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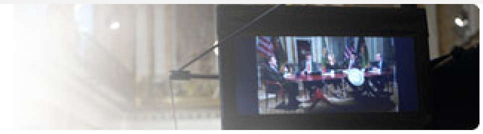

Remarks by Secretary Henry M. Paulson, Jr on Current Financial and Housing Markets at the US Chamber of Commerce

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Washington -- Thank you for inviting me to address your Capital Markets Competitiveness Conference. We share a commitment to competitive markets, and Treasury will soon release a Blueprint for Regulatory Reform that proposes a financial regulatory framework which we believe will more effectively promote orderly markets and foster financial sector innovation and competitiveness.

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As you know, financial market stress began last August and has led to significant de-leveraging and repricing of risk, and sentiment has swung hard to risk aversion. There have been, as there always are during periods like this, bumps in the road and unpleasant surprises along the way.

I am constantly asked how much longer will this take to play out and if this is the worst period of market stress I have experienced. I respond that every period of prolonged turbulence seems to be the worst until it is resolved. And it always is resolved. Our economy and our capital markets are flexible and resilient and I have great confidence in them. I am certain we will work through this situation and go on to new heights as we always do.

As we work our way through this turbulence, our highest priority is limiting its impact on the real economy. We must maintain stable, orderly and liquid financial markets and our banks must continue to play their vital role of supporting the economy by making credit available to consumers and businesses. And we must of course focus on housing, which precipitated the turmoil in the capital markets, and is today the biggest downside risk to our economy. We must work to limit the impact of the housing downturn on the real economy without impeding the completion of the necessary housing correction. I will address each of these in turn. Regulators and policy makers are vigilant; we are not taking anything for granted.

Orderly Financial Markets

For some months now, reduced access to short term funding and liquidity issues have created turmoil in our capital markets. In the midst of these conditions, Bear Stearns found itself facing bankruptcy. The Federal Reserve acted promptly to resolve the Bear Stearns situation and avoid a disorderly wind-down. It is the job of regulators to come together to address times such as this; and we did so. Our focus was the stability and orderliness of our financial markets.

Discount Window Access

As the Federal Reserve resolved the Bear Stearns situation, it subsequently took a very important and consequential action of instituting a temporary program for providing liquidity to primary dealers. I fully support that action. Taking this step in a period of stress recognizes the changed nature of our financial system and the role played by investment banks in the post Glass-Steagall world.

Such direct lending from the central bank to non-depository institutions has not occurred since the 1930s. Recent market turmoil has required the Federal Reserve to adjust some of the mechanisms by which it provides liquidity to the financial system. Their creativity in the face of new challenges deserves praise, but the circumstances that led the Fed to modify its lending facilities raises significant policy considerations that need to be addressed.

Insured depository institutions remain important participants in financial markets, but this latest episode has highlighted that the world has changed as has the role of other non-bank financial institutions, and the interconnectedness among all financial institutions. These changes require us all to think more broadly about the regulatory and supervisory framework that is consistent with the promotion and maintenance of financial stability. Now that the Fed is granting primary dealers temporary access to liquidity facilities, we must consider the policy implications associated with such access.

Historically, commercial banks have had regular access to the discount window. Access to the Federal Reserve's liquidity facilities traditionally has been accompanied by strong prudential oversight of depository institutions, which also has included consolidated supervision where appropriate. Certainly any regular access to the discount window should involve the same type of regulation and supervision.

While there has been extraordinary convergence in financial services, one distinction between banks and investment banks remains particularly important - banks have the advantage that they issue deposits that are insured by the Federal government. A properly designed program of deposit insurance greatly reduces the likelihood of liquidity pressures on depository institutions and as a corollary, makes the funding base of these institutions more stable. The trade-off for this subsidized funding is regulation tailored to protect the taxpayers from moral hazard this insurance creates.

For the non-depository institutions that now have temporary access to the discount window, I believe a few constructive steps would enable the Federal Reserve to protect its balance sheet, and ultimately protect U.S. taxpayers.

First, the process for obtaining funds by non-banks must continue to be as transparent as possible. The Fed should describe eligible institutions, articulate the situations in which funds will be made available, and the magnitude and pricing structure for the funds. The TAF process is a good model for a structure that would provide relevant information to the marketplace.

Second, and perhaps most importantly, the Federal Reserve should have the information about these institutions it deems necessary for making informed lending decisions. The Federal Reserve is currently working to ensure the adequacy of such information. We suggest that the Federal Reserve, the SEC, and the CFTC continue their work of building a robust cooperative framework. Already, at the invitation of the SEC, the Federal Reserve is working alongside their teams within these institutions. These regulators should consider whether a more formalized working agreement should be entered into to reflect these events.

With this added information flow, the Federal Reserve will be better positioned to consider market stability issues like liquidity provisioning and the interconnectedness of financial institutions. The Federal Reserve's participation could also allow for broader consideration of market stability issues by the SEC and the CFTC. This collaborative process will necessarily have a strong focus on liquidity and funding issues.

