STATEMENT OF
DONNA TANOUE
CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
ON LONG-TERM CAPITAL MANAGEMENT LP
COMMITTEE ON BANKING AND FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
10:00 A.M.
OCTOBER 1, 1998
ROOM 2128, RAYBURN HOUSE OFFICE BUILDING

Good morning Mr. Chairman, Ranking Member LaFalce and members of the Committee. I am pleased to be here this morning on behalf of the Federal Deposit Insurance Corporation (FDIC) to discuss the recent recapitalization of Long-Term Capital Management.

As noted in your letter of invitation, the near collapse of Long-Term Capital and its subsequent recapitalization raise a number of very important public policy questions both for the banking system and for the financial system as a whole. At this point, however, only one week after the private sector recapitalization of Long-Term Capital was announced, we have many more questions about the underlying facts concerning this matter than we have answers, and much of my testimony today will focus on the questions we need to answer in the weeks and months ahead.

First, I would stress that not a penny of FDIC deposit insurance funds or other government funds was used in the recapitalization. The use of FDIC funds was never considered, and we were not a party to the recapitalization talks.

The FDIC's primary concerns relating to Long-Term Capital involve the exposure of the deposit insurance funds to the types of risks that hedge funds pose and to the potential for systemic instability. The increasing complexity of financial activities conducted within individual banking institutions requires effective oversight both by the market and the supervisory process. The challenge as the industry evolves is to maintain the proper mix of market and supervisory oversight, so that these systems complement and reinforce each other to provide the maximum effectiveness consistent with a dynamic financial marketplace without creating unacceptable levels of risk. While my subsequent remarks will focus primarily on the supervisory process, recent events highlight the importance of accurate information and adequate disclosure in order for markets to provide effective oversight.

Federal supervision of the banking system is designed to ensure that bank management is capable of understanding and controlling the risk of bank activities. Because exposure to hedge funds in the United States banking system is concentrated in state banks that belong to the Federal Reserve System or in national banks, the FDIC works with the Federal Reserve and the Comptroller of the Currency to monitor and address the risks to federally insured institutions stemming from these activities. The near collapse of Long-Term Capital underscores the need for this type of regulatory cooperation and sharing of information.

Over the past week, the FDIC has been in frequent contact with the other banking regulators regarding the supervisory and regulatory issues presented by the Long-Term Capital matter. We are working with our colleagues to assess the extent of exposure to insured institutions and resulting possible risk to the deposit insurance funds. We have joined in meetings with some of Long-Term Capital's creditor banks and anticipate additional meetings with others over the near-term. The Long-Term Capital situation raises key questions as to the sufficiency of managerial oversight and internal risk management systems. I note that Securities and Exchange Commission Chairman Levitt has said that other funds may be at risk. We are working with other regulators to obtain more information about other funds and assess the potential risks to banks.

One of the central issues posed by the near collapse of Long-Term Capital is whether or not there are gaps in the bank supervision process. The FDIC does not yet know the answer to that question. A primary focus of our efforts will be on the risk management programs in place at the banks involved. We expect that risk management practices will be appropriate to the scope, size, and complexity of an institution's activities.

Bank supervisors do not prescribe universal or standard policies for specific types of activities. These policies are the responsibility of the board of directors and management of each bank. The FDIC expects the board of directors of a bank to fully consider the costs, benefits, and especially the risks of an institution's planned or ongoing involvement in any business venture. These considerations are particularly important when the business venture is engaged in a highly leveraged and volatile activity. Proper risk management requires that the nature of the planned involvement and the level of risk that can be incurred must be fully understood. Understanding the risk includes understanding the most likely and worst case scenarios.

From our review of bank risk management programs, we are working with the other bank supervisors to determine common deficiencies, if any, and determine whether the institutions involved had sufficient information about the nature of Long-Term Capital's strategies and financial condition to make risk determinations. We must also ask whether profit pressures unduly influenced decisions made by the banks involved and whether they used proper underwriting standards; that is, whether the amount of risk associated with Long-Term Capital was reasonable.

Banks that lend to hedge funds face the risk of loan default. But hedge funds may present banks with other risks. A bank that enters into a derivatives contract with a hedge fund faces the risk that the hedge fund -- its counterparty -- may fail to perform, either as the result of its own financial problems or as the result of its own counterparties' failure to perform. Banks must observe prudent limits on their derivatives exposure to any single derivatives counterparty. In addition, bank supervisors and other financial supervisors must determine whether there is a practical way for banks and other participants to aggregate and assess the concentration risk of these exposures and whether the nature of the market would allow access to more and better information to allow the market alone to provide sufficient discipline.

The Long-Term Capital matter has raised other questions that need to be addressed by the bank supervisory system. For example, Long-Term Capital relied heavily on internal models, which apparently failed them. Banks and other financial institutions increasingly use and encounter these models. In light of this increasing use, we need to determine whether banks are viewing these models with sufficient skepticism and common sense, given the complexity and velocity of modern monetary transactions as well as the potential for tremendous volatility in the financial markets. We must also find out whether they are adequately testing the validity of the models' assumptions and the performance of the models under extreme market conditions. The Long-Term Capital example dramatically illustrates the potential pitfalls of undue reliance on internal modeling approaches.

In conclusion, the FDIC is concerned about the risks that hedge funds may pose to banks, the deposit insurance fund and the financial system. A major challenge for members of the financial industry and for the industry's regulators is to stay abreast of the new forms that risks take, to ensure adequate oversight, and to determine that proper controls are in place. We look forward to working with this Committee, the other financial institution regulators, and the President's Working Group on Financial Markets to address these important issues.

