

U.S. DEPARTMENT OF THE TREASURY

Press Center



Remarks by Secretary Henry M. Paulson, Jr. on the U.S. Economy, Housing and Capital Markets

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Before the Washington Post 200 Lunch

Washington - Thank you, Len. Over the last forty years, Washington has transformed into a diverse corporate center. Congratulations to the Post for recognizing this through their annual list of 200. And I am pleased to join you and represent the "old" Washington, the less than ten percent of the region's workers who work for the federal government.

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While the Post 200 companies may be headquartered here, your operations span the nation and the world and so I will provide an update on the housing and credit markets and the U.S. economy, and look forward to learning your views of the same.

Housing Markets

The housing correction began in 2006, and most forecasters expect a prolonged period of adjustment. Four points sum up my current view of the progress of that correction and our efforts to minimize its spillover into the rest of the economy.

First, our focus since last summer - to help homeowners avoid preventable foreclosures - is the right focus and it has been successful. We encouraged the creation of the HOPE NOW Alliance of mortgage lenders, servicers and counselors, to streamline efforts to help struggling borrowers. The Alliance reports that, since July, the industry has helped 1.4 million homeowners with loan workouts that allowed them to stay in their homes. The rate of workouts has now increased to about 2 million per year. In addition, we've taken administrative steps to expand access to FHA programs and enabled almost 200,000 borrowers to refinance into affordable FHA mortgages since August. These are significant numbers, and a significant achievement, particularly when you consider that 2 million is also the estimated number of homes that will go into foreclosure this year.

Second, there is no silver bullet to undo the lax underwriting practices of recent years. Because of these past excesses, foreclosures will remain elevated even if we avoid every single preventable foreclosure.

Third, we know the correction has further to go, and so we should not be surprised at headlines that note rising foreclosures and falling home prices. But the correction is progressing. We are working through the excess inventory --- the inventory of new single-family homes for sale is down 18 percent from its 2006 peak. As of April, single-family housing starts are down to a 692,000 annual rate, off 62 percent from their January 2006 peak. We didn't get here quickly. There were years of excesses. And this won't be resolved quickly.

Fourth, our work is not complete. Housing is the biggest risk to our economy; we are constantly monitoring the situation and examining approaches to address the problem. We are particularly focused on monitoring and continuously improving the execution of the HOPE NOW Alliance efforts, and working with Congress to complete work that is crucial to mortgage financing - creating a world-class regulator for Fannie Mae, Freddie Mac and the Federal Home Loan Banks, and modernizing the programs of the FHA so it can assist more homeowners without imposing additional burden on taxpayers. The mission of Fannie and Freddie, the two largest public companies on the Post 200 list, is more critical now than ever. Together, they touch 80 percent of current mortgage originations, and a regulator on par with other financial regulators will bring confidence to all mortgage market participants.

I will elaborate on these points and start by putting the American housing market and the size of the problem in perspective. Although I am going to talk numbers and statistics, I know that beneath these numbers are many who are struggling and their situation is both real and difficult. As of the end of 2007, there were 55 million mortgages outstanding and 92 percent were being paid on time, every month. About 6 percent had missed one or more payments and the remaining 2 percent, about 1 million, were in the foreclosure process.

There were 1.5 million foreclosures started in all of 2007. Between 2001 and 2005, a time of solid U.S. economic growth and high home price appreciation, about 650,000 foreclosure starts occurred, likely due to financial setbacks and unforeseen life events. In this correction, we see additional foreclosures because some people bought more home than they could ever hope to afford. Many of these people are

becoming renters again. Foreclosures are also up due to an increased number of speculators who bought homes on the assumption that housing prices would endlessly appreciate.

As housing prices decline some homeowners find they have negative equity in their homes. Negative equity is not a trigger for foreclosure and it doesn't alter your monthly payment. When you are in your home for the long run, to raise a family and be part of a community, prices will fluctuate throughout the years.

Homeowners who can afford their payment should honor their obligations --- and we know that the vast majority do. If someone can't afford their home and must move, it is painful. If someone walks away from a mortgage they can afford, it is irresponsible. In both these cases, however, there is little government or industry should do to prevent foreclosure.

We are focused on those homeowners who both want to stay in their home and, with a little flexibility, can afford to do so. We encouraged the formation of HOPE NOW in order to avoid a market failure. As mortgages have been securitized and those securities spread around the world, this complexity reduced the ability of investors to quickly respond to help struggling homeowners who both wanted to keep their homes and were financially able to do so. The Alliance has worked to overcome legal, technical and accounting complexities, and to speed up and simplify the refinancing and modification process so that more people can be helped.

