Testimony Concerning Turmoil in the Credit Markets: Examining the Regulation of Investment Banks by the Securities and Exchange Commission

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Chairman Reed, Ranking Member Allard, and Members of the Subcommittee:

I am pleased to have the opportunity this morning to describe the Securities and Exchange Commission's program for regulation of investment banks, and the lessons learned from the recent turmoil in the credit markets.

Under the statutory scheme that the Congress devised, most recently reflected in the Gramm-Leach-Bliley Act, the SEC is responsible for regulating the broker-dealer subsidiaries of investment banks, but no regulator in the federal government is given explicit authority and responsibility for the supervision of investment bank holding companies with bank affiliates. The law provides for mandatory consolidated supervision by the Federal Reserve Board for commercial bank holding companies, including financial holding companies. For investment banks that do not have U.S. banks within the consolidated group, it provides for a holding company supervision structure that is purely voluntary. Only one investment bank, Lazard Ltd., has elected for this supervision. The four largest investment bank holding companies in the U.S. are ineligible because they have specialized bank affiliates, such as industrial banks or certain savings banks. Therefore, there is simply no provision in the law that requires investment bank holding companies to compute capital measures and maintain liquidity on a consolidated basis. Nor does the law provide for a consolidated supervisor that is knowledgeable in their core securities business, and that would be recognized for this purpose by international regulators.

Because the existing statutory scheme does not address how and by whom investment bank holding companies with specialized bank affiliates should be supervised, and in part because of the implications of the European Union's Financial Conglomerates Directive, which required consolidated supervision either internationally or at a European level, the SEC adopted its Consolidated Supervised Entities ("CSE") program for U.S. investment banks in 2004. This, too, is a purely voluntary program, but in 2004 and 2005, the five largest investment banks volunteered to participate. The CSE program relies on the SEC's authority under the Securities Exchange Act of 1934 to determine net capital rules for regulated broker-dealer subsidiaries of investment banks. In essence, the entire CSE program was constructed around an alternative net capital regime at the broker-dealer, which carried as a condition the affiliated holding company's consent to group-wide supervision by the Commission. This is a significant regulatory extrapolation that the Commission believed was necessary to fill a significant statutory gap.

The CSE program has been recognized as "equivalent" to that of other internationally recognized supervisors for purposes of the European Union's Financial Conglomerates Directive.

It provides consolidated supervision to investment bank holding companies that is designed to be broadly consistent with Federal Reserve oversight of bank holding companies. It allows the Commission to monitor for financial or operational weakness in a CSE holding company or its unregulated affiliates that might place the U.S.-regulated broker-dealers and other regulated entities at risk.

It is within this context that the SEC confronted the rapid deterioration of liquidity at Bear Stearns during the week of March 10th. This was the first time, not only during the relatively brief existence of the voluntary CSE program, but at any time, that a major investment bank that was well-capitalized and fully liquid experienced a crisis of confidence that resulted in a loss not only of unsecured financing, but also short-term secured financing. This occurred even though the collateral it was able to provide was high quality, such as agency securities, and had a market value that exceeded the amount to be borrowed.

The sequence of events at Bear Stearns began when some over-the-counter derivatives counterparties sought to novate contracts – effectively replacing their trades with Bear Stearns by entering new contracts with other dealers – and some of Bear Stearns' prime brokerage clients began moving their cash balances elsewhere. These initial decisions to no longer transact with Bear Stearns apparently influenced others, and quickly other counterparties, clients, and lenders reduced their exposure to Bear Stearns. Ultimately, counterparties simply would not engage in derivatives transactions with Bear Stearns and lenders would not engage in stock lending and triparty repurchase transactions with Bear Stearns. Bear Stearns' hedge fund clients fled, and certain banks hesitated to clear for Bear Stearns. By the weekend of March 15th and 16th, Bear Stearns faced filing for bankruptcy or quickly concluding an acquisition agreement with a larger partner.

