Testimony Concerning Oversight of Risk Management at Investment Banks

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

I am pleased to have the opportunity this afternoon to describe the Securities and Exchange Commission's program for oversight of risk management practices at the major investment banks. Since the events of mid-March that culminated in the sale of The Bear Stearns Companies, Inc., the SEC has revised its analysis of the adequacy of capital and liquidity and is currently directing investment banks supervised under the voluntary Consolidated Supervised Entities ("CSE") program to undertake additional stress testing at the holding companies. The SEC has also engaged both international and domestic regulators in a cooperative manner to provide information and to discuss the broader policy implications of these events, which I shall describe shortly.

The SEC has broadly strengthened liquidity requirements for CSE firms. In particular, we are closely scrutinizing the secured funding activities of each CSE firm, with a view to encouraging the establishment of additional term funding arrangements and a reduction of dependency on "open" transactions, which must be renewed as often as daily. We are also focusing on the so-called matched book, a significant locus of secured funding activities within investment banks. Here we are monitoring closely potential mismatches between the "asset side", where positions are financed for customers, and the "liability side" of the matched book, where positions are financed by other financial institutions and investors. We are 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, together with the Federal Reserve we have developed additional stress 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. Also, we have discussed with CSE senior management their longer-term funding plans, including plans for raising new capital by accessing the equity and long-term debt markets.

The 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 ("Basel Committee"), and the Financial Stability Forum. For example, we have engaged with the Basel Committee in response to Chairman Cox's call for new standards for liquidity risk management by internationally active sophisticated institutions. Also, the SEC continues to improve its prudential oversight of capital, liquidity, and risk management at all CSEs in response to what was learned at these and other institutions during recent market events. Staff's focus on practices related to valuation, stress testing, and accumulation of concentrated positions dovetails with the recommendations of recent reports issued by the FSF, Basel Committee, and Joint Forum.

Further, on a regular basis, the SEC, including SEC staff from the CSE Program, participate in several interagency regulatory efforts focusing prospectively on the impact of the current credit crisis, including the Senior Supervisors Group (SSG), the FSF vulnerabilities group, and the Basel Committee Policy Development Group. These coordinated meetings bring together financial supervisors for the full range of systemically important financial institutions in an effort to identify emerging issues and to coordinate a supervisory response across various jurisdictions.

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, 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 nearing completion of 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. Under the current statutory framework no agency is charged with the stability of the financial system broadly, so this MOU will provide one mechanism for two of the critical agencies with responsibilities in this area to gain a broader and continuous perspective on key financial institutions and markets that could impact the stability of the financial system. This MOU will also provide a framework for bridging the period of time until Congress can address through legislation fundamental questions about the future of investment bank supervision, including which agency should have supervisory responsibility, what standards should apply to investment banks compared to other financial institutions, and whether investment banks should have access to an external liquidity provider under exigent conditions in the future.

Another area of ongoing regulatory concern relates to the volume of novations of OTC derivatives contracts, the related increase in collateral disputes, and other operational issues experienced by dealers during the week of March 10th. A novation of an OTC contract effectively closes a contract with one counterparty through assignment of the contract to another counterparty. As an example, a hedge fund seeking to close a contract with a counterparty could effectively agree with a derivatives dealer to eliminate its obligations to the original counterparty by assigning the contract to the dealer. This has the effect of eliminating the hedge fund's exposure to the original counterparty. The volume of such novations spiked during the week of March 10th, exposing operational challenges related to returning collateral and posting new collateral, the exhaustion of credit limits at dealers asked to accept novations, and the need for extensive analysis when portfolios of contracts were presented for novation. Further, the increased novation activity away from Bear during that week had signaling effects in the dealer community that may have contributed to the loss of confidence in the firm.

The SEC has been a long-time participant in the effort to improve the confirmation backlog of OTC derivatives, which has made progress over the last several years, and continues to be involved in discussions with the industry on improving OTC market infrastructure. The SEC and other regulators, such as the Federal Reserve, are discussing whether and how the market for OTC derivatives contracts might benefit from a central clearing counterparty and elimination of confirmation backlog, among other things. The dealer community is also moving forward on an initiative to improve settlement of OTC contracts, a process the SEC is participating in. A central counterparty, such as a clearing house, ideally would be sized to handle spikes in transaction volume, would promote certainty of contract settlement and so, minimize risk, as well as reduce the negative effects of misinformation and rumors that may occur during high volume periods.

These intensified efforts related to risk management build on an extensive foundation that has developed in the years since the SEC began the CSE Program in 2004. 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 and unregulated entities such as derivatives dealers. 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. The sharing of information between regulators is a critical component of the supervisory regime and is a key driver behind the upcoming MOU with the Federal Reserve.

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 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.

