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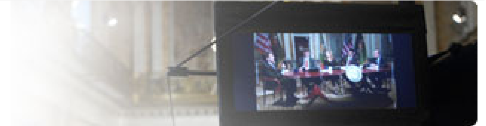

Assistant Secretary Anthony W. Ryan Remarks before the National Association of State Treasurers

3/10/2008

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Washington - Good morning. Thank you for inviting me to join you. It's my pleasure to be here.

Our presence here today on the banks of the Potomac River is tied to a political deal and the relationship between the federal government and the states comprising our union. In 1790, the first Secretary of the U.S. Treasury, Alexander Hamilton, made a controversial proposal that the Federal Government assume state debts incurred during the Revolutionary War.

His bold proposal drew sharp criticism from Thomas Jefferson and James Madison. A deal was proposed and made. Hamilton agreed to use his influence to place the capital of the country here in deference to Jefferson and Madison. In turn, they agreed to encourage their constituents and colleagues in Congress to back Hamilton's debt assumption plan, which together with his proposals for funding the debt, subsequently became law.

The U.S. Treasury continues to work with states on many issues including tax policy and facilitating the financing of municipal debt through our State and Local Government Series (SLGS). Today, I would like to focus on another potential collaboration where together we can strengthen efforts to help protect your beneficiaries and enhance the capital markets in which both your citizens and states invest their assets.

We have the best capital markets in the world. The quality, breadth and depth of our markets enable capital to be allocated in ever more efficient ways over the long term. Our markets' diversity and operating integrity inspire investor confidence and attract liquidity. Our capital markets stimulate competition and innovation -- enabling not just economic viability in each of your states, but vitality.

As public sector executives you know first hand the benefits of dynamic economic growth, and thus have a vested interest in capital markets that enhance investor confidence and market liquidity - - both of which have been significantly challenged in recent months.

One reason investor confidence is being hit so hard, is that many investors were sanguine over the last few years. This sanguine state – perhaps even over-confidence - was a result of many factors. But recent events underscore the importance of prudent regulatory policies, strong market discipline and robust risk management. Efforts to enhance these core components also serve to foster greater market liquidity which reduces costs and improves returns.

The headlines over the past several months include numerous reports of the challenges being confronted by states and municipalities. These range from hedge fund investments by public pension plans gone awry, to municipal officials grappling with investments they made in complicated structures like conduits and SIVs, to valuation challenges of holdings in opaque asset backed securities in cash investment funds, to concerns over bond issues wrapped by financial guarantors, to exorbitant interest rates being paid by state and local authorities as a result of failed auctions of auction rate securities. These reports raise many issues: some old, some new. Collectively, there is a lot we can do to influence what the headlines of tomorrow will be.

As a public sector representative, you fulfill many roles including the management of state fiscal matters. This morning, I'd like to focus on one of your most important roles: the responsibility you have in keeping retirement promises made to state workers.

The total value of our nation's retirement investments--including 401(k)s and IRAs--has been estimated at a staggering $11 trillion. Approximately $5 trillion reside in public-sector retirement plans.

With trillions of dollars in assets, our nation's retirement plans are major players in the economy. Public pension plans hold $2.1 trillion of stock in our corporations, over $158 billion in U.S. Treasury marketable debt, over $311 billion in U.S. agency debt, and over $256 billion in corporate debt.

I choose to focus on this role that you play - not just to illustrate that the health of our nation's public pension assets and our nation's economy is deeply intertwined - but to highlight the importance of the role of institutional investors such as public pension plans not just

can play, but must play in contributing to market discipline, and to underscore a fundamental investment concept: prudence in the role of a fiduciary.

The Prudent Man Rule was established by a Massachusetts court decision in 1830 in which trustees were directed to "observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probable income, as well as the probable safety of the capital to be invested."

The standard has evolved over time as prudent man became prudent expert, and income and safety expanded into return and risk, but after almost two centuries, the principle still resonates. The challenge for fiduciaries is not to focus just on returns or even to avoid risks. Rather, prudence dictates that fiduciaries seek to balance potential future returns with a corresponding identification, assessment and management of risks.

Fiduciaries seeking to fulfill their obligations must appreciate that they represent the first and most important line of defense for the interests of their beneficiaries. No one should suggest that plan trustees or portfolio managers should not take risks – in fact they must take risks in order to generate desired returns. Investors must have the opportunity to succeed, and in doing so they also have the freedom to fail.

However, given the characteristics of many of the investment strategies and securities in which pension plans have investments today, fiduciaries must return to some of the fundamentals of investment management. They must seek to excel in risk management as much as return management. Risk management is not some part-time responsibility – it's a fundamental obligation of a fiduciary's duty. And it's not just investors' responsibility. Risk management is everybody's business.

