



Yale SCHOOL OF MANAGEMENT
Program on Financial Stability

EliScholar – A Digital Platform for Scholarly Publishing at Yale

YPFS Resource Library

5-5-2010

Testimony of Chairman of the SEC, William H. Donaldson Before the FCIC

William H. Donaldson

<https://elischolar.library.yale.edu/ypfs-documents/5908>

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.

**TESTIMONY OF
WILLIAM H. DONALDSON
BEFORE THE
FINANCIAL CRISIS INQUIRY COMMISSION**

MAY 5, 2010

Chairman Angelides, Vice Chairman Thomas, and Members of the Commission:

Thank you for inviting me to testify today. I particularly appreciate the opportunity to offer my views at this hearing on the “shadow banking” system, given my longstanding interest in strengthened oversight of unregulated and opaque sectors of our financial markets, including during my tenure as Chairman of the Securities and Exchange Commission from February 2003 to June 2005.

You have asked me to discuss the origins, approval and structure of the SEC’s “consolidated supervised entity” (or “CSE”) program and the impact of that program on the leverage of CSE participants. You have also asked that I comment on several additional issues, including (i) my understanding of the term “shadow banking,” (ii) the ability of federal regulators to oversee the shadow banking system, (iii) the SEC’s ability to oversee systemic risk and (iv) the role over-the-counter (“OTC”) derivatives played in the financial crisis.

Before I discuss these topics further, let me remind you that the views I express are my own and not necessarily the views of the SEC, any current or former Commissioners or the Commission staff.

I. The Consolidated Supervised Entity Program

First I would like to discuss the CSE program. While some public reports have mistakenly suggested that this step was “deregulatory” in nature, just the opposite is the case.

The program in fact extended SEC oversight into new areas, namely the activities of unregulated holding companies and other affiliates of U.S. broker-dealers.

- Origin, approval and structure of the CSE program

The SEC does not have the legal authority to impose mandatory capital requirements on holding companies of large securities firms. Before 2004, the SEC had required regulatory capital computations only for broker-dealer subsidiaries of such holding companies. The CSE program established for the first time in SEC history a framework for consolidated oversight of the capital, liquidity and risk parameters of such holding companies. The global activities carried out by those holding companies through regulated and unregulated affiliates had begun by that time to extend well beyond the types of products and businesses found in their SEC-registered broker-dealers and were of concern to regulators in certain non-U.S. jurisdictions. In 2004, during my tenure as Chairman of the SEC, the Commission adopted the CSE program by a unanimous vote.

Under the CSE program, the holding company was required to compute, on a monthly basis, risk-based consolidated holding company capital, provide the SEC with information concerning its activities and risk exposures on a consolidated basis, and submit its non-regulated affiliates to SEC examinations. As noted, until that time, the SEC had set minimum capital requirements for and examined only broker-dealer subsidiaries – and the holding company and other unregulated affiliates essentially could, and in some cases did, take on unlimited leverage and risk.

The CSE program relied on the agency's existing authority over those companies' broker-dealer affiliates as a basis to impose examination and regulatory reporting requirements on the parent holding companies. This allowed the major U.S. global investment banks, which at

that time lacked a consolidated holding company supervisor, to submit voluntarily to consolidated regulation by the SEC. Two of those institutions did so during my tenure at the SEC, with the remaining three joining the CSE program afterwards.

The CSE rules adopted the Basel Standard as the benchmark for holding company capital reporting. The Basel Standard was generated through the collaborative efforts of bank regulators from the world's most advanced financial markets, and serves as the standard for internationally active financial institutions. Consistent with Basel, the SEC amended its net capital rule so that the broker-dealer affiliates of CSE holding companies would use their internal mathematical models to calculate the net capital requirements for the market risks of certain positions – which is how commercial banks had been computing market risk for their trading positions since 1997.

During the rulemaking process, in recognition of the possibility that utilizing these models might result in lower capital requirements than otherwise would be required under the net capital rule, the Commission decided to include a requirement that CSE participants provide an early warning to the Commission if their net capital, before utilizing the models, fell below \$5 billion. The \$5 billion early warning threshold corresponded to the amount of net capital that was typically maintained by the broker-dealers believed most likely to enter the CSE program, and so was intended, in practice, to prevent CSE participants from maintaining less capital than they had previously maintained under the standard net capital rule.

