# Archegos Fallout Is A Wake-Up Call For Banks

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The collapse of Archegos Capital Management has cost some banks billions and others almost nothing, underscoring a need for all banks to reexamine their risk management protocols. Banks with solid risk control practices came out relatively unscathed while others faced significant losses and reputational damage.

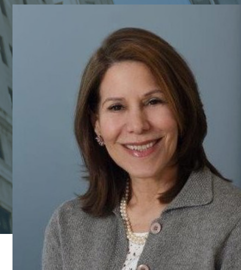
Nevertheless, the Archegos collapse serves as a wake-up call for banks serving family offices to conduct an independent and comprehensive review of their risk management framework to avoid a similar crisis.

Here, we first assess the cause of the Archegos collapse and then focus our analysis in the following two areas: (1) family offices and their lack of regulatory oversight in the U.S.; and (2) deficiencies in bank risk control.

Lastly, we highlight some practical steps for banks' risk management in the aftermath of the Archegos fallout.

## Cause of Collapse

The collapse of Archegos has brought family offices into the spotlight for market participants and regulators. Family offices such as Archegos are opaque investment vehicles with no required regulatory oversight in the U.S., and therefore can make large, concentrated and leveraged bets, which remain largely under the radar.

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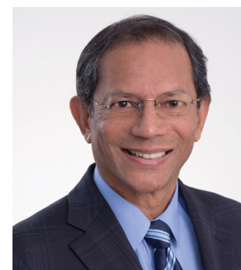


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Many of the trades are structured as equity swaps in which the family office is provided with leverage from multiple banks, gaining exposure to the underlying stocks with only small upfront payments. By doing this, the family office does not own any stocks outright and is not required to disclose its identity and positions.

Meanwhile, the banks that supply the leverage through their prime brokerage business hold the stocks as collateral and manage their risk through variation margin. On the surface, this appears to be a win-win situation for the parties involved in the trade.

Other market participants and regulators, however, are virtually in the dark in terms of aggregate leverage and systemic risk. Although banks still have to disclose their stock positions as registered owners, for outsiders, that is all that is visible.

When the equities referenced by the swap move up, the family office enjoys the daily mark-to-market gains, net of the synthetic financing leg of the swap. When the referenced equities move in the other direction, the family office would experience mark-to-market losses and normally need to post additional maintenance margin to the banks.

If the family office is unable to meet required bank margin calls, banks may cancel the swap and liquidate the long equity positions used to hedge the market risk of the swap.

In some cases, banks may make a business decision to put off the rapid liquidation of the equity hedges, in hopes that the stocks would rebound quickly.

However, once the family office counterparty is unable to meet the swap margin requirements, the equity positions held by the banks become their own, open proprietary risk.

It has been reported that at some point, the banks involved with Archegos became aware they were all on the same side of a crowded equity trade that had been induced by their swaps. It is also possible that the banks had an implicit agreement to hold off or limit liquidations of their long stocks that had been referenced by the swaps, in order to avoid putting massive downward pressure on stock prices.

But even if one bank were to break a standstill agreement and start to sell, the other banks would be exposed to plunging prices of the same collateral. This is exactly what happened in the fallout from Archegos, where the banks that sold first came out fine while banks that failed to react quickly faced significant losses.

Although the total losses that the banks suffered are estimated to be contained, up to $10 billion according to JPMorgan Chase & Co.'s estimation, the Archegos fallout can be taken as a wake-up call for the parties involved and for market participants and regulators.

## Family Offices

A family office is a private financial advisory firm that manages wealth for a single or a small group of ultra-high-net-worth families, having at least $100 million worth of assets. It is different from other private investment firms such as private banks, hedge funds or private equity firms because a family office usually applies a holistic approach to wealth solutions over a range of financial, estate, tax, accounting and nonfinancial services.

With global wealth growing rapidly to over $200 trillion over the last decade, the number of single-family offices has reached over 10,000 around the world. By 2019, the total figure of assets under management for family offices had increased nearly double to those of hedge funds, reaching nearly $6 trillion.[1]

In addition to the recent growth in global wealth, another key driver for the emergence and popularity of family offices may be the lack of regulatory oversight, as evidenced by the conversion of prominent hedge funds, such as Archegos' hedge fund predecessor Tiger Asia Management, into family offices after the 2008 financial crisis.

