

U.S. DEPARTMENT OF THE TREASURY

Press Center



Remarks by Secretary Henry M. Paulson, Jr. on Economy and Markets before Women in Housing and Finance

6/19/2008

HP-1040

Washington, DC-- Good afternoon. Thank you, Mary Martha. And thanks to Women in Housing and Finance for almost thirty years of actively promoting women in the finance and housing professions. Not surprisingly, I think those who work in finance and markets serve an integral role in our economy and congratulate all of you who have chosen to pursue careers in these challenging and dynamic fields.

U.S. Economy

As you know, the U.S. economy is going through a rough period – after six straight years of almost 3 percent average annual growth, our growth rate slowed significantly late last year. We are facing a trio of headwinds – a housing correction, capital markets turmoil and high energy and commodity prices.

We acted quickly in January and February to enact an economic stimulus package that is injecting \$150 billion into our economy now when it's most needed. To date, over 76 million payments totaling almost \$64 billion have been sent. These payments are helping families weather this period of slow growth and absorb unexpectedly higher food and gas prices. These stimulus payments are already having an impact as retailers are reporting increased sales as people receive and spend their checks. While the stimulus is making our economy stronger than it otherwise would have been, the headwind of high energy prices has the potential to lengthen the economic slowdown.

The housing correction is proceeding. We have implemented a series of public and private initiatives to help financially-able homeowners stay in their homes and to keep mortgage financing available. Importantly, Congress has made great progress on reform of the supervision of the GSEs, and needs to complete that work. Fannie Mae and Freddie Mac are the two largest sources of mortgage finance, with a combined 70 percent share of the mortgage market last quarter. A strengthened regulator for Fannie Mae and Freddie Mac will increase investor confidence in these enterprises and will be a substantial tool to ease the housing downturn and increase the availability of affordable mortgages for Americans who want to buy a new home or refinance their current one.

U.S. Capital Markets

Certain sectors of the capital markets are still under stress, but we continue to make progress. As I have said before, we expect to be working through this for some time as de-leveraging and re-pricing of risk continue.

Revaluation of assets and overall market conditions are creating a challenging earnings environment and pressure for some financial institutions. While stressful in the near-term, this re-pricing of risk is necessary and will set the stage for greater confidence and market improvements.

For some time I have encouraged financial institutions to raise capital. Even in this difficult environment, U.S. financial institutions have begun the process by raising billions of dollars in new capital. I expect this process to continue and broaden, which is essential to the ability of these institutions to continue to support the broader economy.

I believe market conditions will continue to improve, but not in a straight line. Our financial institutions must continue to improve risk management and disclosure. I am confident that actions being taken by our financial institutions and regulators will make our capital markets stronger and contribute to sustainable future economic growth. Overall, I believe that the United States is on the right path to resolving market disruptions and building a stronger financial system. Increasingly, our capital markets will reflect the underlying economy. And in that regard, a significant downside risk is housing, which we continue to monitor.

Policy Issues Arising from Market Turmoil

As we work through the immediate market turmoil, the President's Working Group on Financial Markets, the PWG, has also reviewed its causes and, in March, made recommendations to address them.

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

independent assessment by investors 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 for every step of the mortgage originate-to-distribute model, including stronger oversight of mortgage origination, national licensing standards for mortgage brokers, more disclosure from securitizers and ratings agencies, and improved due diligence by investors.

We also outlined specific steps that credit rating agencies should take to provide information that investors need to make more fully-informed decisions about risk. This will require reforming structured credit product rating processes and implementing other changes. The SEC has already begun by proposing new rules on disclosure, due diligence and conflict of interest. Regulators must also review how rules and guidance encourage over-reliance on the use of ratings.

In recent years, credit default swaps and over-the-counter (OTC) derivatives have become integral for hedging credit, default and price risk. Due to innovation and demand, we have seen tremendous expansion in the scale, diversity and impact of these instruments and markets. As price volatility has surged, so have trading volumes; market infrastructure needs to more sufficiently evolve to support this expansion. In response to this pressing need, we recommended the establishment of a functional, well-designed industry cooperative that can meet the needs of the OTC derivatives markets in the years ahead.

