Statement by E. Gerald Corrigan

Managing Director

Goldman, Sachs & Co.

before the

Committee on Financial Services

U.S. House of Representatives

Hedge Funds and Systemic Risk in the Financial Markets

March 13, 2007

Washington, DC

Introduction

Mr. Chairman and members of the Committee; I welcome the opportunity to appear before you this morning to discuss the issues surrounding the role of hedge funds in our contemporary financial system and the larger question of what steps might be taken to further enhance the stability of the national and global financial system. In my remarks I will wear two hats; first as a Managing Director of Goldman Sachs where my duties include serving as Co-Chair of the firm's Risk Management Committee; and second, as Chairman of the Counterparty Risk Management Policy Group which, as you know, published a far reaching and comprehensive Report entitled: "Toward Greater Financial Stability" about 18 months ago.

My written testimony covers four closely related subjects as follows; First; a broad overview of the evolution of the hedge fund industry over the past decade or so; Second; the relationships between hedge funds and large integrated financial intermediaries; Third; a discussion of systemic financial risk; and Fourth; my very positive views regarding the President's Working Group "Principles and Guidelines regarding Private Pools of Capital."

In the interest of time, I would ask that my statement be entered into the record so that I can briefly summarize its major points.

I. The Evolution of the Hedge Fund Industry

— A useful point of departure in tracking the evolution of the hedge fund industry is to trace major developments in the period since the collapse of LTCM in the fall of 1998.

  – The staggering growth of the hedge fund industry since then is well know to this Committee;

- Since the particulars of that growth will be covered by other witnesses, I will not repeat the details except to say that the presence of hedge funds across all segments of financial markets nationally and internationally is truly pervasive.

— It is also widely recognized that hedge funds contribute importantly to the liquidity, efficiency and effectiveness of financial markets as those markets play their vital role in mobilizing savings and putting those savings to their best use.

  - This process of financial intermediation is central to economic growth and rising standards of living.

— While the risk profiles of individual hedge funds vary considerably from one to the next, many funds are significant risk takers.

  - Many such funds also employ complex trading strategies that involve the use of highly complex financial instruments and very large value trades that facilitate rapid turnover in positions;

  - The volume and value of aggregate hedge fund activities now represent a significant fraction of total activity in many classes of financial markets.

— While the growing importance of hedge funds since 1998 is widely recognized, what is not always fully appreciated is the extent to which business practices in the hedge fund sector have matured in recent years.

  - As examples; corporate governance, risk management, disclosures to investors and operational infrastructure capabilities of many hedge funds have improved substantially.

– For some funds these capabilities now have much in common with best practices across the financial system.

– More generally, we have seen in the hedge fund sector what I will call a "cultural institutionalization" whereby many individual hedge funds are now much more sensitive to the broad institutional framework within which they operate including a heightened recognition that hedge funds, too, have a large vested interest in the stability of the financial system.

— Looking to the future we can reasonably anticipate that the pace of evolution in the hedge fund community will remain brisk if not accelerate. Some of the likely future trends may include the following:

– Hedge funds will continue to attract highly talented and experienced personnel from other segments of the financial sector;
– Sustaining high returns across thousands of hedge funds will be increasingly difficult;
– The reach for returns may drive some funds to still more complex and illiquid instruments as well as more risky patterns of asset allocation;
– Pressures on fees are likely to grow, especially for under-performing funds thereby contributing to further consolidation in the industry;
– The distinction between hedge funds and private equity funds will narrow further;
– Spin-offs and/or IPO's of some hedge funds will occur with increasing regularity;
– As the premium on performance intensifies, the orderly attrition of under performing funds may accelerate and, inevitably, a few funds will encounter serious financial problems.

– Such developments are a natural and healthy market-driven phenomenon which need not have material adverse consequences for the stability of the financial system.

II. <u>The Relationship between Hedge Funds and Large Integrated financial Intermediaries</u>

— There are a small number of large integrated financial intermediaries that are major service providers, credit suppliers and trading counterparties for hedge funds.

  – Typically these large financial intermediaries are major banks and securities firms that are all subject to some form of consolidated prudential supervision.

— At the risk of considerable oversimplification the business relationship between hedge funds and such large financial intermediaries consists of two closely related elements as follows:

A. <u>Prime Brokerage</u>

  – Large financial intermediaries provide a wide range of financial, administrative and operational services to hedge funds through their prime brokerage franchises;

    – About a dozen or so of such intermediaries account for a very substantial market share of the prime brokerage business;

    – Most hedge funds have more than one prime broker and some have several

  - Multiple prime brokers are seen by hedge funds as a way to protect proprietary trading positions and strategies and to diversify their credit and operational risk.

— The primary source of credit exposure arising between prime brokers and their hedge fund clients arises in the context of loans provided to hedge funds which are secured by either cash margin or by collateral in the form of securities pledged to the prime brokers.

  - A prudently managed prime broker should always have a generous amount of excess margin or collateral relative to the amount of credit extended.

