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TESTIMONY OF
JULIE L. WILLIAMS
ACTING COMPTROLLER OF THE CURRENCY
Before the
COMMITTEE ON BANKING AND FINANCIAL SERVICES
of the
U.S. HOUSE OF REPRESENTATIVES
October 1, 1998

Statement required by 12 U.S.C. § 250:

The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

Mr. Chairman and members of the Committee, I appreciate this opportunity to testify on issues raised by the near collapse and interim rescue of Long Term Capital Management, L.P. (LTCM) and issues associated with bank involvement with hedge funds. I commend you for holding this hearing to explore the reasons behind and the implications of the near collapse and interim rescue of LTCM. My testimony will be focused on bank supervisory issues presented by LTCM specifically and bank involvement in hedge funds in general.

While we are continuing to verify our understanding of the impact of LTCM on national banks, we know of no national bank that has been jeopardized by the near collapse of the hedge fund. Nonetheless, we are examining these events to discern how bank supervision may be improved to fortify risk management activities in this area. All banks should be revisiting the ways in which they extend credit to hedge funds. At this point, it appears that the lasting impact of LTCM will be the lessons it teaches about proper management of credit risk, particularly involving leveraged customers, and about the kinds of questions supervisors need to ask the banks.

My statement is structured as follows: a brief description of hedge funds and their activities; a discussion of how national banks interacted with LTCM; a general characterization of national bank exposure to LTCM, specifically, and to other hedge funds; a discussion of the Office of the Comptroller of the Currency's (OCC) supervisory strategies for bank lending to hedge funds; and finally some preliminary observations about the lessons of the LTCM situation for banks, supervisors and financial markets.

Hedge Funds and Long Term Capital Management, L.P.

The term "hedge fund" generally refers to unregulated private investment partnerships that use some form of leverage (either through derivatives or direct borrowing) to accomplish their investment objectives. Therefore, the term "leveraged fund" is often used interchangeably with the term "hedge fund". Hedge funds generally are not subject to any reporting or disclosure requirements, and most hedge funds have the unrestricted ability to take short positions, which is not the case with mutual funds. Hedge funds use a greater variety of investment strategies and techniques than regulated funds. Hedge funds also can differ in structure depending on whether they are domiciled in the United States or based outside our geographic boundaries.

Most hedge funds are structured as limited partnerships. The partnership is run by the general partner(s) who is (are) usually an unregistered investment advisor. Hedge funds are not registered as investment companies nor subject to the standards implemented by the Investment Company Act of 1940 because Section 3(c)(1) of the Act provides an exception from the definition of investment company for "any issuer whose outstanding securities ... are beneficially owned by not more than 100 persons and is not making and does not presently propose to make a public offering of its securities ...". Therefore, hedge funds structure themselves to avoid federal securities law regulation by limiting their securities sales to fewer

than 100 participants, all of whom would meet the definition of qualified purchasers.¹ Similarly, fund advisors are not required to be registered and subject to the Investment Advisors Act². Hedge fund managers can avoid the definition of investment advisor by limiting their client base to fewer than 15 hedge fund “clients.” Thus, generally, the limited partners (investors) in such funds are a limited number of wealthy, financially sophisticated parties, who must perform their own due diligence of the hedge fund, since the fund is not subject to standardized disclosure requirements.

Although hedge funds deploy a wide variety of investment strategies, they are typically categorized as one of two types of funds -- either macro funds or relative-value funds. Generally speaking, macro funds exercise some degree of leverage and execute cash market and derivative transactions to take large market direction positions in equities, fixed income and foreign exchange. Most of the new hedge funds are relative-value funds, which specialize in directional positions in specific markets, arbitrage strategies, or taking advantage of pricing inefficiencies in basic financial instruments in asset markets.

