Statement of Senator Jim Bunning
July 15, 2009

Thank you, Mr. Chairman.

In some ways, the structure and incentives of these private pools of capital are what we should be hoping for in the rest of the financial system. Success is rewarded and failure is punished. Pay is based on performance over time, and not just in the short term. And managers have skin in the game, with their own funds at risk. It seems obvious to me that firms and traders will act more responsibly when they know they will face the consequences of their actions, which is why bailouts breed more bailouts.

I do have some concerns about the risks that these firms could pose to our system. Hedge funds in particular use leverage, which can lead to out-sized losses and panic selling. Losses in one part of a portfolio can force the sale of other assets, which spreads the losses to a normally unrelated investment. Just look at last fall for an example.

I am also concerned about the potential for market manipulation and fraud. When firms can seek profit by any strategy they dream up, there will be great temptation to cheat. I am not saying all or even most firms are dishonest, but the temptation will be there. And that cheating is harder to detect because of the secrecy of portfolios and strategies. Huge risks to the system could build up out of sight of the regulators and other market participants as well.

How we address these concerns is not an easy question, and I do not yet know the answer. I am skeptical of the idea of a government regulator being smart enough to recognize concentration of risk and act to reduce it. Instead, it may make more sense to limit how much risk these firms can take on, and thus how much risk they pose to others, by imposing leverage restrictions. However, I am not sure if it is better to put restrictions on the firms themselves, or limit the dealings of banks and other regulated institutions with these firms.

These are by no means all the issues to consider, but I hope to get some thoughts on them here today. Thank you, Mr. Chairman.