Last Updated 06/25/1999

Good morning Mr. Chairman, Ranking Member LaFalce and members of the Committee. I am pleased to be here this morning on behalf of the Federal Deposit Insurance Corporation (FDIC) to discuss the recent recapitalization of Long-Term Capital Management.

As noted in your letter of invitation, the near collapse of Long-Term Capital and its subsequent recapitalization raise a number of very important public policy questions both for the banking system and for the financial system as a whole. At this point, however, only one week after the private sector recapitalization of Long-Term Capital was announced, we have many more questions about the underlying facts concerning this matter than we have answers, and much of my testimony today will focus on the questions we need to answer in the weeks and months ahead.

First, I would stress that not a penny of FDIC deposit insurance funds or other government funds was used in the recapitalization. The use of FDIC funds was never considered, and we were not a party to the recapitalization talks.

The FDIC's primary concerns relating to Long-Term Capital involve the exposure of the deposit insurance funds to the types of risks that hedge funds pose and to the potential for systemic instability. The increasing complexity of financial activities conducted within individual banking institutions requires effective oversight both by the market and the supervisory process. The challenge as the industry evolves is to maintain the proper mix of market and supervisory oversight, so that these systems complement and reinforce each other to provide the maximum effectiveness consistent with a dynamic financial marketplace without creating unacceptable levels of risk. While my subsequent remarks will focus primarily on the supervisory process, recent events highlight the importance of accurate information and adequate disclosure in order for markets to provide effective oversight.

Federal supervision of the banking system is designed to ensure that bank management is capable of understanding and controlling the risk of bank activities. Because exposure to hedge funds in the United States banking system is concentrated in state banks that belong to the Federal Reserve System or in national banks, the FDIC works with the Federal Reserve and the Comptroller of the Currency to monitor and address the risks to federally insured institutions stemming from these activities. The near collapse of Long-Term Capital underscores the need for this type of regulatory cooperation and sharing of information.

Over the past week, the FDIC has been in frequent contact with the other banking regulators regarding the supervisory and regulatory issues presented by the Long-Term Capital matter. We are working with our colleagues to assess the extent of exposure to insured institutions and resulting possible risk to the deposit insurance funds. We have joined in meetings with some of Long-Term Capital's creditor banks and anticipate additional meetings with others over the near-term. The Long-Term Capital situation raises key questions as to the sufficiency of managerial oversight and internal risk management systems. I note that Securities and Exchange Commission Chairman Levitt has said that other funds may be at risk. We are working with other regulators to obtain more information about other funds and assess the potential risks to banks.

One of the central issues posed by the near collapse of Long-Term Capital is whether or not there are gaps in the bank supervision process. The FDIC does not yet know the answer to that question. A primary focus of our efforts will be on the risk management programs in place at the banks involved. We expect that risk management practices will be appropriate to the scope, size, and complexity of an institution's activities.

Bank supervisors do not prescribe universal or standard policies for specific types of activities. These policies are the responsibility of the board of directors and management of each bank. The FDIC expects the board of directors of a bank to fully consider the costs, benefits, and especially the risks of an institution's planned or ongoing involvement in any business venture. These considerations are particularly important when the business venture is engaged in a highly leveraged and volatile activity. Proper risk management requires that the nature of the planned involvement and the level of risk that can be incurred must be fully understood. Understanding the risk includes understanding the most likely and worst case scenarios.

From our review of bank risk management programs, we are working with the other bank supervisors to determine common deficiencies, if any, and determine whether the institutions involved had sufficient information about the nature of Long-Term Capital's strategies and financial condition to make risk determinations. We must also ask whether profit pressures unduly influenced decisions made by the banks involved and whether they used proper underwriting standards; that is, whether the amount of risk associated with Long-Term Capital was reasonable.

Banks that lend to hedge funds face the risk of loan default. But hedge funds may present banks with other risks. A bank that enters into a derivatives contract with a hedge fund faces the risk that the hedge fund -- its counterparty -- may fail to perform, either as the result of its own financial problems or as the result of its own counterparties' failure to perform. Banks must observe prudent limits on their derivatives exposure to any single derivatives counterparty. In addition, bank supervisors and other financial supervisors must determine whether there is a practical way for banks and other participants to aggregate and assess the concentration risk of these exposures and whether the nature of the market would allow access to more and better information to allow the market alone to provide sufficient discipline.

The Long-Term Capital matter has raised other questions that need to be addressed by the bank supervisory system. For example, Long-Term Capital relied heavily on internal models, which apparently failed them. Banks and other financial institutions increasingly use and encounter these models. In light of this increasing use, we need to determine whether banks are viewing these models with sufficient skepticism and common sense, given the complexity and velocity of modern monetary transactions as well as the potential for tremendous volatility in the financial markets. We must also find out whether they are adequately testing the validity of the models' assumptions and the performance of the models under extreme market conditions. The Long-Term Capital example dramatically illustrates the potential pitfalls of undue reliance on internal modeling approaches.

In conclusion, the FDIC is concerned about the risks that hedge funds may pose to banks, the deposit insurance fund and the financial system. A major challenge for members of the financial industry and for the industry's regulators is to stay abreast of the new forms that risks take, to ensure adequate oversight, and to determine that proper controls are in place. We look forward to working with this Committee, the other financial institution regulators, and the President's Working Group on Financial Markets to address these important issues.

Last Updated 06/25/1999