U.S. Securities and Exchange Commission

Testimony Concerning the Consolidated Supervision of U.S. Securities Firms and Affiliated Industrial Loan Corporations

by Robert Colby
Deputy Director, Division of Market Regulation
U.S. Securities & Exchange Commission

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Chairman Frank, Representative Bachus and members of the Committee, I am very pleased to have the opportunity this morning to describe the Securities and Exchange Commission's program for supervising U.S. securities firms on a consolidated basis. I look forward to explaining how this system of supervision provides protection to all regulated entities in the consolidated group, including the Industrial Loan Companies that are the topic of this morning's hearing. And I appreciate the discussions we have had with Chairman Frank and the staff about possible amendments to H.R. 698, the bill under consideration this morning, that would avoid subjecting U.S. securities firms already supervised by the Commission under a comprehensive and effective program, to a second and duplicative consolidated supervision regime.

The Commission currently supervises five of the major U. S. securities firms on a consolidated, or group-wide, basis: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley. For such firms, referred to as consolidated supervised entities or "CSEs", the Commission oversees not only the US registered broker-dealer, but also the holding company and all affiliates on a consolidated basis. These affiliates also include other regulated entities, such as foreign-registered broker-dealers and banks, as well as unregulated entities such as derivatives dealers. Four of the firms, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley own ILCs that account for 1.0%, 0.6%, 7.2% and 1.2% of consolidated assets, respectively. Three of the firms, Lehman Brothers, Merrill Lynch and Morgan Stanley also own thrifts that account for 3.3%, 1.7% and 0% of the consolidated assets of each firm respectively.

The CSE program provides consolidated supervision to investment bank holding companies that is designed to be broadly consistent with Federal Reserve oversight of bank holding companies. This prudential regime is crafted to allow the Commission 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 US and foreign-registered banks and broker-dealers, or the broader financial system at risk. 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 holding company with our fellow regulators, both domestically and internationally. Indeed the Commission's CSE program has been recognized as "equivalent" to that of other internationally recognized supervisors, including the U. S. Federal Reserve, for purposes of the European Union's Financial Conglomerates Directive.

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 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 in all market environments for holding companies that do not have access to an external liquidity provider.

Before I describe the CSE program in detail, I will provide some historical perspective. Over the past twenty years, the Commission, in its role as the functional regulator of US broker-dealers, became increasingly concerned about the risk that a broker-dealer may fail due to the insolvency of its holding company or an affiliate. This risk, as broker-dealers have become affiliated with more and more complex holding company structures, was exemplified by the bankruptcy of the Drexel Burnham Lambert Group and the consequent liquidation of its broker-dealer affiliate in 1990. Post-Drexel, the Commission and its staff undertook a number of initiatives to conduct group-wide risk assessments of financial institutions with significant broker-dealer subsidiaries. The initiatives included (1) Commission risk assessment rulemaking using authority granted by the Market Reform Act of 1990 requiring larger broker-dealers to provide certain information about material affiliates, (2) creation of the Derivatives Policy Group consisting of firms active in OTC derivatives that agreed to voluntarily provide information to Commission staff about their OTC derivatives activities, and (3) the Commission's program for supervision of broker-dealers that register as OTC derivatives dealers. These initiatives assisted the Commission in understanding how financial institutions with large broker-dealer subsidiaries manage risk globally at the group-wide level, and have over time allowed the Commission to develop a unique capacity to regulate securities firms.

Motivated in part by the need for group-wide risk monitoring, and in part by requirements of the European Union's Financial Conglomerates Directive, which essentially requires non-EU financial institutions doing business in Europe to be supervised on a consolidated basis, the Commission in 2004 crafted a new comprehensive consolidated supervision regime that was intended to protect all regulated entities within a group including broker-dealers. The rule was designed to restrict eligibility to those groups with a large and well-capitalized broker-dealer. In other words, 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 incidental to its primary business activity. As a result, the rule effectively requires that the principal broker-dealer have tentative net capital, measured as equity plus subordinated debt less illiquid assets, of at least $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 examines the implementation of these controls. Third, CSEs are also monitored continuously 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 liquidity at the holding company, where these are available for use in any regulated or unregulated entity within the group without regulatory restriction.

Before I expand on each of these in turn, I would like to point out that these five principal program components are implemented in conjunction with the authority to protect regulated entities within the groups. When potential weaknesses are identified, the Commission has broad discretion under our rules 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 pool of highly liquid assets held at the parent. These powers are not theoretical abstractions. All three of the steps that I just cited, namely requiring changes to risk management systems, requiring more capital, and requiring more liquidity have been taken at various firms over the past two years.

1. The requirement to maintain and document a system of risk controls, including measures to manage the market, credit, liquidity, legal, and operational risks associated with a CSEs business activities, is vested in Exchange Act Rule 15c3-4, by which CSEs must abide. Review by the staff, and ultimate approval by the Commission, of this system of risk controls is a critical part of the process by which each of the five investment bank holding companies became a CSE. While in many respects the system of controls present at the CSE firm bears a strong similarity to analogous systems at other large, complex and internationally active financial institutions, they do reflect the importance to securities firms of daily mark-to-market of most positions as a risk management and risk governance tool. Establishing effective controls around the mark process, particularly where less liquid or more complex products are concerned, is a major focus both of the firm's risk management and financial control functions, and of the Commission's supervision program.

2. Subsequent to approval, the Commission conducts periodic examinations of the CSE's risk and financial controls. These examinations are intended to test whether the documented policies and procedures, particularly concerning the marking of positions to market, are implemented in a consistent and robust fashion. Examinations are focused on the holding company and its unregulated affiliates. Banking affiliates, including ILCs, already subject to supervision by a federal financial regulator are not subject to Commission examination.

