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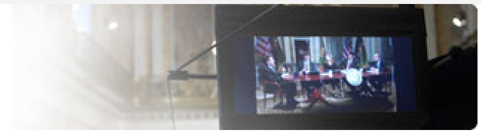

Assistant Secretary for Financial Institutions David G. Nason Remarks on Treasury’s Blueprint for a Modernized Regulatory Structure

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London - Chairman Julius, thank you for that kind introduction. It is a pleasure to be here for the New Financial Frontiers conference. The Chatham House, as home to the Royal Institute of International Affairs, has served its mission well to foster debate and ideas on important international policy matters for over 80 years. I am honored to be here with this distinguished group of conference speakers and participants and to have the opportunity to contribute to this discussion on financial markets.

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I would like to spend my time today in two ways. First, I would like to give an update as to how we see things progressing in the U.S. financial markets. Limiting the impact of the capital market turmoil and housing downturn on the rest of the economy has been and will continue to be our primary focus. Secretary Paulson often says that stable and orderly financial markets are critical to the health of our economy – businesses rely on access to credit in order to invest and create jobs, and families draw on credit markets to finance their homes and daily lives.

Second, I would like to discuss Treasury's recently-released *Blueprint for a Modernized Financial Regulatory Structure*, its approach to addressing long-term challenges with the U.S. regulatory structure and how they connect with current market regulation.

Financial Markets

As we all know, the financial markets stress began last summer. The root causes of the stress are well documented. The turmoil in financial markets was born from a dramatic weakening of underwriting standards for U.S. mortgages, especially subprime mortgages, beginning in late 2004 and extending into early 2007.

The loosening of credit terms in the subprime market was symptomatic of a much broader erosion of market discipline on the standards and terms of loans to households and businesses. Following many years of benign economic conditions and plentiful market liquidity, global investors had become complacent about risks, even in the case of new and increasingly complex financial instruments.

The confluence of many events led to a significant credit contraction and repricing of risk. Sentiment swung hard to risk aversion with perhaps one of the most dramatic series being the events that led to JPMorgan Chase acquiring Bear Stearns.

Our policy makers and central banks have been working diligently to respond. The U.S. Federal Reserve has provided additional liquidity by amending some of its existing policy tools and creating new facilities when needed. The Federal Open Market Committee has lowered the federal funds target rate by 300 basis points since August 2007, to help soften the negative impact of the recent financial market disturbance has on the real economy.

Additionally, the Federal Reserve in coordination with the European Central Bank and Swiss National Bank has provided additional liquidity through a dollar swap facility to help address dollar funding pressures outside of the United States. Other liquidity enhancing measures by the ECB as well as the Bank of England through its recently announced long term debt swap facility have and will continue to help address the acute funding pressures that continue to persist.

As the Federal Reserve helped to resolve the Bear Stearns situation, it subsequently took a very important and consequential action of instituting a temporary program for providing liquidity to primary dealers. Taking this step in a period of stress recognizes the changed nature of our financial system and the role played by investment banks. Such direct lending from the central bank to non-depository institutions has not occurred in the United States since the 1930s. The Federal Reserve's creativity in the face of new challenges deserves praise, but the circumstances that led the Federal Reserve to modify its lending facilities raises significant policy considerations that we must address.

If we pause and examine where our markets stand today, the story is mixed.

There are certainly some encouraging trends such as the narrowing of both commercial and investment bank credit default swap spreads. Also, financial institution equity prices have stabilized largely as a result of institutions recognizing their losses and raising additional capital. This improves market confidence and allows banks to continue to extend the lending necessary for economic growth.

Our largest institutions have gone to market to raise additional capital. Since December of last year, financial institutions have raised more than $175 billion in capital. Importantly, this investment is helping to facilitate price discovery in markets that are suffering from significant illiquidity. We would like to see smaller institutions raise capital as well.

Of course, some trends are not as encouraging. The interbank financing market is still strained and many securitization markets have not revived in a material fashion.

The Treasury Department has worked to decrease the chances that the current challenges will happen again. Treasury, in conjunction with other regulatory bodies, has developed policy responses to begin to address the ongoing crisis of confidence in our markets.

The President's Working Group on Financial Markets (PWG), led by Secretary Paulson, is composed of the Chairmen of the Federal Reserve, Securities and Exchange Commission (SEC), and the Commodity Futures Trading Commission. The PWG is working closely with the Financial Stability Forum (FSF), composed of regulators, finance ministries, and central banks from the world's largest and most significant economies. The PWG and FSF have proposed sets of separate but consistent ways to address the root causes of current market instability. These are specific ideas to deal with some of these challenges within our current regulatory regimes.

