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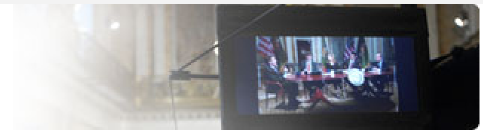

Remarks by Secretary Henry M. Paulson, Jr. on Reinforcing Market Stability and Confidence at the New York Public Library

7/22/2008

hp-1091

Washington, DC-- Thank you, Catie. I appreciate this opportunity to join you this morning to give my thoughts on current market conditions.

As we all know, the U.S. economy and our financial markets are undergoing a period of stress. We will work through this period, as we always do. Our workers, industries and companies are the most productive, resilient and innovative in the world. Periods of economic difficulty are not new. They are, unfortunately, inevitable. Yet, after every such period, the United States emerges stronger and better poised for robust growth. This time will be no different.

Focus on Market Stability

My focus and highest priority is on stability and confidence in our markets and our financial institutions. Orderly and stable markets are critical for the functioning of our economy and to minimize the impact of the current turmoil on the broader economy. Through stable markets, financial institutions make funds available for small and large companies to borrow and grow, for the entrepreneur to start a new business, for families to buy homes and cars and pay for their children's educations. When people and companies save, borrow, and invest, they put their faith in our markets and our financial institutions.

Working through the current turmoil will take additional time, as markets and financial institutions continue to reassess risk and re-price securities across a number of asset classes and sectors. I have and will continue to encourage financial institutions to strengthen their balance sheets by raising capital, de-leveraging and reviewing dividend policies so that they continue to play their vital role in supporting economic growth. Even in this difficult environment, U.S. financial institutions have raised over $150 billion.

Yet, market challenges have also required policymakers to develop unique solutions. In the Bear Stearns situation, the Federal Reserve took the appropriate and necessary actions for market stability, not just by accepting collateral for a loan to JPMorgan Chase to finance the purchase of Bear Stearns, but also in opening a lending facility for investment banks. Today, our number one priority is market stability as we work through the current market stress. Looking forward, we must balance two very important priorities – better regulation through a more effective updated regulatory structure on the one hand and market discipline to limit moral hazard on the other. 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.

Following the Bear Stearns episode in March, markets became calmer. However, as I often note, our markets won't make progress in a straight line and we should expect additional bumps in the road. We have been experiencing more bumps recently, and until the housing market stabilizes further we should expect some continued stresses in our financial markets.

Safe and Sound Depository Institutions

Last week, our markets witnessed the failure of IndyMac Bank. It was the third largest bank failure in U.S. history and worthy of attention. Yet as large as IndyMac is, it represents only 0.2 percent of total banking industry assets. Well-defined policies and procedures exist for those relatively few times when a federally-insured bank does fail, and these protect deposits which are insured up to $100,000 per account and help prevent one failure from destabilizing broader financial markets. We saw this in practice at IndyMac. The FDIC took over the bank on a Friday, worked effectively over the weekend, and on Monday morning the bank re-opened for business as usual. No one has or will lose a penny of insured deposits.

The American people have every reason to remain confident that the U.S. banking system is sound. The FDIC has made clear that of the nearly 8,500 insured banks and thrifts that comprise the U.S. banking system, 99 percent are well-capitalized. One thrift and four commercial banks have failed this year; during the 1980's Savings & Loan Crisis there were an average of 255 failures per year – the circumstances then are hardly comparable to today.

And bank failures do not spring up overnight. Regulators carefully monitor all insured banks' adherence to capital ratios and, if an institution is troubled, the bank and the regulators actively work together to avoid a failure.

Non-Bank Financial Institutions and Market Stability

Beyond the insured depositories the financial services industry has changed, and non-bank financial institutions now play a significantly greater role. Our current financial regulatory structure does not adequately reflect this new reality.

Treasury made our recommendations for an optimal structure when we released our Blueprint for a Modernized Financial Regulatory Structure last March. We recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. It takes into account the new financial landscape and the role played by non-bank institutions. Because our model is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace. Our Blueprint also recognizes the critical role market discipline plays in maintaining stability.

Looking beyond today's market challenges, we need to get to the point where large, complex financial institutions are not perceived to be too big or too interconnected to fail. Essential to this objective is improved market infrastructure and operating practices to increase transparency and efficiency, especially in the OTC derivatives market and the tri-party repo system. Improved infrastructure will add to market stability and mitigate the likelihood that a failing institution can spur a systemic event. We also need additional powers to manage the resolution, or wind-down, of large non-depository financial institutions, such as larger hedge funds, so as to limit the impact of a failure on the broader financial system.

