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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

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SAN FRANCISCO

March 20, 2008

Dr. Nout Wellink  
Chairman  
Basel Committee on Banking Supervision  
Centralbahnplatz 2  
CH-4002 Basel  
Switzerland

Re: Sound Practices for Managing Liquidity in Banking Organizations

Dear Dr. Wellink:

I am writing in connection with the announcement by the Basel Committee on Banking Supervision that your Working Group on Liquidity intends to update the February 2000 guidance entitled "Sound Practices for Managing Liquidity in Banking Organizations" in light of the recent market turmoil. I strongly agree with you that the events earlier this month leading up to the acquisition of Bear Stearns by JP Morgan Chase highlight the importance of liquidity management in meeting obligations during stressful market conditions.

I also strongly support your decision to update the guidance for managing liquidity in banking organizations.

To assist the Working Group in its task, this letter provides you with specific information regarding Bear Stearns' capital and liquidity positions in the days preceding its transaction with JP Morgan Chase. I hope this very recent data will prove valuable as the Working Group examines its guidance on liquidity management practices.

As you will see, the conclusion to which these data point is that the fate of Bear Stearns was the result of a lack of confidence, not a lack of capital. When the tumult began last week, and at all times until its agreement to be acquired by JP Morgan Chase during the weekend, the firm had a capital cushion well above what is required to meet supervisory standards calculated using the Basel II standard.

Specifically, even at the time of its sale on Sunday, Bear Stearns' capital, and its broker-dealers' capital, exceeded supervisory standards. Counterparty withdrawals and credit denials, resulting in a loss of liquidity – not inadequate capital – caused Bear's demise.

It is worth noting, however, that net capital rules are designed to preserve investors' funds and securities in times of market stress, and they served that purpose in this case. This investor protection objective was amply satisfied by the current net capital regime, which -- together with the protection provided by the Securities Investor Protection Corporation (SIPC) and the requirement that SEC-regulated broker-dealers segregate customer funds and fully-paid securities from those of the firm -- worked in this case to fully protect Bear's customers.

### **Data Concerning Bear Stearns' Liquidity and Broker-Dealer Regulatory Capital**

The following data provided to our Division of Trading and Markets by Bear Stearns describe the firm's capital and liquidity position at the holding company level prior to and during last week's events, and the capital in the firm's two SEC-registered broker-dealers:

#### *BSSC Net Capital (\$ billion)*

	<u>Required</u>	<u>Excess</u>
31-Dec	1.26	3.38
31-Jan	1.30	2.92
14-Mar	1.27	>2.00 (estimated)

#### *BS&Co. Net Capital (\$ billion)*

	<u>Required</u>	<u>Excess</u>
31-Jan	0.56	2.71
14-Mar	0.58	> 2.00 (estimated)

#### *Liquidity Pool (\$ billion)*

31-Jan	8.4
4-Feb	12.8
5-Feb	15.8
6-Feb	17
7-Feb	16.1
22-Feb	15
23-Feb	15
24-Feb	15
25-Feb	18
26-Feb	19
27-Feb	19
28-Feb	19
29-Feb	19
1-Mar	19

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2-Mar	19
3-Mar	20
4-Mar	20.1
5-Mar	21
6-Mar	21
7-Mar	18
8-Mar	18
9-Mar	18
10-Mar	18.1 (15.1 adjusted for customer protection rule)
11-Mar	11.5 (15.8 adjusted for customer protection rule)
12-Mar	12.4
13-Mar	2

*Holding Company Capital Ratio*

31-Dec	13.7%
31-Jan	14.4%
29-Feb	13.5% (estimated)

The data above show that Bear Stearns' registered broker-dealers were comfortably in compliance with the SEC's net capital requirements, and in addition that Bear Stearns' capital exceeded relevant supervisory standards at the holding company level. Specifically, throughout the week of March 10 until the closing of the JP Morgan Chase transaction on Sunday March 16, Bear Stearns had a capital ratio of well in excess of the 10% level used by the Federal Reserve Board in its "well-capitalized" standard.

The data above also reflect the fact that the holding company had a pool of high quality, highly liquid assets of over \$18 billion as of the morning of March 11. This was consistent with what the SEC had seen over the preceding weeks, during which SEC staff – both on-site and at headquarters – monitored the capital and liquidity positions of all the CSEs, in the case of Bear Stearns on a daily basis.