Blueprint for a Modernized Financial Regulatory Structure

In the United States, we are at the beginning of a journey to more fundamental change regarding financial services regulation. Since the focus of the conference is on managing risk and the new financial frontiers, I would like to spend the rest of my time talking about a structure that is better suited to deal with the 21 st century financial services markets. Just a few weeks ago Treasury released a *Blueprint for a Modernized Financial Regulatory Structure*, addressing these topics with a series of short, intermediate and long-term recommendations. While this project started more than a year ago, not in response to current market events, there is no question that recent events have transformed these issues from the theoretical to the practical.

For the optimal regulatory structure in our long-term recommendation we started with a blank slate. We thought about the best approach to U.S. financial services regulation. We studied closely regulatory structures in other jurisdictions; we spoke to and reviewed hundreds of comment letters from market participants and regulators worldwide, including our counterparts in the United Kingdom.

After this process, Treasury decided that the optimal regulatory structure would be an objectives-based approach, an approach with individual regulators focused on three key objectives: market stability regulation; prudential regulation, focused on institutions with reliable access to a government backstop or subsidy; and business conduct regulation, focused on consumer protection and disclosure issues.

Our recommendation for a market stability regulator garnered significant interest in both in the United States and abroad. In Treasury's model, a market stability regulator would address overall conditions of financial market stability that could impact the real economy. This regulator would have authorities to focus market stability regulation in areas where financial markets may not function properly, to provide information to enhance the functioning of financial markets, and to provide authority to take actions should the need arise.

Typically, a market stability role is associated with the central bank. Most central banks have a general responsibility to achieve macroeconomic stability through the formation of monetary policy. In the United States, the Federal Reserve plays this role with the goal of promoting overall macroeconomic stability in terms of output and prices. In normal economic conditions, market stability and macroeconomic stability should go hand in hand. But, as the current conditions in credit markets and other past episodes of financial instability illustrate, the traditional toolbox of monetary policy and the regulatory framework associated with financial institutions might not be well-suited to deal with transmission of financial shocks to the real economy in today's financial markets.

We recommended recasting the role of the Federal Reserve as our market stability regulator to expand its assessment and authority over potential risks in the overall financial system, including correlations and common exposures across financial institutions. This contrasts with its existing regulatory authority that focuses primarily on the health of individual financial institutions. This new responsibility can be referred to as "macro-prudential regulation" and the latter as "micro-prudential regulation".

Undoubtedly, the tasks of the market stability regulator would be difficult. Some have likened it to an impossible task of piercing asset bubbles or having an omnipresent view of risk in the financial system. To be clear, we do not view it in that manner. We do not believe that we can eliminate all future bouts of financial instability.

In a dynamic market economy it is impossible to eliminate instability through regulation. At a fundamental level, the root causes of market instability are difficult to predict, and past history may be a poor predictor of future episodes of instability. Nonetheless, we should not stop trying to understand better and mitigate instability. Yes, the task is difficult, but the task remains.

So exactly what would this new Federal Reserve do? It is interesting to note that this current period in financial market stress has created an important change in vocabulary. For years, public policy makers have struggled with the notion that certain institutions could be deemed "too big to fail". Now, we should consider whether certain firms are "too interconnected to fail".

Interconnectedness occurs in formal markets or in more informal networks of trading in financial instruments. These networks or trading mechanisms are essential to the free movement of capital and efficient disbursement of risk. The network structure is much like an airline hub such as Heathrow Airport, where if everything works as planned, airline passengers and their luggage are efficiently moved from one destination to another. But if a breakdown occurs at just one or two departure gates, the entire interconnected airport can turn into complete disarray.

This is one of the key functions of the market stability regulator – carefully monitoring the interconnectivity embedded in our networks of financial institutions. It is a monitoring of the entire system, making sure that passengers and luggage get to where they are supposed to go, having contingency plans for bad weather, and keeping the air transportation system running even if one airline goes out of business.

Obvious focus points here are counterparty risk exposures – whether they occur through standard credit instruments, credit default swaps, credit insurance, or other means; the operation of market structures – whether established on a formal or informal basis; and general practices that could cause problems for the overall financial network – such as concentrations of asset exposures and overall risk management practices.

