Recent Events in the Credit and Mortgage Markets and Possible Implications for U.S. Consumers and the Global Economy

Erik R. Sirri
Director, Division of Market Regulation
U.S. Securities & Exchange Commission

Before the House Financial Services Committee

September 5, 2007

Chairman Frank, Ranking Member Bachus 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 subprime mortgage and credit markets and the Commission's responses.

There is no question that, over the past two months, the default by homeowners with subprime credit on mortgage obligations has had a broad and significant impact. In addition to the difficulties that this has caused borrowers and others in their communities, the sharp rise in defaults has reverberated through the financial markets. Not surprisingly, a variety of securities that referenced pools of subprime mortgages were directly affected. But, in a demonstration of the degree to which markets are linked, the indirect effects were much more broadly visible. As default levels on subprime mortgages exceeded expectations, market participants began to question the value of a variety of financial products. And as valuations came into doubt, liquidity in these products fell sharply, which further complicated the task of valuing particularly complex instruments. Derivatives referencing mortgages were not the only investments that experienced an unexpected decline in liquidity. A variety of other complex financial products that involved non-mortgage assets suffered diminished liquidity as well. As liquidity for structured products diminished, market participants needing to raise funds to meet margin calls and investor redemptions sold less complex financial instruments such as equities and municipal securities, placing downward pressure on prices in those markets. Overall, these dynamics have significantly impacted a wide range of market participants, from individual investors to systemically important financial institutions.

In this environment, as in more benign environments, the Commission seeks to fulfill its basic mandates to protect investors, maintain fair and orderly markets, and facilitate capital formation. In my testimony, I will highlight several ways that the Commission has acted to further these mandates in the context of events in the subprime mortgage and credit markets, for example, by supervising market participants such as broker dealers, investment advisers, and mutual funds, and by facilitating the orderly functioning of the securities markets. Some recent initiatives include: our outreach to a variety of market participants to understand potential exposures to subprime mortgages and related products, and to evaluate operational and liquidity issues that may result in order to assess whether a regulatory response is needed; our regular interaction and cooperation with other regulators in the President's Working Group on Financial Markets (Treasury, Federal Reserve Board, CFTC) to analyze and discuss market conditions; our implementation of rules governing Nationally Recognized Statistical Rating Organizations (NRSROs); our oversight of Consolidated Supervised Entities (CSEs); and our continuing vigorous enforcement of the federal laws in this area.

As I mentioned earlier, the current stresses in the credit markets appear to have emanated from the subprime mortgage market. While the Commission does not directly regulate the origination and sale of mortgage loans, it does have a role when the mortgages are sold to securitization vehicles and when securities are backed by those loans. These securities are sold almost exclusively to institutional investors. In 2004, the Commission adopted for the first time extensive rules – called Regulation AB – comprehensively addressing the registration, disclosure, and reporting requirements for these and other publicly offered asset-backed securities. They require expanded disclosure to investors, including expanded data on the loans underlying the securities, such as information on borrowers' credit scores. In addition, the offering materials are required to include data on the performance of prior securitized pools. The rules also require servicers to provide a report on assessment of compliance with servicing criteria and an auditor to attest to such report. These rules became effective in 2005 and have been phased in over the past few years with full compliance required for all securities sold in 2006 and thereafter.

As a matter of course, the Commission and its staff are in regular contact with the industry to gather information and are coordinating regulatory action as needed. This is particularly true now given the current state of the credit markets. Similarly, we regularly confer with the President's Working Group agencies to discuss market conditions and share observations about issues facing those market participants under the PWG members' respective jurisdictions. All of these discussions and information sharing ultimately lead to a more consistent and coordinated response to the credit market events across markets and their participants.

The Commission also seeks to protect investors through its oversight of investment companies. Investment companies may invest in securities backed by subprime mortgages such as collateralized debt obligations (CDOs) and asset-backed commercial paper. In particular, money funds frequently invest in asset-backed commercial paper, including instruments that provide financing for portfolios of mortgages. Following the emergence in mid-July of significant turbulence in the subprime market, the staff has contacted fund representatives and pricing agents to determine the effect on funds in terms of pricing their portfolio holdings and maintaining sufficient liquidity to meet redemptions. The staff also carefully monitors redemption levels. The staff has made it known that it stands ready to provide assistance, and these contacts with fund representatives are continuing.

In June of this year, the Commission adopted rules governing Nationally Recognized Statistical Rating Organizations or NRSROs. The Commission adopted these rules within the 270 day time frame required by the Credit Rating Agency Reform Act of 2006 (Rating Agency Act), which was enacted by Congress on September 29, 2006. The purpose of the Rating Agency Act is to improve ratings quality for the protection of investors and in the public interest by fostering accountability, transparency, and competition in the credit rating industry. A credit rating agency seeking to be registered as an NRSRO must apply for registration with the Commission, make public in its application certain information to help persons assess its credibility, and implement procedures to manage the handling of material nonpublic information and conflicts of interest. Consistent with the statutory mandate, the rules require disclosure of an NRSRO's conflicts of interest, and proscribe certain conflicts of interest.