Avoiding Preventable Foreclosures

HOPE NOW has made enormous progress. I have met with Alliance members, and am pleased that they are focused on continuously learning from their experience, adapting their practices and improving execution across the industry.

Subprime adjustable rate mortgages account for about 40 percent of all foreclosures, and we have focused much of our efforts on preventing foreclosures here, when possible. Our objective is not to maximize modifications; it is to minimize foreclosures for those who could afford the starter rate. Because lower interest rates have significantly reduced the reset problem, and because industry has acted to fast-track eligible borrowers, we are achieving our objective. Of the more than 400,000 subprime mortgage resets originally scheduled for the first quarter of 2008, only 553 loans that were current at reset have entered foreclosure. We will continue tracking that number closely to monitor progress.

Of course homeowners have responsibility as well. HOPE NOW members send over 200,000 letters a month to at-risk homeowners. While the response rate has increased from less than 3 percent to 20 percent, that still means that 80 percent of at-risk borrowers do not respond to offers of assistance. We can't help those who aren't willing to help themselves, and we must continue to urge struggling borrowers that if they haven't already, they need to reach out for help.

We will continue to look for additional tools to reach and help homeowners and to make existing programs work more smoothly.

Mortgage Finance

As you all know, the availability of mortgage finance has been an enormous challenge in recent months. Subprime loan originations are virtually non-existent today. The Administration has stepped up to that challenge by making FHA mortgages available to a broader group of borrowers. FHA originations are on pace to more than double in FY 2008. And this is occurring without significantly increasing taxpayer risk.

The new FHASecure program has refinanced over 200,000 borrowers into affordable mortgages in the past eight months and HUD is examining means of expanding access further. We are also working with Congress to complete work on FHA modernization legislation proposed by President Bush last year, which would increase the number of affordable FHA mortgages without imposing new costs on taxpayers. This legislation would reach another 250,000 potential FHA borrowers.

Fannie Mae and Freddie Mac are guaranteeing a greater share of mortgages than ever before. It's never been more critical that markets have confidence in how these companies are overseen and regulated. Given their size, complexity and important role, we need to ensure that they have a regulatory structure on par with other financial institutions. I believe there is a renewed commitment in the Congress to completing meaningful GSE reform legislation. The House has passed a bill that makes good progress towards this goal and I am pleased to see the Senate Banking Committee working hard to reach agreement on its version. The time has come to get this done.

Capital Markets

The excesses in the mortgage market were just one of numerous examples of excesses in the broader capital markets as investors reached for yield. This translated into undue leverage in financial instruments and institutions, which was not adequately recognized by market participants and regulators, and in increased complexity of financial products. It will also take time for markets to work through these excesses.

That being said, we are seeing signs of progress as capital and credit markets stabilize. The markets are considerably calmer now than they were in March. The de-leveraging and re-pricing of risk continue, as does the capital-raising that is so essential for our financial institutions to continue to support the broader economy.

Market liquidity and investor confidence are gradually improving, not across the board, but in several sectors including corporate bonds, leveraged loans and high yield debt. Credit default swap, or CDS, spreads on major bank, brokerage firm, and Fannie Mae and Freddie Mac debt have declined appreciably since March. Broader CDS indexes of investment grade and high yield bonds have fallen as well, and while spreads generally are still elevated and significant parts of the market, including securitized credit and interbank lending, are not functioning as normal, the trends indicate on-going improvement. Likewise, we are seeing issuance gradually grow in certain credit sectors.

We meet often with market participants and investors, to understand the remaining obstacles. They routinely report that time is the critical factor --- it simply takes time to reassess and re-price risk, and regain confidence. We should not expect to work through this process quickly and we should expect some bumps in the road ahead. But in my judgment we are closer to the end of the market turmoil than the beginning. Looking forward, I expect that financial markets will be driven less by the recent turmoil and more by broader economic conditions and, specifically, by the recovery of the housing sector.

President's Working Group Recommendations

Our highest priority these past several months has been to address the short term issues arising from market turmoil, so as to reduce its impact on the rest of the economy. At the same time, the President's Working Group on Financial Markets, the PWG, reviewed the causes of the recent turmoil and has made recommendations to address them.

Our review found that the turmoil was fueled by an abundant supply of easy credit, a decline in mortgage and other credit lending standards, increasingly complex and opaque financial instruments and structures, excessive leverage in our financial system, and investor and credit ratings agency issues.

