U.S. DEPARTMENT OF THE TREASURY

Press Center

Remarks by Secretary Henry M. Paulson, Jr. on Financial Rescue Package and Economic Update

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Washington - Good morning. I will provide an update on the state of the financial system, our economy, and our strategy for continued implementation of the financial rescue package.

Current State of Global Financial System

The actions taken by Treasury, the Federal Reserve and the FDIC in October have clearly helped stabilize our financial system. Before we acted, we were at a tipping point. Credit markets were largely frozen, denying financial institutions, businesses and consumers access to vital funding and credit. U.S. and European financial institutions were under extreme pressure, and investor confidence in our system was dangerously low.

We also acted quickly and in coordination with colleagues around the world to stabilize the global financial system. Going into the Annual IMF/World Bank meetings in early October, I made clear that we would use the financial rescue package granted by Congress to purchase equity directly from financial institutions – the fastest and most productive means of using our new authorities to stabilize our financial system. We launched our capital purchase program the following week when we announced that nine of the largest U.S. financial institutions, holding approximately 55 percent of U.S. banking assets would sell $125 billion in preferred stock to the Treasury. At the same time, the FDIC announced it would temporarily guarantee all newly issued senior unsecured debt of participating organizations for up to three years. In addition, the FDIC provided an unlimited guarantee on non-interest bearing transaction accounts that expires at the end of next year.

As I assess where we are today, I believe we have taken the necessary steps to prevent a broad systemic event. Both at home and around the world we have already seen signs of improvement. Our system is stronger and more stable than just a few weeks ago. Although this is a major accomplishment, we have many challenges ahead of us. Our financial system remains fragile in the face of an economic downturn here and abroad, and financial institutions' balance sheets still hold significant illiquid assets. Market turmoil will not abate until the biggest part of the housing correction is behind us. Our primary focus must be recovery and repair.

Housing and Mortgage Finance

Overall, we are in a better position than we were, but we must address the continued challenges of a weak economy, especially the housing correction and lending contraction.

On housing, we have worked aggressively to avoid preventable foreclosures and keep mortgage financing available. In October 2007, we helped establish the HOPE NOW Alliance, a coalition of mortgage servicers, investors and counselors, to help struggling homeowners avoid preventable foreclosures. HOPE NOW created a streamlined protocol to assist struggling borrowers who could afford their homes with a loan modification. The industry is now helping 200,000 homeowners a month avoid foreclosure. In addition, HUD has created new programs to complement existing FHA options, and to refinance a larger number of struggling borrowers into affordable FHA mortgages.

Most significantly, we acted earlier this year to prevent the failure of Fannie Mae and Freddie Mac, the housing GSEs that now touch over 70 percent of mortgage originations. I clearly stated at that time three critical objectives: providing stability to financial markets, supporting the availability of mortgage finance, and protecting taxpayers – both by minimizing the near term costs to the taxpayer and by setting policymakers on a course to resolve the systemic risk created by the inherent conflict in the GSE structure.

Fortunately we acted, citing concerns about both the quality and quantity of GSE capital. Unfortunately, our actions proved all too necessary. The GSEs were failing, and if they did fail, it would have materially exacerbated the recent market turmoil and more profoundly impacted household wealth: from family budgets, to home values, to savings for college and retirement.

Earlier this week, Fannie Mae reported a record loss, including write-downs of its deferred tax assets that make up a significant portion of its capital. We monitor closely the performance of both Fannie Mae and Freddie Mac, and both are performing within the range of our expectations. The magnitude of the losses at Fannie Mae were within the range of what we expected, and further confirms the need for our strong actions.

Eight weeks ago, Treasury took responsibility for supporting the agency debt securities and the agency MBS through a preferred stock purchase agreement that guarantees a positive net worth in each enterprise – effectively, a guarantee on GSE debt and agency MBS. We also established a credit facility to provide the GSEs the strongest possible liquidity backstop. As the enterprises go through this difficult housing correction we will, as needed and promised, purchase preferred shares under the terms of that agreement. The U.S. government honors its commitments, and investors can bank on it.

