EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

4-3-2008

Testimony Concerning Recent Events in the Credit Markets

Christopher Cox

https://elischolar.library.yale.edu/ypfs-documents/1814

This resource is brought to you for free and open access by the Yale Program on Financial Stability and EliScholar, a digital platform for scholarly publishing provided by Yale University Library.
For more information, please contact ypfs@yale.edu.

U.S. Securities and Exchange Commission

Testimony Concerning Recent Events in the Credit Markets

by Chairman Christopher Cox
U.S. Securities and Exchange Commission

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

April 3, 2008

Chairman Dodd, Senator Shelby and Members of the Committee:

Thank you for inviting me to testify on behalf of the Securities and Exchange Commission about recent events in the financial markets and the implications of the merger agreement between JPMorgan Chase & Co. and The Bear Stearns Companies, Inc. The recent actions by the Federal Reserve, as Chairman Bernanke has described, are unprecedented and of unquestioned significance. They include not only the extension of guarantees and credit in connection with JPMorgan's acquisition of Bear Stearns, but also the opening of the discount window to every one of the major investment banks.

What happened to Bear Stearns during the week of March 10th was likewise unprecedented. For the first time, a major investment bank that was well-capitalized and apparently fully liquid experienced a crisis of confidence that denied it not only unsecured financing, but short-term secured financing, even when the collateral consisted of agency securities with a market value in excess of the funds to be borrowed. Counterparties would not provide securities lending services and clearing services. Prime brokerage clients moved their cash balances elsewhere. These decisions by counterparties, clients, and lenders to no longer transact with Bear Stearns in turn influenced other counterparties, clients, and lenders to also reduce their exposure to Bear Stearns. Over the weekend of March 15th and 16th, Bear Stearns faced a choice between filing for bankruptcy on Monday morning, or concluding an acquisition agreement with a larger partner.

In the cauldron of these events, the actions that the Federal Reserve took — in particular, extending access to the discount window not only to Bear Stearns, but also to the major investment banks — were addressed to preventing future occurrences of the run-on-the-bank phenomenon that Bear endured. It remains, however, for regulators and Congress to consider what other steps, if any, are necessary to harmonize this significant new safeguard with other aspects of the existing legislative scheme, and the regulatory structure that resulted from the enactment of the Gramm-Leach-Bliley Act.

The SEC, of course, does not have the function of extending credit or liquidity facilities to investment banks or to any regulated entity. Instead,

through our consolidated supervised entities (CSE) program, the Commission exercises oversight of the financial and operational condition of Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley at both the holding company and regulated entity levels. Our oversight of the CSEs includes monitoring for firm-wide financial and other risks that might threaten the regulated entities within the CSE, especially the U.S. regulated broker-dealer and their customers and other regulated entities, here and abroad. In particular, the SEC requires that firms maintain an overall Basel capital ratio at the consolidated holding company level of not less than the Federal Reserve's 10% "well-capitalized" standard for bank holding companies. CSEs provide monthly Basel capital computations to the SEC. The CSE rules also provide that an "early warning" notice must be filed with the SEC in the event that certain minimum thresholds, including the 10% capital ratio, are breached or are likely to be breached. At all times during the week of March 10 — 17, up to and including the time of its agreement to be acquired by JPMorgan Chase, Bear Stearns had a capital cushion well above what is required to meet the Basel standards. Specifically, even at the time of its sale, Bear Stearns's consolidated capital, and its broker-dealers' net capital, exceeded relevant supervisory standards.

Even prior to the experience with Bear Stearns, the SEC's supervision of investment bank holding companies has always recognized that capital is not synonymous with liquidity — and that more is required to determine a firm's financial health. A firm can be highly capitalized — that is, it can have far more assets than liabilities — while also having liquidity problems. While the ability of a securities firm to withstand market, credit, and other types of stress events is linked to the amount of its capital, the firm also needs sufficient liquid assets — cash, and high-quality instruments such as U.S. Treasury securities that can be used as collateral — to meet its financial obligations as they arise.

For this reason, the CSE program requires substantial liquidity pools to allow firms to continue to operate normally in such environments. Specifically, CSEs are required to maintain funding procedures designed to ensure that the holding company has sufficient stand-alone liquidity 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.

