

## U.S. DEPARTMENT OF THE TREASURY

## Press Center

**Remarks by Treasury Assistant Secretary for International Affairs Clay Lowery**

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**At the Annual Conference of the Institute of International Bankers***Global Financial Stability and Systemic Risk: The Current Financial Market Turmoil*

**Washington – Thank you for your kind introduction. I'm pleased that you have invited me to speak at today's forum. In 2006 I spoke at an IIB Dialogue in Singapore on "Promoting a More Open Global Financial System," and I'm glad to be back today – particularly given how calm everything is in the markets.**

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Today I will briefly review the U.S. and global economic situation and some of the factors contributing to today's financial turmoil. I will then describe some of the lessons we have learned so far and the steps the U.S. and the international financial community is taking to address the issues we face.

**Economic overview**

The U.S. economy is fundamentally sound, diverse and resilient. Economic growth over the past four years has averaged 2.9 percent. More than 8 million jobs have been created since August 2003. However, following several years of what, in retrospect, was unsustainable home price appreciation, the U.S. economy is undergoing a significant and necessary housing correction, which is weighing on near-term economic growth. Headwinds also are coming from higher energy prices and stress in the financial markets.

Looking beyond the U.S., global economic growth remains solid, in the vicinity of 4 percent, which is still well above the 3 ¼ percent average of the 1980s and 1990s, though not as robust as the 5 percent numbers of recent years. Much of the global slowdown is concentrated in G-7 economies, though emerging markets are likely to experience some dampening of their growth prospects as well. However, many parts of the emerging market world are still expected to grow in excess of 5 percent in 2008, with some, especially developing Asia, likely to grow in excess of 8 percent.

**Underlying Weaknesses that Contributed to the Current Financial Market Turmoil**

In the context of these global economic conditions, let me turn to the current financial market turmoil. I know that this has been a roller-coaster ride for you and the financial institutions you represent. Likewise, here at Treasury, we have been very much engaged in monitoring and analyzing the turmoil, both domestically and internationally.

Let me spend some time this morning giving you our perspectives on the underlying weaknesses that contributed to the turmoil and what the U.S. Administration is doing to address the problems. I will then turn to the international response that we have been working in cooperation with many other countries to craft. Of course, we are still in the midst of the turmoil, so it is premature to draw final lessons and make final recommendations.

There are a variety of ways to categorize the weaknesses, but let me try to take a lesson from a key observer of the international financial system – David Letterman – and give you my top ten list. Unlike Mr. Letterman, this will not be in any particular order.

1. Underwriting standards were seriously eroded during the housing boom. On the positive side, securitization brought new capital to sub-prime borrowers and helped them buy homes they otherwise would not have been able to own. However, some mortgage originators encouraged excessive borrowing, or with disadvantageous loan terms.
2. Risk management practices did not keep pace with market developments. Risk managers for loan originators, securitization issuers, and investors did not properly evaluate all of the risks, including the liquidity risks, concentration risks, and reputation risks.
3. Investors did not perform appropriate due diligence for their investments. Some investors relied completely on external credit ratings to determine the risk rather than assessing risk themselves. Many investors misunderstood or ignored the different risk characteristics between structured products and corporate bonds. Some investors did not realize that credit ratings provide only a probability of default risk, and not other risks.
4. Disclosure throughout the securitization process was inadequate. Loan originators did not sufficiently or clearly disclose their terms to borrowers. Securitization issuers did not disclose adequate information for investors to judge the quality of mortgage loans underlying residential mortgage-backed securities and more complex products. And purchasers of often complex securities did not demand adequate information or perform appropriate analysis on the contents of what they were buying.

5. Credit rating agencies failed to adequately communicate risks. Credit rating agencies did not make it sufficiently clear that there are differences in the meaning of ratings between corporate bonds and structured finance products. The agencies also had not adequately considered the potential weaknesses in the underlying data and in their assumptions and models used to arrive at their credit rating decisions.
6. Misaligned incentives encouraged excessive risk-taking. The originate-to-distribute business model encouraged mortgage originators and securitization issuers to produce complex products to satisfy investors' increased demand for yield. The lucrative income stream from originations and securitizations encouraged some to incur risks.
7. The treatment of off-balance sheet exposures encouraged excessive risk-taking, leading to the creation of conduits and SIVs that we all know about so well now. Off-balance sheet exposures were generally opaque, which made risk analysis difficult for investors.
8. The liquidity assumptions of borrowers, securities issuers, and investors often were unfounded. Many borrowers had not considered the possibility that the housing market could decline. Mortgage originators and securitization issuers had assumed that a liquid market for the underlying mortgages and securitizations would continue unabated.
9. The valuation of complex securities proved to be more challenging than expected for many market participants. The application of fair-value accounting to liquid securities is not especially difficult—or at least, so I'm told, for accountants. However, the possibility that such securities could become substantially less liquid, or could even cease trading, in times of market stress was not fully considered in advance.
10. And finally, weaknesses in supervisory frameworks have been exposed. Supervisors in some countries did not have the tools they needed to adequately regulate financial institutions or deal with weak and failing banks.

### United States policy response

With this long list of ten weaknesses I have just identified, it does suggest we might want to do something about it. So what should we do?

In the United States, I would say that we are doing three things that also helps feed into a fourth.