When we took action in September, I said that we would be entering a "time out" – a period where the new President and Congress must decide what role government in general, and the GSEs in particular, should play in the housing market. In my view, government support needs to be either explicit or non-existent, and structured to resolve the conflict between public and private purposes. And policymakers must address the issue of systemic risk. In the weeks ahead, I will share some thoughts outlining my views on long term reform.

In the meantime, the GSEs now operate on stable footing. They have strong government support backing both future capital and liquidity needs. We have stabilized the GSEs and limited systemic risk, and our authorities provide us with additional flexibility to use as necessary to accomplish our objectives.

Implementing the Financial Rescue Package

More recently, we have also taken extraordinary steps to support our financial markets and financial institutions. As credit markets froze in mid-September, the Administration asked Congress for broad tools and flexibility to rescue the financial system. We asked for $700 billion to purchase troubled assets from financial institutions. At the time, we believed that would be the most effective means of getting credit flowing again.

During the two weeks that Congress considered the legislation, market conditions worsened considerably. It was clear to me by the time the bill was signed on October 3rd that we needed to act quickly and forcefully, and that purchasing troubled assets – our initial focus – would take time to implement and would not be sufficient given the severity of the problem. In consultation with the Federal Reserve, I determined that the most timely, effective step to improve credit market conditions was to strengthen bank balance sheets quickly through direct purchases of equity in banks.

Of course, before that time, the only instances in which Treasury had taken equity positions was in rescuing a failing institution. Both the preferred stock purchase agreement for Fannie Mae and Freddie Mac, and the Federal Reserve's secured lending facility for AIG came with significant taxpayer protections and conditions. As we planned a capital purchase plan to support the overall financial system by strengthening balance sheets of a broad array of healthy banks, the terms had to be designed to encourage broad participation, balanced to ensure appropriate taxpayer protection and not impede the flow of private capital.

Capital Purchase Plan

We announced a plan on October 14th to purchase up to $250 billion in preferred stock in federally regulated banks and thrifts. By October 26th we had $115 billion out the door to eight large institutions. In Washington that is a land-speed record from announcing a program to getting funds out the door. We now have approved dozens of additional applications, and investments are being made in approved institutions. Although we are moving very quickly it will take time to complete legal contracts and execute investments in the significant number of institutions who meet the eligibility requirements and are approved, but we are on the path to getting this done.

Although this program's primary purpose is stabilizing our financial system, banks must also continue lending. During times like these with a slowing economy and some deterioration in credit conditions, even the healthiest banks tend to become more risk-averse and restrain lending, and regulators' actions have reinforced this lending restraint in the past. With a stronger capital base, our banks will be more confident and better positioned to play their necessary role to support economic activity. Today banking regulators issued a statement emphasizing that the extraordinary government actions taken by the Fed, Treasury and FDIC to stabilize and strengthen the banking system are not merely one-sided; all banks – not just those participating in the Capital Purchase Program – have benefited, so they all also have responsibilities in the areas of lending, dividend and compensation policies, and foreclosure mitigation. I commend this action and I am particularly focused on the importance of prudent bank lending to restore our economic growth.

Since announcing the Capital Purchase Program, we have been examining a wide range of ideas that can further strengthen the financial system and get lending going again to support the broader economy. First and foremost, because the system remains fragile, we must continue to stand ready to prevent systemic failures. That is the basis for Monday's action to purchase preferred shares in AIG. The stability of our system remains the highest priority.

We must also allow markets and institutions to absorb the extensive array of new policies put in place in a very short period of time. The injection of up to $250 billion of capital into individual banks, the FDIC's temporary guarantee of bank debt and the Federal Reserve's multiple liquidity facilities for banks, money funds and commercial paper issuers have all significantly enhanced liquidity and helped improve market conditions.

Priorities for Remaining TARP Funds

We have evaluated options for most effectively deploying the remaining TARP funds, and have identified three critical priorities. First, we must continue to reinforce the stability of the financial system, so that banks and other institutions critical to the provision of credit are able to support economic recovery and growth. Although the financial system has stabilized, both banks and non-banks may well need more capital given their troubled asset holdings, projections for continued high rates of foreclosures and stagnant U.S. and world economic conditions. Second, the important markets for securitizing credit outside of the banking system also need support. Approximately 40 percent of U.S. consumer credit is provided through securitization of credit card receivables, auto loans and student loans and similar products. This market, which is vital for lending and growth, has for all practical purposes ground to a halt. Addressing these two priorities will have powerful impacts on the overall financial system, the strength of our financial institutions and the availability of consumer credit. Third, we continue to explore ways to reduce the risk of foreclosure.

