Testimony
of
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Before the
U.S. Senate Committee on Banking, Housing, and Urban Affairs

On

The State of the United States Economy and Financial Markets

February 14, 2008

Chairman Dodd, Senator Shelby, and Members of the Committee:

Thank you for the opportunity to update you on the work of the Securities and Exchange Commission in light of recent market events. Beginning last summer, U.S. and overseas markets have been roiled by the deterioration of credit and liquidity conditions in the U.S. residential mortgage market, especially the subprime portion of that market. As mortgage delinquencies rose, other financial instruments tied to the value of those mortgages declined in value, placing pressure on large financial institutions – both those that had packaged and marketed these securities and those that had purchased them based, at least in part, on the high credit ratings. The resulting large losses for some market participants, the concern in the markets about the future performance of a range of complex structured finance instruments, and the more generalized concern about the effects on credit markets overall have led to a more risk-averse environment, and have contributed to a slowdown in the rate of the nation's economic growth.

For the SEC, these recent market difficulties have posed a number of challenges. In addressing them, the Commission has worked closely with the other members of the President's Working Group on Financial Markets – including Secretary Paulson and Chairman Bernanke, who are testifying with me here today. We have also worked closely with our international regulatory counterparts, a reflection of the global impact that the U.S. market events have had, and the increasingly interconnected nature of today's worldwide capital markets.

The Commission's priorities in using the powers within our jurisdiction are to protect investors, keep our markets healthy and vibrant, and promote capital formation. Given the scope and complexity of the issues connected to the problems in the subprime securities market, the Commission's efforts in this area have involved nearly every major SEC division and office, and every area of emphasis – including monitoring systemic risk, guarding against market abuses, and clarifying the application of accounting rules concerning the restructuring of mortgages. To coordinate the efforts of all of the Commission's Divisions and Offices, Erik Sirri, the Director of the Division of Trading and Markets, is leading an agency-wide Task Force composed of senior leadership from each of the relevant disciplines within the SEC.

While the Commission is not a front-line regulator of the mortgage lending business, the derivatives industry, or the monoline insurance industry, as has been widely reported the securities markets and the market participants that the Commission does regulate – not to mention the investors whom it is our mission to protect – have been deeply affected by the problems stemming from the widespread packaging and selling of residential mortgages as securities issued by special purpose trusts that qualify for off-balance sheet treatment under current accounting rules. Among the questions that have been raised within our jurisdiction are the accounting treatment of these trusts and their assets; the adequacy of capital and liquidity at the nation's major investment banks, and the strength of their risk management practices; the impact on money market funds from the devaluation of presumptively safe assets; the quality of issuer disclosure by public companies involved in structured finance; the role of the credit rating agencies, over which the SEC gained regulatory authority eight months ago; and the possibility of violations of the securities laws by subprime lenders, investment banks, broker-dealers, and other market participants.

The accounting issues have centered around the questions of balance sheet consolidation. Current accounting rules limit the discretion of firms to manage special purpose trusts (and the underlying loans they hold) once a loan has been sold, if they wish to continue to maintain off-balance sheet treatment. Twice in recent months, first in July 2007 and again in January 2008, the SEC has provided interpretive guidance on the application of these rules in the case of limited modifications for loans where default is reasonably foreseeable. In that circumstance, we have said, the limited modification would not invalidate off-balance sheet treatment. As a result, these financial institutions were not required to consolidate these trusts – which would have had negative ramifications on the bank's regulatory capital requirements**.** As a result, refinancings and other work-out arrangements have proceeded, with the advantage of keeping people in their homes and maximizing the value of the securitized assets. This is, however, a short term response. The Commission's Chief Accountant has also asked the Financial Accounting Standards Board to revisit the underlying accounting guidance to determine whether the experience of the last several months points to the need not only for further clarifying guidance, but also for changes in the applicable rules.

The members of the President's Working Group on Financial Markets, which includes the Commission, play an active role in overseeing the stability of the financial system. One important aspect of that oversight is our Consolidated Supervised Entities (CSE) program, through which the Commission currently supervises five of the systemically important U.S. securities firms on a consolidated, or group-wide, basis. The CSE program currently includes Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. This prudential supervision of the nation's largest investment banks is designed to be broadly consistent with Federal Reserve oversight of commercial bank holding companies. The purpose of the CSE program is to monitor for, and act quickly in response to, financial or operational weakness in a CSE holding company or its unregulated affiliates that might place regulated entities (including U.S. and foreign-registered banks and broker-dealers), or the broader financial system, at risk.

