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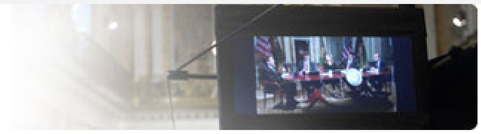

## Press Center

# Under Secretary for Domestic Finance Robert K. Steel Remarks before the Society of American Business Editors and Writers Annual Conference

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**Baltimore - Thank you for the invitation to be here today. Let me congratulate you on a timely and important conference. To my mind your agenda focuses you on the right set of issues, and it is a privilege for me to be included as one of your speakers.**

Thank you for the invitation to be here today. Let me congratulate you on a timely and important conference. To my mind your agenda focuses you on the right set of issues, and it is a privilege for me to be included as one of your speakers.

The Society of American Business Editors and Writers is an important organization, representing more than 3,000 members and setting the highest standards for economic journalism. You play a vital role in our open economy. American citizens – who are both providers and users of capital - rely on accurate and timely information to understand and follow financial markets, and you help distill complicated matters of finance and economics into easily accessible terms. Financial education is an important priority for us at Treasury – and as you may know, April is Financial Literacy Month. We are especially appreciative of the role your organizations play in communicating our message to the American public.

When Secretary Paulson and I arrived at Treasury in 2006, he had a full agenda of global priorities. But on two of his strategic goals – financial preparedness and capital markets competiveness - Domestic Finance has provided leadership.

One of our earliest initiatives was developing protocols for financial preparedness within the President's Working Group on Financial Markets (PWG) – the group chaired by the Secretary of the Treasury that also includes the chairmen of the Federal Reserve Board, the Securities and Exchange Commission and the Commodity Futures Trading Commission. Having spent three decades in financial markets, Secretary Paulson and I understood that periodic market disruptions, many with the potential to impact the real economy, are a reality. While these events are difficult to predict or prevent, we wanted to prepare so as to be ready to take action.

A second early priority for Treasury's Domestic Finance team was enhancing the effectiveness, efficiency and competitiveness of our capital markets. While the U.S. begins from a position of strong financial markets, we undertook a series of initiatives to ensure that our markets remain the world's leader. One of those specific initiatives was a comprehensive review and proposal on modernizing our approach to financial services regulation.

Given recent market challenges, our efforts on both financial preparedness and modernized regulation seem particularly relevant today. This afternoon, I would like to provide an update on our work in each of those two areas, then conclude with some general comments about current conditions and finally take your questions. Let me begin with financial preparedness.

**Perspective on Financial Crises**

The late MIT economist Charles Kindleberger referred to financial crises as "a hardy perennial" (1) and one recent study documents that market disruptions around the world have occurred regularly for the last eight centuries (2). Secretary Paulson and I understood this firsthand. During the three decades we worked in the financial services industry, we lived through many periods of market disruption, including the savings and loan crisis, the Asian financial turmoil, the collapse of Long Term Capital Management, and the dot.com bubble.

Despite the frequency of such occurrences, even the most talented economists or financial regulators cannot predict the exact origin, frequency or severity of financial turmoil. For example, very few foresaw the magnitude of bank failures that occurred worldwide during the 1980s. Three thousand U.S. savings and loan associations failed during that decade, costing U.S. taxpayers more than $100 billion. In Japan during roughly the same time period, bank losses resulting from the collapse of a bubble in real estate and asset prices cost Japanese taxpayers an amount totaling more than 25 percent of the country's GDP, a much larger share of the economy than the losses incurred by U.S. banks during the Great Depression (3). Similarly, most economists were surprised by the contagion that resulted from the collapse of asset prices in Thailand in the 1990s, which spread to Malaysia, Indonesia and eventually most of Asia. And in 1995, when only nine percent of Americans used the internet (4), few could have anticipated the mania and subsequent implosion in the stock prices of U.S. information technology and dot.com companies that occurred just a few years later.