Over these past weeks we have continued to examine the relative benefits of purchasing illiquid mortgage-related assets. Our assessment at this time is that this is not the most effective way to use TARP funds, but we will continue to examine whether targeted forms of asset purchase can play a useful role, relative to other potential uses of TARP resources, in helping to strengthen our financial system and support lending. But other strategies I will outline will help to alleviate the pressure of illiquid assets.

Further Strategies

First, we are designing further strategies for building capital in financial institutions. Stronger capital positions will enable financial institutions to better manage the illiquid assets on their books and better ensure that they remain healthy. Any future program should maintain our principle of encouraging participation of healthy institutions while protecting taxpayers. We are carefully evaluating programs which would further leverage the impact of a TARP investment by attracting private capital, potentially through matching investments. In developing a potential matching program, we will also consider capital needs of non-bank financial institutions not eligible for the current capital program; broadening access in this way would bring both benefits and challenges. Non-bank financial institutions provide credit that is essential to U.S. businesses and consumers. However, many are not directly regulated and are active in a wide range of businesses, and taxpayer protections in a program of this sort would be more difficult to achieve. Also before embarking on a second capital purchase program, the first one must be completed, and we have to assess its impact and use this information to evaluate the size and focus of an additional program in light of existing economic and market conditions.

Second, we are examining strategies to support consumer access to credit outside the banking system. To date, Fed, FDIC and Treasury programs have been targeted at our banking system, and the non-bank consumer finance sector continues to face difficult funding issues. Specifically, the asset-backed securitization market has played a critical role for many years in lowering the cost and increasing the availability of consumer finance. This market is currently in distress, costs of funding have skyrocketed and new issue activity has come to a halt. Today, the illiquidity in this sector is raising the cost and reducing the availability of car loans, student loans and credit cards. This is creating a heavy burden on the American people and reducing the number of jobs in our economy. With the Federal Reserve we are exploring the development of a potential liquidity facility for highly-rated AAA asset-backed securities. We are looking at ways to possibly use the TARP to encourage private investors to come back to this troubled market, by providing them access to federal financing while protecting the taxpayers' investment. By doing so, we can lower costs and increase credit availability for consumers. Addressing the needs of the securitization sector will help get lending going again, helping consumers and supporting the U.S. economy. While this securitization effort is targeted at consumer financing, the program we are evaluating may also be used to support new commercial and residential mortgage-backed securities lending.

Third, we are examining strategies to mitigate mortgage foreclosures. In crafting the financial rescue package, we and the Congress agreed that Treasury would use its leverage as a major purchaser of troubled mortgages to work with servicers and achieve more aggressive mortgage modification standards. Now that we are not planning to purchase illiquid mortgage assets, we must find another way to meet that commitment.

FDIC Chairman Bair has given us a model, in the mortgage modification protocol she developed with IndyMac Bank. Through the end of October, the FDIC has completed loan modifications for 3,500 borrowers, with several thousand more modifications currently being processed. These modifications have reduced payments for participating homeowners by an average of $380 month, or about 23 percent. We have worked with the FHFA, the GSEs, HUD and the Hope Now alliance who yesterday announced a streamlined industry-wide modification program that for the first time adopts an explicit affordability target similar to the model pioneered at IndyMac. With this commitment, the GSEs and large portfolio investors are setting a new industry standard for foreclosure mitigation. Potentially hundreds of thousands more struggling borrowers will be enabled to stay in their homes at an affordable monthly mortgage payment.

Beyond these efforts, there has been significant work to design and evaluate a number of proposals to induce further modifications. Each of these would, however, require substantial government subsidies. The FDIC, for example, has developed a proposal that Treasury and others in the Administration continue to discuss. I believe it is an important idea. As we evaluate the merits of any new proposal, we also will have to identify and justify the means to finance it. We must be careful to distinguish this type of assistance, which essentially involves direct spending, from the type of investments that are intended to promote financial stability, protect the taxpayer, and be recovered under the TARP legislation. Maximizing loan modifications, nonetheless, is a key part of working through the housing correction and maintaining the quality of communities across the nation, and we will continue working hard to make progress here.

