U.S. DEPARTMENT OF THE TREASURY

Press Center

Remarks by Secretary Henry M. Paulson, Jr. at The Ronald Reagan Presidential Library

11/20/2008

HP-1285

Simi Valley, Calif.-- Good morning. I am honored to be here at the Reagan Library. There is perhaps no more appropriate place to discuss a topic important to us all – the need to reinvigorate market capitalism, the foundation of our national prosperity. Although Mrs. Reagan is not with us today, I send her my best wishes and thanks for her kind invitation to speak at this event.

Good morning. I am honored to be here at the Reagan Library. There is perhaps no more appropriate place to discuss a topic important to us all – the need to reinvigorate market capitalism, the foundation of our national prosperity. Although Mrs. Reagan is not with us today, I send her my best wishes and thanks for her kind invitation to speak at this event.

We are working through a severe financial crisis caused by many factors, including government inaction and mistaken actions, outdated U.S. and global financial regulatory systems, and by the excessive risk-taking of financial institutions. This combination of factors led to a critical stage this fall when the entire U.S. financial system was at risk.

This should never happen again. The United States must lead global financial reform efforts, and we must start by getting our own house in order.

The most significant discussion of financial system reform in the last 60 years has begun. This debate offers great opportunities -- and great peril. The events of the last year have exposed excesses and flaws that are, to put it mildly, humbling. If we do not correctly diagnose the causes, and instead act in haste to implement more rather than better regulations, we can do long term harm.

Today I will give my view of recent events, the principles that have guided me, our response to the unfolding crisis and my ideas for regulatory reforms.

My regulatory reform views are based on the principles of transparency and accountability, and my belief that our entrepreneurial nation must continue to foster prudent risk-taking, while not rewarding failure or encouraging recklessness. In all that lies ahead we must never forget that our financial system is built on the hard work of our citizens; it is built on the savings of our citizens – and perhaps most importantly, our financial system depends on the trust and confidence of our citizens.

As I assess our current situation, I believe we have taken the necessary steps to prevent a financial collapse. And the authorities and capacity granted to us by Congress has been the key to this accomplishment. Looking forward, working with the Fed and the FDIC we now have the tools and the commitment to do what is necessary to maintain the stability of our financial system. Many challenges lie ahead and progress will not be in a straight line. The excesses in our system built up over years, and it will take time to work through them.

Genesis of Financial Turmoil: Global Imbalances

The U.S. housing correction was clearly the spark that ignited the financial crisis. But the U.S. housing bubble is just one – albeit the largest – manifestation of global excesses. These excesses have been building for years as benign markets, strong global growth, low U.S. saving rates, and policy choices led to large global imbalances and an extraordinary increase in capital flows.

The world was awash in money looking for higher return, and much of this money was invested in U.S. assets. The combination of a huge amount of capital and low interest rates stoked greater risk taking, financial innovation and complexity, not all of it healthy. Financial institutions found new ways to increase leverage – from designing complex new financial instruments, to creating off balance sheet financing vehicles. The global financial system grew increasingly complex and opaque, and regulation did not keep pace.

Low interest rates and the search for ever higher returns boosted global demand for housing. Home prices rose at unsustainable rates in the United States and a number of countries, and housing-related investments also surged. A housing correction was inevitable and when it occurred, home price declines and a wave of foreclosures hit the value of mortgage-related assets particularly hard. The U.S. housing correction was felt here at home and overseas, and the global financial system began to suffer. After 13 months of stress, excesses and inadequate risk management and regulatory policies outside the United States have also been exposed. As Warren Buffet has said, "It's only when the tide goes out that you learn who's been swimming naked."

Global Financial Turmoil and the U.S. Response

Our economy and the American people are paying a steep price for that neglect. In response, the United States and many nations have taken a series of urgent, necessary, and temporary steps to limit further damage. Until the financial crisis is behind us we must remain vigilant, ready to respond to and manage unpredictable events that might threaten the system, as they occur. Our first priority is stability and recovery and then we need to repair our financial system to help prevent this from every happening again. Our remedial actions should serve as a bridge to a permanent, modern regulatory framework to serve as the cornerstone of comprehensive reform to ensure this turmoil is never repeated.

When I came to Washington in 2006, markets were benign. Notwithstanding this, in my first meeting with President Bush and his economic team I noted that financial turmoil seems to occur every five to ten years and we needed to be prepared. Thereafter, I regularly convened the President's Working Group on Financial Markets, the PWG, to review risk factors and make recommendations for improvements. We focused on systemic weaknesses and how we might mitigate them in the event of turmoil or -- even worse, a financial crisis.

