U.S. DEPARTMENT OF THE TREASURY

Press Center

Assistant Secretary David G. Nason Remarks at the SIFMA

6/4/2008

HP-1006

New York - Thank you for inviting me here to offer opening remarks at the 13th Annual Fixed Income Legal and Compliance Conference. The Securities Industry and Financial Markets Association is a key trade group for the financial services industry and we in Washington have come to value your expertise and perspective. SIFMA is empowered by its mission to champion policies that benefit investors and issuers. Today I would like offer the Treasury Department's perspective on some of the economic and market conditions in the United States and discuss our perspective on key regulatory policy matters.

Think back to the conditions in our capital markets and your last Legal and Compliance Conference. Some of the discussion topics were similar to today's, but the lens through which we look at them is now quite different. These market conditions provide a pertinent backdrop for an examination of financial markets and regulatory issues.

Today I will provide an update on financial market and economic conditions, then I will discuss regulatory issues that policymakers must address in the near-term and in the future. The regulatory issues before financial policymakers today are incredibly complex and deserve measured consideration rather than a rush to conclusion.

Economic and Market Conditions

Undoubtedly, the U.S. economy is going through a difficult period. After six straight years of almost three percent average annual growth, our growth rate slowed significantly late last year. 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 a repricing of risk. Sentiment swung hard to risk aversion with perhaps one of the most dramatic series being the events that led to the unusual transaction where JPMorgan Chase acquired Bear Stearns.

Although we expect to work through housing and capital markets issues for some time, we also expect to see a faster pace of economic growth before the end of the year. We are seeing signs of progress as capital and credit markets have stabilized somewhat. The markets are calmer now than earlier in the year. The deleveraging and repricing of risk continues, as does the capital-raising that is essential for the viability of U.S. financial institutions. Capital raising improves market confidence and allows banks to continue to extend the lending necessary for economic growth.

Secretary Paulson has urged financial institutions to raise additional capital and we have been pleased that our largest institutions have gone to market to do so. Since December of last year, financial institutions have raised more than $200 billion in capital. Importantly, this investment is helping to facilitate price discovery in markets that are suffering from significant illiquidity. It is also encouraging to see signs that different types of investors are interested in financial institution investments such as sovereign wealth funds and most recently private equity firms.

Despite this progress, some trends are not as encouraging. The unsecured interbank financing market faces ongoing challenges and many securitization markets remain strained.

On a separate but related track we are focused on housing, which presents the most significant threat to our economy. Both the Federal Housing Administration and the HOPE NOW Alliance are making a meaningful impact on this problem. The HOPE NOW Alliance announced recently that homeowners had received a record number of mortgage modifications in one month.

Similarly, our government sponsored enterprises, Fannie Mae, Freddie Mac and the Federal Home Loan Banks, are performing their Congressionally-mandated roles by providing liquidity for our mortgage market. Fannie Mae and Freddie Mac are connected to 80 percent of the overall mortgage market. This is an important role and it increases the need to ensure that these enterprises are regulated

appropriately. But we are seeing encouraging developments in efforts to improve their regulatory oversight to give confidence to the market.

A key way policymakers can all work together to send a positive signal to the markets, especially the housing market, is to send a strong GSE reform bill to the President's desk. We are encouraged by the recent progress made in the Senate Banking Committee to strengthen oversight of GSEs and we strongly support it. Chairman Dodd and Ranking Member Shelby have been instrumental in guiding this important legislation through the Committee. The bill provides the new regulator with the appropriate powers, including capital, receivership, new product approvals, and portfolio authority. I have been in Washington long enough to recognize when the stars are aligned to move a complicated piece of legislation like GSE reform. This is one of those moments and we should capitalize on it.

The Treasury Department is working to understand the lessons learned from the current housing and broader market challenges. Treasury, in conjunction with other functional regulators, has developed policy responses to begin to address the ongoing crisis of confidence in our markets. These policy responses can be categorized into broad themes and each of these themes are discussed in a recent policy statement produced by the President's Working Group on Financial Markets.

Regulatory Reform

A confluence of events has moved the topic of financial services regulatory reform from an academic exercise to an economic necessity. While there is great temptation to view these issues through the lens of the problems we are facing today; the forces compelling change are much broader. The most dominant force or trend compelling change is the globalization of the financial services industry.