We will continue to pursue the three strategies I have just outlined: how best to strengthen the capital base of our financial system; how best to support the asset-backed securitization market that is critical to consumer finance, and how to increase foreclosure mitigation efforts. All of these strategies are important, but ensuring the financial system has sufficient capital is essential to getting credit flowing to consumers and businesses and that is where the bulk of the remaining TARP funds should be deployed --- in a program to support the system and as a contingency reserve for addressing any unforeseen systemic events.

We are focused on developing and preparing programs which can be implemented for each of these strategies. We will continue to brief President-elect Obama's transition team on all of these issues.

Global Challenge

Of course managing through this market turmoil while mitigating the impact of the credit crisis is a global as well as a national issue. We in the U.S. are well aware and humbled by our own failings and recognize our special responsibility to the global economy. The U.S. housing correction exposed gaping shortcomings in the outdated U.S. regulatory system, shortcomings in other regulatory regimes and excesses in U.S. and European financial institutions. These institutions found themselves with large holdings of structured products, including complex and opaque mortgage-backed securities. Some European institutions were characterized by high leverage, exposure to their own housing markets, exposure to Central European institutions, weak business models or overly aggressive expansion, while others faced weaknesses because of inadequate depositor protection systems. It should not be surprising that after 13 months of stress in the global capital markets, banks from the U.S. to the U.K., from Germany to Iceland, from Russia to France, had difficulties that exposed some of these weaknesses for the first time. For some of these banks, this proved to be a hurdle too high and government action was necessary to support financial stability.

In that regard the G7 Finance Ministers meeting last month represented a major turning point in stabilizing the global financial system as the ministers came together to support a number of powerful strategies that were soon turned into effective actions in the United States and Europe. It is also clear that our first priority must be recovery and repair. And of course we must take strong actions to fix our system so that the world does not have to suffer something like this ever again. The Leaders summit President Bush will be hosting this weekend marks a very important step in what will be an ongoing process of recovery and reform.

And to adequately reform our system, we must make sure we fully understand the nature of the problem which will not be possible until we are confident it is behind us. Of course, it is already clear that we must address a number of significant issues, such as improving risk management practices, compensation practices, oversight of mortgage origination and the securitization process, credit rating agencies, OTC derivative market infrastructure and regulatory policies, practices and regimes in our respective countries. And we recognize that our financial institutions and our markets are global, but our regulatory regimes are national, so we will examine how best to improve cooperation and information sharing to foster global financial system stability.

But let us not forget one fundamental issue which lies at the heart of our problems. Over a period of years, persistent and growing global imbalances fueled a dramatic increase in capital flows, low interest rates, excessive risk taking and a global search for return. Those excesses cannot be attributed to any single nation. There is no doubt that low U.S. savings are a significant factor, but the lack of consumption and accumulation of reserves in Asia and oil-exporting countries and structural issues in Europe have also fed the imbalances.

If we only address particular regulatory issues – as critical as they are – without addressing the global imbalances that fueled recent excesses, we will have missed an opportunity to dramatically improve the foundation for global markets and economic vitality going forward. The pressure from global imbalances will simply build up again until it finds another outlet.

The nations attending this weekend's summit represent the 20 largest economies in the world – over 77 percent of global GDP. President Bush is convening this group of countries to discuss and address problems such as global imbalances, making regulatory regimes more effective, fostering cooperation among regulators, and reforming international institutions to better address today's global economy. We can't simply task the IMF, the FSF or other International Financial Institutions to solve the problems, unless member nations all see that they have a shared interest in a solution. There are no easy answers, because until we reach a consensus on a broad-based reform agenda, we will not reach a solution. This weekend provides an opportunity for nations to take an important step, but only one step, on the necessary path to reform.

Conclusion

The road ahead, for the U.S. economy and the global economy, is full of challenges. And it will take strong leadership to address them. I am confident the United States, under this and the next Administration, will rise to these challenges. I will do everything I can to put us on the right path, both by working diligently through the end of my term and by working closely to ensure the smoothest possible transition.

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