The government-sponsored enterprises, the GSEs, Fannie Mae and Freddie Mac clearly posed a potential systemic risk. I immediately pursued the Administration's long-sought goal of legislation to improve regulatory oversight of the GSEs. And I directed Treasury staff to begin a study that would lead to practical recommendations for improving our outdated financial regulatory architecture.

As the housing correction progressed in 2007, we acted aggressively to help minimize foreclosures. We convened the industry to develop private sector strategies that now help over 200,000 homeowners avoid foreclosure every month. Since August of 2007, we have pressed financial institutions to raise more capital, and they have -- over $450 billion, and to recognize losses, which they also have -- over $530 billion.

Bear Stearns on the Brink of Bankruptcy

Market conditions continued to worsen. And then last March Bear Stearns faced failure, and we faced our first potential systemic event and major challenge. Regulators did not, and still don't, have the authority to administer receivership-like proceedings for non-depository institutions that fail, as they do for commercial banks. The Bear Stearns situation exemplified something former Federal Reserve Chairman Greenspan has pointed out: the real issue is not that an institution is too big or too interconnected to fail, but that it is too big or interconnected to liquidate in a timely and orderly fashion. We were fortunate that JPMorgan purchased Bear Stearns and prevented a bankruptcy, and that the Federal Reserve has statutory authority to lend against a pool of mortgage loans on a fully secured basis. The Fed was able to assist the JPMorgan purchase because they believed that there was a reasonable prospect of avoiding losses.

The Bear Stearns situation made it painfully clear that the federal government needed the authorities to wind-down a failing non-depository institution, particularly if it posed a systemic risk. Chairman Bernanke and I spoke of the need for this authority in the future but recognized that for the near term we would rely on existing tools, as imperfect at they were.

We averted this first systemic event by using our existing authorities creatively. Unfortunately, we were about to find more need to be creative in the coming months. I will leave history to the historians, but from my perspective we responded as quickly and directly as our authorities allowed as a severe market crisis unfolded, and we have never lost focus of our singular goal -- to stabilize the financial system that supports our economy and the everyday lives of all Americans.

There was no playbook for responding to a once or twice in a hundred year event. Instead, I have been guided by several principles in dealing with the Bear Stearns situation and all that followed. My guiding principles in these past months have been:

One, never forget our awesome responsibility to the American people who depend on the financial system to save for college and retirement, for financing homes, cars and companies. If the financial system were allowed to collapse, it is the American people who would pay the price. This has never been just about the banks; it has always been about continued prosperity and opportunity for all Americans.

Two, run to problems – the cost of preventing a systemic event is less than the cost of addressing its catastrophic consequences;

Three, bring people together to work on solutions. Although it is always desirable, in times like these it is essential for government leaders of both parties and for financial leaders from around the world to work together;

Four, define my portfolio expansively – look beyond how authorities have been used in the past, and motivate the private sector, Administration colleagues and regulators to do what is needed;

Five, guard against systemic risk while maintaining market discipline and protecting the taxpayer; and,

Six, be pragmatic enough to change plans when facts and conditions change.

Throughout the last several months, as a variety of challenges has surfaced, these principles guided my efforts to take comprehensive, decisive action to address market issues and build confidence. Three situations in particular illustrate these principles at work – the loss of investor confidence in Fannie Mae and Freddie Mac, the so-called GSEs, in July; the failure of Lehman Brothers in September; and the implementation of the financial rescue package in October.

Fannie Mae and Freddie Mac: a Crisis in Confidence

In June and July, concerns about the GSEs' credit losses and capital strength seriously and rapidly undermined investor confidence, but legislation to improve GSE oversight was still mired in Congress. With $5.4 trillion in outstanding GSE debt and agency MBS held by investors around the world, failure of the GSEs posed a huge risk to our financial system. We couldn't wait for them to fail formally. We moved quickly to address this challenge and, in late July, Congress provided us authority to backstop the GSEs, and finalized creation of a stronger GSE regulator, the FHFA.

Throughout August, overall market and housing conditions continued to deteriorate. And we learned that the amount and quality of the GSEs' capital was inadequate. It was necessary to take action – before any systemic event. And it was clear that any effective action would require a combined effort on the part of the Federal Reserve, the FHFA and Treasury. We combined our authorities to find the most effective way forward, and the companies consented to FHFA conservatorship. On September 7th the FHFA placed Fannie Mae and Freddie Mac into conservatorship, and Treasury put in place a preferred stock purchase agreement that in essence guarantees all GSE obligations for their duration. We replaced both companies' CEOs and took warrants for up to 79.9 percent of each company. By stabilizing the GSEs, we've enabled them to play their vital role in making mortgage finance available and affordable as we work through the housing correction.

