



Lessons Learned Oral History Project Interview

Interviewee Name and Crisis Position	Erik Sirri ¹ Director, Division of Trading and Markets, Securities and Exchange Commission
Interviewer Name	Mercedes Cardona, Interviewer, Yale Program on Financial Stability
Date of Interview	May 25, 2021
Lessons Learned No.	2021-06

Introduction:

The Yale Program on Financial Stability (YPFS) reached out to Erik Sirri to request an interview regarding his time as director of the Division of Trading and Markets at the US Securities and Exchange Commission (SEC) from 2006 to 2009 and, more specifically, the SEC's regulatory objectives and concerns during the Global Financial Crisis (GFC).² In his post, Sirri was responsible for matters relating to the regulation of stock and option exchanges, national securities associations, broker-dealers, clearing agencies, transfer agents, and credit rating agencies. He is currently a professor of finance at Babson College. His research interests include the interaction of securities law and finance, securities market structure, investment management, and capital markets.

This transcript of a telephone interview has been edited for accuracy and clarity.

Transcript:

YPFS: Can you tell us what you were working on and the discussions you were hearing in late 2007, 2008? You joined the SEC in 2006. What was going on at the time? Were the outlines of the crisis becoming clear?

Sirri: No, not at all. Not in 2006. In 2006, thinking more broadly, the biggest issue was a concern that the US was over-regulated. And, as I remember, one of the biggest stories that was circulating was that the big IPOs that were occurring, none of them were happening in the United States, that firms were avoiding the United States in going public, largely because it was perceived that we had a heavy touch in regulation. This was after the passage of Sarbanes-Oxley and some other things that were thought to make life difficult for some financial firms. So that was one of the big issues.

¹ The opinions expressed during this interview are those of Sirri, and not those any of the institutions for which the interview subject is affiliated.

² A stylized summary of the key observations and insights gleaned from this interview with Mr. Sirri is available in the Yale Program on Financial Stability's *Journal of Financial Crises*.

YPFS: The division that you headed used to be known as the Market Regulation Division, then it became the Division of Markets. Was there a deregulatory lean at the SEC in the years leading to the Global Financial Crisis?

Sirri: Not really. I don't think there was a deregulatory lean. But the division that was known as the Division of Market Regulation changed to the Division of Trading and Markets, and I think there was a sense that the name Market Regulation was an old name. And, over the years, division names with the word "regulation" had gone away. So, the other big divisions, Investment Management, Corporate Finance, Trading and Markets, fit that tone a lot better than Market Regulation, and that was one of the reasons for the change.

YPFS: You also mentioned in an interview that you were the only non-lawyer to head the markets division. What was the thinking there in terms of both the point of view of regulation and the point of view of the market dynamics at the time of going from a lawyer to an economist?

Sirri: If I had said that, I was wrong. There was one other non-lawyer who had headed the division. But having said that, I actually asked the chairman why he did that, and he just said he was looking for a different approach to the oversight of markets. This is Chris Cox. He made the remark that most of our markets are in New York City. The firms are there, the people are there, yet we regulate those markets remotely, if you will, from Washington, DC. He was always sensitive to that, and he thought a purely legal approach to those markets sometimes could be excessive, it maybe wasn't exactly the right approach. So, he liked the idea of having an economist run the division.

To do the work, you need lawyers. My word, we administer statutes, and we administer the law, so you need lawyers to do it. But I think he was always sensitive to the idea that the SEC didn't give enough deference to the idea that these were economic functions, not just legal functions, in terms of our markets.

YPFS: So, what were you working on then in late 2007, 2008? What were the discussions that were going on in the Markets Division before Bear Stearns hit crisis stage in early 2008?

Sirri: There were a lot of issues. One of them was credit rating agencies. Of all things, people forget the sequence, but the Credit Rating Agency Reform Act was passed in September of 2006. So, the newest thing that we have on the plate of Market Reg—it was still called Market Regulation at the time—the newest thing we had on our plate was credit rating agencies.

We were busy drafting the initial rounds of rules to regulate credit rating agencies. What's interesting about this is that it occurred before the credit crisis. Congress passed the first enabling statute that gave us authority over

credit rating agencies, and their framework was one of competition. They were concerned that there was essentially a duopoly in the credit rating agency business, and they wanted to see more entry by other firms, smaller firms, newer firms, to break the duopoly by Moody's and S&P. That was the essential framework of the rules: They wanted the SEC to get out of this business they've been in, designating these firms as nationally recognized statistical rating agencies, NRSROs, get us out it, and let market forces take over there.

