U.S. DEPARTMENT OF THE TREASURY

Press Center

David G. Nason, Assistant Secretary for Financial Institutions Remarks on Financial Regulation Before the Exchequer Club

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Washington- Thank you for inviting me to join you today at this luncheon. I am honored to have the opportunity to speak to this distinguished group of financial services industry professionals and policy leaders. In its 47th year, this group is well regarded as a place where important policy issues are contemplated and solutions are advanced.

I am especially pleased to follow in the footsteps of other Treasury Department officials who have offered remarks here at the Exchequer Club, three of with whom I am fortunate to have worked with -- my previous Under Secretary for Domestic Finance Randal Quarles, my predecessor Emil Henry, and my current Under Secretary for Domestic Finance Robert Steel who spoke here in April. I would also note that my Treasury colleague John Dugan, the current Comptroller of the Currency, served as Chancellor of this distinguished club.

General Economic and Market Conditions

It has been an especially busy time at the Treasury Department. As you know, there has been an adjustment taking place in the overall credit market and the mortgage market in particular.

Largely because of lax underwriting, the mortgage market, especially the subprime market, has been experiencing a high number and percentage of delinquencies and defaults. As a result, subprime mortgage-backed securities have performed poorly. This has led investors to reassess the risk of these securities and as a corollary to reassess their pricing.

Because of the interrelation of our capital markets, the concerns we first saw in subprime mortgages and related securities have had an impact on investors' confidence and on their assumptions about the credit quality and value of other assets, especially asset-backed securities.

This has led to a rather widespread reassessment of risk and a subsequent revaluation across capital markets globally. In general, the marketplace reaction to some of these excesses has been severe. Many of the mortgage originators with weak underwriting standards are out of business. Investors in the subprime mortgage market are experiencing heavy losses, especially those that failed to perform adequate due diligence to understand the risks of their investments. We expect the markets to continue to impose discipline on those lenders and investors who took risks without proper diligence.

We have seen the effects in the financial markets, and it will take time for these market adjustments to play out. At the Treasury Department, we have been actively engaged in the situation as it has continued to develop. Secretary Paulson has been working with all financial regulators and with market participants. At a time like this when risk is being reappraised and market discipline is being imposed, confidence is key. Having the Treasury Department led by a Secretary who has spent his life in the financial markets, through good times and bad times, has been fortunate for our country and the Treasury Department.

Given the importance of credit markets to the functioning of our economy, when we experience a fundamental reappraisal like we have witnessed over the last several weeks and months, it is essential that policymakers evaluate the potential impact on the economy. Fortunately, the capital markets stress is occurring against the backdrop of a strong global economy. However, as Secretary Paulson noted yesterday, the ongoing housing correction, rooted in an eight year period of exceptional housing price appreciation, will continue to impact the economy adversely. We continually analyze this situation, knowing that it will take time to work itself out. In our view, the underlying strength of the economy should enable further continued growth. However, despite these strong fundamentals, it is the Treasury Department's view that the housing decline is the most significant current risk to our economy.

Regulatory Blueprint

When Secretary Paulson arrived at the Treasury Department, he immediately and appropriately focused his attention on financial preparedness and the competitiveness of our capital markets. Today, I am here to talk about capital markets competitiveness. Capital markets are the lifeblood of the United States economy. They enable capital investments to finance companies, which leads to job creation and economic prosperity. American consumers and investors benefit from a vibrant and healthy financial services sector that provides opportunities to access credit, save and invest for the future, and insure against risks. It is important, therefore, that our capital markets remain the best in the world.

The regulatory policies in place for financial institutions must effectively protect consumers and investors, while at the same time promote entrepreneurialism and capitalism that are the foundation of our national economic success. These qualities are not at all mutually exclusive. At the Treasury Department's Capital Markets Competitiveness Conference earlier this year, regulatory effectiveness, including that of our regulatory structure, was cited repeatedly as a key ingredient to maintaining our competitiveness. Secretary Paulson highlighted regulatory structure as a potential primary driver of trends cited as being troubling. He noted that over the course of our nation's history, we have added multiple regulators to respond to the issues of the day. Our regulatory system has adapted to the changing market by expanding, but perhaps not always by focusing on the broader objective of regulatory effectiveness and protecting consumers and investors.

