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Statement of
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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 want to commend you for holding this hearing to explore the reasons behind and the implications of the 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.

At the outset, this morning, I want to make one thing clear -- while the LTCM situation may raise a number of complex and far-reaching public policy questions, I can assure you that the OCC's focus is singular: to assure the safety and soundness of the national banking system -- period.

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 this hedge fund. Nonetheless, we are examining these events to discern what lessons should be learned from this experience -- by bank regulators and by the banks we regulate. Clearly, all banks should be revisiting the ways in which they extend credit to hedge funds. At this point, it appears that one lasting impact of LTCM may well be the lessons it teaches about proper management of credit risk.

National banks can be involved with hedge funds in a number of ways. 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. Holding companies of banks and banks themselves, to a limited extent, may be investors in hedge funds as well.

From what we know now, the handful of national banks with relationships with funds that could be characterized as hedge funds, appear to have managed their credit exposure to these funds. In particular, national banks usually have initial margin, have control of the collateral, and have a process to manage ongoing margin or collateral calls to control their downside risk. In addition, relationships with fund managers, including hedge funds, are predicated both on the ability to provide collateral, and on bank knowledge and experience with the principals. The unsecured syndicated loan made to LTCM by a group of institutions, including a few national banks, appears to be aggressive compared to the exposures of most national banks to other funds.

The national banks that work with hedge funds are generally the largest, most sophisticated, trading institutions, and they have full-time resident OCC staff continually monitoring their trading, credit, and risk management activities.

The syndicated loan to LTCM is actually a good example of slipping credit underwriting standards about which the OCC and other regulators have recently warned. In this particular case, it appears that repayment was dependent on LTCM management's reputation and acumen to continue to generate strong returns in a strong market. Unfortunately, when you are making loans to a highly leveraged business, and you do not have sufficient structural underwriting protections -- in this case sufficient collateral -- you can get unwarranted credit risk.

The OCC has implemented new examination procedures to further focus the attention of both examiners and bankers on the importance of proper loan structure and underwriting standards. By bringing these loans, and their inherent risks, to the attention of bank management and boards now, we are hopeful that they will assess the risks for themselves and make appropriate adjustments to their lending and risk management practices -- before regulators are forced to take action.

In addition to lending, as I mentioned, some national banks engaged in derivatives transactions with LTCM. Effectively managed, derivatives provide users with flexible risk management tools but, depending on the instrument, they can be very complex; with a range of upside potential and downside risk.

The OCC provides extensive oversight and supervision of derivative use in national banks. Our on-site supervisory review of trading departments include both regularly scheduled and focused examinations, as well as ongoing, on-site supervision at the largest banks. We have Ph.D.-trained risk-management staff who assess theoretical and quantitative elements of the models used for pricing and risk management.

Events surrounding the collapse and interim rescue of LTCM may provide some important lessons for banks, their regulators and the financial markets. The most important one may be -- Don't lose sight of fundamental risk management principles. Credit decisions must be made on the basis of the underlying risks of the current transaction.

Thus, the LTCM case underscores the need for banks to understand the full extent of their credit and trading exposure to 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. 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. Finally, we must not allow the sophistication of quantitative risk modeling techniques to tempt us to abandon credit risk management fundamentals.

In conclusion -- although not all 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 regulatory agencies to assure adherence to prudent, effective risk management practices. Technological advancements and sophisticated computer modeling 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 lose sight of basic principles of sound lending and risk management, even in the most sophisticated types of credit transactions.

Thank you.

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