First, we have made adjustments to the macroeconomic policy mix to support the broad U.S. economy while the inevitable corrections take place in the housing and credit markets. The President and Congress responded with a bipartisan fiscal stimulus package totaling more than \$150 billion, while the Federal Reserve has made adjustments in liquidity support and monetary policy.

Second, the Administration has supported a number of initiatives – both private sector led and public sector initiatives – in response to the housing correction, designed to prevent as many foreclosures as possible.

Third, the President's Working Group on Financial Markets – the PWG – an interagency policy coordination group chaired by Secretary Paulson and consisting of the Fed, the SEC, and the CFTC, is actively engaged in a comprehensive review of policy issues related to recent financial market turmoil. This review includes approaches to strengthen risk management practices at financial institutions, improve market discipline in the securitization process, and improve the issuance and use of credit ratings.

### International plan

This is a summary of the actions that the U.S. Administration has supported so far. But the current financial market turmoil is not just a U.S. problem.

Indeed, the financial market turmoil has spread globally. We at the Treasury Department are closely tracking write-downs and losses that international financial firm have publicly disclosed. By our count, it now tallies over \$200 billion. Only about half of this is reported by U.S. financial institutions; European institutions report another \$75 billion and the rest is accounted for by banks in Asia, Canada, and elsewhere.

Last August, as the turmoil spread to Europe, we realized that we needed not just a U.S. response, but a global response. And what better mechanism to address the situation than the Financial Stability Forum – known as the FSF? And if you are keeping count, it is the work of the FSF that I consider the fourth step that we are taking.

The FSF was formed by the Group of Seven finance ministers and central bank governors in 1999 after the Asian financial crisis. The FSF is a unique body. It brings together supervisors, central banks, finance ministries, the IMF and World Bank, and international regulatory groups. Together, the members of the FSF assess international financial system vulnerabilities, identify actions needed to address these vulnerabilities, and help coordination among authorities responsible for financial stability. In short, the FSF is the coordination link between the global phenomenon of capital markets and the national system of regulatory entities.

In October 2007, the G7 tasked the FSF to analyze the causes of the financial turbulence and recommend actions to address them. At last month's meeting in Tokyo, the FSF presented an interim report to the G7 finance ministers and central bank governors. The interim report identified six main policy directions.

- The first area is supervisory framework and oversight. The FSF interim report recommended that the Basel Committee on Banking Supervision assess the need for changes to the Basel II capital framework in light of the turmoil. The FSF also asked the Basel Committee to recommend strengthened industry and supervisory practices for liquidity risk management. Basel II and accounting practices provided incentives for the use of off-balance sheet vehicles, and the Basel Committee has agreed to review these.
- Second, the FSF said that the underpinnings of the originate-to-distribute model need to be strengthened. This should include origination and underwriting standards and transparency. The FSF is encouraging the development of market-based approaches to incentives in the originate-to-distribute model.
- Third, the FSF concluded that investors relied excessively on credit ratings. The credit rating agencies (the CRAs) must improve the information they provide to investors in structured financial products. Authorities should also review the role of credit ratings in their regulations and guidance to ensure that investors do not overly rely on them instead of performing their own due diligence. An IOSCO working group is updating its Sound Practices for credit rating agencies to address structured finance.
- Fourth, the FSF report said that market transparency should be improved. Financial institutions should disclose more useful information on risk exposures and values. Valuation methods and data, particularly for illiquid markets, are a concern. Market-led enhancements to market transparency and disclosure are needed, although the FSF noted that more prescriptive approaches are possible if these improvements are not forthcoming. Transparency is also an area of active work for the Basel Committee, the International Accounting Standards Board (IASB), and IOSCO.

- Fifth, supervisory and regulatory responsiveness to risks should be strengthened, with an increased bias to turning analysis into action. Skills of supervisors should keep pace with industry developments, and supervisors should clearly communicate concerns about risk management to financial institutions. International organizations should improve their decision-making processes. IOSCO is working on aspects of this area.
- Finally, the FSF report said that authorities' ability to respond to crises should be strengthened. Central banks are reviewing lessons from recent experiences to identify improvements in their operational frameworks, communications with markets, and coordination between central banks. Authorities also are considering their structures for dealing with failing banks internally, and cross-border. The Committee on the Global Financial System (CGFS) is evaluating these issues.

These are just the highlights from the FSF's interim report. The G7 finance ministers and central bank governors in Tokyo in February welcomed the report and the solid progress that the FSF is making. The chairman of the FSF, Mario Draghi, is doing an excellent job and providing great leadership to a complex area. The FSF will gather again this month and the final report is scheduled to be released at the April G7 meetings here in Washington.

In addition to the FSF, the European Commission, UK Prime Minister Gordon Brown, and German Finance Minister Peer Steinbrück have been offering proposals. The leaders of four major European countries and the President of the European Commission also met and issued a joint communiqué with a variety of suggestions. These ideas largely cover areas that are within the six overarching policy directions identified by the FSF and its framework.

These efforts underscore that the questions raised by the current market turmoil are complex. And given that volatility in the markets continues, the diagnosis, recommendations and ultimately solutions to those problems will need to be nuanced, probably won't be complete upon first draft, and must not impair future capital market efficiency or innovation. These are global issues that require bilateral and multilateral cooperation and we will continue to work closely with the G7 and the FSF on a wide range of issues to ensure that policy responses are coordinated.

Thank you.