We are working with the PWG member agencies – the Federal Reserve, the SEC and the CFTC – and the Federal Reserve Bank of New York and the OCC, to monitor the efforts of several private sector committees and others to implement these and other PWG recommendations, and will report our progress later this year.

Balancing Market Discipline and Market Oversight

In the last few decades, we have seen an evolution in mortgage finance that reflects a broader evolution in financial services. Commercial banks used to be the primary channel for U.S. financial intermediation. That is less true now, as non-bank financial institutions play a significantly more important role.

Shortly after I came to Washington, I pointed out that our financial regulatory structure has not kept pace with this market evolution. We then began work to outline a new financial regulatory structure that is better suited to protect investors, protect the stability of the financial system, and support the innovation and risk-taking that fuel our economy. We released our report, the Blueprint for a Modernized Financial Regulatory Structure, in March of this year.

Our work on an ideal regulatory structure began 18 months ago, during a period of calm markets, and many viewed it as an academic exercise. The market turmoil last summer, and particularly the failure of Bear Stearns in March, has underscored the need for this overhaul.

The headline question when considering the ideal regulatory structure is how to strike the right balance between two principles: market discipline and market oversight. These are fundamental principles vital to a healthy financial sector and a healthy economy, and must be continually rebalanced if our financial system is to remain strong.

Stresses, losses, fragility and liquidity conditions in certain parts of the market in the last several quarters have revealed how crucial market stability is to our economy. Stable, deep and liquid markets translate into lower cost financing for everything from mortgages to student loans to corporate mergers.

In our Blueprint, we suggested an optimal regulatory structure for the long term in which the Federal Reserve would take on a different but important role as market stability regulator focused exclusively on the market as a whole. We raised for debate whether it was optimal to have a regulator that serves as the system's lender of last resort and also focuses on the safety and soundness of individual institutions. We questioned whether these sometimes conflicting responsibilities should be separated in order to better channel market discipline. We also noted that where the system was at risk additional regulatory authority to complement market discipline would be needed.

Our Blueprint also emphasized that regulation must be strongest where market discipline is most compromised, and the presence of an explicit government backstop significantly weakens market discipline. Therefore, the nature and degree of government support is an important factor in determining the appropriate level of regulation.

Of course, regulation alone cannot fully protect the financial system. Market discipline must also constrain risk-taking. The collapse of Bear Stearns, and the government's response, has put these issues squarely on the plate of financial regulatory policymakers. Decisions on the immediate issues will inform future decisions about how to modernize and improve our regulatory structure and what we should expect from our central bank.

In response to the Bear Stearns collapse, the Federal Reserve acted to address market liquidity issues by giving primary dealers temporary access to the discount window. The Fed took this action to protect the system – not a particular institution. And we strongly supported this important step. But the obvious follow-up question to this extraordinary action is what role should the Fed play now that it is a lender to these institutions? We are working closely with the Fed and the SEC as they answer this. The parties are working to formalize this role in a Memorandum of Understanding, an MOU. Some issues are easy to resolve – the Fed must have information and access so that it can assess its potential borrowers and counterparties. A more difficult issue is how this newly formalized relationship evolves when

these temporary facilities eventually close and how, depending on its scope, the MOU will be perceived by the marketplace. In this context, we should also consider how the SEC and the Fed should coordinate regarding capital and liquidity requirements for these firms.

As the Fed and the SEC work through the immediate issues associated with the primary dealers' current access to the Fed's facilities, we must also begin in earnest the serious work it will take to transform our current regulatory structure into something that meets the objectives we laid out in the Blueprint. This will not be done easily or quickly, nor will it be done in a single step. But we must begin to modernize our financial regulatory structure to reflect the breadth of financial institutions that finance the U.S. and global economy.

