

MEMO# 22251

February 19, 2008

SEC Outlines Approach to Recent Events in the Bond Industry

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TO: MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 6-08
FIXED-INCOME ADVISORY COMMITTEE No. 3-08
SEC RULES MEMBERS No. 17-08 RE: SEC OUTLINES APPROACH TO RECENT EVENTS IN THE BOND INDUSTRY

On January 31, 2008, SEC Chairman Cox sent a letter to Chairman Paul Kanjorski responding to his inquiry regarding the steps the SEC is taking to understand the potential effects of the downgrades in the ratings of monoline insurers for all participants in the financial markets. [\[1\]](#) As part of his response, Chairman Cox enclosed a memorandum prepared by the Division of Trading and Markets with his letter. The letter and memorandum are attached below.

On February 15, 2008, Erik Sirri, Director of the Division of Trading and Markets at the SEC, testified before Congress on "The State of the Bond Insurance Industry." [\[2\]](#) Director Sirri also spoke about the efforts the SEC staff has taken to assess and monitor the effects of downgrades of the monoline insurers on the financial markets and its participants. [\[3\]](#) He began his testimony by stating that the SEC does not regulate monoline insurers. He testified, however, that there are various ways that the securities markets and their participants, which the Commission does regulate, may be impacted by ratings downgrades of monoline insurers. He stated that principal among those are consolidated supervised entities (or "CSEs"), [\[4\]](#) municipal securities issuers and dealers, municipal bond and money market funds, and credit rating agencies. The most significant aspects of his testimony are summarized below.

CSEs

Director Sirri described the staff's supervisory program for CSEs as primarily being concerned with the risks that counterparties and market events potentially pose to the CSE firms specifically and, through the CSEs, to the financial system. Specifically, the focus of the program is the financial and operational condition of the holding company, and monitoring for risks that might place regulated entities within the group or the broader financial system at risk.

Director Sirri outlined the CSEs' current and potential exposures to monoline insurers as falling into three categories: credit risk, market risk, and liquidity risk. In terms of credit risk, he observed that CSE firms execute derivative trades with monolines, generating direct counterparty risk. He noted that they also bear indirect counterparty credit risk exposure through derivative transactions with municipalities that are "wrapped," or guaranteed, by monolines. In terms of market risk, Director Sirri explained that CSEs are exposed to the perceived creditworthiness of monolines through "wrapped" securities they may have in inventory and through trading and hedging positions linked to monolines' creditworthiness.

In terms of liquidity risk, he stated that CSEs have implicit and explicit exposure to monolines through their activities as remarketing agents for certain products. Director Sirri concluded that based on the information available to the SEC staff through its supervision of the firms, the staff believes that the CSEs have adequate capital and liquidity to deal with the consequences of the downgrade or even default of one or more monoline insurers.

Municipal Securities Market

Director Sirri stated that the SEC staff is closely monitoring the developments in the municipal securities markets related to the concerns about the creditworthiness of the monoline insurers. He noted that the issuers and conduit borrowers with primary responsibility for repayment of insured securities generally have investment grade credit ratings or equivalent credit strength, mitigating the impact of downgrades of the insurance providers. He also stated that the SEC is specifically concerned about: the potential impact of downgrades of securities held by municipal money market and other funds (discussed below); possible termination events of liquidity instruments; termination events or collateral posting events of swaps and other derivatives entered into by municipal issuers and conduit borrowers triggered by rating downgrades of either insurers or swap counterparties; and difficulties experienced by some state and local government investment pools. Director Sirri explained that the staff is maintaining close contact with market participants to keep abreast of market volatility, pricing, and other issues.

Director Sirri next observed that auctions of auction-rate securities in the municipal and corporate markets have failed, resulting in an increased interest in converting auction-rate bonds into variable-rate bonds backed by letters of credit or other types of credit enhancement or fixed rate bonds. He also endorsed Chairman Cox's letter to Congress last summer and the SEC staff whitepaper advocating changes in the disclosure regime applied in the municipal securities market. [\[5\]](#) He emphasized that the SEC's regulatory authority was limited over states and political subdivisions issuing municipal securities and conduit borrower that are not public companies.

Mutual Funds

Director Sirri stated that the SEC staff is closely monitoring developments with respect to bond insurers and their actual or potential effects on municipal money market funds, municipal bond funds, and other types of investments. He noted that mutual funds, including money market funds, hold 35 percent of all municipal bonds, and closed-end investment companies hold 2 percent. He also noted that only a small percentage of tax-exempt funds principally invest their assets in municipal bonds that carry insurance issued by the monolines.

Director Sirri also walked through the Rule 2a-7 regulatory regime for money market funds. He said the staff has been in regular contact with fund management companies, and described some of the actions fund managers are undertaking to respond to the current market risks. He highlighted the fact that fund managers have reported that they have been discussing their actions with fund boards of directors. He also emphasized that the SEC –as regulator and in its oversight function – must be careful not to trigger unnecessary sales of securities in the interest of the integrity of the municipal marketplace. Director Sirri concluded with a list of possible effects on funds of monolines creditworthiness.

Credit Rating Agencies

Director Sirri briefly described the SEC's oversight role regarding registered credit rating agencies. He stated that last summer the SEC staff began examinations of whether the credit rating agencies diverged from their stated methodologies and procedures for determining credit ratings in order to publish a higher rating. He said the staff also is focusing on whether the credit rating agencies followed their stated procedures for managing conflicts of interest inherent in the business of determining credit ratings for residential mortgage-backed securities. Director Sirri stated that the examinations would seek to determine whether the credit rating agencies' role in the process of bringing residential mortgage-backed securities to market impaired their ability to be impartial.

Director Sirri noted that the SEC staff has worked with the Federal Reserve Board, the UK's FSA, the OCC, the Treasury, and others in reviewing all of these issues.

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[Attachment](#)

endnotes

[1] See Letter from Christopher Cox, Chairman, SEC to Paul E. Kanjorski, Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Entities, dated January 31, 2008.

[2] See Testimony, "The State of the Bond Insurance Industry" by Erik Sirri, Director of the Division of Trading and Markets, SEC, before the U.S. House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services. The testimony may be found at <http://www.sec.gov/news/testimony/2008/ts021408ers.htm>. Director Sirri is head of the SEC task force reviewing the subprime crisis.

[3] The testimony encompasses in its entirety, and expands upon, the statements made in the memorandum delivered to Chairman Kanjorski.

[4] CSEs are investment bank holding companies that the SEC supervises on a consolidated basis. They include Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch and Morgan Stanley. All five of the CSEs are described as of potentially systemic importance to the broader financial system because they trade on a wide range of financial products, are connected through counterparty relations to other large institutions, and provide services to a variety of market participants.

[5] See Memorandum to Fixed-Income Advisory Committee No. 18-07, SEC Rules Members No. 96-07, Equity Markets Advisory Committee No. 42-07, Money Market Funds Advisory Committee No. 20-07 and Inst. Money Market Funds Advisory Committee No. 21-07, dated July 27, 2007 [21400].

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