I would like to reiterate to this subcommittee what Chairman Cox observed in his testimony before the full committee on April 3, 2008. While the Federal Reserve, by extending temporary access to the discount window to Bear Stearns as well as to the other major investment banks, forestalled a similar run-on-the-bank from playing out elsewhere, it nonetheless remains for Congress to determine whether to provide more predictable access to an external liquidity provider and to harmonize any such measures with other aspects of the existing statutory scheme, in particular the framework established by Congress for considering the resolution of difficulties experienced by commercial banks, but not investment banks, similar to the framework in the Federal Deposit Insurance Improvement Act and the Federal Deposit Insurance Act for systemically important investment bank holding companies.

Detailed Description of the CSE Program

The Commission currently supervises the following U.S. securities firms on a group-wide basis: Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley. For such firms, referred to as consolidated supervised entities, the Commission oversees not only the U.S.-registered broker-dealer, but also supervises the holding company and all affiliates on a consolidated basis, including other regulated entities, such as foreign-registered broker-dealers and banks, and unregulated entities such as derivatives dealers. All of the CSEs are of potentially systemic importance, trading a wide range of financial products, connected through counterparty relationships to other large institutions, and providing services to a variety of market participants. The Commission's supervision of CSEs is primarily concerned with the risks that counterparties and market events potentially pose to the CSE firms and thereby to the regulated broker-dealers and other regulated entities.

When a CSE firm has a regulated entity in the consolidated group that is subject to oversight by another functional regulator, the Commission defers to that functional regulator as the supervisor of the regulated affiliate. We also share relevant information concerning the CSE holding company with our fellow regulators, both domestically and internationally.

While maintaining broad consistency with Federal Reserve holding company oversight, the CSE program is tailored to reflect two fundamental differences between investment bank and commercial bank holding companies. First, the CSE regime reflects the reliance of securities firms on daily mark-to-market accounting as a critical risk and governance control. Second, the design of the CSE regime reflects the critical importance of maintaining adequate liquidity for holding companies that, until recently, did not have access to an external liquidity provider.

The CSE rule was designed to provide consolidated oversight only to those holding companies affiliated with a large and well-capitalized broker-dealer. The Commission believed that it should only supervise on a consolidated basis those firms engaged primarily in the securities business, and not holding companies affiliated with a broker-dealer that was only incidental to its primary business activity. To this end, the CSE rules limit the program to firms whose principal broker-dealer meets certain minimum requirements for tentative net capital (defined as regulatory capital less deductions of illiquid assets), and subjects these to a tentative net capital early warning requirement of $5 billion.

The CSE program has five principal components: First, CSE holding companies are required to maintain and document a system of internal controls that must be approved by the Commission at the time of initial application. Second, before approval and on an ongoing basis, the Commission staff examines the implementation of these controls. Third, CSEs are monitored for financial and operational weakness that might place regulated entities within the group or the broader financial system at risk. Fourth, CSEs are required to compute a capital adequacy measure at the holding company that is consistent with the Basel Standard. Finally, CSEs are required to maintain significant pools of liquid assets at the holding company, for use in any regulated or unregulated entity within the group without regulatory restriction. This liquidity pool is sized to ensure that the holding company has sufficient stand-alone liquidity to meet its expected cash outflows without access to unsecured financing for a period of at least one year.

In particular, it is focused on fulfilling the SEC's explicit statutory responsibility to protect funds and securities of the customers of the investment bank's regulated broker-dealer affiliates.

Regulated broker-dealers are supervised by an extensive staff both at the SEC and at the primary self-regulatory organization, FINRA, which devotes a large amount of resources to overseeing the broker-dealers that are the core regulated entities within the CSE groups. This extensive supervision of the regulated entities in addition to the holding company is akin to bank supervision at the depository institution level as well as the holding company level.

The oversight of the registered broker-dealer is based on regulation at the SEC and SRO (such as FINRA) level, backed by examinations and enforcement. The oversight of the CSEs at the holding company level is similarly based on rules that incorporate principles of prudential oversight, backed by ongoing monitoring and examinations. When potential weaknesses are identified at the CSEs, the Commission has broad discretion under its authority to respond, for example by mandating changes to a firm's risk management policies and procedures, by effectively requiring an increase in the amount of regulatory capital maintained at the holding company, or by requiring an expansion of the liquidity pool held at the parent. These powers are not theoretical abstractions. All three of the steps that I just mentioned have been taken at various firms over the past two years. If these actions are unsuccessful, the Commission can limit the CSE's business or effectively terminate consolidated supervision, which would, inter alia, require disclosure and have significant implications in European jurisdictions.