As I mentioned, one recent study (by Carmen Reinhart and Kenneth Rogoff) examined eight hundred years worth of financial crises and concluded that, by historical standards, current market conditions are "hardly exceptional" (5). In fact, using the framework to interpret financial crises developed by Hyman Minsky – a scholar of business and credit cycles – one can trace the pro-cyclical impact of both the recent expansion and the subsequent contraction in the supply of credit. Minsky described how strong economic periods fueled optimism among lenders and borrowers. Eventually during a boom, however, what is initially rational enthusiasm turns excessive as both borrowing and lending become increasingly speculative. At some point during the later stages of the speculative boom, buyers become less eager to buy and sellers become more eager to sell. That, Minsky postulated, would develop into a period of "financial distress" (6). This framework certainly seems to capture the issues and challenges of today.

However, the fact that current challenges developed in a way that is not unusual by historical standards should not imply that the specific sources of our current headwinds were any more predictable five or 10 years ago. In fact, if you had taken a survey just 18 months ago, in the wake of the failure of the hedge fund Amaranth, many respondents might have expected the next round of market instability to be connected to the hedge fund industry, when in reality hedge funds have generally remained stable during the current period.

While none of us today can precisely anticipate when or where any future financial disruption might originate, symptoms and warning signs do exist. Just as scientists use seismographs to measure ground movements and anticipate earthquakes, market participants and regulators should continuously gauge markets for any potential alarms. Warning signs require attention, but any government intervention should be considered carefully so as to minimize moral hazard and any undue burdens that would damage the efficiency, effectiveness and competitiveness of our markets.

Periods of financial distress will develop and the frequency of these occurrences has significant implications for public policy. The challenge for policymakers is one of balance. The goal of public policy should be a marketplace that protects and gives confidence to investors and also provides a fair playing field for businesses. Government must ensure safe, stable and efficient functioning markets, while also being prepared to promptly respond to disruptions when they arise and minimize any contagion effect.

**Financial Preparedness**

With this in mind, in the fall of 2006 Secretary Paulson directed the President's Working Group on Financial Markets (PWG) to focus on financial preparedness.

In the last 20 months, the PWG has significantly enhanced its own protocols and procedures to improve communication and facilitate effective coordination and manage actions and responses in the event of a financial market challenge. These protocols include the ability for PWG member agencies to bring into the discussions a broader array of U.S. financial regulators, and given the global and borderless nature of financial markets, international supervisors depending on the situation. We have tested the protocols and procedures with our international counterparts.

The PWG works in cooperation with two other established groups to coordinate preparedness efforts: the public-sector Financial and Banking Information Infrastructure Committee (FBIIC); and the private-sector Financial Services Sector Coordinating Council (FSSCC). The FBIIC, chaired by the U.S. Department of the Treasury, is comprised of Federal and State financial regulatory agencies, and has coordinated and improved the resilience and security of the financial infrastructure. The FSSCC is comprised of U.S. exchanges, clearinghouses, financial institutions, financial sector trade associations, and regional coalitions, and has coordinated and improved critical infrastructure protection in the financial services sector.

These organizations have responded collaboratively during challenging periods, and they have also worked during calmer times to prioritize threats and test the financial sector's security and resilience. For example, they recently conducted a sector-wide pandemic flu exercise involving almost 3000 financial organizations in the United States that voluntary tested their plans over three weeks.

This overall commitment to financial preparedness by the PWG proved invaluable when challenges subsequently developed in the summer of 2007.

**Policy Response to Current Challenges**

Current market challenges, like many others before them, developed over a long period of time as complacency about risk built up over many years. Globally, economic growth was strong, businesses were doing well, earnings were healthy and returns to investors good. As a result, investors continuously looked for new investment opportunities, which created increasing demand for all assets, including housing. As prices were bid up, expected returns declined, and in order to maintain returns, investors sought new and more risky alternatives. Throughout the period, due diligence and risk management practices deteriorated. This overarching scenario affected many different asset classes, including housing. As demand for housing slowed, lending standards were gradually loosened to maintain volume. In 2006, the correction in homebuilding began and house price appreciation began to slow. This exposed underlying weaknesses in the mortgage and credit markets.

