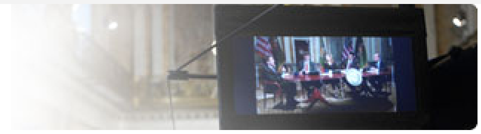
U.S. DEPARTMENT OF THE TREASURY

Press Center



Remarks by Secretary Henry M. Paulson, Jr. on Recommendations from the President’s Working Group on Financial Markets

3/13/2008

HP-872

Washington -- Thank you. I appreciate this opportunity to talk with you about Treasury's work on financial markets. As you know, since the market turmoil began last summer we have been closely monitoring and taking steps to address current market conditions.

We are working to get through the current period of market turmoil while minimizing its impact on our economy. And, as we do so, risk is being re-priced and markets are de-leveraging. This is creating liquidity challenges and, as a result, credit markets are not functioning as normal. We are encouraging financial institutions to continue to strengthen balance sheets by raising capital and revisiting dividend policies; we need these institutions to continue to lend and facilitate economic growth.

As we continue to address current market stress, we must also examine the appropriate policy responses. The President's Working Group on Financial Markets, the PWG, has been reviewing policy issues to help reduce the likelihood that mistakes of the past are repeated. The objective here is to get the balance right – regulation needs to catch up with innovation and help restore investor confidence but not go so far as to create new problems, make our markets less efficient or cut off credit to those who need it.

The focus of my remarks will be the PWG recommendations being released today as part of the policy review. We are at the end of the beginning of that review, and moving forward to the next phase –implementation. Clearly, that implementation must be consistent with today's environment, recognizing that all market participants are under stress and acting prudently to address current strains. We will pursue implementation in a measured way, so as not to impose burdens which might exacerbate the present situation.

And let me be clear: The PWG will stay on top of this. We will continually assess, consider further steps, report as we proceed, and issue a summary progress statement in the fourth quarter of 2008.

Many of these issues are as global as our markets, and we are also working closely with the Financial Stability Forum (FSF) as they prepare their report and recommendations. The FSF efforts, under the leadership of Mario Draghi, will bring a globally coordinated response.

Market Innovation and Complexity
Innovation is a hallmark of our capital markets. Securitization of credit is one example of an innovation that has made more, more flexible and lower-cost capital available to consumers and companies, and stimulated competition.

Financial innovation has brought these and other benefits. Financial innovation has also brought, inevitably, the challenge of complexity. In my judgment, some financial products have become overly complex. Excessive complexity is the enemy of transparency and market efficiency. Investor sentiment has swung hard to risk aversion, and now markets are punishing not only complex, but non-complex products as well.

Complexity is one of the many excesses that exacerbated the current market turmoil – turmoil that was triggered by the dramatic weakening of underwriting standards for U.S. subprime mortgages. Weaker subprime credit standards were part of a much broader erosion of standards throughout corporate and consumer credit markets. We have had a number of years of benign economic financial conditions and abundant liquidity; investors reached ever further for yield, and market participants and regulators became complacent about all types of risks.

As we did our contingency planning at Treasury prior to this period of market turmoil, we recognized the need to be continually vigilant because financial shocks or disruptions are a fact of life, and our markets seem to experience them every six to eight years. In our planning, we also recognized that the precipitating factor of any shock is virtually impossible to predict, except in hindsight, and we didn't try to do so. We did turn our attention to certain risks surrounding hedge funds, and to systemic risk and investor protection. We examined issues such as disclosure and margin requirements and, in February 2007, issued principles and guidelines for addressing issues related to private pools of capital, including hedge funds. Subsequently, we established two private-sector committees to develop industry best practices.

There is a certain irony that during this period it has been the regulated financial institutions which have been the focus of our attention. With a few exceptions, the hedge fund sector thus far has proven resilient to market volatility and protracted illiquidity. We know that a number of hedge funds are now also facing difficulties, as some are missing margin calls, and we are monitoring that closely. However, for a number of months last year much attention was given to various banks' off-balance sheet exposures to conduits and structured investment vehicles (SIVs). This risk exposure was partially due to the opacity of conduits and SIVs; existing capital rules may have also failed to mitigate, or even amplified, the stress associated with these vehicles.