Perhaps the most difficult question is how to create an entity that performs the function of the Blueprint's market stability regulator. In reality, the Fed is already expected to play this role when the system is threatened. Whether it was Long Term Capital Management in 1998 or Bear Stearns this year, our nation has come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But, as we noted in our Blueprint, the Fed has neither the clear statutory authority nor the mandate to anticipate and deal with risks across our entire financial system.

Much of the Fed's current authority as lender of last resort was granted during the Great Depression. In light of the changes and developments in today's financial markets, we should take a hard look at whether the Congress has given the Fed the appropriate authority and direction to execute this lender of last resort responsibility when the system is threatened.

We have now learned that a wider range of institutions can potentially threaten the stability of the financial system. It seems clear that in the future the central bank might need to make liquidity available to a broader range of financial institutions under certain extraordinary circumstances. However, at the same time, the circumstances under which that liquidity is provided must be limited and focused on systemic risk that can impact the overall economy. We must examine this authority and the processes and procedures to implement it and calibrate them appropriately. It is imperative that market participants not have the expectations that lending from the Fed is readily available.

To act as market stability regulator, the Fed would need appropriate authority to respond to and proactively address systemic risks – whether it be a risk posed by a commercial bank, an investment bank, a hedge fund, or another type of financial institution. To perform this function, it is vital that the Fed have information and access across all types of financial institutions. But information gathering alone is not enough. We must also define the scope of the Fed's role in identifying and constraining risk-taking that can detrimentally affect the financial system. This likely requires authority to intervene to prevent the build up of conditions that create significant risk to the stability of the financial system. Ultimately, we should get to the place where the market stability regulator's responsibilities come with broad-based authority applicable to a wide range of institutions - with a focus on the system as a whole. Defining the scope of the Fed's new authorities and responsibilities is not a simple task, and the definition must balance two very important priorities – providing additional stability to the financial system on the one hand, while limiting moral hazard on the other.

The greater the belief in a safety net, the more risk market participants are willing to take and the greater the risk to the taxpayer. A stable system requires that risk-taking bring both reward and loss. Market discipline plays an enormous role in curtailing excessive risk-taking, a role that neither can nor should be completely executed by regulators.

Of course, the mere creation of a market stability regulator can increase moral hazard and decrease market discipline. The expectation that a regulator will intervene to protect the system must be limited to the greatest extent possible. In other words, we must limit the perception that some institutions are either too big or too interconnected to fail. If we are to do that credibly, we must address the reality that some are. To do that, we must strengthen market infrastructure and operating practices in the OTC derivatives market and the tri-party repo system and clarify the resolution, or wind down, procedures for non-depository institutions. Creating a more stable environment will mitigate the likelihood that a failing institution can spur a systemic event.

During the past year, despite dislocations in our financial markets, our market infrastructure has proven quite resilient. Payments were made, margining at clearing corporations continued, and exchanges handled massive surges in volume around the world. Still, there are two areas of market infrastructure where market participants and regulators must focus attention – OTC derivatives and secured lending, including tri-party repos. These activities play important roles and bring many benefits, but have outgrown an infrastructure that needs to be strengthened. And this contributed to the concern that an institution could be too big or too interconnected to fail. And this, together with the implications concerning broader market behavior and market confidence, factored prominently into the Fed's decisions surrounding the failure of Bear Stearns.

Given the massive scale of the OTC derivatives market, we need to enhance trade processing with more automation, clear the backlog and create utilities and protocols that will make the process more efficient. I am pleased that a number of the institutions that account for a significant percentage of OTC derivatives trading are working to do this, by recently forming a cooperative and working with the New York Fed, under Tim Geithner's leadership, to create the necessary protocols to bring more transparency and efficiency and reduce counterparty credit risk. It is imperative that this cooperative bring standardization not only to dealer transactions but to the broader community of counterparties, including hedge funds. For the tri-party repo market, we must address risks associated with a potential counterparty failure and the risk associated with the potential disruption of a clearing bank.