The Rating Agency Act and its implementing rules require an NRSRO to disclose a general description of its procedures and methodologies for determining credit ratings. In addition, an NRSRO must make public certain performance measurement statistics including historical downgrade and default rates within each of its credit rating categories. The Commission believes that these disclosures will assist users of credit ratings in assessing the reliability of a NRSRO's ratings over time, and will provide transparency with respect to the accuracy of a NRSRO's ratings in connection with structured finance products related to subprime mortgages.

As you know, in recent months, some have criticized rating agencies for the accuracy of their ratings of certain structured finance products, including residential mortgage-backed securities (RMBS). Critics fault the rating agencies for not taking rating actions sooner on those securities as the performance of underlying assets deteriorated, and for not maintaining appropriate independence from the issuers and underwriters of those securities. Given recent events in the subprime mortgage and credit markets, the Commission has begun a review of NRSRO policies and procedures regarding ratings of RMBS and CDOs, the advisory services they may have provided to underwriters and mortgage originators, their conflicts of interest, disclosures of their rating processes, the agencies' rating performance after issuance, and the meanings of the assigned ratings. As described in the Commission's adopting release in June regarding the NRSRO rules, the Commission is studying whether it would be appropriate to require additional types of performance statistics be disclosed as an alternative, or in addition, to historical default and downgrade rates, which are required to be disclosed under the rules adopted.

Also important to the systemic health of the financial services sector is the vitality of the largest financial services firms. At present, the Commission supervises five securities firms on a consolidated, or group-wide, basis – Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley – also known informally as the CSEs. For such firms, the Commission oversees not only the U.S.-registered broker-dealer, but the consolidated entity, which may include other regulated entities such as foreign-registered broker-dealers and banks, as well as unregulated entities, such as derivatives dealers and the holding company itself. The Commission's CSE program provides holding company supervision in a manner that is broadly consistent with the oversight of bank holding companies by the Federal Reserve. This program's aim is to diminish the likelihood that weakness in the holding company itself or any unregulated affiliates would place a regulated entity, such as a bank or broker-dealer, or the broader financial system, at risk.

CSEs are subject to a number of requirements under the program, including monthly computation of a capital adequacy measure consistent with the Basel II Standard, maintenance of substantial amounts of liquidity at the holding company, and documentation of a comprehensive system of internal controls which are subject to Commission inspection. Further, the holding company must provide the Commission on a regular basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures.

Under the CSE program, in addition to adequate capital, liquidity and liquidity risk management are a critical focus of the Commission's review of broker-dealer holding companies. As you know, liquidity is essential to the viability of all financial institutions. The ability of a firm to withstand market, credit, and other types of stress events is linked not just to the amount of capital the firm possesses, but also to the sufficiency of liquid assets to meet obligations as they arise. Due to the importance of liquidity to the CSE firms, the Commission seeks to determine whether each CSE firm has adopted and follows 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 for a period of at least one year.

Given the recent events in the mortgage and credit markets and their potential impact on financial institutions, the Commission staff is monitoring the liquidity available to the CSE parent with greater frequency than during periods of normal market stress. All the CSE firms maintain pools of liquidity at the parent level, consisting of cash and highly liquid securities. Access to high levels of liquidity is particularly important in times of abnormally high market stress; so we are monitoring CSE firms' access to their usual sources of both secured and unsecured funding. In addition, the Commission staff is also monitoring contingencies that might place additional strains on the balance sheets of the CSE firms. These include the potential unwinding of off-balance sheet funding structures, such as conduit structures. We also are monitoring the potential funding requirements for certain leveraged lending commitments made by the CSE firms, typically to fund corporate acquisitions or restructurings.

In addition to liquidity monitoring, the Commission staff is engaged in ongoing oversight of the valuation processes at CSE firms. The CSE firms mark most positions to market, which is a critical governance and risk management process. Current market conditions have increased the challenge of marking certain complex positions to market. We are reviewing the valuation methods used by each firm to ensure that they are robust and consistently applied across such firm's businesses.

Finally, critical components of the Commission's efforts to protect investors and the integrity of our trading markets are our examination program that examines registered securities firms for compliance with federal securities laws, and our enforcement program that investigates indications of violations of the federal securities laws. The Commission has been, and will continue to be, vigilant in bringing cases for fraud and other violations of the securities laws that implicate the integrity and fairness of our trading markets.

I hope my remarks today have highlighted the Commission's ongoing and heightened activities in light of the recent mortgage and credit market events. I believe the regulatory community must also continue to engage with the systemically important banks and securities firms, encouraging additional efforts to improve and expand risk management capabilities. We will work with our PWG colleagues and other market participants to further this agenda.

Thank you for the opportunity to testify before you today. I would be happy to answer any questions you might have.