MEMORANDUM

TO: Chairman Cox

FROM: Erik R. Sirri, Director E RS
Division of Trading and Markets

DATE: January 30, 2008

RE: Monitoring of Monoline Insurers

You have asked the staff to apprise you of how monoline insurers impact the securities markets and what efforts the staff has made to assess and monitor the impact of potential ratings downgrades of such insurers. As a threshold matter, the Commission does not regulate monoline insurers; rather this is the domain of state insurance regulators. However, 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. Principal among these are certain systemically important financial services firms (known as CSEs), municipal securities issuers and dealers, and municipal money market funds, all of which engage with monoline insurers, either directly or indirectly, and may be affected by recent events.

Commission Supervision of CSEs and Exposure to Monolines

The Commission supervises certain investment bank holding companies, known as consolidated supervised entities (CSEs), on a consolidated basis. The focus of this prudential regime 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. At present, five internationally active securities firms are supervised under this regime: Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley.

All five of the CSEs are of potentially systemic importance, trading a wide range of financial products, connected through counterparty relationships to other large institutions and providing services to a variety of market participants. The Commission's supervision of CSEs is primarily concerned with the risks that counterparties and market events potentially pose to the CSE firms specifically and, through the CSEs, to the financial system. 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.

The Commission's CSE program supervises holding companies in a manner similar to the Federal Reserve's oversight of bank holding companies. 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. 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.

In addition to its focus on liquidity and liquidity risk management, Commission staff meets regularly with senior managers of critical control functions. Specifically, Commission staff meets monthly with senior risk managers focused on market and credit risk exposures, and meets quarterly with senior financial controllers, senior treasury personnel, and senior internal audit personnel.

In the course of its frequent contact with CSE firms, the Commission staff has discussed and reviewed the CSEs' current and potential exposures to monoline insurers. These exposures fall into three broad categories: credit risk, market risk, and liquidity risk.

In terms of credit risk, many CSE firms execute derivative trades with monolines, generating direct counterparty credit risk exposure. For instance, a CSE may purchase credit default swap protection from a monoline. In such transactions, should the credit underlying the CDS contract default, the monoline would be expected to make a protection payment to the CSE. CSE firms also bear indirect counterparty credit risk exposure to monolines through derivative transactions with municipalities that are "wrapped," or guaranteed, by monolines.

In terms of market risk, the CSE firms are exposed to the perceived creditworthiness of monolines through "wrapped" securities they may have in inventory. These include municipal securities, tender option bonds, auction rate securities, and some mortgage products. In addition, most of the CSE firms have trading and hedging positions linked to monolines' creditworthiness, e.g., credit default swaps referencing monoline debt.

Finally, the CSE firms also have implicit and explicit liquidity risk exposure to monolines through their activities as remarketing agents for certain products, such as auction rate securities and tender option bonds. These programs fund longer-term obligations, such as municipal debt, with liabilities that have the characteristics of shorter-term paper. Often, monolines wrap the underlying longer-term obligations. Some of these programs are required to have liquidity backstops. Thus, a CSE may bear liquidity risk explicitly by acting as the liquidity provider for a particular program, e.g., for tender option bonds or variable rate demand notes. Even where that liquidity backstop is provided by a third party or where a backstop is not required, a CSE bears implicit liquidity risk when acting as the remarketing agent on a program, as it may be compelled to support the program and take securities on balance sheet out of client and franchise considerations.

Based on Commission staff's recent meetings and discussions with CSE firm risk managers, treasurers, and business unit personnel, the CSE firms are highly aware of and actively managing their exposures to the monoline sector.

The Commission staff is also in regular communication with other financial services regulators, particularly the Federal Reserve Bank, which directly oversees most of the systemically important commercial banks, the OCC, which oversees nationally charted commercial banks, and the UK's Financial Services Authority.

Municipal Securities Market

Commission staff is also monitoring developments in the municipal securities markets related to the actual or potential ratings downgrades of bond insurers and the associated downgrades and withdrawals of ratings on bond issues in the municipal securities market.[1] In recent years, about half of all municipal securities offerings have been insured; insurance is also obtained in the secondary market. Although such downgrades will negatively affect the price of most bonds insured by companies that have been downgraded, the issuers and conduit borrowers with primary responsibility for repayment of these securities generally have investment-grade credit ratings or equivalent credit strength, mitigating the impact of downgrades of insurance providers.

