Recent Market Events and the Foundation for Global Market Crises: The Experience of Republic National Bank

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I will start with a very brief overview of Republic National Bank ("Republic"), and particularly how Republic was affected by the somewhat embarrassing events of the third and fourth quarters of 1998. I will also explain the effects of the Russian economy, adjustments to our capital under FASB-115, and finally, our minuscule involvement in Long-Term Capital Management ("LTCM"). All of these events led to some downgrading of Republic's senior debt.
Republic started with a single retail branch in 1966, with $11 million of capital. At December 31, 1998, our total shareholders' equity was $3.14 billion. Republic was the twenty-first largest banking company in the United States as of September 30, 1998. Republic has achieved a reputation for safety, conservatism, liquidity, capital strength, and earnings consistency that is at the pinnacle of banking. Prior to a downgrade by Moody's Investors Service and Standard & Poor's, Republic enjoyed superior debt rating. We lost these ratings because of three specific occurrences that converged in the third quarter of 1998.

Of those three reasons, the most significant was the loan default by Russia, which resulted in a $92.7 million loss to Republic for the third quarter. In lending to Russia, we thought we were building a serious bank for the long pull in Russia. We had a history of dealing with the Soviet Union in precious metals, bank notes, and other trading. We started correspondent Bank of New York persuaded large banks to invest over $3.5 billion in LTCM in return for a 90% ownership stake, and to prevent a financial crisis should it unwind its positions); Steven Mufson, *What Went Wrong? Fund's Big Bettors Learned that Risk Trumps Math, History*, WASH. POST, Sep. 27, 1998, at H1 (corrected Sep. 29, 1998) (listing fourteen major banks and institutions which invested a total of $3.6 billion); Steven Syre, *Fleet, BankBoston in Syndicate Backing Troubled Hedge Fund*, BOSTON GLOBE, Sep. 26, 1998, at F1 (reporting that Fleet Financial Group had loaned $25 million to LTCM as part of the bail-out); Joseph Kahn & Peter Truell, *Troubled Investment Fund's Bets Now Estimated at $1.25 Trillion*, N.Y. TIMES, Sep. 26, 1998, at A1 (citing financiers' estimates that LTCM had leveraged borrowings of $125 billion into $1.25 trillion in open trading positions). For comprehensive information on LTCM's background and near-collapse, see Michael Lewis, *How the Eggheads Cracked; N.Y. TIMES*, Jan. 24, 1999, § 6, at 24; Carol J. Loomis, *A House Built on Sand, Fortune*, Oct. 26, 1998, at 110; Michael Siconolfi, Anita Raghavan & Mitchell Pacelle, *All Bets are Off: How the Salesmanship and Brainpower Failed at Long-Term Capital; WALL ST. J.*, Nov. 16, 1998, at A1.


banking there in 1992, we opened a representative office in 1994, and we had a full bank subsidiary by 1996. We were one of three U.S. banks that owned a bank in Russia; the other two were Citibank and Chase Manhattan Bank. Then, the Russians did what to us was the unthinkable—they defaulted on domestic debt. We anticipated a cross-border debt default, but not a domestic default in Russia. During the fourth quarter of 1998 and the first few weeks of 1999, there were substantial recoveries and improvements in the value of the Russian securities. Had these improvements occurred sixty to ninety days earlier, Republic's losses that quarter would have been substantially reduced or eliminated. After the Russian default, there was a flight to quality, and much volatility in emerging markets securities. Prices were driven down to the point that FASB-115 required a reduction of our capital.

Notwithstanding the Russian default and downgrading of Republic's senior debt, the single item that raised the eyebrows of the rating agencies most was Republic's exposure to hedge funds. At September 30, 1998, Republic's total exposure to hedge funds, both collateralized and unsecured, was $165 million, less than 0.3 percent of our total assets. However, LTCM was among the hedge fund names. The rating agencies asked what a conservative bank like Republic was doing in LTCM; that question alone was enough to influence our downgrading another notch. LTCM repaid 100 percent of its debt to Republic before the end of 1998, and less than sixty days after the downgrade, we no longer had exposure to LTCM.

