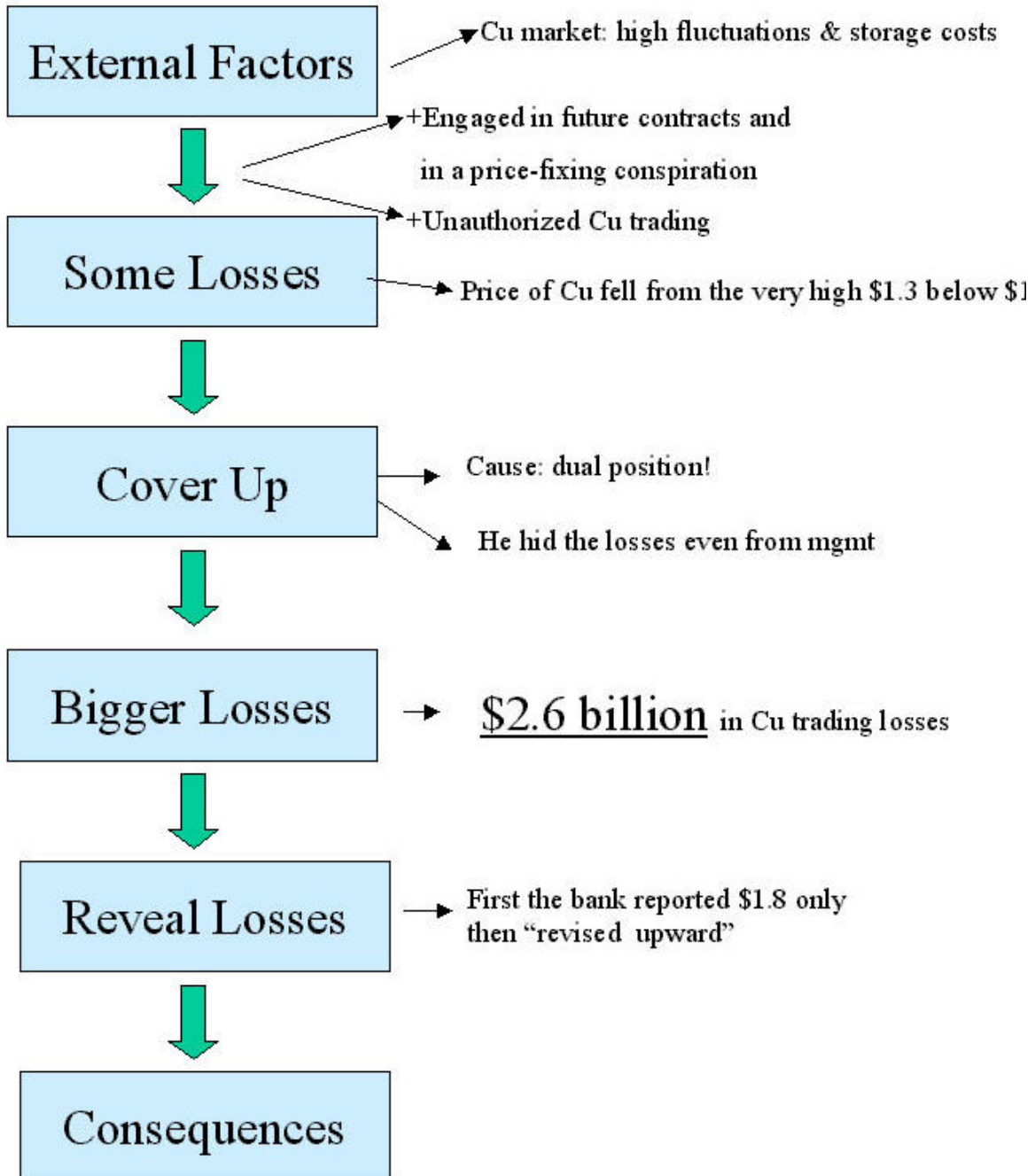
    [medium risk],
    200/9) ~~|
Total Investments[high risk]= INTEG (
    "New investments."[high risk]+"Rate of return on investments."[high risk]-
"Liquidation of investments."\  

    [high risk],
    200/9)
    ~    Dollars
"Withdrawals."=
    Withdrawals
    ~    Dollars/Year
    ~    |
*****
    .Control
*****~
                Simulation Control Parameters
FINAL TIME = 100
    ~    Month
    ~    The final time for the simulation.
INITIAL TIME = 0
    ~    Month
    ~    The initial time for the simulation.
SAVEPER =
    TIME STEP
    ~    Month
    ~    The frequency with which output is stored.
|TIME STEP = 1
    ~    Month
    ~    The time step for the simulation.