The combination of these steps should provide the Federal Reserve with a structure and the information that it would need to make liquidity backstop loans during periods of market instability to non-banks. They address the current situation, in which investment banks have temporary access to the discount window. Clearly, many difficult policy questions must also be addressed on a going-forward basis.

Despite the fundamental changes in our financial system, it would be premature to jump to the conclusion that all broker-dealers or other potentially important financial firms in our system today should have permanent access to the Fed's liquidity facility. Recent market conditions are an exception from the norm. At this time, the Federal Reserve's recent action should be viewed as a precedent only for unusual periods of turmoil.

As we work through this period, we will learn through this experience. And the Federal Reserve will learn as it works with financial institutions as they come to the window. It is appropriate that we evaluate that experience in the coming months, and use the lessons of that experience to inform a path forward. Very relevant to this issue is the fact that bank regulation, which applies to institutions with an explicit taxpayer-funded backstop, is fundamentally different from non-bank regulation, which applies to institutions that are not supported by federal deposit insurance. The President's Working Group on Financial Markets will evaluate these issues and their implications for regulation of bank and non-bank financial institutions.

Housing and Mortgage Markets

The housing downturn and the surrounding uncertainty are significantly impacting our financial institutions and capital markets. However, we should not lose sight of the fact that this downturn was precipitated by unsustainable home price appreciation which was particularly pronounced in a relatively few regions. A correction was inevitable and the sooner we work through it, with a minimum of disorder, the sooner we will see home values stabilize, more buyers return to the housing market, and housing will again contribute to economic growth. Having stability in housing markets will in turn contribute to better conditions in credit markets for mortgage-backed securities.

Data releases every month create headlines about declining housing sales, starts and prices. Yet, declines are exactly what we should expect during a correction. It takes time to work through the excess inventory – and we are. The question many are asking is how deep the correction will be and how long it will last. The Case-Shiller index of home prices in 10 major metropolitan areas showed an 11.4 percent decline in home prices over the 12 months ending in January, and the futures market is predicting that the index will decline another 13 percent in 2008. But we do not have a national housing market; housing markets are regional – and there is considerable variation in adjustment, with prices changing the most in areas that had the greatest overbuilding.

Amid this correction, there are many calls to "do something about housing." When people say this, they are urging any number of possible things – minimize foreclosures, make affordable mortgages more available, improve the secondary market and liquidity for mortgages, improve the mortgage origination process, prosecute fraud, reduce the inventory of homes for sale, or help communities hardest hit by foreclosures.

The `to do' list tends to get conflated. We must sort through each of these shared and desired outcomes, carefully choosing policies that minimize the impact of – but do not slow – the housing correction.

Availability of Mortgage Finance

Turbulence in the financial markets has disrupted and reduced the availability and increased the cost of mortgage financing. The secondary mortgage market is still facing liquidity and pricing issues. We are taking steps to increase the availability of affordable mortgage financing. The Federal Reserve's temporary lending facility for non-banks will help in this area, as will the Federal Housing Finance Board's decision to authorize the Federal Home Loan Banks to increase purchases of agency mortgage backed securities, which could provide over $100 billion in new MBS market liquidity.

Another helpful step is the agreement reached last week among Fannie Mae, Freddie Mac and OFHEO, their independent regulator, to inject more capital into the mortgage market.

Fannie and Freddie, two of the nation's housing Government Sponsored Entities or GSEs, have been playing an important, countercyclical role in supporting the secondary market for mortgage finance. The GSEs' market share has grown substantially from 46 percent of all new mortgages in the second quarter of 2007 to 76 percent in the fourth quarter. It is very important that the GSEs remain positioned to play this critical role. That is why I was pleased that the GSEs committed to raise significant capital. A stronger capital base will better enable them to support more home purchases and refinancings through their securitization activities. Additional capital not only increases the availability of mortgage financing, but also strengthens mortgage market fundamentals.

The Economic Stimulus Act of 2008 also temporarily raised the conforming loan limit, which should reduce costs for homebuyers seeking a jumbo mortgage.

The subprime mortgage market accounted for a large portion of housing purchase growth before the downturn, and the market for subprime mortgage financing is now largely closed. Last August, President Bush launched the FHASecure initiative, an important new solution for subprime homeowners. To date, FHASecure has helped more than 130,000 families refinance their mortgages and stay in their homes. That number is expected to reach 300,000 by year end. More can be done. Secretary Jackson continues to examine administrative tools to make FHA mortgages more widely available. And it is essential that Congress pass FHA modernization that would provide FHA the authority to help as many as 250,000 more homeowners at this critical time.

We will continue to look for solutions that expand mortgage access and availability for all borrowers, including financially-able subprime borrowers.

Foreclosures

Home foreclosures are also a significant issue today. Foreclosures are painful and costly to homeowners and, neighborhoods. They also prolong the housing correction by adding to the inventory of unsold homes. Before quickly reviewing our initiatives to prevent avoidable foreclosures, let me observe that some current headlines make it difficult to put foreclosure rates in perspective. So let me try to do so.