Accomplishing the right regulatory balance is not a task to be undertaken just once and never again considered. Markets are constantly evolving, in recent years particularly global markets, so it is very much an ongoing process. We should analyze and understand the rationale or justification for our current regulatory structure as well as the inefficiencies it can breed along with the benefit and burden of our regulations.

Policymakers have an obligation to assess continually whether our current regulatory structure is serving America as well as it could. Our current regulatory structure has been largely knit together over the last 75 years. Much of this framework was put into place for particular reasons in a different time.

Therefore, under Secretary Paulson's leadership, the Treasury Department is engaged in a comprehensive review of our regulatory structure to evaluate this issue and propose solutions that achieve the right balance. Over the next several months, we will produce a regulatory reform blueprint that will outline recommendations on how to modernize our regulatory regime. The Treasury Department is undertaking this report on its own initiative, unlike previous reports that were mandated by Congress. Examination and reexamination of financial services regulation are essential to fulfilling the Treasury Department's mission to promote the conditions for prosperity and stability in the United States and to encourage prosperity and stability in the rest of the world. This report will be framed by the goal of ensuring America's competitiveness and anticipating potential systemic issues that may arise.

It has been ten years since the Treasury Department released a financial services industry study – a time during which the financial services industry has undergone significant change. Markets and capital flows ignore national boundaries and tremors in one market can lead to impacts across other markets. The Treasury Department will take a holistic approach to reviewing the current financial services regulatory structure, taking into account all financial services industry players including insurance, securities, and futures firms, in addition to depository institutions, upon which most past Treasury Department studies have focused.

There is a rich tradition of this work coming from the Executive Branch. In 1984, President Reagan's Administration produced the Blue Print for Reform under the leadership of Vice President Bush's Task Group on Regulation of Financial Services. In 1991, President Bush's Treasury Department authored a study known as the Green Book. These reports shaped the debate for reform of regulation in the 1980s and 1990s. For instance, the 1984 and 1991 reports laid the foundation for the ideas (such as functional regulation) carried through in the Gramm-Leach-Bliley Act of 1999.

In preparing a regulatory reform plan, we will assess the current financial services regulatory structure in the United States and make recommendations to modernize oversight to fit demands of the marketplace. We believe that a 21st Century regulatory regime should:

- safeguard the safety and stability of the financial system;
- maintain high standards of both consumer and investor protection; and
- promote efficient and competitive capital markets.

As part of this effort and in order to inform our work, the Treasury Department published a Federal Register notice seeking public comment. We are asking for thoughts on topics including: overlapping state and federal regulation, ways to improve market discipline and consumer protection, and the strengths and weaknesses of having multiple regulators and multiple Federal charters for financial institutions.

We will focus our attention on depository institutions and securities, futures, and insurance firms. Our examination will include consideration of issues that are specific to each of these three financial services functions. The Federal Register notice raises what we believe are the important questions for each of these areas. But, we do not believe that we should necessarily separate our work product or recommendations among the three general areas under consideration. The Federal Register notice also includes a section of general questions to enable consideration from a broad and integrated perspective of certain issues, including functional regulation, overall risk, principles for and of regulation, rules-based regulation and macro-level regulatory structure models.

While this project was contemplated well before we entered this period of mortgage market stress, the complexity of the mortgage market regulatory structure provides an interesting backdrop. More people are now willing to consider and discuss regulatory structure and these events highlight the importance of the questions posed in the Federal Register notice. In particular, at the federal level, there are laws addressing mortgage fraud; disclosure; fair lending; unfair and deceptive practices; and other aspects of the mortgage process. The regulatory authority to implement these laws varies across different Federal agencies as does the enforcement authority. States have also enacted numerous laws addressing various aspects of the mortgage process. These state laws typically only apply to certain institutions that operate within a particular state and are enforced by state agencies. While there are various efforts underway within the current structure to improve the process, we should evaluate fully how many of the problems were related to the structure itself.

These are significant issues that many policymakers have considered over the years. Success of this initiative will not and should not be tied to short-term accomplishments. Today, I have identified the issues and segments that we are going to focus on during this project. We will recommend specific changes to our financial services industry regulatory structure. Some of the recommendations will be immediately relevant to legislative and regulatory policy issues. On these matters, our hope is that the Treasury Department's report will spur near-term tangible results. Implementation of other, longer-term recommendations will be subject to outside factors, but will be ready should support for these reforms develop. Finally, our hope is that some of the recommendations will shape debates in the future when regulatory structure issues are considered.