The PWG presented specific near-term steps to address underlying weaknesses, steps that should be implemented by regulators, investors, financial institutions and credit ratings agencies. Among these, we identified improvements to be made in every step of the mortgage originate-to-distribute model, including stronger oversight of mortgage origination, national licensing standards for mortgage brokers, more disclosure from ratings agencies, improved due diligence by investors and safeguards in mortgage securitization.

We also outlined specific steps that credit rating agencies should take to provide information investors need to make more fully-informed decisions about risk. This will require reforming structured credit product rating processes and implementing changes suggested by the SEC review of conflict of interest issues. Regulators must also review how they encourage the use of ratings in rules and guidance.

In recent years, credit default swaps and over-the-counter (OTC) derivatives have become integral for hedging credit and default risk. Due to innovation and demand, we have seen tremendous expansion in the scale, diversity and impact of these instruments and markets. As trading volumes have surged, so has price volatility, but market infrastructure has not sufficiently evolved to support this expansion. We need a functional, well-designed industry cooperative that can meet the needs of the OTC derivatives markets in the years ahead. Such an industry cooperative must capture all significant processing events, and accommodate all major asset classes and product types over the entire lifecycle of trades. It must be operationally reliable and scalable, and enhance counterparty risk management through netting and collateral agreements by promoting portfolio reconciliation and accurate valuation of trades.

We are working to implement these PWG recommendations, and will report on our progress later this year.

Another issue that has been raised in recent weeks is investment bank access to the Federal Reserve's liquidity facilities. The Federal Reserve has made these available for a temporary period. Policymakers are considering the difficult issues associated with this extension of credit to non-banks.

Blueprint for a Modernized Financial Regulatory Structure

We are also focused on the long-term. In March, we released a Blueprint for financial regulatory reform to frame the needed discussion that should lead to modernizing our regulatory structure to keep pace with our financial system. The ultimate beneficiaries from improved financial market regulation are America's workers, families and businesses – both small and large. Our current regulatory system has largely evolved from early 20th century financial models; it's a system that has been patched together over time in response to the issues of the day. Regulators have adapted to keep pace with innovation, but they do so within a rigid structure that can not readily adapt as the financial services industry evolves.

The Blueprint included several immediate steps that we are already working to implement. One is a new executive order to clarify the PWG mission and increase the PWG membership to include additional financial regulators. Through this, we will formalize current coordination and communication. This will support the PWG's efforts to enhance financial market integrity and promote consumer and investor protection.

Second, we recommended creating a federal Mortgage Origination Commission. The MOC would establish minimum conduct and competency standards for mortgage originators and require information to evaluate each state's mortgage compliance standards for improved transparency in the securitization process. This Commission, coupled with the Federal Reserve's strong regulatory proposal regarding the Home Ownership and Equity Protection Act (HOEPA) rules, should go a long way in preventing recent issues from recurring.

Third, we recommended that the Federal Reserve and the SEC enter into a formalized information-sharing agreement. I am pleased to see this process underway.

Fourth, we recommended the creation of an office of insurance oversight housed at the Department of Treasury, and legislation has been introduced that is consistent with our recommendation.

Beyond these steps, the Blueprint's recommendations are intended to provoke thoughtful discussion that will ultimately lead to change. And we must begin that discussion now, because these changes are important to the long-term strength and effectiveness of our capital markets.

U.S. Economy and Stimulus Package

Although we are still working through housing and capital markets issues, and expect to be doing so for some time, we also expect to see a faster pace of economic growth before the end of the year. This is in part because the Administration and Congress worked together and worked quickly to pass the Economic Stimulus Act of 2008, a robust, broad-based and temporary package that will put money into our economy this year, when it's needed.

By the middle of July, about 130 million households will have received nearly \$100 billion. These payments, along with the incentives for business investment included in the Act, will provide a boost to our economy in the coming months and add over 500,000 jobs this year that wouldn't have been created otherwise.

This fiscal stimulus will provide support to the economy as we weather the housing correction, capital markets turmoil and higher energy and food prices. Unemployment remains low and increased exports are partially offsetting other less positive factors. Overall, I believe we are on the right path to resolving market disruptions and building a stronger financial system. We are working through this period and our long term prospects remain strong. One thing is very clear to me – whatever our current difficulties, I wouldn't bet against the U.S. worker or the U.S. economy.

Conclusion

America's workers have benefited from six years of strong economic growth. We know that now, they are also feeling the current strain. The President and his entire economic team are vigilant. We are working to help Americans get through today's difficulties. And while we do this, I remind all of us that our economy is structurally sound, with long-term fundamentals that compare favorably to any other place in the world. Thank you.