The conservatorship is a temporary condition, a "time out" period where the new President and Congress must decide what role government in general, and the GSEs in particular, should play in the housing finance market. In my view, government support needs to be either explicit or non-existent, structured to resolve the conflict between public and private purposes, and policymakers must address the issue of systemic risk. This is a situation where the next Administration and Congress will need to take decisive action.

As we worked on the urgent, comprehensive plan that stabilized the GSEs, we were racing to stay ahead of other, likely destabilizing market events.

Lehman Brothers Unable to Solve its Problems

There had been rumors of Lehman's potential failure all summer and Lehman had been searching, without success, for a buyer or other solutions to the serious problems they were facing. I had monitored these efforts closely, and as the company reached a critical moment, Fed Chairman Ben Bernanke, New York Fed President Tim Geithner, SEC Chairman Chris Cox and I sought to do everything we could to avert a Lehman failure. We gathered industry leaders the weekend of September 13th to explore all possible options. I was actively engaged in the process as we encouraged two potential buyers to make offers. Each examined Lehman's books, but neither was willing to go forward without off-loading billions of dollars of assets that they considered had substantial unrealized losses.

Treasury and the Federal Reserve had no authority to resolve this problem. Federal law, and in particular the Anti-Deficiency Act, prohibits Treasury from spending money, lending money, and guaranteeing or buying assets without Congressional approval. The Federal Reserve can and does lend on a secured basis, but only if it expects not to realize losses. The Fed couldn't legally lend against the Lehman assets if it expected that loan to result in a loss of any size; this was much different than the case with Bear Stearns.

I tried to put together an industry consortium to facilitate the transaction by purchasing the off-loaded assets, but once the potential buyer failed to obtain regulatory approval, the entire transaction disappeared. Without any federal authority to intervene, we had no choice but to do everything possible to try to mitigate the consequences of a Lehman failure.

That weekend, the management of the nation's largest insurance company, AIG, also informed us that they faced an imminent bankruptcy. AIG's businesses were intertwined throughout the global financial system. Because AIG's underlying insurance companies had value, the Fed could use its authority to make a fully secured loan to AIG. By doing so, it prevented a systemic disruption that would have been an order of magnitude far greater than the Lehman failure.

Some have chosen to scapegoat the Lehman failure as the cause of the deepening crisis in September, as opposed to a symptom. That is at best naïve, and at worst disingenuous. The U.S. government had no authority to rescue Lehman Brothers. Even if Lehman had been acquired, it would not have averted the virtually simultaneous collapse of AIG, or the collapse of Washington Mutual, or the wave of failures that European governments stepped in to avert shortly thereafter.

Financial Crisis hits the United States and the World

By mid-September, after 13 months of market stress, the financial system essentially seized up and we had a system-wide crisis. Credit markets froze and banks substantially reduced interbank lending. Confidence was seriously compromised throughout our financial system. Our system was on the verge of collapse, a collapse that would have significantly worsened and prolonged the economic downturn that was already underway.

That was the background against which Chairman Bernanke and I met with the Congressional bipartisan leadership to request emergency legislation. We needed the financial rescue package so we could intervene, stabilize our financial system, and minimize further damage to our economy.

During the two weeks Congress worked on the legislation, market conditions worsened significantly. Many Americans look at the stock market as an indicator of the economy, and during this period they saw tremendous volatility. The Dow Jones Industrial Average fell more than 700 points on one single day, and over 9 percent during the two weeks the legislation was debated – stock market losses amounted to slightly more than $2 trillion.

As disturbing as this was, we were even more focused on the credit markets because they provide our basic economic fuel – borrowing and lending capital – that supports and creates jobs. The confidence in banks and of banks continued to diminish, as did the flow of funds between them. The problems extended to blue chip industrial companies who could only issue commercial paper with very short maturities as the commercial paper market became severely impaired. Small and medium-sized companies, with no direct connection to the financial sector, were losing access to the normal credit needed to meet payrolls, pay suppliers and buy inventory.

During that same period, the government intervened to protect the financial system. The FDIC acted to mitigate the failure of Washington Mutual by facilitating its sale, and made clear that it would intervene to prevent Wachovia's failure. And turmoil had developed in European markets. In a two-day period at the end of September the governments of Ireland, the United Kingdom, Germany, Belgium, France and Iceland intervened to prevent the failure of one or more financial institutions in their countries.