Long-Term Capital Management (LTCM)

LTCM was founded in March 1994 by John Meriwether, a former bond trader at Salomon Brothers, and can be characterized broadly as a relative value fund. We understand the firm's investment strategy consisted of a sophisticated computer-assisted arbitrage strategy known as “convergence trading”. This strategy seeks to take advantage of small differences in the values of securities, currencies and other financial instruments within and between different markets. It generally relies heavily on quantitative analysis and computer models, which identify temporary anomalies that may be taken advantage of in anticipation of their return to normal levels.

It has been reported in the financial press that some of LTCM's trading positions experienced losses as the expected convergence did not materialize -- largely due to the recent pronounced “flight to quality” from riskier markets along with unanticipated market volatility.

¹Under a 1996 amendment to the Federal securities laws, hedge funds are exempted from Securities and Exchange Commission regulation as long as they are limited to fewer than 500 “sophisticated” institutions or individuals -- meaning institutions with total investments exceeding \$25 million and individuals with investment portfolios of at least \$5 million.

²Section 3(c)(7)(A) of the Investment Company Act provides an exception for “any issuer, the outstanding securities of which are owned exclusively by persons [regardless of number] who, at the time of acquisition of such securities, are qualified purchasers, and which are not making and do not at the time propose to make a public offering of such securities....” A qualified purchaser is defined in Section 2(a)(51) of that Act and includes persons with more than \$5 million in assets. Section 203(b)(3) of the Investment Advisors Act of 1940 provides an exemption from registration for any investment advisor “who during the course of the preceding 12 months has had fewer than 15 clients and who neither holds himself out generally to the public as an investment advisor nor acts as an investment advisor to any [registered] investment company....”

We understand that LTCM's high levels of borrowing, to leverage invested capital and increase returns to borrowers, greatly contributed to the firm's vulnerability to adverse market shifts. When market prices moved against LTCM's positions, the extreme leverage in their positions resulted in sizable and accelerated losses. These adverse events triggered margin or collateral calls from creditors that were met through draws under lines of credit or the liquidation of holdings, which resulted in the realization of additional losses and adverse price movements. Last week, a private sector creditor group convened to design and implement a long-term workout that included a change in managerial control of LTCM and the infusion of capital.

National Banks and Hedge Funds

National banks can be involved with hedge funds in a number of ways, and with varying degrees of exposure. Among the services banks provide to their hedge fund customers are:

- loans and credit enhancements;
- execution, clearance, and settlement of trades, including derivatives transactions; and
- custodial services and cash management services.

In addition, holding companies of national banks may be equity investors in hedge funds³.

National Bank Exposure to LTCM

The most recent information we have received from our examiners indicates national banks do not have meaningful exposures to LTCM. Five national banks were participants in a syndicated, unsecured, revolving credit⁴ pursuant to which those banks loaned, in the aggregate, \$94 million to LTCM. In addition, there were unfunded commitments totalling \$76 million, and equity and other investments by national bank holding companies or the banks themselves totalling \$107 million. The unsecured trading exposure of national banks to LTCM was approximately \$21 million as of earlier this week.

The unsecured, revolving credit was extended based on the reputation of the principals at the firm, LTCM's track record over the last few years, and the fact that the principals had invested a significant amount of their own capital in the firm. These exposures to LTCM were aggressive compared to the exposures these banks typically had with other fund managers.

³National banks may invest directly in a hedge fund provided that the portfolio of the fund consists exclusively of assets that a national bank may purchase and sell for the bank's own account, and the fund otherwise meets all applicable requirements for ownership by a national bank. See 12 C.F.R. 1.3(h).

⁴This is part of a \$700 million unsecured revolving credit led by a major financial institution.

National Banks and Other Hedge Funds

National banks have exposures to hedge funds arising from direct lending, trading lines, and investments. As of earlier this week, eight national banks had exposures totalling approximately \$1.8 billion, net of cash or Treasury collateral, from firms that are generally categorized as hedge funds. No bank's exposure exceeded 6.0 percent of its total risk-based capital.