Government Sponsored Enterprise (GSE) Regulatory Reform

The last issue that I would like to discuss with you today is GSE regulatory reform. This is an area where the current regulatory structure is clearly deficient. In a period where the capital markets, especially the mortgage market, are undergoing stress, it inevitably leads to a question of the proper role of the GSEs. The regulatory structure of GSEs has had a long and tortured history. Looking back on history, and given the current debate on GSE regulatory reform, the regulatory framework established for Fannie Mae and Freddie Mac in 1992 that created Office of Federal Housing Enterprise Oversight (OFHEO) appears to have been flawed from the outset. However, it was the best that could be achieved at the time, and it was largely and appropriately viewed as an improvement over what had existed previously. Now is the time to build on the improvements made in 1992.

As many of you know, the Treasury Department has been and continues to be a strong proponent of meaningful GSE regulatory reform. As has been well documented, the current GSE safety and soundness regulator is hindered by a number of shortcomings:

- there is limited flexibility to set capital standards;
- no receivership authority;
- a bifurcation of regulatory authority with the Department of Housing and Urban Development (HUD);
- less authority to take enforcement actions; and
- a requirement to go through the appropriations process to obtain funding.

Put another way, these trillion dollar organizations are regulated by an entity with less tools and authorities than a small community bank's regulator possesses. As Secretary Paulson recently noted in Congressional testimony, "[m]any argue that a good solution would be for the GSEs to be regulated in a manner consistent with regulation of large national banks. However, in our view, the GSE regulator should have more tools available than does a bank regulator to take into account the unique characteristics and tensions of the GSEs."

The idea that the GSEs have unique characteristics that could create tensions or potential problems is not an ideological or partisan view. Policymakers have been struggling with the inherent tension and the potential problems posed by the GSEs for decades. In fact, a Treasury Department official stated in testimony a few years ago that: "As the GSEs continue to grow and to play an increasingly central role in the capital markets, issues of potential systemic risk and market competition become more relevant." That statement was not from a member of the Bush Administration Treasury Department, but rather from testimony delivered in March of 2000 by former Under Secretary Gensler of the Clinton Administration Treasury Department.

As we all know, Fannie Mae and Freddie Mac were established in part to help provide a degree of liquidity to the secondary market for home mortgages to increase the capital available for home mortgage financing. To perform that mission, Congress granted the GSEs benefits and imposed constraints. The most important benefit is the market's misperception that the GSEs are somehow backed by the Federal Government. It is this misperception that has provided the GSEs with the ability to grow rapidly with little market discipline, and creates the potential for the GSEs to pose systemic risks.

We have an opportunity to strengthen regulation of the GSEs. The House of Representatives has passed a meaningful GSE regulatory reform bill that, while not perfect, goes a long way toward addressing the issues that must be considered. Unfortunately, there has not been any action in the Senate on comprehensive GSE regulatory reform. We will continue to press for this, especially at a time when increased attention on the mortgage markets is warranted.

Unfortunately, the legislative focus now seems to be on lifting the retained portfolio caps put in place by OFHEO. This is an unfortunate development. The reason these caps were put in place are well documented and not worth rehashing. The GSEs have made improvements and are working to remediate those problems, and OFHEO has acknowledged their progress. However, decisions impacting safety and soundness should continue to be left to OFHEO, as Congress intended.

The housing market is undoubtedly going through a transition. The Administration has put forth a comprehensive plan to address these issues, which include: passing Federal Housing Administration (FHA) modernization legislation; targeted tax reform; and working with all mortgage market participants to avoid as many foreclosures as possible. The GSEs can and should play a role in addressing current mortgage problems, and they can play that role with the current portfolio caps in place. The GSEs have ample opportunity to provide assistance through additional securitization activity, which can assist multiple borrowers in comparison to increasing the size of their retained mortgage portfolios. In addition to the recent portfolio cap flexibility granted by OFHEO, the GSEs also have additional flexibility under the portfolio caps as mortgages in their existing portfolios are paid down.

There are no easy fixes to the current problems in the housing market. But if we are serious about promoting a sound and resilient housing finance system, Congress must take action to pass a meaningful GSE regulatory reform bill.

Thank you for listening and, again, thank you for inviting me to join you here today. I hope my remarks were informative. I would be happy to take a few of your questions.