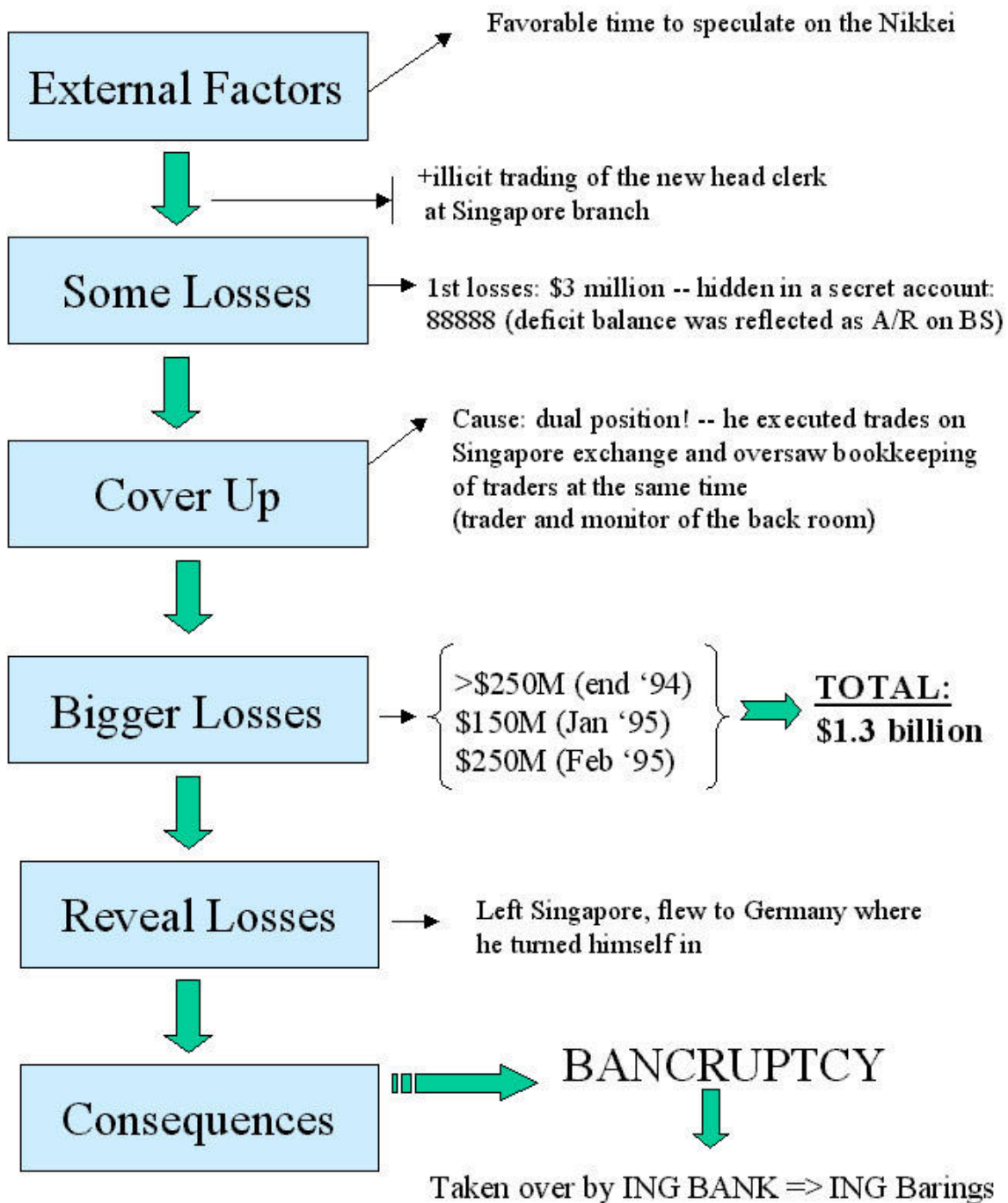
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**APPENDIX B-E: TIME LINE DIAGRAM FAILURES: SUMITOMO BANK,
BARINGS BANK, LTCM HEDGE FUND AND TIGER HEDGE FUND**