PWG Policy Review Recommendations

We must have better policies, processes and mechanisms to understand and manage complexity, to discourage its excess, and to better understand and manage risk. Hopefully, the PWG policy recommendations will make progress in doing just that. Our recommendations have six key objectives:

- One, stronger transparency and disclosure. The challenges of complexity were exacerbated by opacity. The best antidote to opacity is transparency and disclosure.
- Two, stronger risk awareness. Regulators and all market participants must be more aware of and better able to respond to risks. Credit rating agency practices must improve, and the users of their services must rely less on, and appreciate more the limitations of, ratings products.
- Three, stronger risk management. We need improved risk management practices by investors, issuers, financial institutions, rating agencies, and regulators alike. Risk management is everyone's business.
- Four, stronger capital management. Well-capitalized institutions are better prepared to deal with challenges, foster economic growth and enhance market confidence.
- Five, stronger regulatory policies. Regulatory policies, including capital requirements, must address risk management weaknesses and improve the safety and soundness of our institutions and financial system.
- Six, stronger market infrastructure. Perhaps the best example of innovation is the over-the-counter (OTC) derivatives markets. These markets have grown tremendously; but the infrastructure has not kept up – and it must.

This effort is not about finding excuses and scapegoats. Those who committed fraud or wrongdoing have contributed to the current problems; authorities need to and are prosecuting them. But poor judgment and poor market practices led to mistakes by all participants.

Let me now summarize how the PWG recommendations will impact some of the issues we are facing in the marketplace and certain market participants. I will briefly discuss mortgage origination, credit ratings, securitization, financial institutions, investors, credit default swaps and other OTC derivatives, and regulators.

Mortgage Originators and Brokers

The PWG is recommending three important changes for mortgage originators and brokers. First, federal and state regulators should strengthen oversight of all mortgage originators. Second, state financial regulators should implement strong nationwide licensing standards for mortgage brokers. Third, at the end of the current comment period, the Federal Reserve will issue revised rules for consumer protection and disclosure requirements. As part of a larger study of financial regulatory structure, Treasury will soon release additional recommendations to improve the mortgage origination process.

Credit Rating Agencies

Credit rating agencies play a major role in financial markets, and their ratings products must provide information investors need to make more fully informed decisions about risk. This will require reforming structured credit product rating processes to ensure integrity and transparency, and improving the quality of data, models, and assumptions. Credit rating agencies must enforce policies and procedures that manage and disclose conflicts of interest, and implement changes suggested by the SEC review of conflict of interest issues.

The credit rating process needs to clearly differentiate between structured products ratings and ratings for corporate and municipal securities. And agencies should require securitized credit issuers to perform robust due diligence of originators of assets that are securitized or used as collateral for structured credit products.

The PWG will form a private-sector committee to work toward implementation of these rating agency recommendations and develop additional ones, as needed. The PWG member agencies will reinforce credit rating agencies' efforts through revisions to supervisory policy and regulation, and revisit the need for stronger oversight if the industry-led reforms do not lead to the integrity and transparency we seek. Regulators must also review how they encourage the use of ratings in rules and guidance; at a minimum, regulatory policies should distinguish between structured credits and corporate and municipal bonds.

Securitization

The securitization of a number of credit products, including residential and commercial mortgages, credit card receivables, student loans and business loans have brought us greater availability and lower cost credit. This has been positive for our economy. But with innovation in securitization and structured credit products has come varying degrees of complexity and other challenges, particularly related to securitization of mortgages.

For illustrative purposes, I will describe how the PWG recommendations will impact mortgage securitization. But first a few words about the process.