In these ways, the supervisory model has focused on the importance of both capital and liquidity. In particular, the liquidity measurement has been designed to withstand the complete loss, for an entire year, of all sources of unsecured funding. But what neither the CSE regulatory approach nor any existing regulatory model has taken into account is the possibility that secured funding, even that backed by high-quality collateral such as U.S. Treasury and agency securities, could become unavailable. The existing models for both commercial and investment banks are premised on the expectancy that secured funding, albeit perhaps on less favorable terms than normal, would be available in any market environment. For this reason, the inability of Bear Stearns to borrow against even high-quality collateral on March 13th and March 14th — an unprecedented occurrence — has prompted the Federal Reserve's action to open the discount window to investment banks. Beyond this obviously powerful step, the Bear Stearns experience has challenged the measurement of liquidity in every regulatory approach, not only here in the United States but around the world.

It was in this connection that I recently wrote to the Basel Committee offering my strong support for their proposed work to consider whether the capital adequacy standards applicable to internationally active sophisticated institutions should be extended to deal explicitly with liquidity risk.

The Federal Reserve's decision to provide funding to Bear Stearns through JPMorgan Chase was made because, as you have heard Chairman Bernanke testify, Bear's extensive participation in a range of critical markets meant that a chaotic unwinding of its positions could have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties, placed additional pressures on the financial system, and caused damage that would not have been confined to the financial system but would have been felt broadly in the real economy through its effects on asset values and credit availability. These are considerations of systemic risk that extend far beyond the Commission's mandate to protect investors, ensure orderly securities markets, and promote capital formation through such means as the CSE program. But it is important to observe that the SEC's statutory and regulatory regime, including not only our broker-dealer net capital regime, but also the protection provided by the Securities Investor Protection Corporation and the requirement that SEC-regulated broker-dealers segregate customer funds and fully-paid securities from those of the firm — worked in this case to achieve the purpose for which it was designed. Despite the run on the bank to which Bear Stearns was subjected, its customers were fully protected. At no time during the week of March 10th — 17th, up to and including the date of the agreement with JP Morgan, were any of the customers of the Bear Stearns's broker-dealers at risk of losing their cash or their securities.

The question has been asked what might have happened if, notwithstanding the Federal Reserve's action, the transaction with JPMorgan had not been announced before Monday, March 17. Unfortunately, unlike a laboratory in which conditions can be held constant and variables changed while the experiment is repeated, in the social science of the market the selection of one course of action forever forecloses all other approaches that might have been taken. But there is one thing we know to a certainty: with or without JPMorgan Chase's acquisition of Bear, and with or without a bankruptcy, Bear Stearns's securities customers are and would have been fully protected from any loss of cash or securities.

Beyond demonstrating the importance of short-term liquidity in the form of available sources of secured funding, the Bear Stearns experience has highlighted the statutory supervisory gap in this area. Congress recognized the importance of having in place a framework for considering the resolution of difficulties experienced by commercial banks, but not investment banks, when in 1991 it enacted the Federal Deposit Insurance Improvement Act ("FDICIA"). FDICIA, together with the Federal Deposit Insurance Act, provides the FDIC with the authority to take preemptive action to resolve a troubled bank or other federally insured depository institution and prescribe methods for resolving those that fail. These statutes reflect Congress's conviction that it is best not to improvise the principles which will guide federal intervention in financial institutions. That is a principle that I believe is equally valid not only with respect to depositary institutions, but other systemically important financial institutions as well.

Now, as always, the SEC is working closely with the Department of the Treasury, the Federal Reserve, and the Federal Reserve Bank of New York among others to ensure that our regulatory actions contribute to orderly and liquid markets. In addition to the specific actions that the Commission staff took in connection with the Bear Stearns — JP Morgan transaction, the Commission's broader work to address the subprime turmoil has involved nearly every major SEC division and office, and every area of emphasis. It includes, among other things, monitoring the financial condition of securities firms, guarding against market abuses, assessing the performance and revising the rules for credit rating agencies, 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 Subprime Task Force composed of senior leadership from each of the relevant disciplines within the SEC, including the Division of Enforcement.

The SEC's mission — the protection of investors, the maintenance of orderly markets, and the promotion of capital formation — is more important now than it has ever been. The recent turmoil in credit markets has made this a particularly challenging time. We will continue to work not only within the SEC but in close cooperation with the Federal Reserve and our other regulatory counterparts to promote the continued health and vibrancy of our markets, the strengthening of investor confidence, and the economic growth to which our securities markets are so essential.

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

http://www.sec.gov/news/testimony/ts040308cc.htm