By the time legislation had passed on October 3, the global financial crisis was so broad and so severe, we knew we needed to move quickly and take powerful steps to stabilize our financial system and to get credit flowing again. Our initial intent had been to strengthen the banking system by purchasing illiquid mortgages and mortgage-related securities. But by this time, given the severity and magnitude of the situation, an asset purchase program would not be either effective enough or quick enough. Therefore we exercised the authority granted by Congress in this legislation to quickly deploy a $250 billion capital purchase program, fully anticipating we would follow that with a program for troubled asset purchases.

Again at this time, we collaborated widely and creatively to combine all the tools of the federal government to most effectively address the problem. In a unified set of actions, at the same time we announced the capital purchase program, the Federal Reserve announced a program to support the commercial paper market and the FDIC put in place a temporary guarantee of certain debt issued by banks. These actions, taken as part of a coordinated strategy with policymakers around the world, together prevented a very bad outcome, and significantly increased investor and public confidence in our banks. But it was equally clear we continued to face significant stresses and challenges in our capital and credit markets.

Since mid-October, we have continued to assess how best to use the remaining TARP funds, given the uncertainties around the deteriorating economic situation in the U.S. and globally, and the continuing financial market stresses. We have always said that the housing correction is at the root of the economic downturn and our financial market stress. And as the economy slows further, it threatens to prolong the housing correction.

We knew, too, that to be effective a mortgage asset purchase program would require a massive commitment of TARP funds. In September, before economic conditions worsened, $700 billion in troubled asset purchases would have had a significant impact, providing more flexibility and firepower for this Administration and the next. Although we are not proceeding with direct asset purchase programs, we plan on using our resources aggressively to support the normalization of credit markets and the expansion of credit to support economic recovery. We are actively engaged in developing programs to be implemented when ready.

With the financial system on the verge of collapse, our clear objective when we went to Congress was to stabilize it through measures that would increase capital strength. Our intended strategy had been to free-up capital by purchasing illiquid assets. Since we were careful to get broad authorities from Congress, we were able to change our strategy in order to best achieve our objective.

By proactively addressing the problems we saw coming and being pragmatic enough to change strategy in the face of changed facts and despite the inevitable criticism -- we prevented a far worse financial crisis that would have severely damaged our economy and the economic well-being of all Americans. Had we executed the wrong strategy, and depleted the TARP resources in doing so, we would not have achieved our objective and would have deserved the severe criticism that would have inevitably followed such a failure.

U.S. Regulatory Reform Recommendations

Clearly with the market stresses continuing, maintaining stability throughout the recovery process continues to be our first priority and recovery will take some time. There is, quite rightfully, focus on reforming the system that enabled the excesses. We should resist a hasty response for two reasons. First, it is difficult to develop a comprehensive solution while the situation is still unfolding. Second, simply adding new regulations won't be a long-term solution. We need more effective regulations within an entirely new regulatory framework and a stronger capacity for resolution and crisis intervention that reinforces market discipline.

In the Blueprint for Regulatory Reform that we developed prior to this financial turmoil and released last March, and which has proven to be remarkably appropriate, we recommend a U.S. regulatory model based on objectives that better align the regulatory structure with the reasons why we regulate – to ensure stability, safety and soundness and to protect consumers while also supporting innovation.

In our model, a market stability regulator would have authority to review any systemically important financial company, and to look for problems anywhere in the financial system in order to protect against systemic risk. Our continuing challenge has been what to do about non-depository institutions that may be too big or too interconnected to fail. We need a mechanism, essentially an amendment of the federal bankruptcy system, for the orderly wind-down of such institutions. Also, to ensure the market stability regulator can fulfill its role, large, systemically-important institutions, including hedge funds, should be required to have a charter that would permit some type of oversight.

Similarly, any financial product whose market size presents a systemic issue should be subject to regulatory oversight. The PWG has taken steps to achieve this in the crucial OTC derivatives market. Moves to strengthen trade processing, including centralized clearing, although not yet a complete solution, they should enhance transparency and promote standardization.

Transparency must be a higher priority. We need disclosures that can be understood, because complexity often hides risk. Greater standardization would also improve market transparency. And we must conduct a wholesale review of the originate-to-distribute securitization model, because for every significant financial product each party in the product chain must bear certain responsibility or potential risk.

We must address those aspects of our system that reinforce rather than counterbalance cycles; regulators and ratings agencies often take actions after a problem emerges that exacerbates the cycle. For example, mark-to-market accounting is clearly pro-cyclical. Yet I know of no better accounting method, and welcome the steps to review and modify its implementation during severe market stress.

And policymakers and regulators must examine financial services industry compensation practices. Given their role in supporting and sustaining U.S. economic activity, financial institutions' compensation practices should not encourage unsafe and unsound risk taking or reward failure.