What began last summer as concerns in housing and credit markets, raised questions about market liquidity in the autumn, and today is raising uncertainty about the real economy.

The Administration and the independent regulators have responded vigorously to manage and minimize the impact of current challenges on the broader economy. Our goal has been to ease the housing correction, provide an economic stimulus and strengthen market discipline. We are making significant progress on all three of these fronts. Let me elaborate on each.

*Housing*

The Administration's housing market initiatives seek to prevent avoidable foreclosures and increase the availability of affordable mortgage financing. Our key initiatives include FHA Secure, announced by the President in August, and the HOPE NOW Alliance, launched in October at the encouragement of the Treasury. To date, the Federal Housing Administration (FHA) has refinanced more than 170,000 borrowers into affordable loans, and the Hope Now Alliance announced today that nearly 1.4 million homeowners have been helped through workout plans since the middle of last year. We continue to work with the Hope Now Alliance to gauge progress and evaluate ways for further success.

The stimulus package temporarily allows Fannie Mae and Freddie Mac ("the GSEs") to inject more liquidity into the jumbo mortgage market. This action, in conjunction with the recent capital relief from their regulator and the GSEs' pledges to raise additional capital, will enable them to provide further support to homeowners. The GSEs play an important role in housing finance and these recent actions and commitments should have a positive influence on housing markets.

While we are making significant progress, there is more work to be done. Last summer, the President announced three legislative priorities. One of them – forgiving taxes owed on cancelled mortgage debt – was passed and signed into law in December. We are waiting for Congress to act on the other two – FHA Modernization and GSE reform. These additional tools will help more homeowners.

Let me drill down a bit further into housing issues beyond the headlines. First of all, predatory lending is wrong and should be an area of focus during these housing challenges. We believe independent regulators are taking steps to address this issue. Also important to recognize is the reality that many homes begin the foreclosure process every year, even when housing markets are strong. Between 2001 and 2005, for example, the U.S. annual rate of foreclosure starts averaged approximately 1.7 percent, meaning more than 650,000 homeowners began the foreclosure process each year. While we certainly expect foreclosures to rise this year, we must bear in mind the frictional rate of foreclosure that happens every year.

Additionally, data releases every month create headlines about declining housing sales, starts and prices. Yet, declines are exactly what we should expect during a correction. Similarly, credit standards are improving – also, exactly what we should expect. It takes time to work through the excess inventory – but we are. Housing remains the biggest downside risk to the economy right now, but we are seeing some signs of progress. We are working to limit the impact of the housing downturn on the real economy without impeding the completion of the necessary housing correction.

Finally, let me address a topic that has recently received a lot of attention in the media: some people estimate that approximately 10 million homeowners are "underwater" on their mortgages; that is they owe more money than their home is currently worth. Many have suggested that lenders or taxpayers should make people whole for their investment losses. Let me be clear: a house falling in value does not necessarily change one's ability to afford your monthly mortgage payment. For most Americans, a house is not just an investment, it is their home. It is where they raise their children and live in their communities. We strongly believe people should and will continue paying their mortgages regardless of short-term price fluctuations. If investors choose to walk away because they put no money down and their free option is now worthless, we do not believe taxpayers should be held accountable. We are focused on helping homeowners who want to stay in their homes and have the financial wherewithal to do so.

*Economic Stimulus*

In addition to mortgage efforts, the Administration has also acted aggressively to support the economy as it weathers the housing correction and financial market challenges. The bi-partisan fiscal stimulus package, signed into law by President Bush on February 13, puts money back into the hands of American households and businesses. The package's $150 billion infusion will support the creation of over half a million additional jobs by year-end.

Just today, we are sending the first payments. And within the next few weeks, millions of Americans will receive their stimulus payment. Professionals at the Treasury Department and the IRS are working overtime to send 130 million projected stimulus payments, while simultaneously fulfilling their normal heightened responsibilities for this time of year, which include processing 138 million individual tax returns and issuing over 100 million regular tax refunds.