Globalization means that foreign economies are maturing into market-based economies, contributing to global economic growth and stability, providing a deep and liquid source of capital outside of the United States. These markets often benefit from recently created or newly developing regulatory structures that are more adaptive to the complexity and increasing pace of innovation. At the same time, the increasing interconnectedness of the global capital markets poses new challenges: an event in one jurisdiction may ripple through to other jurisdictions as we have witnessed firsthand in our securitization markets.

In addition, improvements in information technology and information flows have led to innovative, risk-diversifying, and often sophisticated financial products and trading strategies. However, the complexity intrinsic to some of these innovations may inhibit investors and other market participants from properly evaluating their risks.

Further, the growing institutionalization of the capital markets has provided markets with liquidity, pricing efficiency, and risk dispersion and has encouraged product innovation and complexity. At the same time, these institutions can employ significant degrees of leverage and more correlated trading strategies with the potential for broad market disruptions.

Finally, the convergence of financial services providers and financial products has increased over the past decade. Financial intermediaries and trading platforms are converging. Financial products may have insurance, banking, securities, and futures components.

These developments also pressure the U.S. regulatory structure, exposing regulatory gaps and redundancies. As is evident in the topics that I will emphasize next, the U.S. regulatory structure reflects a system, much of it created over 70 years ago, grappling to keep pace with market evolutions and facing increasing difficulties at times in preventing and anticipating financial crises.

Treasury never intended our recently released *Blueprint for a Modernized Regulatory Structure* (Blueprint) to be responsive to current market events. The analysis and rationale behind our Blueprint recommendations are instructive, however, as we move through this extraordinary period in our capital markets.

Depository Charters

An honest discussion about the evolution of our capital markets and the attendant changes to our regulatory structure would be incomplete without looking closely at the charters of our depository institutions. It requires an examination of why Congress decided to create organizations. This requires a willingness to challenge the status quo. Candid self-analysis is critical to evolutionary and progressive change. Change of this type is often and inevitably met with those who have an interest in keeping things the way they are.

A key principle in Treasury's analysis of these issues is that federal prudential regulation and oversight should accompany the provision of federal support, such as federal deposit insurance. While the states and the federal government have jointly provided prudential regulation of depository institutions over time, the responsibility ultimately falls back to the federal government for the deposit insurance program and the overall solvency of the system.

In our Blueprint, our goal was to set forth issues that we should be thinking about in the long-term. The overarching issue driving our review of banking charters was to establish a level playing field for all federally insured depository institutions. Competition should take place broadly across different types of financial institutions. The most efficient way to get there is to establish a uniform charter, and let competition take place on the basis of competitive market factors instead of regulatory factors.

Charter choice, whether through multiple federal charters or a state charter, had an important place in our history. But, it is decades of political inertia that got us where we are today. The world is different, and intervening changes over the years have made many of the

charter distinctions unnecessarily inefficient and costly to the public that utilizes these depository institutions and to the institutions themselves.

Choosing a regulator for an insured depository should not be a fundamental business decision. The overall charter consolidation process and reorganization of regulatory responsibilities in the Blueprint will take care of many tertiary issues associated with outdated regulatory burden.

This is the case with the federal thrift charter and the Office of Thrift Supervision, the OTS. The thrift charter is no longer necessary to ensure sufficient residential mortgage loans availability for U.S. consumers, which was the charter's primary purpose. As a step towards a more rational structure for depository institutions we concluded that the thrift charter has run its course and should be discontinued.

Another clear example of the need for a fresh look at our depository institution charters is holding company oversight. The type and features of holding company oversight is tied to the type of charter. Commercial banks are regulated at the holding company level by the Federal Reserve. For entities electing the thrift charter, the OTS provides holding company regulation, which provides a set of different and less restrictive requirements. And, parents of industrial loan companies are not subject to any holding company supervision. If the basis of holding company oversight is to protect the assets of the insured depository, how can this differing treatment make sense?

Few people would argue, and it is largely not permitted anyway, that different bank charters should have different bank level regulations surrounding safety and soundness. Likewise, while developing new activities could serve as some motivation for different charters, at least for banks, activities have converged to a large degree to those permissible for national banks.

The goal should be create a level playing field where competition among financial institutions can take place on an economic and marketplace basis, rather than on the basis of regulatory differences. For activities within the bank, all insured depository institutions would be subject to the same broad rules and could be modeled on activities that are authorized for national banks today.

