Speech by SEC Staff:
Remarks at the National Economists Club: Securities Markets and Regulatory Reform

by

Erik R. Sirri[1]

Director, Division of Trading and Markets
U.S. Securities and Exchange Commission

Washington, D.C.
April 9, 2009

Thank you for the kind introduction. It is a pleasure to be here with you today. Before I begin, it is my obligation to remind you that my remarks represent my own views and not necessarily the views of the Commission, the individual Commissioners or my colleagues on the Commission staff.

We are in the midst of one of the most serious financial crises since the 1930s. Systemically important institutions across all three financial sectors — banking, insurance and securities — have either collapsed into bankruptcy or required massive government support to stay afloat. The survivors and newcomers must instill within their firms a culture that promotes long-term stability through prudent risk-taking and rejects the inclination to "bet the company" for short-term and ultimately unsustainable returns. Financial supervisors also bear a responsibility to learn from these events and improve their practices and, where necessary, strengthen oversight of activities that can put a firm at risk of failure.

To this end, we supervisors must seek to identify the core reasons why firms such as Bear Stearns, Lehman Brothers, Wachovia, Washington Mutual, AIG, and Citigroup experienced significant stress or collapsed. In this regard, the Commission is working closely with the other financial supervisors through the President's Working Group on Financial Markets, the Financial Stability Forum and other initiatives to gain an understanding of what went wrong and develop coordinated and targeted regulatory responses.

Today, I want to discuss a Commission action that I believe has been unfairly characterized as being a major contributor to the current crisis. I am referring to the Commission's 2004 rule amendments to the broker-dealer net capital rule that established the consolidated supervised entity (CSE) program. Since August 2008, commenters in the press and elsewhere have suggested that the 2004 amendments removed a leverage restriction that had prevented the firms from taking on debt that exceeded more than twelve times their capital and, as a consequence, the Commission allowed these firms to increase their debt-to-capital ratios to unsafe levels well-above 12-to-1, indeed to 33-to-1 as some have suggested. These commenters point to the 2004 amendments as a significant factor leading to the demise of Bear Stearns. While this theme has been repeated often in the press and elsewhere, it lacks foundation in fact.

The 2004 Amendments Did Not Undo Leverage Restrictions

First, and most importantly, the Commission did not undo any leverage restrictions in 2004. Rather, I believe that the Commission sought to fill a gap in the statutory system of supervision by offering to the US investment banks, for the first time, a regime of comprehensive consolidated oversight by virtue of its conditions on the broker-dealers. Given pressures from Europe, it was expected that the five largest US investment banks would make the necessary one-time election to be supervised under this regime. Thus the Commission effectively added an additional layer of supervision at the holding company where none had existed previously. While certain changes were made in 2004 to the net capital rule to conform more closely with the methods of computing capital adequacy that would be applied at the holding company, the changes were unrelated to the "12-to-1" restriction.

New Requirements for the Investment Bank Holding Company

Through conditions on broker-dealers, the 2004 amendments provided for information on the CSE investment bank holding companies to be reported in a manner consistent with the capital adequacy standards for US (and international) bank holding companies. The capital adequacy standard is known as the "Basel Accord." Specifically, under these amendments, a CSE investment bank holding company would report allowable capital and charges for market, credit, and operational risk using standards in the Basel Accord. In addition, for the first time, the Commission had the ability to examine the activities of the investment bank holding companies taking place outside the U.S. broker-dealer subsidiary. This allowed Commission staff to get a direct view of the risk taking (and corresponding risk management controls) of the entire enterprise.

Thus, the Commission did not eliminate or relax any requirements at the holding company level because previously there had been no requirements. In fact, the Commission increased its supervisory access to the CSE investment bank holding companies.

Changes to the Broker-dealer Net Capital Rule

The net capital rule requires a broker-dealer to undertake two calculations: (1) a computation of the minimum amount of net capital the broker-dealer must maintain; and (2) a computation of the actual amount of net capital held by the broker-dealer. The "12-to-1" restriction is part of the first computation and it was not changed by the 2004 amendments. The greatest changes effected by the 2004 amendments were to the second computation of actual net capital.

