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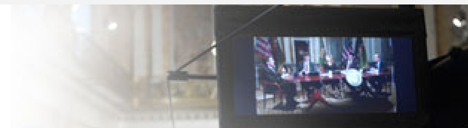

# Remarks by Under Secretary David H. McCormick to the CFA Society of Chicago

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*The International Response to Financial Market Turmoil*

**Chicago –** Thank you for your invitation to be here today. I'm delighted to meet this distinguished group.

Today, I've been asked to speak about the public policy response to financial market turmoil. Unfortunately, the rhetoric surrounding this subject has sometimes drifted towards sweeping regulation or unbounded injections of public money. Such suggestions seem motivated by hope for a simple and easily implemented solution.

But in fact, there are no quick fixes, no simple solutions. The reality of market developments since August 2007 is much more complicated and requires multi-dimensional responses. Recent events highlight some age-old truths and the ever-present need to cultivate strong market discipline, greater transparency and disclosure, prudent regulatory policies and robust risk management.

Today, I'd like to discuss with you the forces that led to current market conditions and I plan to explain an ambitious combination of domestic and international actions which are being undertaken to address these challenges. While there will inevitably be more bumps in the road ahead, U.S. long-run economic fundamentals remain sound, and the flexibility, resilience and strength of our capital markets and our economy will prevail.

**The Market Turmoil in Perspective**

The current turmoil finds its original roots in a long period of benign macroeconomic and financial conditions that encouraged widespread complacency about risk. Investors in search of higher yields created significant demand for structured credit products but, in many cases, did not conduct adequate due diligence.

Meanwhile, demand for housing began to slow in 2004, and credit standards loosened significantly, particularly for subprime mortgages. Hybrid-adjustable-rate mortgages (ARMs) with low teaser rates, interest-only features, low or no down payments, and even negative amortization, became popular. In 2005 and 2006, non-traditional ARMs comprised about one-quarter of mortgage originations, exposing mortgage holders to far greater risk than traditional fixed rate mortgages.

At the same time, the pace of financial innovation gathered momentum and the trend toward securitization of assets accelerated. Financial innovation clearly brought enormous benefits to investors and consumers, and contributed to domestic and global economic growth. We also see, however, that the resulting dramatic increase in leverage and complexity of financial instruments brought new risks to financial markets – not only to the United States but to other interconnected markets in Europe and around the world.

The looser credit standards, combined with the aforementioned complacency, inevitably contributed to an unexpected rise in mortgage delinquencies. This, in turn, triggered a global reassessment of risk beginning in August 2007, followed by significant de-leveraging. The dramatic swing in sentiment, subsequent market volatility and heightened uncertainty ratcheted up demand for cash and liquidity. Many structured finance markets seized up, causing markets for asset-backed commercial paper to contract substantially.

These developments revealed serious weaknesses in risk management practices at many large U.S. and European financial institutions, particularly in the area of liquidity risk management. Some institutions experienced significant losses and significant balance sheet pressures, contributing to a tightening of lending standards and potential impact on economic growth.

**U.S. Domestic Actions**

The Administration has responded vigorously, both on the domestic and the international fronts. Here at home, the Administration's response addresses near-term as well as longer-term measures. The goals are straightforward: minimize the impact on the real economy; maintain efficient and liquid markets; ensure continued availability of credit; and enhance risk management. Our domestic approach includes three sets of actions to help accomplish these goals.

First, the Administration has acted aggressively to support the economy as it weathers the housing correction and financial market challenges. The housing correction will undoubtedly take time to run its course. The fiscal stimulus package, signed into law by President Bush on February 13, provides temporary tax relief to over 130 million American households and temporary tax incentives for businesses. This year's $150 billion infusion will support the creation of over half a million additional jobs by year end.

Our housing market initiatives also seek to increase the availability of affordable mortgage financing, prevent avoidable foreclosures, and minimize the economic disruption of the housing correction. They include temporary actions to raise the conforming loan limit, which will allow Fannie Mae and Freddie Mac to inject more capital into the mortgage market. Two other key initiatives include FHA Secure, launched in September, and the HOPE NOW Alliance, launched in October at the encouragement of the Treasury. To date, the Federal Housing Administration has refinanced more than 155,000 borrowers into affordable loans, while the HOPE NOW Alliance recently announced that nearly 1.2 million homeowners have been helped through workout plans since the middle of last year. As this effort progresses, the Administration will continue to look for new ways to assist more struggling homeowners, as was evident with the recent expansion of FHA Secure to help additional borrowers qualify for government-insured mortgage loans.

Second, U.S. policymakers have also initiated a number of medium-term efforts to strengthen market discipline and address regulatory gaps. Secretary Paulson chairs the President's Working Group on Financial Markets – the PWG – an interagency policy coordination group that includes the Fed, the SEC, and the CFTC. On March 13, the members of the PWG issued a comprehensive review of policy issues related to recent financial market turmoil. That review identified several areas of underlying weaknesses, including:

- lax underwriting standards for mortgages, particularly for subprime mortgages;
- an erosion of market discipline in the securitization process;
- flaws in credit rating agencies' assessments of some complex structured credit products;
- risk management weaknesses at global financial institutions; and
- regulatory policies that failed to mitigate risk management weaknesses.