At the outset, a goal of this regulator is to attempt to harness market forces. The market stability regulator must have access to detailed information from all types of financial institutions, including data submissions and the ability to join in or initiate examinations. Second, the market stability regulator should have the authority to require additional disclosure by financial institutions so that market participants can better evaluate their risk profiles. Third, the market stability regulator should also be involved in financial institution regulatory requirements to include a focus on broader market stability perspectives. Finally, the market stability regulator should have the ability to require financial firms to undertake corrective actions to address financial stability problems.

As the market stability regulator collects and analyzes this type of information, it could publish aggregate information to highlight issues and trends associated with potential risk exposure. Such actions, combined with enforcement authority as necessary, would provide a clear signal to market participants and other regulators that the market stability regulator has identified some potential problems that should be addressed. We would expect that this action alone could have an impact on overall behavior.

This process is what some have referred to as "leaning against the wind" in an attempt to prevent broad economic dislocations caused by potential excesses. I would agree, so long as the lean can be calibrated based on the conditions of the storm and the effectiveness of the regulators initial actions.

This would not be an easy task. In addition to the difficulty of determining just where and when to lean against the wind, there could be a tendency of a regulator to lean too heavily simply to avoid blame for any ensuing financial instability. Moreover, regulated entities could push back, alleging regulatory over-reach. But if we clearly understand that this process will not prevent all financial instability and that the dynamic and innovative aspects of financial markets must be preserved, then it is a process worth trying.

The optimal structure in Treasury's Blueprint was an ambitious attempt to recast the debate on regulatory structure for financial institutions and the entire financial system in the United States. As we have acknowledged, change of this magnitude would require considerable debate and time.

Near-Term Steps to Consider

The recent challenges in credit markets illustrates that the world has changed and we need to think continually about what steps can be considered now while broader changes regarding regulatory structure are debated. Fortunately, the Blueprint's analysis is instructive in this regard.

For example, one obvious question is the proper regulatory oversight of investment banks, especially the largest firms- the SEC's consolidated supervisory entities. Right now, the Federal Reserve and the SEC are working constructively together while the primary dealers have access to the Federal Reserve's liquidity facilities. This is appropriate, as the Federal Reserve needs to have information about institutions to which it is lending.

What happens next after that facility eventually closes is a more difficult policy question. We are in the first act of what is a multi-act play. Some decisions seem clear. If firms have permanent access to a government backstop, then these firms need to be regulated in the same way as all other institutions that have access to this backstop. Similarly, as our markets have gotten more inter-connected, it is necessary to have some type of oversight to ensure that broader issues of market stability are considered adequately.

Many other issues still need to be resolved. Some market participants question whether the primary dealers' access to the Federal Reserve's liquidity facilities is truly temporary, which has an impact on behavior. Uncertainty leads some to conclude that these non-banking financial institutions should have the same type of regulation as institutions that have a significant percentage of their liabilities insured by the government.

Others believe the increasing complexity of financial transactions and structure of financial institutions is a logical reason for extending bank-like regulation to additional firms. Greater complexity has not developed in a vacuum. While new financial products and complex riskhedging strategies provide the benefit of wider risk dispersion, if market participants cannot evaluate fully the risk profiles of the financial institutions using these products, then it remains unclear that innovation has reduced risk.

If we expand bank-like regulation to a wider range of firms it seems that two outcomes are possible. One outcome could be that innovation and risk-taking decline to levels below what the market would normally allow. This could inhibit overall economic growth and could push market-permitted risk-taking to those firms not swept into broader regulatory reach. Another outcome would be to provide a false sense of security to market participants, potentially leading to less market discipline and even greater complexity and opacity in the future that could lead to even greater financial instability. Both of these outcomes are unattractive. But so is the status quo. Change, in one form or another, is likely to come.

For this reason, the Blueprint advocated for a separation of responsibilities between a regulator looking at the system as a whole and another regulator focused on the health of individual institutions. A bifurcation of regulatory responsibility properly aligns regulatory incentives. A macro-stability regulator should generally not be concerned with the failure of an individual institution. In contrast, especially where the government safety net is at risk, the tendency of a micro-prudential regulator would be to be very concerned with individual institution failures.

If these two functions continue to be combined and the distinction is further blurred, the result could be more overall government support for troubled financial institutions, whether explicit or implicit. This further distorts financial markets and can make the financial system more fragile rather than more stable.

We look forward to further considering the appropriate role of regulation in pursuit of market stability in the coming months. Market stability regulation should reflect a fine balance of addressing areas where the market may not function, allowing for innovation, and harnessing market discipline. It will be difficult to balance these roles, but if we go into this process understanding that we will never fully eliminate market instability, we have a much better chance of establishing a more stable financial system for the future.

Thank you.

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