SEC and CFTC Merger

As you are all well aware, we believe that there should be a merger of the Securities and Exchange Commission (SEC) and the Commodity Futures Trading Commission (CFTC). Treasury believes that the realities of the current marketplace, such as the convergence of futures and securities products and market participants, and globalization and its resulting pressures, make it increasingly difficult to rationalize separate regulatory regimes.

Treasury was careful in not recommending an immediate regulatory combination, but a merger preceded by a number of steps to ensure an effective and smooth transition. In making this recommendation, Treasury noted particularly the benefits of several of the process-oriented changes or modernizations that the Commodity Futures Modernization Act of 2000 (CFMA) brought to the futures markets. Regulation of securities markets, where the amount of change in the past decade has been staggering, also warrants this sort of modernization.

In this context, Treasury has made a series of recommendations to modernize securities regulation. First, the SEC should to adopt core principles for clearing agencies and securities exchanges, such as those relating to operational and risk management practices, similar to those adopted for the equivalent futures market participants under the CFMA.

In addition, the SEC should expedite its rule approval process for exchanges and other self-regulatory organizations. The SEC has made adjustments to this rule approval process in the past. This is all the more important today with exchanges' rapidly evolving electronic trading systems whose rules must be frequently adjusted for operational efficacy and market integrity.

A close look at these recommendations make plain that we are trying to improve some of the processes by which the SEC responds to a dynamic marketplace. These recommendations are not, as some have indicated, a push to morph the SEC into the CFTC or vice versa. The choice is not binary and we attempted to create a process where the strengths of each agency could be preserved.

Market Stability Regulation

Our Blueprint offered a stepping-stone approach to a new way to think about our capital markets regulatory structure – to utilize better market forces while improving the line of sight and mission of our regulators. We expect a thoughtful and deliberate discussion balancing the need for better, more modernized, regulation, while recognizing that regulation alone cannot and will not weed out all financial instability.

We saw an omission in our current regulatory structure; no regulatory body is charged specifically and exclusively to focus on the overall conditions of market stability that could impact the real economy.

Typically, the 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 might not be well-suited to deal with transmission of financial shocks to the real economy in today's financial markets.

This is why 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.

Undoubtedly, the tasks of the market stability regulator would be difficult. 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.

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". And, if so, what can we do to address this concern.

Monitoring the interconnectivity embedded in our networks of financial institutions is a key attribute of market stability regulation. 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. I note many of these topics are issues of focus today.

This reform is not meant to supplant market forces. It is intended to complement them with new and broad authority. 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.

Near-Term Market Stability Steps to Consider

The recent challenges in credit markets illustrates that the world has changed. While broader changes regarding regulatory structure are debated, we need to think continually about what steps can be considered now. For example, one obvious question is the proper regulatory oversight of investment banks, especially the largest firms, the SEC's consolidated supervisory entities (CSEs). 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. If the Federal Reserve is going to lend to the CSEs, then it is important it have adequate information about its borrowers.

The SEC and the Federal Reserve are also in the midst of discussions to determine the appropriate arrangement for information sharing going forward. Treasury supports establishing a memorandum of understanding between the SEC and the Federal Reserve. What happens next 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 access to a government backstop, then there must be a regulatory cost for this benefit. Determining the specifics of this regulatory regime requires a balancing act of somewhat conflicting policy objectives.

Many other issues still need to be resolved. Some question whether the primary dealers' access to the Federal Reserve's liquidity facilities is temporary, which has an impact on behavior.

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 risk-hedging strategies provide the benefit of wider risk dispersion, if market participants and supervisors cannot evaluate fully the risk profiles of the financial institutions using these products, then it remains unclear that innovation has reduced risk.

It seems clear that we need to improve how we regulate complex financial firms. Policymakers have begun this process in earnest and should find resolution in the near-term, which certainly will result in further coordination and information sharing among regulators.

These are incredibly complex matters. As we undergo this process, there are several issues we should consider.

First, we should be concerned about the consequences of forcing 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. If that is the case, have we improved overall market stability?

Another issue is putting responsibility on our supervisors that convey unreasonable expectations. This provides 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. We need to develop ways to ensure that private institutions, even complex ones, can fail without threatening the real economy. Participants must believe this if they can be expected to discipline each other and this form of discipline is a vital component to a more stable financial system.

Lastly, it is clear that regulation has a critically important role in the quest for a more stable system. We look forward to considering further that role in the coming months. Market stability regulation should reflect a fine balance between protecting the government's interest, allowing for innovation, and harnessing market discipline. It will be difficult to balance these objectives, 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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