Mortgage brokers shop home loan applications to financial institutions and other lenders. Lenders then originate the mortgage loan and provide funds so the borrower can buy a home. The next step is securitization, packaging mortgage loans into securities. The originators sell these loans to securitizers that pool them with other loans into mortgage-backed securities (MBS). The MBS can be pooled again into collateralized debt obligations (CDOs), and multiple CDOs can be pooled further into what are called a "CDO Squared." Along the way, the mortgage loans can also be sliced into tranches representing different cash flows and payment risks.

The PWG has determined that there is no single, simple solution to the problems that have emerged from the mortgage securitization process, yet we have determined that market participants' behavior must change. I expect that market participants and regulators will implement these recommendations; when they do, we will see changes at every step of the securitization process:

Mortgage Brokers will be held to strong national licensing and enforcement standards. There will be stricter safeguards against fraud, and full and clear disclosure to borrowers about home loan terms, including long-term affordability.

Credit Rating Agencies will clearly differentiate structured product ratings from ratings for corporate and municipal securities. They will also disclose reviews performed on asset originators, and strengthen data integrity, models and assumptions.

Issuers of Mortgage-Backed Securities will disclose the level and scope of due diligence performed on underlying assets, disclose more granular information regarding underlying credits. And, if issuers have shopped for ratings, disclose the what and why of that as well.

Investors will conduct more independent analysis and be less reliant on ratings. They will require, receive and use more information and more clearly differentiate between structured credits and corporate and municipal securities.

These practices will better align the interests of mortgage originators and homebuyers, of originators and securitizers, of securitizers and rating agencies and, ultimately, investors.

Regulators have a role to play in every change. They will issue new rules and seek regulatory authorities as needed, evaluate progress, provide guidance and enforce laws – to ensure that implementation follows recommendation.

Covered Bonds, which allow banks to retain originated mortgage loans while accessing financial market funding, are another alternative worth considering. Covered bonds may address the current lack of liquidity in, and bring more competition to, mortgage securitization. Rule-making, not legislation, is needed to facilitate the issuance of covered bonds. Through clarification of covered bonds' status in the event of a bank-issuer's insolvency, the FDIC can reduce uncertainty and consider appropriate measures that will protect the deposit insurance fund. These steps would encourage a covered bond market in the U.S.; similar changes in Europe have resulted in more covered bond activity.

Financial Institutions

As key participants in virtually every phase of the markets, financial institutions must identify and address any weaknesses in risk management practices, especially those revealed by the current turmoil. This means enhancing internal risk measurement and reporting systems, a robust valuation of instruments and exposures, and aggregation of exposures across business lines. It also means more comprehensive disclosure of fair value estimates for complex and illiquid instruments, and of credit or liquidity enhancements provided to off-balance sheet commitments, such as conduits and SIVs.

The PWG's guidance on risk management and disclosure issues for financial institutions is important, but the quality of the top management team responsible for executing this guidance is even more important. I know from first-hand experience how increasingly difficult, yet how critical, it is to successfully manage today's large, integrated global financial institutions. The leadership challenge here is enormous. Market difficulties often expose weaknesses; weaknesses which can often only be overcome with experience. And that experience often comes from lessons learned from prior challenges and prior mistakes.

The ultimate success of any CEO is largely determined by the answer to one question: Do we have the right people in the right jobs with the right incentive structure? And these large financial institutions have a large number of key jobs to fill. They must have people with talent, judgment, expertise and motivation that best serve their institutions and, by extension, contribute to the quality and strength of our markets. I cite this management issue because I do not believe that the top jobs in our large financial institutions are going to get easier any time soon, and the markets, not regulators, will ultimately sort this out.

Investors

I will speak for a moment about investors – many of whom bought products they didn't fully understand, or bought products based solely on credit ratings. Many investors became complacent about risk and they have learned a costly lesson, one that amplifies the need for thorough due diligence. In fact, it seems that today's risk aversion is an aftermath of yesterday's risk complacency.