Despite long-standing efforts to address the treatment of derivatives and other financial contracts in the case of a failed financial institution, there still seems to be uncertainty surrounding the process by which a large complex institution is wound down and what impact that would have on the overall financial system. U.S. bankruptcy law was updated significantly in 2005 to address many issues associated with OTC

derivatives contracts. We should evaluate whether the resolution, or winding down, process for large complex institutions should be modified to help mitigate disruption to the financial system and improve market discipline. This requires addressing a number of difficult questions, including whether we need to assign a particular regulatory agency to oversee resolutions and how any potential intervention is justified and explained.

Finally, we must review the emergency authorities of the Federal Reserve, Treasury and other financial regulators, and update them to reflect the current financial system. To be effective in the future, our regulatory system needs an overhaul.

Clearly, these are difficult questions. They will not be resolved quickly. Nor will they be resolved in one single reform effort. The solutions will evolve, as regulators and market participants consider the issues. Recent events have revealed the disconnect between the ever-evolving financial system and our outdated regulatory framework. Dedicated and innovative regulators have found ways to address current issues within the bounds of authorities created when the financial system was markedly different.

This work is absolutely necessary, and must be engaged as we address the narrower, immediate issues that are today in the public debate. Beginning to address these fundamental issues is critical to finding the right balance between discipline and oversight that will strengthen our financial system.

Conclusion

I will sum up my main points today. When we published the Blueprint in March, I made clear I believed we were laying out a long-term vision that would take time to consider and implement. Since then, the Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system. We are working with the Fed and the SEC on the immediate issues raised by the Fed's provision of liquidity to the primary dealers. But we must dramatically expand our attention to the fundamental needs of our system, and move much more quickly to update our regulatory structure – always keeping in mind that there must be a balance between market discipline and market oversight.

I see three clear lessons from the experience of recent months:

First, we should quickly consider how to most appropriately give the Federal Reserve the authority to access necessary information from complex financial institutions and the authority to act to mitigate systemic risk in advance of a crisis.

Second, we need to take several critical steps to make sure that market discipline continues to play the vital role it needs to play to keep our financial system in balance, as we work to ensure the system's stability. To reduce the perception and the likelihood that a complex financial institution is too interconnected to fail, steps are needed to strengthen our practices and financial infrastructure in the OTC derivatives market and in the tri-party repo system, and to provide greater certainty around the mechanics of winding down a failed institution that is not a federally insured depository institution.

Third, we must re-examine the emergency authorities of the Federal Reserve, Treasury and other financial regulators to ensure they are adequate to the roles they are expected to play in today's modern and multi-faceted financial system.

As we address each of these lessons, we must be guided by the desire to balance market oversight with market discipline. The stability of our financial system is essential, and market discipline is also essential to the preservation of a healthy financial system. I know from first hand experience that normal or even presumed access to a government backstop has the potential to change behavior within financial institutions and with their creditors. It will compromise market discipline and lower risk premiums, which ultimately puts the system at risk.

And for the sake of the system and its impact on the overall economy, we need businesses to manage their affairs without the expectation or presumption that the government will be there if they get into trouble. We need to encourage this by our words and our deeds. And this should be an important consideration as we debate how best to give our regulatory structure a much-needed and long-overdue overhaul to meet the needs of our financial markets.

We know that the combination of high energy and commodity prices, market stress and a housing correction makes this a tough time for America's families and workers. We also know that the U.S. economy's performance for the past 50 years has been second to none, and that we have undergone difficult economic periods in the past. I understand that doesn't make the day-to-day much easier right now. But I am confident, because our economy is resilient, deep and competitive. And I want Americans to be confident as well. I travel overseas quite often, and am constantly reminded that our long term economic fundamentals compare favorably to any advanced economy in the world. One thing is clear – whatever our current difficulties, I wouldn't bet against the U.S. worker, the U.S. economy, or the U.S. financial system. Thank you.