5. See Regimes in a Fix: Adjustable Exchange Rates and Free Capital Flows Do Not Mix. If Crises Are to be Avoided, Countries Must Choose Between Them, FIN. TIMES, Aug. 19, 1998, at 18 (noting that the Russian government caused a general default through a combination of restructuring its domestic debt, imposing capital controls, and putting a ninety-day moratorium on foreign commercial debts).

6. See supra note 1 (discussing the impact of FASB-115 on capital reporting).
I thought it would be interesting to go into some of the details of Long-Term Capital's saga and how it affected Republic. There are three articles that I would like to recommend to give you an overall background: a Wall Street Journal article by Michael Siconolfi, a New York Times Magazine Section article by Michael Lewis, and an article by Carol Loomis in Fortune. All of these articles provide an accurate picture of how LTCM grew, its strategy, and what ultimately happened.

Republic's total loan commitment to LTCM was $85 million, and the outstanding balance never exceeded about 80 percent of that commitment. To put this in perspective, note that by the end of 1997, capital additions and reinvested earnings increased LTCM's total capital to almost $7 billion, which had a negative impact on their earnings as a percentage of capital. LTCM forced investors to take back about $2 billion of that capital, which made some investors quite unhappy, because it meant that they would miss part of those incredible earnings. In 1994, after only ten months of operation, LTCM earned 20 percent on capital; 43 percent in 1995, 41 percent in 1996; and in 1997, as a result of having too much capital, they earned 17 percent on capital.

LTCM had very little month-to-month volatility, although it was highly leveraged. Press reports say the leverage was twenty to thirty times capital on-balance-sheet; with off-balance-sheet and open trades, it could have been more than 250 times capital, or $1 trillion. Some reports say there could have been 1,000 times leverage.

LTCM's investment strategy was to do hedge trades based on small premiums, or discounts, which diverged from the market on similar instruments, but the divergence would close out upon the

maturity of the trades. It was basically a very conservative strategy. LTCM told its investors that according to its computer models, the probability of losing twenty percent or more of capital was insignificant, only a one in one-hundred chance. Many large players, such as Salomon Brothers and Goldman Sachs, mimicked LTCM's strategy by copying, as closely as possible, each LTCM trade that they could recognize.

**WHY DID REPUBLIC LEND TO LTCM?**

The only way that Republic could gain access to equity participation in LTCM for some of our better customers was to become part of the lending syndicate. That was also the way we could become a trading partner of LTCM, by trading in foreign exchange, and emerging market securities, and perhaps some precious metals.

But, to enter the club you had to play by LTCM's rules. The terms were non-negotiable—take it or leave it. Provisions to protect creditors, normally included in loan agreements, were often missing or very limited in LTCM's loan agreements. Republic joined the crowd in a small way, and like others, we may have been mesmerized by these "supermen." Their results, after all, were hard to question.

**THE EVENTS WHICH LED TO LTCM'S NEAR-COLLAPSE**

As a delayed reaction to the Asian crisis, markets became more volatile in the spring of 1998. In May and June, LTCM lost about sixteen percent of its capital, but it was still no great impact. Non-directional strategy and hedging were still at the heart of its business, and the market was comfortable with that strategy. In July 1998, Salomon Smith Barney began to liquidate a large amount of its proprietary portfolio, especially those instruments that were based upon LTCM's non-directional hedge

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10. See, e.g., Greenspan Warning on Asia/Tells Congress Impact on U.S. Now Being Felt, NEWSDAY (New York), May 22, 1998, at A71 (reporting that the Asian financial crisis was beginning to significantly affect the U.S. economy).
strategies.\textsuperscript{11} Despite this event, LTCM did not incur significant losses until after July.

In August 1998, Russia defaulted,\textsuperscript{12} and with the flight to quality that followed in the fixed-income and equity markets, many trading houses had large losses.\textsuperscript{13} Hedge funds increased liquidations to meet margin calls, dealers stopped making markets or bid large discounts, the spreads that were the basis of LTCM's strategy widened to the point that it did not have enough capital to carry the marked-to-market losses, and the downward spiral became a whirlwind. LTCM reported a forty-five percent loss in August 1998, which was fifty-two percent year-to-date.