YPFS: **The credit rating agencies did have a part to play in what happened next with the mortgage crisis, those pools of mortgages and the rating of various securities that would later become part of the crisis.**

Sirri: They did. They did, that's right. After the fact, they were very much chastised for awarding high ratings to complex securities that later would become near worthless. And pretty clearly, they got some things wrong.

YPFS: **How was that addressed from the SEC's vantage point? Was it addressed?**

Sirri: That was after the fact. In 2006, when I started, nobody knew that that was to come, that the ratings that were being assigned to some of the mortgage products were going to be inaccurate ex-post. After the fact, when that happened, the SEC just continued with their rulemaking, trying to get at what it perceived as the cause behind the failures of those credit ratings.

Reflecting back at that, and even at the time, that was one of the hardest problems, and one that I think the SEC has still not solved. Regulating credit rating agencies is a very, very difficult business. They're offering opinions, and at the same time, they're in a business; they're in the market for information, and that's a very, very difficult market. You don't see that many markets for information where people are paid for information. It is very hard to design a compensation mechanism for such businesses.

Those credit rating agencies were subject to their own economic forces trying to get business, and to me, the mystery isn't the credit rating agencies made perhaps some compromises in their ratings or were inaccurate in assigning high ratings to certain structured products. The bigger mystery was everyone knew what the conflicts were that the rating agencies faced, and yet institutional investors continued to rely on these ratings. Why were the investors relying on those credit ratings? That, for me, is the big mystery.

YPFS: **How much of that was also a factor of the institutional investors at one level of sophistication, and then you had the opening of the market to pretty much anyone with a computer, bringing in a lot of much less sophisticated investors contributing to the volatility?**

Sirri: Well, don't forget the things that the credit agencies rated that became problematic were largely mortgage derivatives or packaged loans. No retail

investors invested in those. Those were institution-only products. So, they were only purchased or sold by sophisticated, institutional investors. In that market, this was not the case of mom and pop buying mortgage slices of CMOs [collateralized mortgage obligations] or CLOs [collateralized loan obligations]. That's not what was going on. This was an institutional market.

YPFS: **These institutions seemed to be relying on these credit ratings almost exclusively.**

Sirri: Well, that's the puzzle. The puzzle is, why didn't they do their own research? People understood the conflict that existed within credit rating agencies. The conflict being that the credit rating agencies were there to offer an opinion about the creditworthiness of the security they were rating, but at the same time, they were paid by the issuer of that paper. So, in the competition for a credit rating agency, the issuer was going to pick the rater who gave the most favorable rating.

Everybody knew that. This was not a secret. In fact, it was common practice for large institutional investors to hire some of the employees out of the big credit rating agencies as analysts, because you wanted that knowledge within your firm.

So, the bigger puzzle for me is: Why was there such tremendous reliance on ratings that people and sophisticated investors knew were not fully at arm's length? It's not that they weren't at arm's length, it's that they were compromised, that there was a conflict of interest between the credit rating agency and the opinion they were offering.

YPFS: **In your view, has that been addressed effectively since the crisis?**

Sirri: You know that's what's very, very hard. I don't fault the SEC for this. It's just that it's very, very hard to write rules that get at that. It is that it's still the case today, that the issuer pays for and selects the firm that rates their securities. I mean, that's still the case today.

Hopefully it is reliance that's changed. That is, the investors are being a bit more skeptical about these ratings. Other things have changed as well. Even the government's own rules, both of the SEC and other agencies, relied on credit ratings in their regulations. That was quite common. So even the government in its rules, relied on credit rating agencies. That's a lot of reliance.

YPFS: **And how do you correct for that over reliance on credit ratings? Is there a mechanism that could help?**

Sirri: Well, one of the things that was done is--and it's not been done uniformly, but for sure—the SEC looked through its rules and tried to remove references to credit ratings. It went through and, where possible, it got those credit ratings

out of there. I think some other government agencies did, as well. That's not to say they're all gone, but they tried to lessen the reliance.

What credit ratings get at is a valuable piece of information: the creditworthiness of the security. So, for example, when someone like the Fed lends money against collateral, the Fed wants high-quality collateral to lend against, and one of the benchmarks for high-quality collateral is its credit rating. And that was one of the things that was used.