— The process of (1) evaluating the credit worthiness of hedge funds; (2) determining the value of margin and/or collateral that can be securely obtained by the prime broker and (3) determining the amount of credit extended against the value of the margin or collateral is extremely complex requiring a multi-disciplinary approach anchored in sound credit fundamentals.

  - Contrary to popular opinion in some circles, a well managed secured lending program by prime brokers – with appropriate covenants and trip wires – is a relatively low credit risk activity by such prime brokers.

B. Other Counterparty Relationships

— Aside from the prime brokerage relationship, large financial intermediaries often have multiple counterparty relationships with large numbers of individual hedge funds, some of which are not prime broker clients. Hedge funds are (1) major trading counterparties of large banks and securities firms across the full range of financial instruments including OTC and exchange traded derivatives; (2) active participants in the primary and secondary markets for all classes of securities, listed options, futures, private placements, syndicated loans and most classes of structured financial products.

— These relationships – especially the bi-lateral trading relationships – give rise to significant elements of market, credit, liquidity and reputational risk to both the large intermediaries and to their hedge funds counterparties.

— At Goldman Sachs – and at other major financial institutions as well – counterparty risk management is a core competence involving all levels of management including the Chief Executive Officer.

— While the menu of risk management tools and techniques involves thousand of metrics and hundreds of mathematical or statistical models, the foundation for effective risk management rests on a culture of sound corporate governance, collective analysis and decision-making and, above all, sound judgments by experienced business leaders

— Looked at in this light, risk management is more an art than a science.

  – As an example, there will always be gaps in the information that can be compiled as a part of the counterparty due diligence process;

    – Typically, for example, using stress tests and other tools to monitor a given counterparties' risk profile can only be performed on positions that are visible to its trading partner and those visible positions may only be a small fraction of that counterparties overall risk profile.

      - The implications of crowded trades are especially difficult to anticipate much less quantify with any precision.

    - Similarly, even monthly financial statements may be stale almost before the printers' ink is dry.

- These and other limitations in the risk management process are well understood by experienced practitioners and by prudential supervisors. More importantly, these limitations also forcefully underscore the point that risk management cannot be left to the models and the mathematics but must be guided by the judgment of experienced executives.

III. Systemic Risk

- The starting point for the Report of the Counterparty Risk Management Policy Group was an effort to better understand the phenomenon of systemic financial risk and to help frame approaches to better mitigate the ever present risk of future systemic financial shocks.

  - Systemic financial risk is typically defined as a financial shock that brings with it the reality – or the clear and present danger – of inflicting significant damage on the financial system and the real economy.

    - Financial shocks are distinguished from financial disturbances the latter of which occur with some frequency but are sorted out by the marketplace with little or no damage to the financial system or the economy.
    - Since 1998 we have experienced a not inconsequential number of financial disturbances all of which have been absorbed by the financial system with a remarkable degree of resiliency.

- Examples of such shocks include the bursting of the dot.com bubble, a recession, September 11, two wars, multiple corporate scandals, oil shocks, serious trade imbalances, and periodic bouts of instability in segments of financial markets.

- The forty seven Recommendations of the CRMPG Report were shaped by three threshold conclusions about systemic financial risk as follows:

  - **First**; overtime, the already low statistical probabilities of the occurrence of systemic financial shocks had declined further but were still well short of zero.

  - **Second**; while the probabilities of such shocks were lower, the potential damage that could result from such shocks is greater due to the increased spread, complexity and tighter linkages that characterize the global financial system.

  - **Third**; our collective capacity to anticipate the specific timing and triggers of future financial shocks is extremely low, if not nil.
    - Indeed, if we could anticipate the timing and triggers such shocks would not occur.

— Thus, since we certainly cannot rule out future financial shocks we have no choice but to strengthen what I like to call the "shock absorbers" of the global financial system in order to limit and contain the damage caused by future financial shocks when – not if – they occur.

- I believe it is fair to say that the CRMPG Report has played an important role in helping to stimulate efforts to strengthen those shock absorbers.

– More generally, both the official community and the private sector are actively engaged in multiple initiatives all working constructively in that same direction.

— Before turning to the President's Working Group Principles and Guidelines, allow me to digress briefly to offer a few observations about the Amaranth episode.

- In looking at the Amaranth incident, many observers take comfort from the fact that the marketplace was able to mange this incident with a remarkable degree of success especially considering the staggering losses incurred in that funds' natural gas trading activities.

  - In many respects that sense of comfort is justified.

- However, there were features of the Amaranth episode that point to the need for caution in drawing generalized conclusions from this event. For example.

  - The trades in question, while hugely concentrated, were in large part executed using relatively simple and straight-forward transactions;
  - There was little or no evidence of the so-called "crowded trade" phenomenon;
  - Once the scale of the losses became evident, the management of Amaranth moved quickly to sell or liquidate both the natural gas and other positions such that all margin and related obligations were met in a timely fashion thus avoiding default or bankruptcy.