Under the net capital rule, a broker-dealer calculates its actual net capital amount by starting with net worth computed according to generally accepted accounting principles and then adding to that amount qualifying subordinated loans. Next the broker-dealer deducts from that amount illiquid assets such as fixed assets, goodwill, real estate and unsecured receivables. This leaves the broker-dealer with what is known as tentative net capital, which, generally consists of liquid securities positions and cash. The final step is to take percentage deductions (haircuts) from the securities positions. The percentage deductions are prescribed in the rule and based on, among other things, the type of security (e.g., debt or equity), the type of issuer (e.g., US government, public company), the availability of a ready market to trade the security and, if a debt security, the time to maturity and credit rating. The amount of the deduction is based on the inherent risk in the type of security. For example, a US government security with a maturity of between 9 and 12 months has a haircut of 1% whereas one with a maturity of 25 years or more has a haircut of 6%. An exchange traded equity security has a haircut of 15%. The amount left after deducting the haircuts from the securities positions is the broker-dealer's net capital. This actual amount of net capital needs to equal to or greater than the required minimum amount that is calculated using a different process.

The 2004 amendments changed two elements of the process for computing actual net capital. The more significant change permitted the CSE broker-dealers to reduce the value of the securities positions (the last step in computing actual net capital) using statistical value-at-risk (VaR) models rather than the prescribed percentage haircuts in the net capital rule. This is how commercial banks — under the Basel Accord — had been computing market risk charges for trading positions since 1997. In addition, a special class of SEC-registered broker-dealers that limited their business solely to dealing in over-the-counter derivatives had been permitted to use VaR models to compute haircuts since 1998.[2]

Because the CSE broker-dealers were permitted to use modeling techniques to compute market and credit risk deductions, the Commission imposed a requirement that they file an early warning notice if their tentative net capital fell below $5 billion. This became their effective minimum tentative net capital requirement — under the previous requirement the minimum was $250,000 in net capital (which could be increased to no more than $1,000,000 for market making activity). The $5 billion minimum amount was comparative to the amount of tentative net capital they maintained prior to the 2004 amendments. It was designed to ensure that the use of models to compute haircuts would not substantially change the amount of capital maintained by the broker-dealers. Some commenters have suggested in the press and elsewhere that the use of VaR models allowed the broker-dealer subsidiaries to significantly reduce their capital levels by paying large dividends to their holding company parents. This simply is not the case. The levels of capital in the broker-dealer subsidiaries remained relatively stable after they began operating under the 2004 amendments, and, in some cases, increased significantly.

The "12-to-1" Restriction Was Not Addressed by the 2004 Amendments

The second fatal flaw to the theory about the 2004 amendments is that, as noted above, the "12-to-1" restriction was not even effected by the 2004 amendments. Moreover, even if it had been eliminated, the CSE broker-dealers would not have been impacted because they had been using a different financial ratio since the late 1970s.

As discussed above, the net capital rule requires a broker-dealer to undertake two computations: one to determine required net capital and one to determine actual net capital. The first computation — required net capital — requires the broker-dealer to use one of two financial ratios prescribed in the rule. The first ratio prohibits a broker-dealer from having aggregate indebtedness that exceeds fifteen times its net capital. There is a corresponding "early warning" rule that requires the broker-dealer to file a notice with the Commission if its aggregate indebtedness exceeds twelve times its net capital. This effectively makes the requirement a 12-to-1 aggregate indebtedness-to-net capital requirement. This financial ratio generally is used by smaller broker-dealers with simpler balance sheets and that do not carry customer accounts.

The second financial ratio requires a broker-dealer to maintain a minimum level of net capital equal to 2% of its customer debit items. This ratio is used by broker-dealers that carry customer accounts — generally the largest broker-dealers — because it relates their net capital requirement to the amount of customer obligations ("debit items") they originate. Customer debit items are obligations of customers to the broker-dealer arising from, for example, margin loans. The "early warning" rule requires notice when net capital falls below 5% of customer debits making that ratio the effective minimum requirement. The broker-dealer subsidiaries of the investment banks used the 2% of customer debit items ratio to compute their minimum net capital since the 1970s.

Moreover, the 2004 amendments did not eliminate these ratios from the net capital rule, nor exempt any broker-dealers from adhering to them. As discussed above, the changes to the net capital rule primarily impacted the computation of actual net capital. Thus, the broker-dealers subject to the 2004 amendments continued to compute their minimum net capital requirement using one of the two financial ratios prescribed in the rule and, as noted above, they used 2% of customer debits ratio (not the "12-to-1" restriction).