YPFS: **That gets at the whole issue of establishing a risk profile—leverage ratio and the quality of the securities they were holding as collateral. The Fed as well, when they started putting together their bank stress tests and trying to get data on the leverage and the securities that were held found that a lot of it was self-reported. It goes back to what you were saying about the credit ratings, that a lot of it is a little opaque.**

Sirri: Well, if I ask you right now, which loan is more risky: A loan to Ford or a loan to GM? Absent a lot of work on your part, you're not going to know the answer to that question, let alone its absolute risk. Relying on creditworthiness in your oversight, naturally leads to people wanting to rely on credit ratings. That is how the SEC got into the credit rating agency business.

It got into the business because it was interested in regulating the net capital of broker-dealers. It wasn't interested in regulating credit rating agencies, per se. It was trying to ensure that broker-dealers capital levels were appropriate. And the question arose, "Well, if a broker-dealer has a bunch of bonds, how do we tell how much capital to require against those holdings." There could be Treasury bonds which are quite safe from a credit perspective. There could be investment-grade, high-quality bonds, or there could be low-quality "junk" bonds. It makes sense that you would want a different amount of capital held for those. So, the SEC's framework, in the end, had to assess the riskiness of the bond, and where they settled, when they first crafted this framework, was on credit ratings.

The reason why they relied on the credit ratings, was to assess the net capital of a broker-dealer. It just happened that when they set up that framework, it mushroomed over time.

YPFS: **You mentioned the broker-dealers, and that leads me to a piece of testimony where you went over the 2004 amendments and what they did in terms of the capital requirements for broker-dealers, how the SEC was incorrectly seen as having relaxed those requirements and contributing to their decreased liquidity and eventually to the crisis. Can you walk us through the 2004 amendments? What did the Commission try to do, and what did the amendments actually do? And how did that somehow give the wrong impression to the Congressional Oversight Committee?**

Sirri: People very much misunderstood how firms are regulated, and it just became very broadly the case that everyone was saying the SEC let these investment banks get leveraged. So, the first thing you have to understand is that the SEC, as a regulator, regulates broker-dealers. It regulates other things, such as investment advisors, but when we're talking about this part of the investment banking business, they regulate broker-dealers.

Now, a broker-dealer is an entity that primarily is in the business of buying and selling securities. In a large investment bank like Goldman Sachs or Lehman Brothers or Merrill Lynch, they have one or more broker-dealer subsidiaries. But they have many, many other subsidiaries. A Lehman would have 1,000 subsidiaries, conceivably. The broker-dealer was just one of many entities under this large, corporate umbrella.

The SEC's authority began with and ended with the broker-dealer. It didn't have authority over the holding company, so it didn't have authority over Goldman Sachs, Inc. What it had authority over was Goldman Sachs' Securities. It didn't have authority over Merrill Lynch. It had authority over Merrill Lynch's securities affiliates. And that's a small piece of the larger firm.

These firms were investment bank holding companies. They were banks that held all sorts of other things. They might have investment advisors, they'd have broker-dealers, as we said. They might have industrial loan corporations or entities; they might have a thrift. So, they have a bunch of other companies. And by the way, they were all multinational. So, we're just talking about the US affiliates. So, the SEC only has authority over the US affiliate.

The reason why people became confused about this, I think, is because not only did they not understand the basic framework about broker-dealers, but the SEC instituted a program of consolidated supervision in 2004 with those rules that you were talking about.

The SEC had absolutely no authority to look at anything other than the broker-dealer. It especially had no authority to look at the holding company or any of the investments or exposures of the holding company or their risk controls. And that was problematic for the SEC's mission. And the reason why it was somewhat problematic is, a broker-dealer could be perfectly sound, but if you take enough risks outside of the broker-dealer at the holding company level, or in other affiliates, you can take down the firm and the broker-dealer with it. So, if the SEC's mandate was to ensure the soundness and the orderliness of the broker-dealer—to ensure that the broker-dealer was functioning properly and could unwind properly—that could be imperiled by risks outside the broker-dealer.

We understood that, but also the European Union understood that. And the reason why I bring up the European Union is that at this time, if firms like big

investment banks wanted to do business in the European Union, they needed to have a consolidated supervisor. That was an EU requirement. So that meant our firms like Morgan Stanley and Goldman Sachs and Lehman Brothers would not be able to do business in the UK without a consolidated supervisor, unless they ring-fenced the foreign affiliate, which is economically very inefficient.