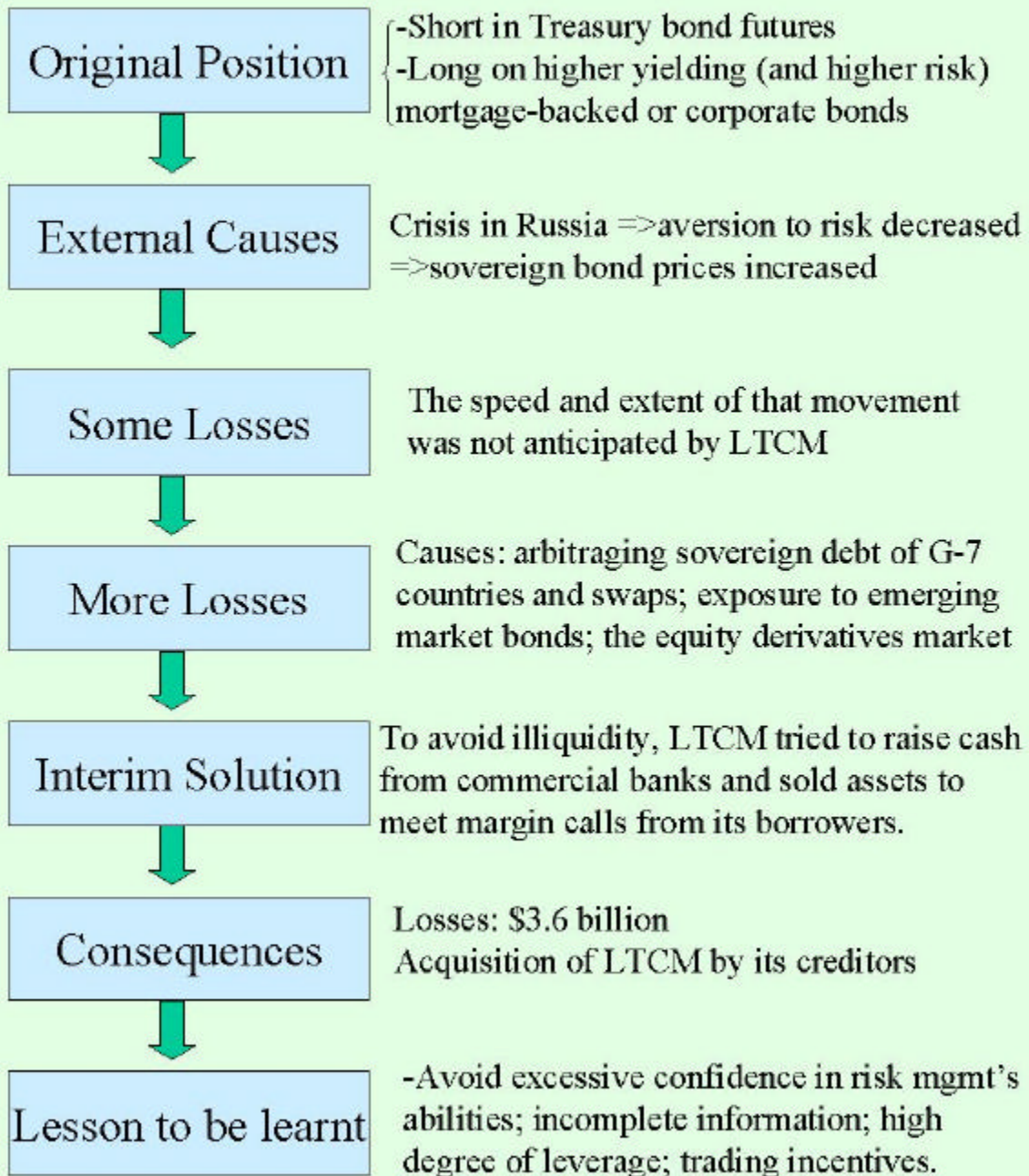
SUMITOMO Corp.



BARINGS



LTCM



Tiger Management LLC

First losses

Growth rate: -4% in 1998 and -8% in Jan-May 1999 => many clients cancelled their contracts.



Main causes

Movements of the exchange rates, failure in investments in the European & American bond markets, confusion due to Russian crisis.



Economic background

Dreadful econ. situation in Japan, low interest rates in the US.



Mgmt's decisions

They borrowed from Japan at low interest rates and took leveraged positions in the US gov't securities.



Bigger losses

\$1.5 billion



Economic causes

The yen went strong, US rates have surged sharply higher, \$ went down, US bond prices went down.



Consequences

Tiger was forced to liquidate its positions