*Strengthening Market Discipline*

While we are focused on housing initiatives and stimulus payments, it is not too early to learn from these recent market challenges. Therefore, U.S. policymakers have also initiated a number of near and medium-term efforts to strengthen market discipline and regulatory practices. On March 13, the members of the President's Working Group issued a comprehensive review of policy issues related to recent financial market turmoil. The PWG recommended measures to reform mortgage origination, strengthen risk management, enhance disclosure and improve market discipline in the securitization process, and reform disclosure and use of credit ratings.

As implemented, these recommendations will change behavior and strengthen our markets through greater risk awareness, enhanced risk management, strong capital positions, prudent regulatory policies, and greater transparency. The PWG has committed to measuring progress by the end of this year, so as to ensure the implementation of these recommendations.

Also, the Treasury Department and key U.S. regulators have come together to speak with one unified voice on hedge funds. If we remember back to the fall of 2006, hedge funds were an area of focus among market participants. It was clear that the status quo was not optimal. The PWG responded in February 2007 by releasing principles and guidelines for private pools of capital to guide market participants and regulators. To complement and further improve the effectiveness of these efforts, last autumn the PWG convened a diverse set of leaders from both the asset management and investment communities to form two committees charged with reviewing and enhancing their respective market practices. These two committees released best practices for hedge fund managers and investors just two weeks ago and we look forward to their implementation in the months ahead.

**The Regulatory Blueprint Report: Modernizing Financial Regulation**

Progress for the financial system is a function of both market discipline and regulatory effectiveness. Our work to ensure the long-term effectiveness, efficiency and competitiveness of U.S. markets is critical to future economic growth and so it will remain a key area of focus throughout our time at Treasury.

Secretary Paulson kicked off this initiative in the fall of 2006 with a keynote address in New York. In March 2007, Treasury hosted a conference on capital market competitiveness at Georgetown University. Conference participants, who included investor and consumer advocates, academics, public policy experts and business leaders, concluded that our current financial regulatory system could more effectively promote stable and resilient markets and a more competitive financial services industry. So, last year we began work on, among things, a Blueprint for a modernized financial regulatory structure that would be more effective and more appropriate for modern financial markets.

Treasury's Blueprint has generated a great deal of discussion since its release on March 31st, , both in publications like yours as well as among market participants and academics. While some pundits characterized our recommendations as either "more" or "less" regulation, both descriptions are a bit simplistic. The goal of the Blueprint was to envision an optimal structure for financial regulation. This is not about more or less regulation; this is about preparing our financial marketplace to be better positioned to bring benefits to our citizens in the 21st century. We need to modernize our regulatory approach to one that is objectives based, globally oriented and flexible in scope.

Treasury's work began by first articulating the optimal regulatory structure, and then developing short- and intermediate-term recommendations that will help move us toward the ideal structure. Along the way we engaged U.S. and international regulators, market participants, consumer and investor advocates, and academics, and received over 200 comments from the public in response to a notice in the Federal Register. What emerged from our work on the Blueprint is a series of short-term, intermediate-term, and long-term recommendations.

The Blueprint outlined a long-term optimal regulatory structure consisting of three regulators, each with a separate objective: a Market Stability Regulator, a Prudential Regulator, and a Business Conduct Regulator. This new structure, an objectives-based approach, improves on today's functional regulation by creating dedicated regulators to address market challenges. While we considered several different conceptual models of regulation, we believe that an objectives-based approach offers the best potential for enhancing regulation, addressing market failures, and eliminating inconsistencies or duplication by creating regulators with clear missions to provide greater consistency and reduce coverage gaps. Although this optimal model is clearly aspirational and will only be achieved in the long-term, we at Treasury believed it was important to begin a discussion by setting forward our view and then engaging with others. In a similar way, two previous studies in 1984 and 1991 ultimately laid the foundation for many of the changes adopted in the Gramm-Leach-Bliley Act of 1999.