The "12-to-1" Restriction was not an Absolute Constraint on Leverage

The third fatal flaw in the leverage theory is that the "12-to-1" restriction — incorrectly characterized as a victim of the amendments — was not an absolute constraint on leverage (i.e., it would not have accomplished the results the author suggests). As discussed above, broker-dealers using the "12-to-1" financial ratio are prohibited from allowing their aggregate indebtedness to exceed 15 times their net capital (actually 12 times given the early warning requirement). Viewed another way, they must maintain a minimum amount of net capital equal to at least 1/15 (6.67%) of their total aggregate indebtedness. The net capital rule defines "aggregate indebtedness" and, in doing so, specifies the types of obligations that are and are not included in the calculation. Significantly, the definition excludes obligations that are fully collateralized by a liquid proprietary security. Thus, securities financing transactions are not included in a broker-dealer's aggregate indebtedness for purposes of calculating the minimum requirement. This means that the aggregate indebtedness standard does not limit the amount of assets the broker-dealer could take on through financing transactions. Substantial portions of the balance sheets of the CSE broker-dealers were comprised of these types of financing transactions.

A Limit on the Broker-dealer Cannot Constrain the Parent

The fourth fatal flaw to the theory is the notion that a requirement applicable to an investment bank's broker-dealer subsidiary could somehow constrain the leverage of the parent.

The investment banks within the CSE program were global financial institutions with operating subsidiaries located around the world. The net capital rule only applied to the US broker-dealer subsidiary of the investment banks. Many of the investment banks' activities — including those with the highest levels of inherent risk — such as OTC derivatives dealing and the originating and warehousing of real estate and corporate loans occurred outside the US broker-dealer subsidiary. The net capital rule alone could not limit the ability of the investment banks to undertake these activities outside the US broker-dealer subsidiary.

Leverage Restrictions can Provide False Comfort

Finally, given the all the discussion about the "utility" of leverage ratios, I believe a little perspective is in order. While the attraction of leverage tests is clear, their implementation is anything but, and can easily provide false comfort. For example, two firms with identical 33-to-1 leverage ratios (assets-to-net worth) may have very different risk profiles. The degree of risk arising from leverage is dependent on the type of assets and liabilities making up the balance sheet. Assets that are highly liquid can be sold quickly to close out financing and, thereby, reduce leverage. The risk arises from assets that cannot be quickly sold or whose sale will cause markets to drop and that are financed with short-term loans.

While some of the investment banks had leverage ratios on the order of 33-to-1, substantial portions of their balance sheets were comprised of secured financing transactions that could be closed out fairly quickly allowing them to de-lever without incurring large losses. For example, they had large matched book repo businesses where the assets were government securities and the liabilities obligations secured by government securities. These transactions can be liquidated or closed out without much difficulty. In addition, the investment banks maintained large stock borrow/stock loan books, which also can be liquidated or closed out in a relatively short time. Similarly, substantial portions of their balance sheets were allocated to customer margin lending, which — because of over-collateralization — were highly liquid assets. Viewing the balance sheets on a risk-adjusted basis to account for the relative safety of these positions would reduce the leverage ratios substantially.

Conclusion

In the coming months, I anticipate that debate over the proper regulation of financial institutions will rage on. The various proposals will provide all of us with an opportunity to evaluate aspects that require improvement and to reflect on that which has worked. I look forward to hearing your views on these important issues. Thank you.

Endnotes

[1]The Securities and Exchange Commission disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author's views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

[2]The second change related to the treatment of unsecured receivables. As described above, a broker-dealer computes net capital by starting with net worth, adding qualified subordinated loans and then deducting illiquid assets such as fixed assets, goodwill, real estate and unsecured receivables. CSE broker-dealers continued to compute net capital by deducting illiquid assets in full except for one type of unsecured receivable: receivables from OTC derivative counterparties. In the case of OTC derivative receivables, the amendments permitted the CSE broker-dealers to take a deduction based on the creditworthiness of the counterparty using credit-modeling techniques approved for commercial banks in the Basel Accord. The amount of receivables subject to this new provision was relatively small as compared with the amount of securities positions subject to the VaR model treatment.

http://www.sec.gov/news/speech/2008/spch040909ers.htm