Under a new framework, which includes market infrastructure, transparency and wind-down authorities, we could achieve again the proper balance between market discipline and regulatory oversight, and no institution should be deemed to be too interconnected or too big to fail.

Global Reforms

Throughout the period of crisis, I and my team have been in constant communication with our international colleagues. We have collaborated on many occasions with clear and compelling results. At the height of the turmoil in October, for example, we and our G-7 colleagues committed to a comprehensive global strategy to provide liquidity to markets, to strengthen financial institutions through capital investment and guaranteeing interbank lending -- to prevent failures that pose systemic risk, to protect savers, and to enforce investor protections. This was a first important step to stabilizing the rapidly deteriorating financial system. I also called a meeting of the G-20 Finance Ministers, which President Bush attended, to begin to build support for a global response.

These efforts laid a foundation for that response. Under President Bush's leadership, the G-20 nations came together this past weekend in a confidence-inspiring session to realistically assess the nature of our problems and agree on an ambitious reform path forward. In several areas, the United States has led the effort for global reform, and these must remain critical priorities for the future.

First, the Treasury and other U.S. regulators, in collaboration with other members of the G-7, have worked tirelessly through the Financial Stability Forum, the FSF, to make rapid and meaningful regulatory reforms to address the root causes of the crisis. There is a growing recognition across major economies that the global financial markets demand that national financial regulation be as consistent as possible and not working at cross-purposes.

Contradictory global regulation impedes cross-border flows, increases costs to consumers, and hurts market transparency and efficiency. To address these realities, national regulators must continue to strengthen cooperation with foreign counterparts in international standard setting bodies and, where appropriate, make regulations more consistent across the world's boundaries. We have taken great care to ensure our efforts abroad are closely integrated with the work of the President's Working Group, which has proven a useful forum for bringing independent regulators together without undermining their independence to achieve important and timely reforms.

The second important priority must be continued reform of the International Financial Institutions like the World Bank and the IMF to allow for greater participation of developing nations. The pressure on these Institutions to respond swiftly and effectively has never been greater. But they are constrained by outdated governance structures and policies. Since coming to Washington, I have consistently said that for these institutions to remain relevant, their membership must reflect the seismic shifts in the global economy. The United States has been the leading advocate for governance reform, and while there has been some progress, more needs to be done.

As examples, the FSF needs to broaden its membership to include key emerging market economies. Similarly, the IMF and World Bank need to accord dynamic emerging market economies greater representation and participation in their daily operations. In addition, the IMF, the World Bank, as well as the regional development banks should consider how to reform their executive boards to make them more accountable, streamlined, and effective. We should also consider whether these institutions could benefit from non-resident boards. This proposal could free-up resources and enable management to focus on issues of more strategic importance. Governance reforms such as these would be usefully discussed by the outside commissions that Managing Director Dominique Strauss Kahn and President Bob Zoellick have set up for their respective institutions.

A final reform priority must be consistent liberalization of policies on trade and investment, with an emphasis on avoiding new protectionist measures and achieving a breakthrough in the Doha round of global trade talks. In this time of anxiety and uncertainty, we must not lose sight of the importance of free trade and open investment in spurring economic growth. Expanding markets through trade promotes investment that fuels economic dynamism and innovation, as well as deployment of new technologies that raise productivity, and ultimately our standard of living. I have made pro-investment policies for the United States a priority since arriving at Treasury, and we have made very good progress on this front. But open investment policies are not enough. With global growth expected to slow, we need to support trade policies that will help lower trade barriers, create market access for developing countries and a path to prosperity for the world's poor. In the United States, this means finalizing already negotiated trade agreements and supporting free trade policies in the future. Especially during such a difficult economic period, we must resist the pressures to turn inward and we must ensure that our international colleagues share this strong commitment.

Conclusion

Until the financial crisis is behind us, we must remain vigilant, ready to respond and to manage unpredictable events as they occur. And we have the capacity and the commitment to do just that. Our first priority is on stability and recovery. And then we will need to repair our financial system and the global system to help prevent this from ever happening again.

The key to success is pro-active, creative collaboration. In the United States, this means Democrats and Republicans must cooperate and manage an unprecedented situation, and find solutions that restore and maintain our national economic well-being. Globally, it means sovereign nations working together to protect economic and social stability. In this increasingly inter-connected and inter-dependent global economy we are all in the same boat. We must work together to first plug the leak, bail, and row together to reach the shore. Then we must work as a team to overhaul and refit the boat so we can handle the rough seas that will undoubtedly test us in the future.

The journey ahead will no doubt be a difficult one. But I am an optimist and believe we will work together, both domestically and globally, on this path to recovery and an eventual return to prosperity.

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