OCC Supervision of Bank Relationships with Hedge Funds

The majority of national bank activities relating to hedge funds can be grouped under two main categories of bank operations: lending and capital markets activities. A bank may, for example, extend loans directly to hedge funds. A bank also may be an intermediary for hedge fund transactions through its trading department. Bank relationships with hedge funds mostly occur at the very largest institutions, which have full-time resident staff who monitor trading, credit, and risk management activities.

Supervision of Lending Activities

The OCC expects national banks to analyze the credit risk of secured and unsecured lending to hedge funds consistent with the overarching principles of credit risk management established through its examination and supervisory procedures. Strategic planning and risk limits are necessary to address these expectations. Loan policies are expected to include standards for portfolio composition and credit decisions and are usually supplemented by detailed underwriting standards, guidelines, and procedures.

Loans and other lines of credit to hedge funds are reviewed by the OCC when commercial loans are examined, using loan portfolio management procedures to assess the quantity and quality of credit risk. The credit procedures encompass assessment of the loan policy; underwriting guidelines and practices; portfolio composition and strategic factors; internal controls; external factors such as economic trends; staffing; and management information systems.

The loan to LTCM is an example of slipping credit underwriting standards that the OCC and the other regulators have recently warned about. In this case it appears that repayment was dependent on LTCM management's reputation and acumen to continue to generate strong returns in a strong market. The banks extending the loan to further leverage an already highly leveraged business must have assumed that LTCM would turn that leverage into profits sufficient to repay the loan. This, in and of itself, is not necessarily a bad thing; it is one of the ways that banks assume credit risk through lending. Properly underwritten and controlled, the risk/reward relationship can be acceptable. Unfortunately, when you combine this type of lending with the lack of any significant structural underwriting protections, in this case sufficient collateral, you can get an unwarranted credit risk.

In good economic times, such as those of the past several years, it is easy to become complacent with regard to proper loan structure. Lenders tend to focus more on the risk of default and less on the likelihood of loss in the event of default. Proper loan structure and underwriting are the key to controlling loss in the event of default. It is easy to do because when borrower's businesses and profits are strong, the likelihood of default (let alone a loss) appears remote. One of our jobs as bank regulators is to ensure that bank lenders structure loans in a manner that will maximize the likelihood of repayment and minimize losses to shareholders and depositors irrespective of the economic environment.

The OCC has implemented examination guidance to further focus the attention of both examiners and bankers on the importance of proper loan structure and underwriting standards. We are asking our examiners to identify loans with structural weaknesses that could jeopardize orderly liquidation of the loans, and to bring them to the attention of bank management and boards in every Report of Examination. Additionally, we are asking our examiners to identify, and report to bank management and boards, loans for which repayment is heavily dependent on projected (as opposed to demonstrated) repayment sources. In bringing these loans, and their inherent risks, to the attention of bank management and boards now, we want them to assess the risks for themselves and make appropriate adjustments to their lending and risk management practices prior to the regulators requiring such actions.

Supervision of Capital Markets Activities

As stated earlier, some national banks engaged in derivatives transactions with LTCM. The OCC believes that, effectively managed, derivatives provide users with flexible risk management tools. Because of their inherent leverage and the potential for adverse exposure to a bank's reputation, however, the OCC provides extensive oversight and supervision of derivative usage in national banks. Eight commercial banks account for 95 percent of the total notional amount of derivatives in the banking system, with approximately 99 percent held by the top 25 banks.

Over the past six years, the OCC has incorporated into its supervision of national banks the examination of derivative contracts and activities. In October 1993, the OCC issued Banking Circular 277 (BC 277), "Risk Management of Financial Derivatives", to establish safe and sound practices for managing financial risks, including those arising from derivatives activities. BC 277 states that banks should adopt systems and controls to measure and monitor properly the individual and aggregate risks associated with their derivatives portfolios and advises banks to set up and follow appropriate risk limits. It includes separate standards for dealer banks and end-users. BC 277 also emphasizes the need for banks to establish controls that assess the appropriateness of specific transactions for customers in order to manage the credit and reputation risk to the bank. To ensure customer appropriateness, we require that dealer banks understand the nature of each counterparty's business and the purpose of its derivative activities.