Now, the big consolidated supervisor in the United States is the Federal Reserve. But these firms weren't banks, and they did not want to fall under the supervision of the Fed. In fact, the Fed just wasn't their consolidated supervisor; some of them didn't have a consolidated supervisor. And more surprising for the ones that did (a couple of them, I don't remember which ones) the consolidated supervisor was OTS, the Office of Thrift Supervision, which I'm pretty sure almost no one knows. But they weren't doing the supervisory work. This was just the regulatory framework that Congress set up out of Gramm-Leach-Bliley. That body of regulation really did not provide for consolidated supervision of investment bank holding companies. They were largely unsupervised at the holding company level.

That became a problem then when they wanted to do business in the EU. The compromise was that the EU agreed to accept consolidated supervision by the SEC at the holding company level. They would say, "Okay, that satisfies the consolidated supervision regime." That was the framework.

What the 2004 rules did was a trade-off. The SEC gained oversight and some transparency into the risks at the holding company level. That was something that it did not have before. It didn't do it by statute; it did it by rule. It could look at the risks and see the risk controls at the level of the holding company of the big investment banks. The 2004 rules also let the SEC require a pool of unrestricted liquidity at the holding company level. The SEC had not been able to implement these regulations before. In exchange, it gave the investment banks an alternate method for computing the required level of broker-dealer capital that they held.

This is going to get very technical, very quickly, so I'll try and go through it. Capital was calculated before using a rules-based system. Capital was computed in such a way that, well, if you held stocks, there was a certain haircut applied to the stocks. If you held a bond, there was a certain haircut applied to the bond. It was a rules-based system for computing capital. That changed with this rule. We went to a value-at-risk system. It is, in fact, the same system that is used by banks in the Basel Accord.

That was the trade-off. It allowed for the computation of actual broker-dealer capital using a different measure. That's all it did, and in particular, it did not change the required broker-dealer capital. At these firms, their broker-dealers didn't fall out of capital compliance. They didn't run into a situation where they ran out of capital. The problems arose at the holding company level, where the

SEC had a window into what was going on, but we didn't have statutory oversight. Then people started thinking the SEC allowed a ton of leverage to occur in these firms at the parent level. We couldn't have stopped them from taking holding company leverage. We didn't have the authority to do that.

YPFS: **It does sound almost, from my conversations with people at the Fed, I've heard similar things in regards that, "we only regulated banks. We had a limited toolkit available to address this."**

Sirri: They're right. They did not have authority. The Fed is right. It did not have authority over these firms. This is the problem. Nobody did. That is the problem.

YPFS: **That sounds like a blind man touching the elephant or game of Whac-A-Mole, where nobody seems to have the purview to address the root causes, if they can even see them.**

Sirri: Well, people knew there was an issue, but nobody had the authority. Congress has to give you the authority. So, with the exception of the Office of Thrift Supervision, which did have consolidated authority for the thrift holding companies, they weren't really in the game. With the exception of them, there was no one who was a consolidated supervisor. That's why the EU was so unhappy.

YPFS: **Why was OTS not in the game?**

Sirri: That's a great question. They weren't. Think of what the Fed does. They take a very hands-on approach to the firms they regulate. They have bank examiners that are all over these people. They kind of live at the bank. They understand the risks that are being taken. They understand the risk control. They have a very tight model of supervision. With respect to the risks going on outside the thrifts and in the holding companies, OTS did not have that approach. OTS did not supervise the thrift holding companies in the same way that the Fed supervised the bank holding companies. They just didn't.

YPFS: **It sounds like this fragmented regime is part of the problem.**

Sirri: It is. That's Gramm-Leach-Bliley.

YPFS: **So, what happened then? The CSE program, correct me if I'm wrong, but it was largely voluntary, wasn't it?**

Sirri: Oh, it's entirely voluntary. No firm needed to do it, you opted in.

YPFS: **If they didn't have to, why would they do it? It sounds like it would have been more paperwork for them.**

Sirri: Because they couldn't have done business in Europe. So, the Fed couldn't become their supervisor because they didn't have the authority. There was no bank in these firms, so that takes the Fed out of the equation. And they didn't want to be supervised by the Fed.

Of course, any of these firms could have just gone and purchased a bank. They would have immediately become a bank holding company and then the Fed would have been their consolidated supervisor and they could have done business in the EU. But they didn't want to be supervised by the Fed.