The SEC also modified the rules to require CSE holding companies to hold more liquid assets than otherwise required under Basel. CSE holding companies were required to maintain funding procedures designed to ensure that they had sufficient liquidity to withstand the complete loss of all short-term sources of unsecured funding for at least one year. These procedures were required to incorporate a stress test that estimated what a prudent lender would

lend on a secured basis under stressed market conditions. In addition, each CSE holding company was to maintain a pool of unencumbered, highly liquid and creditworthy assets.

- Impact of the CSE program on leverage of its participants

The CSE rules did not, contrary to the suggestions in some published reports, eliminate “leverage ratio” restrictions on broker-dealers. Large broker-dealers have not been subject to leverage ratio requirements under the capital standards that have been in place since the 1970s. Moreover, the net capital rule never constrained leverage at a broker-dealer’s holding company or other unregulated affiliates, and so many risky activities, such as OTC derivatives dealing and trading in real estate loans, were usually conducted outside the SEC-registered broker-dealer. Therefore, comparing the leverage of the broker-dealer affiliates of CSE participants before and after joining the CSE program is in many ways an apples-to-oranges comparison, since prior to joining the CSE program risky and leveraged activities could be conducted through the broker-dealer’s holding company and other unregulated affiliates without comprehensive SEC oversight.

Even at the holding company level a simplistic comparison of CSE leverage ratios to leverage ratios at bank holding companies is misleading. The product mix of securities firms typically differs significantly from that of banks with relatively more extensive holdings of highly liquid assets in market-making books and more limited exposure to off-balance sheet funding vehicles.

The CSE program, in other words, represented a significant, forward-looking effort to improve oversight over the holding companies and unregulated affiliates of U.S. broker-dealers, including by requiring computation of the same capital adequacy measures by broker-dealer

holding companies as governed banks – an effort that reached to the fullest extent of the SEC’s legal authority.

Unfortunately, neither the CSE requirements (nor those applicable to banks or insurance companies) proved sufficient in the recent financial crisis. A broad array of financial institutions faltered and proved incapable of withstanding the severe market distress – including broker-dealer, insurance and bank holding companies, both in the United States and abroad. It became clear that more robust holding company capital standards, together with access to vital backstop liquidity from the Federal Reserve, was needed to assure the stability of these institutions in a time of crisis. It is also become clear that the SEC’s current legal authority to impose mandatory minimum capital requirements solely on broker-dealer affiliates is insufficient, standing alone, to achieve this objective. Where a large financial holding company becomes systemically significant, we have seen that the failure or threatened failure of any affiliate poses a potential threat to the institution as a whole, even if the broker-dealer affiliates of that institution are well-regulated and capitalized.

II. Shadow Banking and Other Issues

Let me turn now to the other topics that you have asked me to address.

- Your understanding of the term “shadow banking”

Many commentators have used the term shadow banking system to refer to non-bank financial institutions and instruments that play a vital role in lending or extension of credit. By definition such institutions do not accept deposits like a depository bank and therefore are not subject to current banking regulations. At various times reference is made to a broad range of institutions and instruments including hedge funds, securitized products, OTC derivatives, private equity funds and asset backed commercial paper conduits. While these institutions and

instruments vary greatly one thing they have in common is that they have been developed outside the traditional regulatory structure.

A principal example would be asset backed commercial paper conduits. Like an ordinary bank, these entities borrow on a short-term basis in order to invest in long-term assets. However, instead of accepting retail deposits they fund themselves by selling commercial paper to large institutions, such as money market funds, pension funds and insurance companies. Because they do not accept deposits, commercial paper conduits are not regulated like ordinary banks. Also, because they sell commercial paper only to large institutions, they are not regulated like mutual funds and they are not required to register their commercial paper with the SEC. Further, the SEC's authority to regulate credit rating agencies – whose role in the growth of the asset backed commercial paper market and the securitization market generally was critical – was limited.

Although asset backed commercial paper conduits and other more lightly regulated sectors of the financial system by and large do not directly interact with average investors or finance small businesses or consumers, their activities do affect those groups indirectly. Some of these effects are positive – for instance, an active securitization market enhances the ability for banks to lend to small businesses and consumers by opening up new funding sources. By the same token, however, the more that banks and other traditional financial institutions rely on the more lightly regulated sectors of the financial system, the more those institutions, and by extension the economy as a whole, are exposed to the risks that develop there. The past ten years, of course, illustrate both types of effects.

- The ability of federal regulators to oversee the shadow banking system

Products and practices that develop outside the traditional regulatory structure are not inherently harmful, but they do present the potential for very significant risks to develop as they

grow outside of regulators' field of vision and authority to act. Federal regulators naturally cannot be expected to oversee effectively those sectors of the financial system that are not fully visible to them. Moreover, "shadow banking" activities heighten the risk that regulators will be put in the position of reacting to market problems, rather than anticipating them. The principal strategy for regulators to combat this possibility is to identify and prioritize risks before they become extreme or systemically troubling.