The Commission subjects the CSE firms to a number of requirements, including monthly computation of a capital adequacy measure consistent with the Basel II Standard; maintenance of substantial amounts of liquidity at the holding company level; and documentation of a comprehensive system of internal controls. Further, the holding company must provide the Commission on a regular basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures. Under the CSE program, liquidity and liquidity risk management are also a critical focus. This is because the ability of a firm to withstand market, credit, and other types of stress events is linked not just to the amount of capital the firm possesses, but also to the sufficiency of liquid assets to meet obligations as they arise. The Commission seeks to determine whether each CSE firm has adopted and follows procedures to ensure that the holding company has sufficient stand-alone liquidity and financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year.

In addition to monitoring capital adequacy, liquidity, and liquidity risk management at the CSE firms, Commission staff meet regularly with senior managers of critical control functions at the firms who are focused on market and credit risk exposures. These include senior financial controllers, treasury personnel, internal audit personnel, and risk managers. Commission staff also meet periodically with the top management of the CSE firms. As a result of this regular interaction, the Commission has been able to identify emerging trends − for example, the CSE program provided an early window for our accounting professionals into the challenge facing all financial firms in valuing assets for which the secondary market was no longer liquid.

Another aspect of our oversight is the mutual fund industry. Here, too, the Commission staff has been active in working with the managers of money market funds as they cope with the downgrading of ratings and the declines in value of securities in which their funds have invested. Commission rules limit money market funds to investing in high-quality, short-term investments in an effort to ensure that these bedrocks of the financial system are reliable in all market conditions. Losses by a money market fund would be reflected by the fund re-pricing its securities below $1.00 (known as “breaking the buck”). Only one fund, and that of very modest size, has ever broken the buck since the development of money market funds in the 1970s. The Commission is closely monitoring the fund industry and while we have seen some instances of funds requiring infusions of capital from the corporate parents of fund advisers, we are not aware of any money market fund that is threatened with having to reprice below $1.00.

We are also working to increase the transparency of the key publicly-traded financial institutions in their disclosures to markets and investors. In December 2007, Commission staff wrote to 25 leading financial institutions that are publicly owned companies, highlighting specific disclosure issues that the firms should consider in relation to their exposure to off-balance-sheet entities and certain structured finance products. Better illuminating the facts concerning these exposures should give counterparties increased confidence in the fundamental soundness of the financial system.

Last summer, using the new statutory authority that gave the SEC regulatory jurisdiction over the credit rating agencies effective in June 2007, the Commission began examinations of the role of the rating agencies in the subprime market turmoil. The rating agencies have been publicly criticized regarding the accuracy of their ratings of certain structured finance products, especially subprime residential mortgage-backed securities and collateralized debt obligations. Critics have faulted the rating agencies for initially assigning ratings to those securities that were too high; for failing to adjust those ratings as the performance of the underlying assets deteriorated; and for not maintaining appropriate independence from the issuers and underwriters of those securities.

Our examinations are focused on whether the rating agencies diverged from their stated methodologies and procedures for determining credit ratings in order to publish higher ratings. They are also focusing on whether the rating agencies followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings for residential mortgage-backed securities. In this regard, the examinations will seek to determine whether the credit rating agencies' role in the process of bringing residential mortgage-backed securities and collateralized debt obligations to market impaired their ability to be impartial in their ratings. I expect to receive preliminary reports from these examinations in the coming months, with a final report in the early summer. In the meantime, we will keep you apprised of our progress and ongoing lessons from these examinations.

In addition to the Commission's examinations of credit rating agencies, President Bush has directed the President's Working Group on Financial Markets to examine more generally the role of credit rating agencies in lending practices, how their ratings are used, and how securitization – the repackaging and selling of assets – has changed the mortgage industry and related business practices. As a member of the President's Working Group, the SEC is taking a leading role in this study.

Beyond these ongoing reviews, we are also re-examining the wisdom of the legislative and regulatory provisions that have granted a central role to the rating agencies in our markets. More than just providing the markets one view of the likelihood of default, the past several months have demonstrated the power of credit ratings to move markets, and their potential to create cascading effects in those markets. For example, the precipitous downgrade of the ratings of residential mortgage-backed securities and CDOs affected not only the rated securities but the funds and institutions that held and sponsored them; and now, the actual and anticipated ratings downgrades of the monoline insurers has impacted the ability and willingness of money market funds to hold certain assets, and contributed to a retrenchment from risk as some market participants have lost faith in the ratings.