By converting hedge funds into family offices, hedge fund managers are exempt from regulatory scrutiny for their strategies and portfolios. The rules of the Commodity Futures Trading Commission and the U.S. Securities and Exchange Commission exclude family offices from key registration, filing and disclosure requirements.

Family offices were also provided exemptions in the Dodd-Frank Act, which has been seen as the foundation of reform since the 2008 crisis. As a result, money managers can trade derivatives on behalf of wealthy families without filing registration documents.

Another factor that allowed Archegos to keep its portfolio from disclosure is that its equity exposure was in the form of total return swaps, a type of derivative product. For cash equities, the SEC rules require that any person or firm, including a family office, that acquires more than 5% of a company's shares must publicly disclose the stake. Additional disclosure rules apply if the stake exceeds 10%. Large investment firms must also disclose their stock holdings at the end of each quarter. However, the SEC has stated in the past that investors are not required to disclose positions in equity derivatives unless they have voting power over related shares.

Therefore, a family office that trades equity derivatives with banks is not required to register with regulators or disclose any position under the existing regulatory framework. This is how Archegos could amass such a significant synthetic position in a concentrated basket of eight to 10 stocks with an estimated five or more times leverage, without leaving any visible trace in the market.

Effective October 2021, banks and other firms that trade significant volumes of equity swaps must comply with a variety of new rules under the Dodd-Frank Act, including "know your counterparty" obligations and the required reporting to surveillance databases.

However, only limited details about the equity swap trades are required to be disclosed and family offices remain exempt from the Dodd-Frank Act. The lack of regulatory oversight over family offices in the U.S. could pose a risk to banks with deficient risk control capacity and to global financial markets at large.

## Banks' Risk Control Deficiencies

The collapse of Archegos and the subsequent bank losses may indicate that there are deficiencies in risk control and compliance practices not only for the banks that suffered losses but for the other banks that may have taken on excessive exposure to a single customer.

The history of the founder of Archegos, Bill Hwang, who pleaded guilty to federal wire fraud charges in 2012 and was subsequently banned from the U.S. securities industry, could have been viewed as a red flag to the banks. According to Bloomberg, some banks refused to trade with Archegos, while others, as we know, agreed to trade.

In addition to compliance due diligence, banks should look at the concentration risk from a single customer, lack of consideration for systemic leverage and inadequate collateralization, and lagged response for collateral liquidation.

For some of the banks involved with Archegos, it was reported that business needs sometimes trumped sound risk management considerations. For the banks that liquidated the collateral quickly and suffered no or immaterial losses, the question remains whether they had foreseen the excessive risk-taking activities and provision of bank leverage from a single customer prior to the failed margin call.

If another Archegos-type customer blows up, would the banks be able to avoid losses by successfully playing musical chairs with each other?

To be sure, banks with perfect internal risk management still may find it challenging to avoid or mitigate losses due to their limited visibility into the total leverage of an Archegos.

Through those joint margin call negotiations, banks may have some color on others' exposure but it is likely that no bank would have perfect information about Archegos' total borrowings due to the lack of disclosure associated with family offices and equity swaps. As a result, regulators may take a closer look at the operations of family offices for registration, filing and disclosure requirements.

It may also be useful to expedite the implementation of equity derivatives under the Dodd-Frank Act framework to avoid having a similar systemic crisis.

Based on our review of publicly available reports regarding the Archegos fallout, we suggest consideration of the following practical steps for banks, especially their prime brokerage units, to strengthen risk management practices:

- Understand the counterparty's portfolio and risks that they pose. This is particularly important in the context of family offices.
- Understand the portfolio that the counterparty has with other banks and prime brokers.
- Conduct systematic, periodic, and frequent examination of the risk exposures under a wide range of market scenarios.
- Insist on portfolio diversification.
- Insist on a portfolio of liquid—that is, heavily traded instruments—rather than thinly traded equities, which are harder to liquidate without incurring a huge loss during a margin call-induced liquidation.
- Regularly review risk management policy and procedures.

We hope the Archegos fallout will serve as an opportunity for all the players involved to review their risk policies and procedures.

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[1] Campden Research, global family office asset growth increased to $5.9 trillion in 2019, https://www.campdenfb.com/article/global-family-office-growth-soars-manages-59-trillion; Value of assets managed by hedge funds worldwide reached $3.2 trillion in 2019 and $3.8 trillion in 2020. https://www.statista.com/statistics/271771/assets-of-the-hedge-funds-worldwide/.

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