Prior to the crisis and even today, the best (and sometimes only) way for federal regulators to identify risks is by gathering and analyzing information from regulated institutions, such as commercial banks and broker-dealers, that transact with the "shadow banking" system. For instance, federal regulators might seek to assess, based on transactions with regulated counterparties, whether a particular unregulated institution, by virtue of some combination of size, leverage and interconnectedness, poses systemic risk. Regulators also use information from regulated institutions to try to spot trends, such as so-called "crowded trades," that span multiple unregulated institutions and markets. Further, in a global, diversified financial system, federal regulators must gather and correlate data across jurisdictional boundaries, both cross-border and between different domestic regulators, at both the federal and state levels.

- The SEC's ability to oversee systemic risk

When I first began my tenure as Chairman of the SEC, one of my top priorities was to reevaluate and determine how the SEC dealt with risk, so that the agency would be in a better position to anticipate, identify and manage emerging risks and market trends that stood to threaten its ability to fulfill its mission. To that end, we created the Office of Risk Assessment, which housed a new initiative to analyze risks across the boundaries of the SEC's divisions and was headed by a director reporting directly to the Chairman. The duties of the Office of Risk

Assessment focused on three areas: gathering and maintaining data on new trends and risks, analyzing that data to identify new areas of concern, and preparing assessments and forecasts of the SEC's risk environment. I am pleased to say that Chairman Schapiro, in her first year as Chairman, elevated the functions of this Office into a new Division of Risk, Strategy and Financial Innovation.

Of course, given the historic allocation of responsibility among federal regulators – with a multitude of agencies having overlapping jurisdictions and distinct missions – it is very difficult for any one of the existing agencies (whether the SEC, the Federal Reserve or any other agency) to identify risks to the financial system as a whole. For this reason, it is critical that there be an agency with a system-wide perspective and an explicit mandate to identify sources of systemic risk. Recognizing this, recent legislative proposals would establish a systemic risk regulator, although the precise responsibility or composition of that regulator, and the scope of its rulemaking and other authority still need to be defined.

Anticipating and identifying risks is not sufficient. Regulators must also have adequate authority and resources to act upon what they see. While I served at the Commission, for example, we determined after extensive study that it was important to adopt rules providing for increased transparency and oversight of the activities of hedge funds. Yet our efforts to implement this initiative were stymied by limits on the Commission's jurisdiction, as was the case in other areas such as oversight of credit rating agencies at the time.

- The role over-the-counter derivatives played in the financial crisis

The need for fewer “shadows” and more comprehensive federal regulatory authority can also be seen in the market for OTC derivatives, the final item that you have asked me to address today. Although OTC derivatives can in many cases be valuable tools for managing financial

and commercial risks, as we saw during the recent crisis they can also spread and multiply risk. This is principally because entering into an OTC derivative exposes an institution to risk that its counterparty might default. Although prior to the crisis market participants had developed a number of netting, collateralization and other arrangements to reduce that risk – and these arrangements likely prevented the financial system from suffering even more extreme turbulence – the risk was still, in many cases, significant.

The bilateral nature of the market for these instruments also resulted in a large number of overlapping contracts. This increased the counterparty risk in the system. It also made the financial system more interconnected, which increased the vulnerability of the system to the failure of a major counterparty. For regulators, the proliferation of overlapping contracts made the financial system more complex and less transparent.

Additionally, and perhaps most seriously, there was a lack of transparency regarding the appropriate valuations of certain key types of OTC derivatives and the financial positions of many key market participants. This presented challenges for both regulators and market participants alike in evaluating and addressing emerging risks in the OTC derivatives market. It also likely complicated efforts to take a more coordinated, deliberate approach to averting the collapses of Bear Stearns, Lehman and AIG.

Moreover, while it is difficult to quantify the precise contribution of OTC derivatives to the recent financial crisis, it is clear that no regulator had the tools to regulate these instruments comprehensively or even, in fact, to value them adequately in the absence of centralized markets. Specifically, most of the OTC derivatives market was exempted from federal oversight and regulation by the Commodity Futures Modernization Act of 2000. Strengthened authority to

oversee and regulate these innovative but complex instruments could play an important part in reassuring the public of the integrity and stability of our financial system.

I would be glad to address any questions that you may have.