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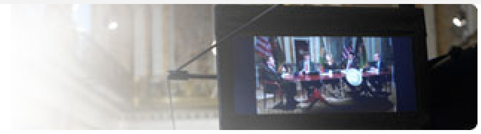
Anthony W. Ryan

U.S. DEPARTMENT OF THE TREASURY

Press Center



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Washington - Good afternoon. Thank you for inviting me to join you today. It's a pleasure to be here.

The title of this conference is Wall Street to Washington. It sounds like a one way trip, but I imagine that most of you are only visiting our nation's capital, and plan on returning to New York later this evening. Your trip reflects that it is a two way street, and recognizes that the relationship must be as well. The reality is, not only does Wall Street go to Washington, but as we have also witnessed in recent weeks, Washington goes to Wall Street.

This two-way relationship goes back to the founding of our Republic. In fact, our first Secretary of the Treasury, Alexander Hamilton brought Wall Street ideas to Washington. These ideas continue to affect how we finance the Federal government's operations to this day.

The relationship between Wall Street and Washington is critically important because it influences what ultimately is experienced on Main Street. Our policies and regulations, coupled with how efficiently and effectively capital is created and transmitted, affects every American. This is true for citizens who seek to borrow money to purchase a car, parents looking to finance their children's education, married couples looking to buy their first home, and entrepreneurs hoping to secure a small business loan. It is equally true for providers of capital, whether they are individuals investing their savings, or a pension official overseeing a retirement plan.

How should we define this relationship? What forces affect it? What are the mechanisms for change? Fortunately, nature provides alternative models.

One is competition. We embrace competition and the efficiency it brings to our markets. Competition is a force that is critically important in our capital markets. Competition spurs innovation. As market participants seek better ways to meet consumer and investor demands, more choices are created, and the cost of capital is reduced.

A second model is predation. While predation is the law of the jungle in nature, as civilized society, we need to have laws in place to protect investors and consumers. Market integrity is critical for a sound and robust market. Market participants must know the playing field is level and the rules are fair. There is a real benefit to the existence and enforcement of broad anti-fraud and anti-manipulation authorities. Predatory lenders, rumor mongers, market manipulators, insider traders and others who seek to gain an unfair advantage must be identified and prosecuted. It is important that regulators have broad authority to investigate and prosecute these actions. These measures instill confidence in market participants that the market is operating in a fair and transparent fashion where rules matter.

Other types of relationships also come to mind. For example, commensalism is one relationship in which one entity gains some benefit while the other is neither helped nor harmed. Another relationship that we all know is parasitism, whereby one entity gains some benefit at the expense of another.

Each of these types of relationships exists and play a role as the natural world continually evolves. The capital markets are no different. Well before the days of Hamilton, financial systems had been evolving. They will continue to evolve, and remain influenced by various types of relationships.

Successful capital markets and effective regulatory policy do not happen independently; quite the contrary. The fact is, success is inter-dependent; hence the need for the relationship to be two way. How it evolves is up to both the private and public sectors.

Evolution is not only driven simply by competition, but also by cooperation, interaction, and some level of mutual dependence. As we look forward, we must recognize how much we have to gain or lose, individually and collectively, if the relationship is not more symbiotic.

We need to ensure that our capital markets remain the most efficient in the world. I have great confidence in our markets, but private sector calls for more voluntary industry efforts will ring hollow if they are not followed with proactive and tangible actions that result in changed behavior. The objective is not to study issues, write reports, or propose protocols that sit on a shelf. We need to see constructive ideas not just developed, but implemented. We need to see changes in market practices. It is that simple.

Meaningful change often requires leadership. It is not surprising that it is difficult to ensure unanimous support for strengthening practices or that suggesting change attracts antagonism.

Make no mistake about it, change will occur, one way or the other, and there is a great deal to be said when it originates within the private sector. Policy makers will welcome such constructive developments by the private sector, but regulatory practices will have to change as well. The question, which time will ultimately answer, is what is the appropriate balance? If private sector market practices do not change, and market discipline is not significantly strengthened, legislators and regulators will certainly move to address the weaknesses in the private sector's contribution to market discipline.

So, let me highlight four areas where Washington is looking to partner with you, and where we need to work together to strengthen our capital markets.

Market Turmoil

Our first priority must be to confront the current challenges in our capital markets, and to seek to minimize the spillover effects on our real economy. A great deal of de-leveraging is occurring, which has created liquidity challenges and compromised our credit markets' ability to facilitate economic activities.

Working closely through the President's Working Group on Financial Markets (PWG), we recently completed a rigorous review of the underlying causes of the turmoil, and released a policy statement that included specific recommendations to address the underlying weaknesses that caused, facilitated, and exacerbated the challenges in our capital markets.