3. The CSE supervisory regime is designed to leverage the work of the control functions within the firms. To monitor the financial and operational condition of the holding company, and to verify that the risk control system is functioning effectively, a multi-disciplinary team of Commission staff, including economists, financial engineers, and accountants, meet regularly with senior risk managers, financial controllers, treasury personnel, and internal auditors of the CSEs. A key theme throughout these discussions is risk concentration, and how the control functions collectively manage concentrated exposures of various types.

Commission staff meets monthly with senior market and credit risk managers of the CSEs charged with managing a bidirectional flow of risk information between the trading businesses which take market and credit risk, and the senior management. In one direction, value-at-risk and other techniques are used to aggregate exposures across diverse businesses with different underlying risk factors both for internal risk management and regulatory capital computations. In the other direction, a granular system of limits articulates to each business or desk the risk appetite of senior management. During the monthly meetings, the performance of the models and aggregation tools are assessed, by comparing ex ante measures of risk with ex post realizations of gain and loss. The monthly discussion is structured around a review of risk reporting and analytics prepared for the internal use of the firm's management.

On a quarterly basis, Commission staff meets with CSE treasury personnel at each firm. The focus of the discussion is the liquidity position of the holding company and, in particular, the amount and nature of liquid assets that are held at the parent, and thus available for use anywhere within the group. Of equal importance, however, are the less liquid assets held by the firm. The CSE firms use a liquidity scenario, approved by the Commission, which is intended to capture the effects of a prolonged market stress event to calibrate liquidity requirements, which includes retirement of outstanding short-term debt and additional funding requirements reflecting a presumed deterioration in the ability to fund less liquid assets through repo and repo-like transactions. During the quarterly discussion, material changes in the liquidity requirements generated by this analysis are discussed.

Quarterly meetings are also held with the CSE financial controllers to review the financial results including significant profit or losses at the desk level. Financial results are also compared with the risk exposures theoretically associated with those gains or losses as a means of validating that the risk measurement systems are functioning properly. The results of the firm's internal price testing processes, intended to validate the marking-to-market of complex and illiquid products, are also reviewed.

Also on a quarterly basis, Commission staff meets with CSE internal auditors to cover significant audit findings and the evolution of the audit plan throughout the year. The resolution of findings, or their escalation to the firm's audit committee, is tracked. Selected audit reports, particularly those related to risk governance, are discussed in detail with the audit staff.

4. The on-site work described above is augmented by the Commission staff's review of monthly holding company capital adequacy measures, which are required under the CSE rule to be computed in a manner consistent with the Basel Standard. While not required by the rule, all of the firms are applying Basel II and its advanced approach to credit risk exposure. Each CSE has undertaken to maintain a ratio of regulatory capital to risk-weighted assets of at least 10 percent, the Federal Reserve's standard for a well-capitalized institution.

5. The final component of the program is a liquidity pool that each CSE is required to maintain at the parent level. In addition to the Basel capital calculation required of CSE firms, the Commission also requires CSE firms to meet certain liquidity standards. Securities firms rely on a wide range of funding sources, notably repo and repo-like secured financing of assets. In the face of any crisis - whether real or only perceived - secured lenders are likely to require significantly more collateral while unsecured lenders may

disappear altogether. CSE firms must conscientiously manage this liquidity risk using their own resources. There are a number of instances where securities firms that were adequately capitalized by the measures of the day collapsed because the asset side of the balance sheet proved insufficiently liquid to withstand a stress event. Thus, under the CSE program, the Commission looks not just at capital adequacy, but also at the liquidity of the assets being supported by that capital through an additional set of standards. Generally, each CSE firm must have sufficient stand-alone liquidity and sufficient financial resources to meet its expected cash outflows in a stressed liquidity environment for a period of at least one year. To meet these standards, each CSE firm holds a substantial amount of liquid assets that are available to the ultimate holding company and its subsidiaries to deal with a crisis or perceived crises anywhere within the organization. Again consistent with the Commission's authority under the rule, each CSE has undertaken to maintain a liquidity pool of specified size.

I have described this morning a system of consolidated supervision that I believe effectively achieves the goal of reducing the likelihood that weakness within the holding company or an unregulated affiliate will place a regulated entity, including an ILC, or the broader financial system, at risk. I have described the means by which we monitor on an ongoing basis the financial and operational condition of the CSE holding companies, leveraging our many years of experience in overseeing broker-dealers and their affiliated holding companies. And I have described our broad authority under the CSE rules to take action in the event of a weakness or potential weakness. Further, while the program is similar to other consolidated supervision regimes, notably the Federal Reserve's oversight of Bank Holding Companies, the CSE regime is tailored to reflect the reliance of securities firms on mark-to-market accounting as a critical risk and governance control, as well as the need for such firms to maintain adequate internal liquidity sources to withstand market stress events. Finally, the CSE program is recognized internationally as providing consolidated supervisory oversight of our largest U.S. securities firms that is equivalent to that of well recognized federal banking regulators.

In conclusion, while we generally support the goals of the H.R. 698, the bill as introduced would subject the CSEs that already are highly regulated under the Commission's consolidated supervision program to an additional layer of duplicative and burdensome holding company oversight. The bill should be amended to recognize the unique ability of the Commission to comprehensively supervise the consolidated groups that are overwhelmingly in the securities business, especially given the heightened focus on these issues in an era of increased global competitiveness. Because the Commission has established a successful consolidated supervision program based on its unique expertise in overseeing the securities businesses, the Commission's program should be carved out of this legislation in the same way as are the holding companies supervised by the Federal Reserve and OTS.

Thank you again for the opportunity to speak on behalf of the Commission. I would be happy to answer any questions that you may have.

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