Every investment strategy introduces risks. We should acknowledge that the risks are many. They range beyond volatility to include market, liquidity, counterparty, credit, operational risk and reputation risk. But, despite more tools and greater experience, the responsibility seems to be becoming harder to fulfill.

Investors must appreciate risk in its myriad dimensions and seek to identify, assess, and manage it. Successfully doing so requires continuous evaluation from multiple perspectives, and humility to know the limitations of any single or even comprehensive assessment of risk.

Sound practices on the part of fiduciaries are critical to fulfilling their obligations. Fiduciaries have an ongoing responsibility to perform due diligence and must continually ensure that their investment decisions are prudent and conform to sound practices, including diversification.

While pension laws have a dramatic impact on pension plan management, we have also witnessed how the presence and scale of institutional investors has influenced many market practices.

Today, many public pension plans are invested in strategies and securities that are very complex and opaque. These characteristics create additional challenges. To address these challenges many fiduciaries are demanding more detailed information, higher quality business standards and operational practices, effective compliance and increased transparency.

Fiduciary responsibility is real, and fiduciaries should be held accountable. Nobody likes having responsibility without the corresponding authority. Appropriately, fiduciaries define and exercise their authority in several ways including their governance models and investment guidelines. Such implementation mechanisms should be carefully considered and reviewed to accomplish not only the intended objectives, but also to mitigate the likelihood of unintended, deleterious consequences such as relying solely on a credit rating to be a sufficient standard for assessing investment risks.

It is understandable that many fiduciaries struggle with complexity in the financial markets. Let's acknowledge that complexity may be a very legitimate reason a potential investor decides not to make a certain investment. However, we must also acknowledge that complexity can be no excuse for an existing investor or buyer of such a security to justify a loss. Investors and their fiduciaries must understand the risks associated with a potential investment. This is true of any investment – whether it is in a structure like a structured investment vehicle or in a security like a collateralized debt obligation or auction rate security.

Given such an innovative and evolving financial marketplace, a commitment to continual education seems appropriate so fiduciaries can fulfill their responsibilities and possess the requisite skills and knowledge to make informed investment decisions.

These efforts help to define market discipline. Federal policy makers are very supportive of efforts that strengthen market discipline, since such efforts serve to mitigate systemic risk.

Fiduciaries play two critical roles. In addition to contributing to market discipline, fiduciaries -- both trustees and asset managers -- play a powerful and important investor protection role. They help protect their beneficiaries' financial interests by continuously evaluating and monitoring their investments in the capital markets.

At the Treasury Department, we are vigilant in monitoring the global capital markets, and the past eighteen months have provided us with many issues to evaluate and address. These issues range from financial markets preparedness, to hedge funds, to market infrastructure, to challenges in the housing sector of our economy and the resulting implications in the capital markets.

The latter category includes funding challenges in the short term credit markets, enhancing financial institutions' risk management including liquidity and counterparty credit risk, reporting and disclosure issues, as well as the use of ratings and investor practices.

We also work closely with our colleagues comprising the President's Working Group on Financial Markets (PWG), which is chaired by Treasury Secretary Paulson and includes the Chairmen of the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission.

One marketplace development that we continue to address is directly related to institutional investors' (such as public pension plans) increasing allocations to alternative investments and investments in private pools of capital such as hedge funds and private equity.

In February 2007, the President's Working Group on Financial Markets produced principles and guidelines regarding such investments. Last September, Secretary Paulson announced the establishment of two separate yet complementary private sector committees. The first is comprised of investors such as state pension funds and the second committee is comprised of asset managers.

The first task for each group was to develop detailed guidelines that would define "best practices" for their respective communities. These guidelines have as a foundation, and are consistent with, the principles and guidelines developed by the PWG. They have also built upon existing industry work where possible. These will be released for public comment in the weeks ahead, and I would urge all of you to review them, share them with your colleagues and consultants, and provide feedback to the respective committees.

Implementing these practices will help strengthen market discipline, mitigate systemic risk, augment regulatory safeguards regarding investor protection, and complement regulatory efforts to enhance market integrity.

The PWG is also reviewing the underlying policy issues contributing to the current stress in our capital markets. While working through the current situation is our first concern, getting the long-term policy right is just as important.

Conclusion

As fiduciaries and leaders, I want to encourage you to not only stay engaged, but to redouble your efforts. There is much work to do and I encourage you to take the necessary steps to protect your beneficiaries' interests and enhance market discipline.

As stewards of the public trust we all must continually uphold and enhance the highest quality standards of excellence. It is both a privilege and responsibility to help strengthen the vitality, stability and integrity of the public's investments and our capital markets. Let our efforts, as well as those of the private sector to meet those goals, be the headlines of tomorrow. The system works when all stakeholders recognize the benefits, mitigate the risks, and choose to participate. Thank you again for the opportunity to speak here today.

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