Market participants have informed us that a few auctions of auction-rate securities in the municipal and corporate markets may have attracted too few bidders to establish a clearing rate as a result of turmoil in the credit markets, resulting in higher interest rates on those securities for a period of time. We understand that some municipal issuers and conduit borrowers have expressed an increased interest in converting their auction rate bonds into variable-rate bonds backed by letters of credit or other types of credit enhancement or fixed rate bonds. However, heavy demand for such credit enhancement instruments and market concerns may have made them more difficult and time consuming to obtain.

The National Association of Bond Lawyers recently asked Commission staff for guidance on the potential impact of failures to file material event notices about

---

[1] There are approximately $2.4 trillion of municipal securities outstanding. Annual trading volume is about $6 trillion.

downgraded issues pursuant to Exchange Act Rule 15c2-12.[2] Commission staff expects to issue such guidance shortly. We are also concerned about the potential impact of downgrades of securities held by municipal money market and other funds, possible 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 problems experienced by some state and local government investment pools. We are maintaining close contact with market participants to keep abreast of market volatility, pricing, and other issues.

The securities laws limit the extent of Commission regulatory authority over states and political subdivisions issuing municipal securities and conduit borrowers that are not public companies. Municipal securities are exempt from the registration and reporting provisions of the federal securities laws, and the Commission cannot specify line-item disclosure requirements or review disclosure documents in connection with offerings of municipal securities. Issuers and other participants in municipal securities offerings are, however, subject to the antifraud provisions of the federal securities laws, which prohibit materially misleading disclosures in connection with the offer, purchase, and sale of securities.

The disclosures made by private conduit borrowers with primary responsibility for repayment of many securities in the municipal market are often much less comprehensive than disclosures made by comparable entities in the corporate market. In fact, some conduit borrowers, in offerings backed by letters of credit, bond insurance, or other forms of credit enhancement, make no disclosures about themselves in their offering documents on the theory that the investors are looking solely to the credit enhancer for payment. Although a prior Commission release expresses the view that the presence of credit enhancements generally would not be a substitute for material disclosure concerning the primary obligor on municipal bonds,[3] some offerings do not contain such disclosures.

As you previously noted in your letter to the heads of several Congressional committees last summer, disclosure in the municipal securities market, particularly in the secondary market, is substantially less comprehensive and less readily available than disclosure by public reporting companies. Despite the size and importance of this market, it lacks a variety of the systemic protections found in many other sectors of the U.S. capital markets. The recent problems of municipal bond insurers and the direct and indirect impact on municipal bond investors illustrate once again some of the shortcomings of the regulatory structure of this market.

---

2 We believe that more than 130,000 such notice filings would be required for Fitch's downgrade of Ambac alone.

3 Securities Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 (July 10, 1989).

Municipal Money Market Funds

The Division of Investment Management is monitoring the affects on municipal money market funds related to the ratings or potential ratings downgrades of bond insurers. Municipal ("tax-free") money market funds own municipal bonds, about 40 percent of which we estimate are "wrapped," or guaranteed, by monolines. These securities include variable rate demand notes and tender option bonds that have liquidity backstops provided by a CSE or other large financial institution. In addition to providing a source of cash to satisfy redemptions by fund shareholders, these liquidity features operate to shorten the municipal bonds' maturity and make them appropriate investments for a money market fund.

In most cases, the liquidity backstops require that the municipal bonds maintain certain ratings, which may be threatened by the ratings downgrades of the monolines. The Division of Investment Management has been in regular contact with fund management companies, which are aware of these risks and have taken steps intended to protect the funds from the loss of these liquidity backstops. Fund managers have begun to examine the credit quality of the underlying municipal issuers and evaluate the risks of continuing to hold the instruments should they no longer be able to rely on bond insurance. Where the underlying credits are unsatisfactory, some fund managers are attempting to obtain alternative credit support or are selling the instruments (typically to remarketing agents). Where the underlying credits are satisfactory, fund managers are seeking amendments to program documentation that will preserve the liquidity feature in reliance on ratings issued to the municipal issuer (without regard to the ratings issued to the monoline insurer). Fund managers report that they have been discussing their actions with fund boards of directors which are keenly interested in these developments.

Losses by a money market fund, including a municipal money market fund, would be reflected by the fund re-pricing its securities below $1.00 ("breaking the buck"), an event that has occurred only once since the development of money market funds in the 1970s. The Division of Investment Management is unaware of any municipal money market fund currently threatened with breaking the buck as a result of recent downgrading and potential downgrading of monoline insurers.

cc: Peter Uhlmann
Paul Wilkinson
Jonathan Burks