October 3, 2008
HP-1173

Under Secretary David H. McCormick Remarks at Wharton's Eleventh Annual Investment Management Conference

Responding to Today's Market Turmoil

Philadelphia - These are incredibly challenging and unprecedented times for the United States. Over the last twelve months, we have witnessed one of the most significant periods of economic turmoil that has ever faced our country, and I have had the opportunity to see first hand how our country's leaders have responded. Today I'd like to share my views on how we arrived at this place, what we have done about it up to this point, and what else we must do to stabilize our markets and ensure America's long term prosperity.

The seeds of the 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 crisis.

We are now paying the price. We've seen the results for homeowners in higher foreclosure rates affecting individuals and neighborhoods. We are now seeing the impact on struggling financial institutions. These weak loans started a chain reaction, and in recent weeks, our credit markets have tightened dramatically with even some non-financial companies around the country having difficulties financing their day-to-day business operations. These effects are already beginning to trickle down and affect all parts of the U.S. economy.

In response to this worsening situation, the U.S. government has taken bold and decisive actions in recent months to stabilize the markets, mitigate the impact on our financial system and the U.S. economy, and address the underlying sources of market uncertainty.

Root Causes of the Market Turmoil

How did we get to this point? The story begins with a decade of benign economic conditions 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 assets, 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. 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. 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 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 Administration and Congress acted quickly earlier this year to pass a $150 billion stimulus bill. At Treasury, we brought together mortgage providers through the HOPE NOW alliance to help families avoid foreclosure on their homes. Yet, as we seek to minimize the impact of the housing correction on the economy, we must avoid impeding 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 once again contribute to economic growth.

In the financial markets, progress has not moved in a straight line, and additional challenges clearly lie ahead. There have been some positive developments. In the past year, for example, 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 a number of institutions – demonstrate continued weakness across the financial services sector.

In March, the Federal Reserve took unprecedented action to ensure an orderly resolution for Bear Stearns, and in September, authorities around the world took steps to mitigate the impact of the bankruptcy of Lehman Brothers, America's fourth largest investment bank. That same week, the Federal Reserve provided funding to American International Group (AIG) to address the systemic risk that would have resulted from a sudden collapse of the firm. And last week, the FDIC brokered a deal and supported the sale of Wachovia's banking operations to Citigroup in order to prevent its failure following the earlier collapse of Washington Mutual. In each of these cases, policymakers attempted to strike a careful balance of mitigating systemic risk while promoting market discipline, holding investors and management teams responsible, while protecting blameless consumers from collateral damage.

And we are not alone. Europe and Asia are also suffering through their own financial turmoil. In recent days, the United Kingdom, Iceland, Belgium, the Netherlands, Luxemburg, France and Germany have all intervened to support troubled institutions. And last week, we also saw how rumors precipitated a run on Hong Kong's Bank of East Asia. We see from these examples that our financial markets are more global and more interdependent than at any time in history.

The cases of the Government Sponsored Enterprises (GSEs), Fannie Mae and Freddie Mac, deserve special mention, particularly given their significance to investors around the world. The GSEs have become the largest sources of mortgage finance in the United States, touching roughly 70 percent of mortgages originated. Not surprisingly, the prolonged housing correction weakened their financial condition, and both institutions faced a loss of investor confidence. 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 have far reaching effects on the U.S. and global economies. Business finance would be more difficult to obtain, constraining job creation and making it harder for Americans to get home loans, auto loans, and consumer credit.

This past summer, investors began to express growing concerns over the stability of Fannie and Freddie and the ambiguity over the scope and certainty of government support for these institutions. In response, Secretary Paulson asked Congress for authorities regarding Fannie Mae and Freddie Mac in order to help stabilize our financial markets and support our housing market. Congressional leaders acted promptly and decisively with the needed legislation, and in the days and weeks that followed, Jim Lockhart, the director of the GSE's regulator, the Federal Housing Finance Agency (FHFA), Federal Reserve Chairman Bernanke, and Secretary Paulson concluded they needed to act decisively to avert instability in our markets. As a first critical step, the FHFA put Fannie and Freddie into conservatorship, allowing for the government to take temporary control and make needed changes at both institutions.