If they wanted to be supervised by the Fed, they could have bought some \$100 million bank and been supervised by the Fed. They didn't want that. They could have all opted into that. So, they would have all had the option to be supervised by the Fed by buying a bank. They didn't want that. They could instead, give the Securities and Exchange Commission a look into the holding company and a window into looking at their risk and their risk controls and their liquid reserves at the holding company level. The SEC's rule allowed the SEC that, in exchange for this alternative net capital treatment at the broker-dealer, not at the holding company. So even doing what we did, the SEC could not have controlled the leverage of the holding company.

YPFS: So, there wasn't and may still not be any kind of requirement to compute and report liquidity on a consolidated basis?

Sirri: With the SEC, with the CSE program, we had a consolidated liquidity reporting regime, but that was by rule, not by statute. What the Fed does, I don't know. I can't speak to the Fed's authority to get at consolidated liquidity. I'm the wrong person to talk for that.

YPFS: It sounds like that consolidated reporting might have at least given some view of the level of risk and the potential meltdown that was brewing.

Sirri: It might have. For sure, it was the case that people didn't have a handle on what these positions were, because the firms, by design, held the risky securities in question or the positions in question outside of regulated entities. If you're talking about certain kinds of swaps, or very illiquid loan positions, or mortgage derivatives, or whatever they were, you're going to hold them outside the broker-dealer or any other supervised entity.

YPFS: In an interview, you were talking about Long-Term Capital Management and how that was an unregistered entity that you couldn't very well police what they were doing. Is this another case of not having the statutory authority to see what was going on? Was there any interest within the SEC to change the dynamics of letting investment banks self-regulate?

Sirri: We would have had an interest in that, even sticking to our own knitting, where our knitting was the broker-dealer. We understood it was when Drexel Burnham Lambert, the investment bank, folded. The problems arose not in the broker-dealer, but outside the broker-dealer, but it caused the implosion of the broker-dealer as well. It was then, I think, that the SEC learned that broker-dealer could be perfectly healthy, but if the parent is in trouble, then just watching the broker-dealers just is not sufficient to ensure the orderly operation of the broker-dealer. Because risks outside can take it down.

Broker-dealers are essentially trading entities. Even if people think the securities affiliate is perfectly sound, if they think the parent is teetering, then they're not going to want to deal with the broker-dealer. And the minute people stop trading with the broker-dealer, they're done.

YPFS: Might it have been a concern about not inflicting damage on the parent organization by going after the subsidiary?

Sirri: No, it was that risks in the parent would bring down the subsidiary. It was that the subsidiary was perfectly healthy but risks in the parent or other affiliates could take down the broker-dealer. That's what the SEC understood.

The real question, for me, is why did Congress allow this framework? Why did they set up a framework where some of the biggest financial firms in the country had no consolidated supervision?

YPFS: And yet, Drexel was in the '90s-

Sirri: It was.

YPFS: More than a dozen years later, comes this crisis. Had nothing shifted in the meantime in terms of regulation, Congressional desire?

Sirri: Well, Gramm-Leach. They did this in '99. Then '99 to 2008, those weren't bad times.

YPFS: But 2008 was pretty bad.

Sirri: 2008 was bad. That's right. There's no question about it.

YPFS: Let's go back to the narrative of what was going on in 2008. The beginning of 2008, in March, Bear Stearns goes into crisis mode and is eventually dismantled. What were the discussions at the SEC at the time? Was there any kind of imperative to get Congress to act on some kind of authority?

Sirri: Bear Stearns, in the end, had a liquidity problem. One of the lessons out of Bear Stearns was, for us at least, how rapidly liquidity could vanish from a firm of that size that was in that business.

You have to appreciate the way these firms work. Bear Stearns had a huge matched book repo operation. They were holding a lot of securities that they had brought in against which they had put money out. They'd financed a bunch of positions on repo, so they were running what's called a matched book repo operation that was essential to the funding of the firm. That had been the method of funding these firms for years. And these firms were reliant on things like commercial paper, as well—a lot of short-term funding, secured and unsecured.

One of the things that happened with Bear Stearns is, as people began to question their solvency, the funding just ran away from them and they were not able, in the end, to finance positions, even US Treasury positions, that they held. Treasuries are perfectly good; there was no problem with the US government, but they weren't able to finance Treasury positions. The lesson out of that for us, the thing that was so remarkable about Bear Stearns, is how rapidly funding could run away from a firm that itself; although it had some issues, didn't have the same kind of issues as, say, a Lehman Brothers.