More specifically, in electing to operate under the CSE program, the holding company must, among other things, compute on a monthly basis its group-wide capital in accordance with the Basel standards. To put it simply, just like commercial banks, CSEs are subject to consolidated regulatory capital requirements. Further, the holding company must provide the Commission on a periodic basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures, as well as an analysis of the holding company's liquidity risk.

With respect to regulatory capital measures, CSEs are expected to maintain an overall Basel capital ratio at the consolidated level of not less than the Federal Reserve Bank's 10% "well-capitalized" standard for bank holding companies. CSEs provide monthly capital computations to the SEC, applying the same Basel II standard that is currently used by European financial institutions and will soon be adopted by U.S. commercial banks. In fact, Commission staff have been for the past several years heavily engaged, working together with other supervisors in the U.S. and Europe, in refining these rules to more completely address the technical issues of particular importance to securities firms. CSEs are also required to file an "early warning" notice with the SEC in the event that certain minimum thresholds, including the 10% capital ratio, are breached or are likely to be breached. And, beginning with their second quarter filings with the Commission, the CSE firms will disclose their capital positions, in addition to the liquidity positions that are currently disclosed.

In addition to capital, liquidity and liquidity risk management are of critical importance to broker-dealer holding companies. Due to the importance of liquidity to the firms, CSEs have adopted funding procedures designed to ensure that the holding company has sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment where access to unsecured funding is not available for a period of at least one year. Another premise of this liquidity planning is that any assets held in a regulated entity are unavailable for use outside of the entity to deal with weakness elsewhere in the holding company structure, based on the assumption that during the stress event, including a tightening of market liquidity, regulators in the U.S. and relevant foreign jurisdictions would not permit a withdrawal of capital. Following the recent events at Bear Stearns, this long-standing scenario-based requirement has been augmented, as noted above, to reflect the potential impact of other more severe but shorter duration events that contemplate a significant decline in secured funding capacity.

Applying such a "liquidity standard" alongside a capital standard is critical to the effective supervision of a CSE and, as noted earlier, is a critical difference between the supervisory regime for commercial and investment banks.

In addition to regular examination of and monitoring for key risk control areas, in particular market, credit, liquidity and operational risk, the CSE program leverages the firms' internal audit functions. CSE staff meet regularly with internal auditors to review and explore issues identified by their risk assessment and audit program. To be sure that communication of critical risk information and audit findings flows between risk managers, auditors, and senior management as well as the board, the CSE program requires internal auditors to review the functioning of major governance committees, including that these committees are meeting consistent with their charters and that the information being received by the committees is complete and accurate. The internal auditor must represent in writing to the SEC annually that this work has been done, and the results presented to the external auditor and the audit committee of the Board of Directors. Also, as circumstances require, or as risk management issues arise, senior officers of the SEC meet with CEOs, CFOs, and senior management, to raise issues for focus and resolution by CSE senior management.

At the broker-dealer level, the CSE Program 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.

Of note, regulated broker-dealers are supervised by an extensive staff both at the SEC and at the primary self-regulatory organization (SRO), 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.

When potential weaknesses are identified at the CSEs, the Commission has broad discretion 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.

The SEC has also conducted a series of cross-firm projects in recent years focusing on risk management issues related to material and growing businesses, including leveraged lending, securitizations, hedge fund derivatives, and private equity. The results of this work were communicated to the firms through feedback sessions intended to explain to institutions where they stand on various issues relative to their peers. This feedback process allows firms to learn where they fall within the spectrum of observed practices and has been incorporated into the new business model for the CSE inspections program which was implemented earlier this year.

At present the SEC has 25 staff persons in the CSE program with a range of expertise including financial analysts, statisticians, economists and lawyers. The size of the program has risen as the complexity and range of supervisory activities has grown, and further expansion is currently underway. Earlier this year, Chairman Cox requested from Congress a dedicated funding stream for the CSE program that would be sufficient to support a staff of 40 staff persons. The agency remains committed to supporting the program and is prepared to allocate additional resources as warranted.

Conclusion

The CSE program adopted by the Commission has served to fill a gap left after the Gramm-Leach-Bliley Act broadly restructured the regulation of financial institutions. Although supervised on an elective basis by the Commission under the CSE program, and in compliance with 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. As detailed above, the Commission has taken the lessons learned from the Bear Stearns events to improve the supervision of the remaining investment banks and to enhance existing relationships with other supervisors to address the issues that these and other financial institutions are experiencing in the current turbulent market conditions.

An imperative from the Bear Stearns crisis is addressing explicitly through legislation 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. Chairman Cox has called for such an explicit mandate, together with a dedicated funding stream for the CSE program. These steps are intended to ensure that the supervisory regime for investment banks is adequate in light of evolving market conditions and builds on a long history of Commission involvement in the supervision of securities firms.

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