In accordance with customary industry practice, Bear Stearns relied day-to-day on its ability to obtain short-term financing through borrowing on a secured basis. Beginning late Monday, March 10, and increasingly through the week, rumors spread about liquidity problems at Bear Stearns, which eroded investor confidence in the firm. Notwithstanding that Bear Stearns continued to have high quality collateral to provide as security for borrowings, market counterparties became less willing to enter into collateralized funding arrangements with Bear Stearns. This resulted in a crisis of confidence late in the week.

In particular, counterparties to Bear Stearns were unwilling to make secured funding available to Bear Stearns on customary terms.

This unwillingness to fund on a secured basis placed enormous stress on the liquidity of the firm. On Tuesday, March 11, the holding company liquidity pool declined from \$18.1 billion to \$11.5 billion. This improved on Wednesday, March 12, when Bear

Stearns' liquidity pool increased by \$900 million to a total of \$12.4 billion. On Thursday, March 13, however, Bear Stearns' liquidity pool fell sharply, and continued to fall on Friday. The market rumors about Bear Stearns liquidity problems became self-fulfilling. On Sunday, March 16, Bear Stearns entered into the transaction with JP Morgan Chase. These events illustrate just how critical not just capital, but liquidity is to the viability of financial firms and how the evaporation of market confidence can lead to liquidity being impaired.

### **The SEC's Consolidated Supervised Entity Program Use of the Basel Standards**

I also want to provide the Working Group with the following contextual information to provide a better understanding of how the SEC has incorporated the Basel standards into our supervision of large broker-dealers.

Under the SEC rules, a broker-dealer's holding company and its affiliates (known as consolidated supervised entities, or CSEs) may elect to be subject to group-wide SEC supervision. In electing to operate under this program, the holding company must, among other things, compute on a monthly basis its group-wide capital in accordance with the Basel standards. Further, the holding company must provide the Commission on a periodic basis with extensive information regarding its capital and risk exposures, including market and credit risk exposures, as well as an analysis of the holding company's liquidity risk.

With respect to computing capital at the holding company level, CSEs are expected to maintain an overall Basel capital ratio at the consolidated holding company level of not less than the Federal Reserve Bank's 10% "well-capitalized" standard for bank holding companies. CSEs provide monthly Basel capital computations to the SEC. The CSE rules also provide that an "early warning" notice must be filed with the SEC in the event that certain minimum thresholds, including the 10% capital ratio, are breached or are likely to be breached.

In addition to capital, liquidity and liquidity risk management are of critical importance to broker-dealer holding companies. Due to the importance of liquidity to the firms, CSEs have adopted 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 where access to unsecured funding is not available for a period of at least one year.

In evaluating the liquidity risk management processes at a CSE, the SEC staff considers not only capital but also the assets supported by the capital. Applying such a "liquidity standard" alongside a capital standard is critical to the effective supervision of a CSE. To assess the adequacy of liquid assets, the SEC staff takes a scenario-based approach. The CSEs have developed a set of scenarios for use internally in assessing liquidity. A key assumption underlying the scenario analysis is that during a liquidity

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stress event, the holding company would not receive additional unsecured funding but would need to retire maturing unsecured obligations.

Further, firms generally assume that during a liquidity crisis, assets would not be sold to generate cash. Another premise of this liquidity planning is that any assets held in a regulated entity are unavailable for use outside of the entity to deal with weakness elsewhere in the holding company structure, based on the assumption that during the stress event, including a tightening of market liquidity, regulators in the US and relevant foreign jurisdictions would not permit a withdrawal of capital. There are also considerations as to the degree a firm relies on overnight and other short-term funding versus long-term funding.

I hope this information will be of use to the Working Group as it revises its liquidity guidance for banks. I would be pleased to provide additional information or otherwise contribute to the examination of banks' liquidity management that the Working Group is undertaking.

Sincerely,

A handwritten signature in black ink, appearing to read "Chris Cox", written over a large, stylized cursive flourish.

Christopher Cox  
Chairman

cc: Michel Prada, Chairman, Technical Committee of the International Organization of Securities Commissions (IOSCO)

Tokio Morita, Chairman, IOSCO Standing Committee Three

Mario Draghi, Chairman, Financial Stability Forum