The President's Working Group recommended measures to reform mortgage origination, strengthen risk management, enhance disclosure and market discipline in the securitization process, and reform the use of credit ratings. Secretary Paulson also has proposed establishing a new federal Mortgage Origination Commission to fill an important gap in the current regulatory structure.

Finally, the Administration also is working on longer-term efforts to maintain competitive capital markets. Long before our current challenges, Secretary Paulson had launched a broad Capital Markets Competitiveness Initiative to improve financial regulation effectiveness. Since then, work has proceeded in a variety of areas such as accounting and auditing, disclosure, and financial education. These long-term efforts remain central to the resilience of our financial markets, and their ability to support sustainable economic growth.

Of particular note, there is a pressing need to modernize our regulatory framework, which resembles a patchwork of overlapping agencies and responsibilities conceived over the last 75 years. After extensive consultations, Treasury concluded in its Blueprint for modernized financial regulation that the optimal financial regulatory model mirrors the reasons we regulate: market stability, safety and soundness associated with federal guarantees, and consumer and investor protection. This proposal includes a market stability regulator, prudential financial regulator and business conduct regulator. This approach would foster innovation, mitigate risk, and enhance competitiveness.

**International Coordination**

These concerted domestic efforts notwithstanding, financial turmoil witnessed on a global scale also has required an international response. Internationally, as market turmoil began to spread, Treasury quickly engaged with our counterparts in the Group of Seven (G-7) countries and the Financial Stability Forum.

Across global markets, and with the support of their national regulators, many financial institutions took aggressive action to write down assets, disclose losses and raise new capital. Write downs and losses in the past six months total well over $200 billion with U.S. financial institutions accounting for about half, Europeans over a third, and Asians, Canadians and others the remainder. Global financial institutions have raised over $150 billion in capital, with sovereign wealth funds making significant contributions. It remains vital that financial institutions act promptly to recognize the losses, secure adequate capital, and ensure credit availability for consumers and businesses.

In September, the G-7 asked the Financial Stability Forum to examine underlying weaknesses and develop appropriate international responses. The Financial Stability Forum (FSF), formed by the G-7 in 1999 following the Asian financial crisis, occupies a unique place in the international landscape. The FSF brings together supervisors, central banks, finance ministries, the International Monetary Fund and the World Bank, and other international regulators. Together, the members of the FSF assess international financial system vulnerabilities and identify needed actions among responsible authorities. This provides critical coordination between globally integrated capital markets and national regulatory agencies.

The FSF presented its findings to the G-7 last week. The report's conclusions and recommendations are consistent to those of the President's Working Group, but on a global scale. The recommendations include:

- Strengthening prudential oversight of capital, liquidity and risk management.
- Enhancing transparency and valuation.
- Changing and clarifying the role and use of credit ratings.
- Strengthening the authorities' responsiveness to risks.

- Creating robust arrangements for dealing with stress in the financial system.

Let me expand briefly on each of these areas.

**Prudential oversight: Firms need to strengthen their risk management practices, liquidity buffers and capital. The Basel Committee should raise capital requirements for complex securities and off-balance sheet vehicles. Supervisors need to issue revised liquidity risk management guidelines by July 2008, enhance monitoring, and require more stress testing.**

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**Transparency and valuation: Well-functioning markets rely on timely disclosure and robust valuations. Firms need to fully disclose their risk exposures and fair value estimates for complex securities. Supervisors need to require improved transparency for off-balance sheet entities. The International Accounting Standards Board should urgently act to improve standards for off-balance sheet entities and improve guidance for fair value accounting.**

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**Credit ratings: Investors should improve their due diligence efforts, reducing their reliance on credit ratings. Credit rating agencies need to clearly differentiate the ratings for structured products, improve their disclosures, and reassess the quality of the information they use to determine ratings for structured products.**

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**Authorities' responsiveness to risks: Supervisors and central banks need to increase their cooperation and information exchanges, including assessments of financial stability risks.**

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**Dealing with stress in the financial system: Central banks need to effectively provide liquidity when the financial system is under stress. In addition, authorities should strengthen arrangements for dealing with weak and failing banks, domestically and across borders.**

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These recommendations, while primarily aimed at filling regulatory gaps, also include suggestions that could enhance market conditions. These include, for example, encouraging stronger mid-2008 financial reporting, enhanced transparency for off-balance sheet entities, and fair value estimates for complex securities. These are important and immediate steps for boosting market confidence.

Work is already underway in many areas. Last week, the G-7 committed to the timely implementation of the FSF recommendations by the end of 2008. The Financial Stability Forum will report on progress on this ambitious agenda to the G-7 Finance Ministers next October. This important work – and this important body – will continue efforts to strengthen market discipline and encourage efficient and competitive markets.

**Moving Ahead**

Over the past 8 months, we have learned that our efforts must evolve quickly and creatively as events unfold and new information becomes available. And, we must maintain our perspective. Secretary Paulson, drawing on years of experience, has observed that: "every period of prolonged turbulence seems to be the worst until it is resolved. And it always is resolved."

Recent events highlight the ever present need to cultivate strong market discipline, greater transparency and disclosure, prudent regulatory policies and robust risk management. The actions being taken are doing just that.

I believe we will work through this period as we have those in the past, and will return to robust growth. The long-term prospects of the U.S. economy remain solid. Inevitably, more challenges lie ahead, but we will learn from this experience. We will adapt and we will emerge stronger. The flexibility, resilience and strength of U.S. capital markets and the U.S. economy will prevail.

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