Going forward, investors must demand and use better information about investment risk characteristics, when they buy and as they hold. They, and the markets, will be better served by independent evaluations and by understanding that different types of instruments have different types of risks.

Credit Default Swaps and OTC Derivatives

In recent years, innovation has also facilitated the tremendous expansion in the scale, diversity and impact of credit default swaps and over-the-counter (OTC) derivatives. These instruments and markets have become important for the hedging or transfer of credit and default risk. Heightened price volatility and surging trading volumes underscore the need for the OTC derivatives market infrastructure to evolve to support this expansion. Industry has taken some, but not enough steps.

We need a dedicated industry cooperative. Market volume and instrument complexity call for a clear, functional, well-designed infrastructure that can meet the needs of the OTC derivatives markets in the years ahead. We have similar facilities for other asset classes, such as the Depository Trust and Clearing Corporation (DTCC).

Such an industry cooperative must capture all significant processing events over the entire lifecycle of trades. It must have the capability to accommodate all major asset classes and product types. It must be operationally reliable and scaleable, and use automation to promote standardization that will create efficiency and moderate excessive complexity.

In addition, the infrastructure must have a flexible and open architecture for interoperability, upgrades, and improvements. The facility also should enhance counterparty risk management through netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades.

Some steps can be implemented quickly; others will take longer, but we need movement on all. With the continued leadership of the Federal Reserve Bank of New York, we also need to work with market participants to establish ambitious standards for trade data and for accurate and timely trade resolution. The industry also should incorporate, without delay, cash settlement protocol into standard documentation. We don't need good ideas sitting on the shelf; we need good ideas put into practice. All market participants, not just the dealer community, need to participate in the solution.

Supervisors, PWG, and Treasury

The PWG recommendations would not be complete unless they also included steps for regulators, including PWG member agencies. Regulators should take steps to ensure that investors improve due diligence and have greater awareness of risk characteristics. To further support this, regulators should work closely with FASB, to review accounting issues and implement policies that ensure aggregation of exposure across business lines and rigorous valuation of instruments and exposures.

Supervisors and regulators of global and U.S. institutions must closely monitor to ensure that institutions address risk management weaknesses and take action as needed. Regulators should also review capital requirements, as this plays such an important role in financial institution behavior. To this end, the Basel Committee on Banking Supervision should review the Basel II capital requirements for resecuritizations and off-balance sheet commitments, and promptly complete its liquidity management guidance update.

Efforts in Addition to these Recommendations

Today's recommendations are part of a much larger effort that spans multiple fronts. Treasury has commissioned a study on the cause of financial restatements. As I mentioned earlier, there is a financial regulatory review that will be released as a regulatory blueprint in the weeks ahead. We also have private sector committees developing best practices for investors and hedge fund managers and anticipate publishing guidelines for public comment next month.

Investors in vibrant capital markets require accurate financial statements, and that can only occur with a vibrant accounting profession. Recognizing the challenges facing this industry, last spring the Treasury Department formed an advisory committee to review the sustainability of the auditing profession. The committee will report its final recommendations this summer.

Together, these additional committees and efforts will provide further guidance to enhance market integrity, investor protection and mitigate systemic risk.

Conclusion

We have learned many lessons from this period and we may learn still more as events unfold. Today I have summarized the results of a great deal of hard work by the PWG member agencies. We have laid down objectives and recommendations, which form a good start. Although we haven't yet worked completely through this period of market turmoil, and that is our highest priority today, it is not too early to suggest appropriate policy responses.

No silver bullet exists to prevent past excesses from recurring. In these remarks, I have focused a great deal on challenges related to excessive complexity, but complexity is only one of many issues we face. I believe today's recommendations put us on the path towards more transparent, better-functioning, and better-managed markets, which are integral to attracting and allocating capital to fuel our economic growth and prosperity. We will continue to re-assess conditions, monitor progress, put forward new recommendations and take additional steps as necessary.

- 30 -