In evaluating a bank's trading and derivatives activities, the OCC's procedures encompass the assessment of policies, procedures, practices; management information systems; effectiveness of the risk management process as well as the level of risk undertaken in relation to the bank's overall risk governance framework; compliance with laws, regulations, and regulatory guidelines; profitability; and overall strategy.

Our on-site supervisory review of trading departments includes both regularly scheduled and focused examinations, as well as ongoing, on-site supervision at the largest banks. During focused examinations, emphasis is directed at those bank activities or departments exhibiting higher than average risk or growth, potential instability, or unique or new characteristics. These examinations may also cover certain products, such as interest rate swaps, or a given risk category, such as interest rate risk. Staff from the OCC's Risk Analysis Division -- who hold Ph.D.s in economics or finance -- participate in these and other examinations to assess theoretical and quantitative issues in the models used for pricing and risk management. In analyzing bank models, however, what is most important is that supervisory staff understand the infrastructure and culture of the institution in which the model is embedded, know the assumptions underlying the model, and determine who in the organization understands the assumptions and the risk management processes associated with the models.

Preliminary Observations about Impact of LTCM

Events surrounding the near collapse and interim rescue of LTCM may provide some important lessons to banks, their regulators and the financial markets. First is the need not to lose sight of fundamental risk management practices. Credit decisions must be made on the basis of the underlying risks of the current transaction. While the experience or reputation of a customer or the past performance of a client's endeavors is and should be relevant to a bank's credit or investment decision, those factors should not be the only or principal elements taken into account in determining whether or not to make loans or engage in transactions with hedge funds.

Thus, the LTCM case underscores the need for banks to understand the full extent of their credit and trading exposure to leveraged customers, including hedge funds. As creditors, banks need to get as much information as possible about the fund's investment strategy and the exposure of other financial institutions to the fund. Although hedge fund managers may wish to limit available information on their investment strategies and other investors, since this is part of their perceived proprietary advantage vis a vis their competitors, banks should be conservative about their hedge fund lending and investment activities when they receive insufficient information to make informed risk management decisions.

Where the transparency of hedge fund financial information is inadequate, the need for banks to secure and maintain sufficient collateral for their credit risk is enhanced. Even when market conditions are such that banks face increased competition for a given type of loan or

service, they need to adhere to basic principles of sound credit risk management. One such principle teaches that if a lender lacks sufficient information about the financial condition and activities of a borrower or counterparty, the lender should obtain collateral to protect its credit risk position.

Finally, we must not allow the sophistication of quantitative risk modeling techniques to tempt us to abandon banking fundamentals. Modeling has proven to be a valuable tool for risk management. To realize fully the benefits of quantitative modeling, however, models must be accompanied by sound risk management practices and appropriate risk oversight from experienced personnel. Importantly, senior decision makers need to understand how to interpret the output and limits of quantitative models. The fact that a borrower or counterparty employs sophisticated modeling techniques in its business is no substitute for a lender having collateral to protect its position in the event the borrower/counterparty's financial condition comes under stress.

Conclusion

In conclusion, although not all of the facts about the LTCM situation are in, the events surrounding the interim rescue of the firm certainly illustrate the continuing need for financial institutions and the regulatory agencies to assure adherence to prudent, effective risk management practices. Technological advancements and sophisticated computer modeling techniques have contributed to more precise risk management techniques, but we cannot be complacent about the potential for market volatility and risk and we must not forget the ongoing need to follow fundamental principles of risk management, even in the most sophisticated types of credit transactions.