The PWG recommendations cover the practices of a broad array of market participants, as well as supervisors. The participants include originators of credit such as mortgage brokers, financial firms that securitize credit, rating agencies, and investors.

At the Treasury Department, we look forward to seeing the recommendations implemented. Everybody has a role to play, and efforts must be made to strengthen practices in:

Transparency and disclosure. The effect of many of the weaknesses in the market and the resulting challenges in addressing them were exacerbated by complexity and opacity. The best antidote to opacity is transparency and better and more useful disclosure.

2. Risk awareness. Regulators and all market participants must be more aware of, and better able to respond, to risks. Credit rating agency practices must improve, and the users of their services must rely less on, and appreciate more, the limitations of ratings products.

3. Risk management. We need improved risk management practices by investors and financial institutions, and continued review and guidance from regulators. Risk management is everyone's business.

4. Capital management. Well-capitalized institutions are better prepared to deal with challenges, foster economic growth and enhance market confidence.

As Chairman Bernanke recently remarked, "We do not have the luxury of waiting for markets to stabilize before we think about the future. Indeed, many of the necessary changes that have been identified, including increasing transparency, improving risk management, and attaining better coordination among regulators, could provide important support to the process of normalizing our financial markets."

Hedge Funds

Another area in which the private sector must continue to move forward is hedge funds. Over a year ago, the PWG released principles and guidelines regarding private pools of capital. While private pools of capital bring many advantages to our capital markets, they also pose challenges, including systemic risk and investor protection. We must rely on a combination of strong market discipline and regulatory policies to address these risks.

In September 2007, the PWG tasked two private-sector committees, comprised of well-known and well-respected asset managers and investors, to develop best practices for their respective groups. Their reports were released for public comment two weeks ago, and after a period of public comment, the groups will release final reports this summer.

The "Best Practices for Asset Managers" calls on hedge funds to adopt comprehensive best practices in all aspects of their business, including the critical areas of disclosure, valuation of assets, risk management, business operations, compliance and conflicts of interest. They recommend innovative and far-reaching practices that exceed existing industry standards, and called for increased accountability for hedge fund managers.

The "Best Practices for Investors" includes both a Fiduciary's Guide and an Investor's Guide. The Fiduciary's Guide provides recommendations to individuals charged with evaluating the appropriateness of hedge funds as a component of an investment portfolio. The Investor's Guide provides recommendations to those charged with executing and administering a hedge fund program once a hedge fund has been added to an investment portfolio. Their best practices offer a guide for responsible investment in hedge funds. In the months ahead, we believe that it is critical to see these implemented.

There is also need to move forward on a longer term, strategic basis. Treasury recently released a Blueprint for Financial Regulatory Reform. Our current regulatory structure is not optimally positioned to address the modern financial system with its diversity of market participants, innovation, complexity of financial instruments, convergence of financial intermediaries and trading platforms, and global integration and interconnectedness.

We suggested in the Blueprint a new framework, one that includes a market stability regulator with broad powers focusing on the overall financial system. The market stability regulator would have the ability to evaluate the capital, liquidity, and margin practices across the entire financial system and their potential impact on overall financial stability.

To do this effectively, the market stability regulator would collect information from commercial banks, investment banks, insurance companies, hedge funds, and commodity pool operators. Rather than focus on the health of a particular organization, the market stability regulator would focus on whether a firm's or industry's practices threaten overall financial stability. It would have broad powers and the necessary corrective authorities to deal with deficiencies that pose threats to our financial stability.

Our ambition is to frame the debate and put forth a model that can guide all stakeholders as we seek to modernize our financial regulatory structure.

Market Infrastructure

A third area where we need to see further progress by the private sector is market infrastructure. It includes market-making capacity and systems for processing, settling, and clearing financial transactions. Comprehensive and dependable market infrastructure inspires investor confidence and plays an important role in the integrity of our marketplace. Market infrastructure is critical as it ultimately affects the ability to transfer risk and facilitate liquidity. For this reason, the financial industry must continue its efforts to enhance its strong system of clearance and settlement, including secure custodial arrangements.

Over the past ten months, despite dislocations in our financial markets, our market infrastructure has proven quite resilient. Payments were made, transaction processing continued, and exchanges handled massive surges in volume across the globe.

While these signs are encouraging, we constantly must seek to improve our position and ensure business continuity. Over the past decade there has been a tremendous expansion in the scale, diversity, and impact of over-the-counter (OTC) derivatives, which have become important vehicles for hedging and transferring risk. But as with most financial products, infrastructure development has lagged innovation. Market volume and instrument complexity call for a clear, functional, well-designed infrastructure that can meet the needs of the OTC derivatives markets in the years ahead.