I don't recall a discussion that said, "Congress needs to act now to give authority to someone." I think at that point, people understood what some of the issues were. The problem was: how are you going to save these firms? What's going to happen in the markets? Are they going to be able to fund themselves? Are these positions going to continue to become impaired? And from Bear Stearns through Lehman Brothers, there was not a lot of good news in that period of time.

YPFS: How did the discussions change, once we hit September, and Lehman and AIG, and the stock market cratered? I'm assuming more of an imperative to do something.

Sirri: Well they did, but at that point the SEC's role became much more attenuated. Because at that point, you've got to ask yourself: What can the SEC do for these firms? And the answer is: almost nothing. The tool that you needed at this point was capital. You needed someone's wallet. So, from a regulatory side, it was the Fed and the Treasury that were important now, not the SEC.

It wasn't an issue of broker-dealers, it was an issue of these firms that had all this illiquid or marginal positions or positions of questionable value. There was nothing that the SEC could do from them. We don't have any ability to provide liquidity to firms the way the Fed does.

The Fed was able to create all these facilities with the help of the Treasury to lend against collateral and reopen markets—like the money markets, the

commercial paper markets, certain secured markets—through various lending facilities they put in place, either based on the kind of security that was there, or the primary dealers or whoever it was. The Fed was able to do that, and that's what was needed. There was not much the SEC could do at that point.

YPFS: Was there any kind of postmortem after 2008, maybe in 2009, on what could have been done before the crisis to hopefully either forestall the crisis, or alleviate some of its effects?

Sirri: There was active discussion or what should we have done, or what could we have done, or did we miss the warning signs.

With respect to the SEC, you can ask yourself the question: Was the consolidated supervised entity, the CSE program, a good idea? Now, the Yes answer was: "Well, the SEC was trying to create a system that let it do its job better." Maybe the No response was: "It tried to do by rule what should have been done by in Congress by statute." It wasn't very successful. It didn't have enough authority over the holding company, and really, had it not stepped in, maybe either Congress would have acted, or these firms would have eventually opted for Fed supervision.

I'm not saying that would have forestalled the crisis, but maybe the choice that the SEC made there, wasn't the right choice. Now, hindsight's 20/20, so...

YPFS: In hindsight, it sounds like some kind of consolidated oversight, a statutory authority to take action, coming from congressional action was a necessity in this case, to get any of these things to happen.

Sirri: In retrospect, there was a regulatory hole there, and Congress should probably have filled it. You probably didn't want firms as big as our investment banks running around without consolidated supervision, or certainly without the ability for someone to look into and look holistically at the risks and the amount of liquidity across the whole entity. And there was no one to do that, and these were big, important firms.

The only entity that can provide for that was Congress. Congress had to give the authority to someone, and it was probably too much to expect the banks to opt into a regime. At some point, Congress probably not needed to put them into a regime.

YPFS: In a real world of political pressure and partisan politics, is that realistic?

Sirri: Well, I guess it's a question of what's necessary. If you as Congress can say, "Those firms don't need supervision." That's one thing. If you say, "Well, they probably should be supervised, but it's a political hot potato, and I don't want to handle it." That's a different story.

I think what you and I are both saying is that there probably was a need for some kind of supervision outside just the broker-dealer, or the advisors or whatever in here. There was a need for supervision of the holding company. The SEC tried to manufacture it by rule, with very, very mixed results. I think it would have been better to do by statute.

YPFS: **In the aftermath of the crisis, there was a general feeling among the public that Wall Street was running amok and Congress tried to address that with the Financial Crisis Inquiry Commission and the Dodd-Frank Act. Has that resolved anything, or is there unfinished business left after the Global Financial Crisis?**

Sirri: Well, there are places where people are still having discussions. There's still a discussion around what some people call shadow banking. Shadow banking refers to entities that engage in certain types of financial intermediation outside of bank regulations.

An example of what people talk about are money market mutual funds. They can be thought of as shadow banking. Now, they're heavily regulated by the SEC, but there are people within banking regulators who say: "The regulatory framework is inappropriate. These things are essentially banks, without bank regulation, and thus are prone to runs." The securities people, the mutual fund regulators, the SEC would respond and say: "No, they're mutual funds. There's a regulatory framework for mutual funds and it's worked very well, thank you." That's active debate today, so that would still be one piece of unfinished business.