On September 22, 1998, LTCM drew down $500 million under its revolving credit agreement in order to satisfy a demand for additional margin deposits, as required by Bear Stearns, LTCM's main clearing broker. On the next day, LTCM attempted to draw down the remaining $400 million of its $900 million revolving credit. Some revolving credit syndicate members, including Republic, began to object, claiming that LTCM was in default under the revolving credit agreement. By the end of September, with LTCM's capital down by eighty-five percent, the Federal Reserve Bank of New York—let's say "invited"—a consortium of fourteen banks and securities companies to invest $3.6 billion of new capital in LTCM, to save the situation and protect against a meltdown.\textsuperscript{14}

\textsuperscript{11} See Peter Truell, The Markets; Salomon Set to End Group on Arbitrage, N.Y. Times, July 7, 1998, at D1 (reporting on Salomon Smith Barney's decision to disband its bond arbitrage group in a shift away from proprietary trading).

\textsuperscript{12} See supra note 5 and accompanying text (discussing Russia's general default in August 1998).

\textsuperscript{13} See, e.g., More Firms Attribute Losses to Troubled Russian Markets; Finance: Citicorp, Morgan Stanley Dean Witter and Bankers Trust are Latest to be Affected, L.A. Times, Sep. 2, 1998, at D3 (reporting heavy losses by several investment banks due to Russia's default).

\textsuperscript{14} Fourteen banks invested a total of $3.6 billion in LTCM, and were later joined by a fifteenth bank, which loaned $25 million to LTCM. See Steven Mufson, supra note 1, at H1 (listing the fourteen major banks and institutions which invested $3.6 billion in return for a ninety percent equity stake); Steven Syre, supra note 1, at F1 (reporting that Fleet Financial Group subsequently loaned $25 million on a $50 million credit line to LTCM).
Republic's objection to the draw-downs was based primarily on a negative covenant contained in the revolving credit agreement. The issue was whether LTCM could validly draw on its revolving credit agreement during September 1998, with the following circumstances in existence: LTCM had reported that by August 31, 1998, it had lost fifty-two percent of its December 31, 1997 capital. In a September 1, 1998 letter announcing its loss to its lending syndicate and others announcing the loss, LTCM acknowledged that “absent any change in relevant facts between the end of August and the end of September 1998, there would result an event of default.” Under those circumstances, no draws under the revolving credit could be made.

As to whether a default actually existed, the language of the revolving credit agreement is clear. There is an event of default if LTCM permits partners' capital on any date to be less than fifty percent of the amount of partners' capital at the end of the prior year. The language does not appear to be very complicated. To Republic, “on any date” meant on any date, not just at quarter ends. The legal question however was, “Could there be a draw under the revolving credit agreement and a cross-default clause under a note purchase agreement to which Republic was a party, or had defaults been triggered?”

The result was a compromise, the way things often end up in business. The compromise agreement was that the $900 million revolving credit agreement was amended and the maximum amount of the credit was reduced to $500 million. Most importantly, the original expiration dates, which were May 28, 1999 under the revolving credit agreement and December 12, 2000 under the note purchase agreement, both became December 31, 1998. The loans under both agreements became very short term, and there was a high level of comfort from the almost $4 billion of new capital that was infused. In any event, all of the advances under the revolving credit agreement and under the notes were fully repaid on December 11, 1998.
In late September, the Federal Reserve made the first of three reductions in the Federal funds rate.\textsuperscript{15} These helped return stability and liquidity to the global capital markets. It reduced the flight to quality, stabilized the LTCM portfolio, and reversed the losses. It reminds me of the early 1990s, when the Fed reduced short-term rates while leaving the long-term yields high, thereby pumping enormous profits into a sick, capital-short banking sector.

It has been reported that by the end of November 1998, the $3.625 billion of new capital had increased by approximately $400 million in that two-month period, a tidy sixty-six percent per annum rate of return.\textsuperscript{16} Once again, short-term, quarter-to-quarter swings in a highly volatile market resulted in a grotesque result, which could have been made to appear level and normal if someone had just rolled the calendar forward about sixty days.
