

U.S. DEPARTMENT OF THE TREASURY

Press Center

Remarks by Treasury Under Secretary for International Affairs David H. McCormick at CLSA Hong Kong Investors' Forum

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Washington, DC— The seeds of the significant challenges we face today were sown many years ago, beginning with a gradual weakening of lending practices by banks and financial institutions, and by greater willingness by borrowers to take out mortgages they couldn't afford. These factors combined with growing complexity and opaqueness in our capital markets are at the heart of the current market turmoil.

We are now paying the price. We've seen the results for homeowners--higher foreclosure rates affecting individuals and neighborhoods. And now we are seeing the impact on financial institutions. These weak loans have started a chain reaction, and last week, our credit markets tightened dramatically with even some non-financial companies around the country having difficulties financing their day-to-day business operations. If this situation was to persist, it would threaten all parts of the U.S. economy. In response to this worsening market turmoil, Treasury has undertaken a number of bold actions in recent months and recent days to stabilize the markets, mitigate the impact of a number of failing or troubled institutions, and address the underlying sources of market uncertainty.

Root Causes of the Market Turmoil

How did we come to this point? The story begins with an abnormally long period of benign economic conditions in the preceding decade marked by low interest rates, low inflation, and less volatile asset markets which led many to ignore the "risk" half of the risk-reward equation at the heart of financial markets. Investors around the world, who in preceding years had enjoyed above-historical returns on most types of investments, continued reaching for ever-higher gains. The financial-services industry created a variety of complicated new products to meet this demand. Regulators and investors alike showed a growing complacency toward risk. These factors blended into a dangerous cocktail of underlying conditions ripe for instability.

This imbalance between risk and reward was most evident in the U.S. housing market, where lenders significantly loosened credit standards--particularly for a new generation of adjustable-rate mortgages with low teaser rates, interest-only features, and low or no down payments. Yet aggressive financial innovation went well beyond mortgages. Banks and brokers created an alphabet soup of products with simple names like CDOs, CLOs and SIVs, which were in fact complex and opaque investment products and structures. They relied on bundling assets, particularly mortgages, to better distribute the investment risk, and the greater use of leverage or borrowing to generate higher returns. Credit-rating agencies responsible for assessing and rating these assets, as well as investors who purchased them, failed to question the chances of these underlying investments going bad.

Last summer these new vulnerabilities in our financial system became clear. Looser credit standards in the housing market, combined with an end to rapid home-price appreciation, led to a significant rise in delinquent mortgages. This in turn contributed to immediate and unexpected losses for investors and a reconsideration of the risk-reward relationship--first in housing, and soon after, across all asset classes. The shaken investor confidence in housing assets had a domino effect throughout world markets, ratcheting up demand for cash and liquidity, and curtailing the pace of the new lending and investment necessary for strong growth to continue.

Actions to Mitigate Risk and Stabilize Markets

Recognizing the risk to the U.S. economy of the housing downturn, the Treasury and Congress acted quickly during the winter to pass a \$150 billion stimulus bill and brought together mortgage providers through the HOPE NOW alliance to help families avoid foreclosure on their homes. While we have tried to minimize the impact of the housing correction on the rest of the economy, we do not want to impede its progress. The sooner we turn the corner on housing, the sooner we will see home values stabilize, the sooner we will see more people buying homes, and the sooner housing will again contribute to economic growth. Still, it will take time to work through these stresses.

In the financial markets, progress has not moved in a straight line, and it is clear that many challenges lie ahead. There have been some positive developments. Since the market turmoil began, U.S. financial institutions (often under new management) have recorded losses of over \$300 billion and raised over \$200 billion in new capital. Yet, the events of the last few weeks – where we have acted on a case-by-case basis to address destabilizing financial conditions in several institutions – are evidence of continued weakness across the financial services sector.

Following the support provided by the Federal Reserve in March for an orderly resolution for Bear Stearns, U.S. authorities recently took action to help mitigate the impact of the bankruptcy of the fourth largest U.S. investment bank, Lehman Brothers, in early September. That same week, the Fed provided funding to American International Group (AIG) to address the systemic risk that would have resulted from a sudden collapse of the firm. In each of these cases, authorities sought to strike the appropriate balance between mitigating system risk while promoting market discipline, holding investors and management responsible, while protecting blameless market participants or consumers from collateral damage.

The cases of Fannie Mae and Freddie Mac, where in August the government took comprehensive and unprecedented action, deserve special mention, particularly given their significance to many foreign investors. These Government Sponsored Enterprises (GSEs) have become the largest sources of mortgage finance in the United States, touching 70 percent of mortgages originated in the first quarter. Their continued activity is critical in turning the corner on the housing situation and removing the underlying uncertainty in our financial markets and financial institutions.

Not surprisingly, the prolonged housing correction weakened the financial condition of both of these enterprises, and they faced a significant loss of confidence among investors. Fannie Mae and Freddie Mac are so large and so interwoven in our financial system, that if either of them were to fail, it would be harder for Americans to get home loans, auto loans, and other consumer credit. Business finance would be even harder to obtain, constraining job creation and our overall economic growth.