First, 92 percent of all homeowners with mortgages pay that mortgage every month right on time. Roughly 2 percent of mortgages are in foreclosure. Even from 2001 to 2005, a time of solid U.S. economic growth and high home price appreciation, foreclosure starts averaged more than 650,000 per year.

Last year there were about 1.5 million foreclosures started and estimates are that foreclosure starts might be as high as 2 million in 2008. These foreclosures are highly concentrated – subprime mortgages account for 50 percent of foreclosure starts, even though they are only 13 percent of all mortgages outstanding. Adjustable rate subprime mortgages account for only 6 percent of all mortgages but 40 percent of the foreclosures. So we are right to focus many of our policies on subprime borrowers.

There are approximately 7 million outstanding subprime mortgage loans. Available data suggests that 10 percent of subprime borrowers were investors or speculators. This figure is likely higher, as some investors misrepresented themselves to take advantage of a cheaper rate, and others speculated on a primary residence, expecting prices to continue going up.

Other subprime loans were very poorly underwritten and borrowers simply can not afford the home they bought. Almost 18 percent of adjustable rate subprime mortgages underwritten in 2006 were in foreclosure six months before the initial rate was scheduled to reset. Subtracting the speculators and those who took on more than they could handle leaves us with our target population of subprime borrowers for whom we are seeking a solution – those who want to keep their homes, have the financial wherewithal, but are facing challenges making their monthly payments.

We are focused on private sector and government efforts to help these borrowers avoid foreclosure.

The HOPE NOW alliance has announced that, since July, more than 1 million struggling homeowners received a work out, either a loan modification or repayment plan that helped them avoid foreclosure. HOPE NOW's work-out efforts are accelerating more quickly than the foreclosure rate. In the month of January foreclosure starts were up 5 percent while the number of mortgage workouts grew 19 percent.

HOPE NOW and the American Securitization Forum together have implemented a protocol targeted specifically at subprime borrowers facing mortgage resets. Through the protocol, those who made their initial payments and want to keep their home should be fast-tracked into a sustainable refinancing or loan modification.

We are closely monitoring the implementation and results of HOPE NOW and the ASF efforts. Responsible homeowners who have been making their payments and want to find a way to stay in their home should not go into foreclosure merely because the volume of people seeking help overwhelms the system.

Homeowners with Negative Equity

Much attention has been given to the fact that an estimated 8.8 million households may currently have negative home equity. We can expect that number to rise as the housing correction plays out, and to begin to reverse once the correction has run its course. The best outcome for these homeowners is to work through this correction as quickly as possible.

Homeowners with negative equity are more common in this housing downturn because lending practices changed dramatically in recent years. In 2007, 29 percent of mortgages were originated with no down payment. Some of those mortgages went to speculators; others to responsible borrowers who were able to buy a home because of expanded access to credit.

But let me emphasize that we do not need a system-wide solution for the vast majority of loans where a homeowner temporarily has negative equity. Negative equity does not affect borrowers' ability to pay their loans. Homeowners who can afford their mortgage payment should honor their obligations --- and most do. They know that there are housing cycles, and they bought more than houses. They bought homes to become part of a community, and they bought them as places to live, not as investments. And if they live in them for the long term, they are likely to become good investments.

Let me also emphasize that any homeowner who can afford his mortgage payment but chooses to walk away from an underwater property is simply a speculator. Washington can not create any new mortgage program to induce these speculators to continue to own these homes, unless someone else foots the bill.

The people we seek to help are those who want to keep their homes but can't afford the monthly payment because of an ARM reset. If they also have negative equity in their homes, refinancing becomes almost impossible and so workouts become even more important. Secretary Jackson is examining the potential for FHA to be a solution for these borrowers.

Conclusion

In summary, there is bipartisan interest in bolstering our economy, maintaining stable and orderly capital markets, and helping struggling homeowners. New ideas and solutions can come from either side of the aisle. The Administration and Congress demonstrated how well bipartisanship can work when we quickly passed and enacted an economic stimulus package earlier this year. I am hopeful we can demonstrate this again by quickly concluding the FHA Modernization bill, and I am working hard to make progress on comprehensive GSE reform legislation because stronger oversight is essential for these large, critically important financial institutions.

I know Members of Congress have outlined other ideas, but most are not yet ready for the starting gate. FHA Modernization and GSE reform are well on their way to the finish line – let's complete this important legislation now, so we can implement them and help homeowners and our economy.

Timeliness is critical for adding confidence in today's markets. I continue to focus on additional steps that the Administration can take without delay – things that don't require congressional action and will immediately impact the availability of affordable mortgage finance.

We are obviously well aware that the housing market correction was not only a precipitating cause but continues to be an underlying factor in our capital markets' stress. Both are disrupting our economy right now. We will continue to pursue policies that strike the right balance: that do not slow the housing correction, yet also help avoid preventable foreclosures and unnecessary capital market turmoil.

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