I think credit rating agencies are, in some sense, unfinished business. There's a regulatory framework for them, but I don't think many people think that the conflict of interest problems are solved with the existing regulatory framework. There are still issues with credit rating agencies and the way we rely on them.

There are also issues with other types of unregulated, or partially regulated entities. We can call them hedge funds, if you want, but they don't all have to be hedge funds. These are just entities that do business, like some kind of financial intermediation, where they buy assets that are less liquid than the liabilities they issue. And in that world, if these things were to fail, then they can have knock-on effects. Most recently, we saw things like Archegos (Capital Management), which induced some losses in some banks related to their exposure through prime brokerage. Areas like these are still out there, and people are still concerned about them—that there are risks that have negative externalities. That is, if the firm were to become impaired, there could be damage, not just to the particular firm but to the larger financial system. So, I think that's one place where some people believe more needs to be done.

YPFS: **To sum up here, if you were going to write a memo, to send it back in time to 2008, or 2006, when you took the job at the SEC, what would be the top-line points? What do you wish had been handled differently? Could more or less have been done to prevent the crisis and to set ourselves in a position to avoid a future one?**

Sirri: I think cooperation amongst the various regulators could have been better. I think that's certainly one thing that was true. If you read some of the narratives that came out in the aftermath of the financial crisis, then you saw that information-sharing and authority-sharing amongst the various regulators, like the Securities and Exchange Commission, Office of Thrift Supervision, OCC [Office of the Comptroller of the Currency], the Fed, it wasn't terrific at all times.

The authority was divided, and they did not all play ball well. I think that was one thing that was unfortunate. But this is politics. Regulatory entities want to defend their own turf, so that's somewhat to be expected.

As we talked about, I think the Consolidated Supervised Entity program, while noble in what it set out to do to improve the SEC's regulation of the broker-dealers, was a tough thing in retrospect. Whether it should have done it or not, that's a tough discussion.

If Congress doesn't do what you think it should have done, should you step in and try and patch it up or not? That's a tough discussion. We could have a long talk about that, and it would be pretty detailed.

But beyond that, let's just pick Bear Stearns: Could we have seen that Bear Stearns was going to implode in early 2008? You go back a year and a half and they had their most profitable year ever. If you would have been given the gift of foresight and seen Bear Stearns' demise and you could have gone to the commissioners and said, "Look, Bear Stearns is in trouble with respect to its funding mechanism; this is not sustainable over time." They would have been like: "What are you talking about? They're very profitable. They're doing just fine. They're just like every other investment bank in the world, and they've been operating like this for decades and decades." I think they would have thought you had lost your mind.

It's very hard. The cracks didn't appear until they appeared. It wasn't like it was a teetering framework.

YPFS: **It sounds like information, the lack of, or the self-interest in the parsing of information was a big factor in everything that happened and apparently still happening. Is there any way to improve that flow of information, other than doing your own research?**

Sirri: Well, the research question was one we brought up with respect to credit rating agencies. There's probably no substitute for doing your own research. I think the reason why credit ratings are there is: they're efficient. Why should everyone spend lots of time and money to establish that really, Apple's bonds are a very, very low risk investment? Why does everyone have to do that work on their own, when one or two entities could do it, put a particular label on it, and then everyone can benefit from that information? It's efficient if you can do it with a credit rating agency. The problem is, of course, the conflicts that we've already talked about.

I want to point out, the credit rating agencies shortcomings weren't with respect to their ratings of corporate debt. They failed on certain flavors of mortgage-related structured products. They failed on CMOs, and CDOs, and various kinds of structured finance products. That's where the problem came up. Their basic core models about the solvency of operating corporations seems to be fine. That hasn't been problematic. It was the structured products that caused the issue.

Suggested Citation Form: Sirri, Erik, 2022. "Lessons Learned Interview by Mercedes Cardona, May 25, 2021." Yale Program on Financial Stability Lessons Learned Oral History Project. Transcript. <https://ypfs.som.yale.edu/library/ypfs-lesson-learned-oral-history-project-interview-erik-sirri>

Copyright 2020 © Yale University. All rights reserved. To order copies of this material or to receive permission to reprint any or all of this document, please contact the Yale Program for Financial Stability at ypfs@yale.edu.