Supervisory Next Steps

I will now turn to steps the SEC has taken and additional protections that are being contemplated by CSEs in the wake of Bear Stearns. In addition to strengthening the liquidity requirements for CSE firms relative to their unsecured funding needs, we are closely scrutinizing the secured funding activities of each CSE firm, with a view to lengthening the average term of secured and unsecured funding arrangements. We are currently obtaining funding and liquidity information for all CSEs on a daily basis, and discussing with CSEs the amount of excess secured funding capacity for less-liquid positions. Further, we are in the process of establishing additional scenarios, focused on shorter duration but more extreme events that entail a substantial loss of secured funding, that will be layered on top of the existing scenarios as a basis for sizing liquidity pool requirements. This additional analysis is providing the basis for requiring firms to take steps such as increasing the term of secured funding and diversity of funding sources. Also, we are discussing with CSE senior management their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets.

Because, the CSEs now have temporary access to the Primary Dealer's Credit Facility ("PDCF"), which would operate as a back-stop liquidity provider should circumstances require, and assures the necessary breathing space to implement the various measures outlined above, the SEC is in frequent discussions with the Federal Reserve Bank of New York both about the financial and liquidity positions of the CSEs, and issues related to the use and potential use of the PDCF. The SEC and the Federal Reserve Board are developing a formal Memorandum of Understanding that would provide an agreed-upon scope and mechanism for information sharing, both related to the PDCF and other areas of overlapping supervisory interest. Moreover, should Congress enact legislation to provide access to an external liquidity provider under exigent conditions in the future, the SEC stands ready to develop a process by which the Commission would formally communicate with the Federal Reserve or other relevant agencies in the event that an institution required access to any successor facility. Finally, the Chairman has publicly requested dedicated funding for the CSE program, and a significant expansion in staff.

Conclusion

The CSE program adopted by the Commission has served to fill a serious gap left after the Gramm-Leach-Bliley Act broadly restructured the regulation of financial institutions.

Although supervised on a elective basis by the Commission under the CSE program, and in compliance with applicable capital standards at the holding company and regulated entity level, Bear Stearns ultimately was overwhelmed by the unprecedented demands for liquidity it faced in a crisis of confidence. The CSE program ensured that, despite this unprecedented occurrence, the funds and securities of customers of the broker-dealer were never imperiled, and remained protected both by the significant capital at the holding company level and the Commission's financial responsibility requirements, including segregation of customer securities and funds, at the broker-dealer level. As a result, despite the run on the bank to which Bear Stearns was subjected, at no time during the week of March 10th, up to and including the date of the agreement with JPMorgan, were any of the customers of the Bear Stearns' broker-dealers at risk of losing their cash or their securities.

The CSE oversight of Bear Stearns also provided a ready source of information for banking supervisors of the deteriorating condition of Bear Stearns as the crisis unfolded, enabling rapid and knowledgeable decision-making by the Federal Reserve.

Bear Stearns' experience has challenged a number of assumptions, held by the SEC and by other regulators, relating to the supervision of large and complex securities firms. The SEC is working with other regulators to ensure that the proper lessons are derived from these experiences, and changes are made to the relevant regulatory processes to reflect those lessons. This work is occurring in a number of venues, including working groups operating under the auspices of IOSCO, the Basel Committee on Banking Supervision, and the Financial Stability Forum. For example, we are working in the Basel Committee to implement Chairman Cox's call for amended capital adequacy standards for internationally active sophisticated institutions to deal explicitly with liquidity risk.

An imperative from the Bear Stearns crisis is addressing explicitly how and by whom large investment banks should be regulated and supervised, and specifically whether the Commission should be given an explicit mandate to perform this function at the holding company level, along with the authority to require compliance. We look forward to working with you on these broader questions.

Thank you again for this opportunity to discuss these important issues. I am happy to take your questions.