In a complementary step, Treasury established contractual Preferred Stock Purchase Agreements with both institutions under which it 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 address the systemic risk posed by the scale and breadth of the agency debt.

The terms of these purchase agreements provide taxpayers significant protection. The existing common and preferred 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 the agreement, Treasury has received from each company

$1 billion in senior preferred stock and warrants providing options to purchase up to 79 percent of the companies' outstanding shares.

Second, Treasury established a new, temporary credit facility for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank to fund, if necessary, their regular business activities. 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, thereby providing additional capital to the mortgage marketplace.

These steps are the best means of protecting taxpayers and stabilizing our markets, but they leave for future policymakers fundamental 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 next Administration to address the inherent conflict in the GSE charters that require them to serve the interests of private investors and the broader public.

A Comprehensive Policy Response

Despite the hardening of the government's support and involvement in Fannie Mae and Freddie Mac, and the decisive resolutions of Bear Stearns, Lehman Brothers, AIG, Washington Mutual, and Wachovia, investors have become increasingly concerned over the possibility of other failing financial institutions. And, this has made them increasingly reluctant to extend credit.

This has 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. Given 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. The three components of the plan rolled out two weeks ago by Secretary Paulson and Chairman Bernanke seek to achieve these goals.

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 has experienced funding problems in recent weeks. This temporary $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 put forward a plan to provide much needed capital to address the root causes 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 this root cause would mean that every aspect of our financial and funding markets, ranging from consumer credit to money market funds, would continue to be impaired.

The Administration has worked with Congress to develop a $700 billion comprehensive program for addressing the problem of these illiquid assets on the balance sheets of institutions within the financial system. This will help reduce an enormous source of uncertainty in the markets and stimulate the raising of capital within the financial services sector. In addition, the bill will help ensure the availability of credit so American families can meet their daily needs and American businesses can make purchases, ship goods, and meet their payrolls. A failure to act comprehensively and decisively could have dire consequences for the U.S. economy and all Americans. This plan also sends a strong signal to markets around the world that the United States is serious about restoring confidence and stability to our financial system.

Third, we have taken steps to improve market operations and market integrity. As an example, 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 were joined by regulators in the UK, France, Germany, and other countries who also imposed restrictions on short selling.

A Possible Turn Inward

In addition to the things we must do, there are also things we must avoid. Our recent downturn has contributed to a climate of increased distrust and anxiety among Americans that is fueling support for protectionist policies. The benefits of trade and open investment are being openly questioned across the political spectrum, and this rhetoric is particularly pronounced on Capitol Hill. There is reluctance, for example, to pass the pending trade agreements with Colombia, Panama, and Korea, and there are concerns over foreign investment in U.S. companies, despite the clear and unequivocal benefits of both to the United States. These trends, dangerous at any time, could be devastating in this period of heightened market uncertainty and fragility.

This trend is all the more concerning because trade and investment play such an important role in the competitiveness and success of the U.S. economy. Overseas sales by U.S. companies account for about 50 percent of all U.S. exports, and the profit growth of U.S. companies comes chiefly from the global sales. Remarkably, exports now account for 13% of the U.S. GDP – the highest level in history. Moreover, foreign-owned firms in the US employ more than 5 million workers directly and another 5 million indirectly, and these jobs pay on average a quarter more than jobs created by U.S.-owned companies.

However, these facts are understandably lost on many Americans who have been negatively affected by the dynamism and speed of global markets. With this in mind, we must work to build public support for openness in this era of globalization, even as we acknowledge and take steps to mitigate some of its negative consequences of dynamic global competition. This too must be a priority as we work through the economic challenges that lie ahead.

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 decisively implementing policies that address our short-term economic challenges and rebuild faith in the market. When we emerge from this difficult period – and we will emerge both wiser and stronger – our next task will be to strengthen our financial regulatory structure to guard against 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. I'm confident that our leaders and our great country are up to this pressing challenge.

Thank you.

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