This past summer, investors began to express growing concerns over the stability of Fannie and Freddie and the uncertainty over the scope and strength of the long standing ambiguous promise of government support. In response, Secretary Paulson asked the Congress for authorities with regard to Fannie Mae and Freddie Mac in order to support our housing markets and the stability of our financial markets more broadly. Congressional leaders acted promptly and decisively with the needed legislation. In the days and weeks that followed, the Director of the Federal Housing Finance Agency (FHFA) Jim Lockhart, Federal Reserve Chairman Bernanke, and Secretary Paulson conducted a rigorous analysis of the situation, which led to the unpleasant but necessary decision to utilize these authorities.

This analysis showed that we had no choice but to act decisively to avert instability in our markets. Our goals are to support the availability of mortgage credit and protect taxpayers to the maximum extent possible. As a first critical step, the Regulator put Fannie and Freddie into conservatorship, allowing the government to take temporary control and make management changes at both institutions.

Under the control of the conservator FHFA, Treasury established contractual Preferred Stock Purchase Agreements with both institutions under which Treasury has committed up to \$100 billion per institution to ensure that each GSE maintains a positive net worth. These Preferred Stock Purchase Agreements are intended to explicitly address the underlying ambiguities in the GSE Congressional charters and to give the holders of Fannie Mae and Freddie Mac debt confidence in the promise of government support for their investments. Because the U.S. Government created these ambiguities and the resulting uncertainty, Secretary Paulson felt strongly that we had a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and agency mortgage-backed securities.

The terms of these purchase agreements provide significant taxpayer protection. The existing shareholders of the GSEs will lose 100 percent of their investment before the American taxpayers lose a penny. Moreover, as part of the terms of this agreement, Treasury has

received from each company \$1 billion in senior preferred stock and warrants providing an option to purchase up to 79 percent of the companies' outstanding shares at a nominal price.

Second, Treasury has established a new, secured and temporary credit facility for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank to fund, if necessary, their regular business activities in the capital markets. Finally, to further support the availability of mortgage financing for millions of Americans, Treasury is initiating a temporary program to purchase mortgage-backed securities issued by the GSEs. This will provide additional capital to the mortgage marketplace. There is no reason to expect taxpayer losses from this program, which will also expire in December 2009.

These steps are the best means of protecting taxpayers and stabilizing our markets, but they leave for future policymakers fundamental policy decisions about the role and structure of these enterprises. Our recent actions have afforded a "time out" – providing the stability, time, and flexibility for Congress and the current and next Administrations to address the inherent conflict in the GSE charters that requires they serve both the interests of private investors and a public mission.

A Comprehensive Policy Response

Despite the hardening of the government's support and involvement in Fannie Mae and Freddie Mac and the rapid and decisive resolutions of Bear Stearns, Lehman Brothers, and AIG, investors have become increasingly concerned over the possibility of other financial institution failures, making them reluctant to extend credit to one another.

This unwillingness to lend led to sharp increases in the cost of credit for financial and non-financial companies, increasing the risk that corporate America would be unable to roll over maturing corporate debt. In this environment, it was necessary for U.S. authorities to act decisively and comprehensively to provide capital, liquidity, and smooth market operations with the goals of stabilizing the markets and addressing the underlying sources of uncertainty.

First, central banks from around the world have acted together to provide additional liquidity for financial institutions. The Federal Reserve has established swap lines with nine central banks to reduce pressures in global short-term U.S. dollar markets. Additionally, Treasury implemented a temporary guaranty program for the U.S. money market mutual fund industry, which was experiencing a funding problem last week. This \$50 billion guaranty program offers government insurance that was previously unavailable in order to address concerns about whether these investments are safe and accessible.

Second, we have a plan for providing much needed capital to address the root cause of the current stress in our financial system – the ongoing housing correction and the consequent buildup of illiquid mortgage-related assets. These troubled assets remain frozen on the balance sheets of banks and other financial institutions, constraining the flow of credit that is so vitally important to our economic growth. The failure to address the troubled mortgage-related assets would mean that every aspect of our financial and funding markets, ranging from consumer credit to money market funds, would continue to be impaired.

Treasury has proposed a \$700 billion comprehensive program for removing these illiquid assets from the balance sheets of institutions within the financial system. As we work with Congress to pass this crucial legislation, we have also undertaken two immediate steps to ease further market pressures. First, the GSEs will increase their purchases of mortgage-backed securities in their portfolios. Second, Treasury will expand the purchase of mortgage-backed securities through a program that we announced earlier this month. These two measures will provide some initial support to mortgage assets, but they will not address the broader issue of asset illiquidity that the troubled asset purchase program will.

Third, we have taken steps to improve market operations and integrity. The Securities and Exchange Commission took temporary emergency action to prohibit short selling in financial companies to protect the integrity and quality of the securities market and strengthen investor confidence. The SEC's exceptional actions for these extraordinary times were joined by regulators in the UK, France, Germany, and other countries in imposing temporary bans on short selling.

Conclusion

Ladies and Gentleman, now is the time to act quickly, decisively, and collaboratively with regulators and market participants around the world to restore stability and confidence to our markets. It will no doubt take time to work through the excesses that were built up over a number of years. U.S. policymakers are implementing policies that address our short-term economic challenges and rebuild faith in the market. When we emerge from this difficult period, our next task will be to strengthen the financial regulatory structure to forestall such excesses in the future. The interdependence of our global economy makes this challenge more complex, and it also makes our work with international counterparts to promote growth and financial stability all the more important.

Thank you.

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