In order to move today's regulatory structure in the direction of the optimal structure, the Blueprint makes a number of short- and intermediate-term recommendations. For example, in the short-term the paper recommends:

- Modernizing the President's Working Group on Financial Markets;
- And creating a new Mortgage Origination Commission to evaluate, rate, and report on the adequacy of each state's system for licensing and regulation of participants in the mortgage origination process.

In the intermediate-term, the Blueprint recommends taking steps such as:

- Creating a federal charter for systemically-important payment and settlement systems;
- Transitioning from the federal thrift charter to a national bank charter;
- Studying the role of federal regulation of state-chartered banks;
- Creating an Optional Federal Charter for insurance;
- And merging the SEC and the CFTC.

Some may view these recommendations as a response to the circumstances of the day; yet, that is not how they were developed or are intended. This Blueprint addresses complex, long-term issues that should not be decided in the midst of current market strains. Nevertheless, current challenges have highlighted the need to modernize our regulatory structure. We believe these recommendations will help ensure the long-term effectiveness, efficiency and competitiveness of our capital markets.

**Conclusion**

Let me conclude by again thanking you for the invitation to be here today. It is certainly an interesting time for all of us who focus on the economy, current challenges and the appropriate policy response.

In summary, our first priority is to remain vigilant and minimize the impact of current challenges on the broader economy. By historical standards current market disruptions are not out of the ordinary. Our early focus on enhancing financial preparedness helped equip us to respond appropriately and minimize impacts to the broader economy. In recent months, the Federal Reserve Board has taken strong action and we appreciate their leadership.

We are also working to ease the housing correction and real progress is being made. New data released from Hope Now today indicate that almost 400,000 homeowners have received loan modifications since last summer. In December, we announced a plan to fast-track subprime ARM borrowers who could afford their starter rate into refinancings and loan modifications. Hope Now's data shows that 47 percent of loans scheduled to reset in the first quarter paid in full through a refinancing or sale. Another 14,000 received a modification, of which 64 percent were for 5 years or longer.

To be clear, our objective is not maximizing modifications; rather it is minimizing foreclosures for homeowners who want to stay in their homes and have the financial wherewithal to do so. Hope Now's data shows that less than 1 percent of borrowers who were current at reset have entered foreclosure. The industry is proving it has the ability to help able homeowners avoid foreclosure, and we look forward to continued progress in the near future.

Our economy today has slowed after a period of very strong economic growth. Just last fall, GDP growth in the third quarter was 4.9 percent. Since then energy prices, housing correction, and credit contraction have created substantial economic headwinds. The Administration is focused on easing the housing correction and providing an economic stimulus. We are also focused on longer term improvements, such as enhanced market discipline and modernized regulatory policies.

I am often asked where we are in the recovery process, and my response today is that clear progress has been made. We are seeing many signs of improvement and this progress is encouraging. Certainly, there will be continued challenges in the months ahead. However, we have worked through challenges in the recent past and I have great confidence in the resilience and strength of our economy. As a result of our efforts, I expect our economy to emerge even stronger.

(1) Kindleberger, Charles and Robert Aliber; *Manias, Panics and Crashes: A History of Financial Crises*; (2005).

(2) Reinhart, Carmen and Kenneth Rogoff; "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises"; NBER Working Paper #13882; March, 2008.

(3) Kindleberger, Charles and Robert Aliber; *Manias, Panics and Crashes: A History of Financial Crises*; (2005); pg 2-3.

(4) Harris Interactive Poll, May 2006.

(5) Reinhart, Carmen and Kenneth Rogoff; "This Time is Different: A Panoramic View of Eight Centuries of Financial Crises"; NBER Working Paper #13882; March, 2008.

(6) Kindleberger, Charles and Robert Aliber; *Manias, Panics and Crashes: A History of Financial Crises*; (2005); pg 21-29.

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