  - Since a default did not occur, counterparties of Amaranth did not face the need to close out their positions with Amaranth – a process that under the best of conditions is extremely complex and potentially destabilizing.

— In pointing to these features of the Amaranth episode, I want to be clear that I, too, take comfort from how well the system worked in managing this situation but I would urge caution in drawing conclusions from this event as to how other situations in the future may play out especially if they were to occur in a more hostile market environment.

IV. The PWG and U.S. Agency Principles and Guidelines

— In my judgment the Principles and Guidelines regarding Private Pools of Capital as spelled out by the President's Working Group and the Leaders of the major regulatory agencies constitute a timely and constructive approach aimed at further strengthening the broad range of institutional, behavioral and risk management arrangements as they apply to the relationships between private pools of capital and virtually all other classes of market participants. The principles and guidelines warrant particular praise because:

- They rely heavily on market forces and market discipline;
- They are principles based in a context in which the speed and complexity of the activities to which they are directed cannot be managed or supervised by reliance on detailed rule books;
- They pay particular attention to sensible approaches to enhanced transparency that should not aggravate the already counter-productive information overload problem associated with public disclosure;
- They stress the responsibilities of all classes of market participants to strengthen due diligence and risk management capabilities with particular emphasis on valuation practices especially as applied to complex and illiquid instruments; and
- Finally, they stress the clear need for international policy collaboration and coordination. In this connection, I would note that the FSA in the UK is already

moving in the direction of a principles based approach to these issues, the philosophy and practices of which have much in common with the approach contained in the PWG Principles and Guidelines.

While I consider the Principles and Guidelines to be a constructive step forward, I would respectfully suggest a couple of areas in which some fine-tuning to the approach might be considered.

First; the statement of Principles and Guidelines acknowledges that the PWG Principles "have increasingly been reflected in best practices." While not disputing that conclusion, the question that arises in my mind is whether some effort should be made to develop a common benchmark of best practices especially as such best practices would apply to the "Systemic Risk Principles" in the PWG statement.

Having in place such a common benchmark of best practices would provide some real assurance across classes of institutions that "best" means "best." In turn this should help encourage an environment that stresses competitive excellence rather than a gradual drift toward the least common denominator of such practices.

The obvious major drawback to the creation of a common benchmark of best practices is the difficulty of drafting such a statement in a manner that guards against slippage into unwanted detail that compromises the principle's based approach called for by PWG. While that risk is very real, the potential benefits arising from the presence of common benchmarks of best practices are considerable. Moreover, many of the building blocks for such a statement of best practices are already available in the CRMPG Report and elsewhere.

Second; the Principles and Guidelines call for enhanced transparency and rightly so. In discussions about transparency it is important to keep in mind that transparency in this context has four mutually interdependent legs as highlighted in the CRMPG Report. The *first* is the bilateral and confidential exchanges of information that take place between counterparties. The *second* is the information such as offering memoranda which are made available to prospective investors in hedge funds or other private pools of capital. The *third* is the formal and informal exchanges of information – much of it also confidential – that take place between regulated institutions and their supervisors. The *fourth* leg is, of course, information that is disclosed to the public at large.

While there are opportunities to strengthen all four legs of the infrastructure surrounding transparency I would argue that the greatest payback in financial stability terms is to be found in the first three legs rather than the fourth. This is especially true if much of the emphasis surrounding exchanges of information have elements of informality associated with the process. The recent exercise whereby the Fed, the SEC and the FSA conducted a joint inquiry into the business relationships between a small group of major banks and investment banks and their hedge fund counterparties is an excellent example of the benefits of a less formal dialogue on these critical issues. In this regard, even as hedge funds remain largely unregulated, I would hope that systemically important hedge funds would welcome the opportunity to participate in periodic voluntary and informal discussions with the official community about market developments and changing business practices, including risk management practices.

However, if we are to maximize the benefits of increased reliance on the first three legs of enhanced transparency, we must be prepared to allow the philosophy of PWG Principles and Guidelines to shape the process and we must avoid the temptation to back slide into a detailed “rules of the road” approach aimed at micro-managing the process. Such a temptation will surely arise when, inevitably, something goes badly wrong.

In conclusion, Mr. Chairman, allow me to congratulate you and the Committee for holding this hearing. The issues you have focused on are of vital importance and they are also extraordinarily complex. For almost 40 years, these issues have been a large part of my professional life but even after all that time, hardly a week goes by when I don’t find something new to worry about. By the same token, hardly a week goes by when I don’t learn of some initiative or development that is working in the direction of strengthening those shock absorbers I spoke of earlier. One of the most difficult challenges in human endeavor is how we manage low probability events – such as financial shocks – that can cause so much damage. In the financial arena I believe we are making progress in meeting that challenge and we must continue the effort for we know that the future will bring new tests of the stability and resiliency of the financial system.

Thank you.