Finding the right balance between market discipline and market oversight is going to require additional progress on the part of market participants and policymakers. While doing so, it is critical that we maintain the market stability and innovation necessary to support vibrant economic growth.

Over the last several weeks, the need to move more quickly toward an optimal regulatory structure that establishes a prudential financial regulatory system, focused on promoting long-term market stability has become all the more apparent. I look forward to working with Congress and government regulators to achieving this goal.

GSE Importance to Housing Markets and Financial Market Stability

As you know, today we are also working closely with Congress to immediately address the current challenges presented by the housing GSEs Fannie Mae and Freddie Mac, which are among the largest and most interconnected of all global financial institutions. Of the $5 trillion in debt and mortgage backed securities guarantees issued by these two GSEs, over $3 trillion is held by domestic financial institutions including commercial banks, savings and loans, and credit unions, and over $1.5 trillion is held by institutions and central banks overseas. Because of their size and scope, Fannie and Freddie's stability is critical to financial market stability. Investors in our nation and around the world need to know that we understand how important these institutions are to our capital markets broadly, and to the U.S. economy.

The GSEs are also currently the largest sources of mortgage finance in the United States. Their continued activity is central to the speed with which we emerge from this housing correction and remove the underlying uncertainty in our financial markets and financial institutions.

Turning the corner on the housing correction requires homebuyers to return to the market, and homebuyers need available and affordable mortgage financing. Housing is not only important to our economy; it is also the largest factor currently impacting our financial markets. The sooner we work through the housing correction, the sooner home prices will stabilize, and uncertainty about the values of mortgage-related assets will be more easily determined. So now, more than ever, we need Fannie and Freddie out there, financing mortgages. That means we must, in the short term, take steps to boost confidence in the GSEs, while also taking steps to address the potential systemic risk they pose.

My views on their structure are well known – they are an odd construct, with a difficult dual mandate to serve both a public mission and private shareholders. The GSEs are providing an essential function when they securitize and guarantee high-quality mortgages. This attracts capital into mortgage markets and lowers borrowing costs for homebuyers.

For years, we have advocated that the GSEs need a stronger and world-class regulator, with the authorities appropriate and necessary for the task. From the time I arrived in Washington I have worked with Congress to achieve this objective. Congress is very near completing its work to create that regulator, and it must do so quickly. And, as it does so, last week we asked for the addition of temporary provisions to promote market stability and confidence – not just in the GSEs but throughout the financial system.

Recent developments convinced policymakers and the GSEs of the need to increase confidence and respond to market concerns by providing assurances of their access, if necessary, to liquidity and capital on a temporary basis.

After consultations with Congressional leaders and U.S. financial regulators, last week I put forward a proposal that will accomplish this in two phases. The proposal is aimed at supporting the short and longer term stability of financial markets, not just these two enterprises. I would rather not be in the position of asking for extraordinary authorities to support the GSEs. But I am playing the hand that I have been dealt. There is a need to support efforts that strengthen Fannie and Freddie's ability to continue to play their important role in financing mortgages and in our capital markets more broadly.

The first phase of our proposal is aimed at immediate market confidence and stability. I have asked Congress to provide temporary authority for 18 months to provide a liquidity backstop and a capital backstop to the GSEs. There are no plans to access either of these. As I assured Congress last week, if using either of these authorities does become necessary, we would do so only under terms and conditions that protect the U.S. taxpayer and are agreed to by both Treasury and the GSE.

We need to act in the short-term because the GSEs are vital institutions in our capital markets today and are vital to emerging from the housing correction. We also know that for long-term market stability we must address the potential systemic risk these entities pose to taxpayers and markets going forward

That's why we are urging Congress to finish legislation creating a world-class GSE regulator, including a consultative role for the Federal Reserve in the new GSE regulator's process for setting capital requirements and other prudential standards. As this new regulator implements its mandate, we expect and welcome a larger examination of the structural issues inherent in these GSEs, so that we don't find ourselves in this same position again in the future.

I have been consulting closely with members of Congress from both houses and both sides of the aisle. I am confident they recognize the demands of the current situation, and will act to complete work on this legislation this week.

Conclusion

I am well aware that financial market and housing challenges continue to concern America's families. Progress has not come in a straight line, and we need to remain patient as we work through these challenges. Policymakers and regulators are vigilant in our efforts. We are using all available tools and seeking new ones, not merely for immediate concerns but also to do what we can to ensure that these issues do not recur.

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 here we are fortunate that our long-term fundamentals are strong. Thank you and I am pleased to answer your questions.

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