This sensitivity to changes in credit ratings (which extends to the monoline insurers, whose own ratings determine the degree to which investors and issuers are willing to rely on them) is perhaps nowhere more pronounced than in the municipal securities market. In the municipal market, the lack of uniform, timely, and robust disclosure can leave investors with little more than a credit rating to rely on when making an investment decision. In a letter to the Chairman and Ranking Member of this Committee in July 2007, I proposed a more comprehensive disclosure regime to ensure that investors have access to the same high-quality disclosure from municipal issuers that is already required of corporate issuers. The recent problems reinforce the need for such disclosures. I hope the Committee will seriously consider those proposals to provide investors with better information in this important sector of the market.

Government's contribution to the widespread market reliance on credit ratings, by incorporating them into the regulatory and legal framework, has a long history. But the need to revisit the issue was recognized several years ago. In the Sarbanes-Oxley Act of 2002, the Congress rightly focused on whether the government imprimatur for the ratings agencies was wise. The Sarbanes-Oxley Act required the Commission to study and report on the role of the rating agencies − and that report, in turn, contributed in part to the Credit Rating Agency Reform Act, which has now given the SEC the opportunity to write new rules that can create greater competition and transparency in this area.

During the past 30 years, regulators, including the Commission, have increasingly used credit ratings as a proxy for objective standards for monitoring the risk of investments held by regulated entities. We have also used them as a shorthand to determine what securities may be sold through a streamlined registration process. For example, since 1975 the Commission has relied on credit ratings to distinguish among grades of investment safety in various regulations under the federal securities laws. In addition, a number of federal, state, and foreign laws and regulations today use credit ratings in this and analogous ways. The recent market disruptions highlight the limitations of this arrangement. As a result, I have directed the Commission staff to explore alternatives to Commission regulatory reliance on credit ratings where feasible.

I have also directed the staff to develop proposals for new, more detailed rules under the new Credit Rating Agency Reform Act that respond directly to the shortcomings we have seen through the subprime experience. Among the proposals that the Commission may consider as early as this spring are rules that would require credit rating agencies to make disclosures regarding past ratings, in a format that would improve the comparability of track records and promote competitive assessments of the accuracy of the agencies' past ratings. In addition, new rules could be aimed at enhancing investor understanding of important differences between ratings for municipal and corporate debt and for structured debt instruments.

Policing our markets to ensure compliance with the securities laws is also a critical aspect of our jurisdictional responsibility in connection with the subprime market turmoil. Our Division of Enforcement currently has more than three dozen subprime-related investigations underway. The Division formed a subprime working group in the spring of 2007 to coordinate the investigations in this area. They are coordinating with banking regulators as appropriate. The investigations involve several areas of potential violations of the securities laws, including securitization issues by underwriters and other firms involved in the process of bringing subprime securities to market, as well as disclosures, valuations, and sales to investors. Because these law enforcement investigations are underway, specific details remain confidential. It has not yet been determined in any particular case whether or not securities laws were broken.

Finally, the Commission has been actively working with our international counterparts to deal with the global market aspects of the recent market disruptions. In just the past two weeks, I have met to discuss these issues with my European Union counterpart, with securities regulators from over two dozen countries at the International Organization of Securities Commissions meetings in Amsterdam, and with the chairmen of securities regulatory agencies in China, Brazil, South Africa, and South Korea this week in Washington. The SEC is also working with the Financial Stability Forum, an international grouping of financial regulators, international financial institutions, and government officials, to develop a common understanding of the root causes of the market turbulence, and to develop responsible solutions.

There are two IOSCO projects of particular relevance to today's discussion. First, I am co-chairing IOSCO's Subprime Task Force, which was created to systematically study the recent financial market turmoil and make appropriate recommendations to better protect public markets from the spillover effects of mortgage underwriting practices and securitization activities. Specifically, this Task Force is looking at four areas:

- enhanced transparency by issuers of structured products and appropriate due diligence from investors;
- the risk management process for intermediaries;
- valuation and accounting issues; and
- the roles and duties of credit rating agencies.

The Task Force is due to publish its final conclusions in May 2008.

Second, reporting to the Subprime Task Force is an IOSCO Task Force focusing exclusively on the role of credit rating agencies in the structured finance market. This Credit Rating Agencies Task Force, which the SEC also chairs, is examining various advancements in the IOSCO Code of Conduct Fundamentals for credit rating agencies. IOSCO plans to produce a consultation paper on proposed changes to the model Code of Conduct.

Each of the regulatory actions we are taking and each of those that we are contemplating, both here and abroad, is designed to promote the health of our capital markets, to protect investors, and to promote capital formation. I appreciate the opportunity to describe the main aspects of the Commission's work in this area, and I would be happy to take your questions.