Asset managers, investors, counterparties, and creditors must promptly set ambitious standards for trade data submission and resolution; promptly amend standard credit derivative trade documentation to incorporate the cash settlement protocol; and develop a longer-term plan for an integrated operational infrastructure supporting OTC derivatives. The industry needs to take further steps to limit the domino effect of lagging and uncertain post-trade processes in the event of a counterparty default or failure.

We need to remain focused and complete the work already underway. The Federal Reserve Bank of New York (FRBNY) and an industry group (the "Operations Management Group" or OMG) have been working collaboratively to address the OTC processing and infrastructure issues. ISDA has developed a cash settlement protocol and is exploring incorporating the auction mechanism into its documentation. The private-sector committee on risk management recommended by the PWG statement will look at strengthening the operational infrastructure of financial markets, including settlement protocols, close-outs in defaults, and processing of OTC derivatives. On all of these issues, the industry has an opportunity to improve market practices, and must do so.

U.S. Treasury Market

The final area that I will highlight this afternoon concerns an issue that is core to the mission of my Department – the U.S. Treasury marketplace. We value the symbiotic relationship that we have with the participants in the Treasury market. Because our operating principles of transparency and predictability are well established, buyers of Treasury securities come to us in greater numbers and bid with more confidence and in larger amounts. Our predictability, coupled with our unitary financing approach, increases the depth and liquidity of the Treasury marketplace and results in lower cost borrowing for the government.

We appreciate the principles-based framework outlined by the Treasury Markets Practices Group (TMPG). The principles and guidelines they put forth provide a strong foundation for how all stakeholders should enhance their current practices, fulfill their responsibilities, and support actions that facilitate liquidity in the U.S. Treasury market. As debt managers, we constantly encourage the implementation and evolution of these principles in our discussions with major institutional investors, reserve managers, and central banks.

When these principles were laid out almost a year ago, I remarked that success will be determined by how market participants interpret and implement these practices, and how market practices evolve from this point forward. I also pointed out that SIFMA is engaging its membership on negative repo rate trading, improved buy-in procedures, and the margining of fails.

At the February 2008 Quarterly Refunding, we discussed settlement failures in the Treasury market with our Treasury Borrowing Advisory Committee (TBAC), a committee sponsored by SIFMA and comprised of some of the finest, most experienced professionals in the financial market place. As you know, settlement failures, or fails, occur when a party selling a security fails to deliver the security to the buyer on the agreed upon settlement date. Settlement failures, occur for a variety of reasons including errors in the back office and miscommunications, and are generally small and resolved quickly.

Larger, more chronic fails can occur due to wide-scale operational disruptions or financial market conditions, such as when interest rates reach low levels.

Treasury and the TBAC discussed the potential risk of chronic fails in a lower interest rate environment, a risk that we believe impairs liquidity and threatens to raise our cost of borrowing. In addition, we asked market participants to pursue market-oriented solutions, adapt and implement practices for such a situation, and report back to us regarding their progress.

Over the past twelve weeks, we have seen rates drop quickly, the demand for Treasury securities skyrocket, and a rapid increase in fails to deliver in the Treasury market. In a short time period, we entered an interest rate regime in which the cost associated with fails declined significantly – and, perversely, weakened the financial incentive to rectify a fail. While the cost of failing to deliver may be low for a single market participant, the aggregate cost can be high when it potentially impairs the overall system, and such behavior is certainly not consistent with professional best practices.

This week, at the May 2008 Quarterly Refunding, we asked the TBAC for their view on actions taken by market participants to date. Committee members were encouraged by the collaborative efforts undertaken by the private sector industry groups to formulate viable solutions to address chronic fails, and members broadly accepted that the initiatives outlined by SIFMA and TMPG would improve market practices for fails monitoring and remediation in the near-term.

Implementation of the potential steps outlined and recommended by SIFMA and the TMPG, such as encouraging cash settlement of fails before the 30th day after the fail had occurred, "Fails Best Practices" which define such parameters as margining of fails, cash settlement procedures, and initiatives related to pair-offs and security-delivery, and the enactment of a Fails Monitoring Committee, were broadly agreed upon. The TBAC emphasized the need for industry groups to quickly execute recommended practice guidance and urged both groups to employ measures that would collectively help prevent chronic fails situations.

Treasury agrees that now is the time to act. We believe that private sector action now regarding the implementation of these mitigating initiatives is optimal, and we will continue to monitor progress closely.

Conclusion

As financial industry professionals and policy leaders, you know first hand the benefits of dynamic economic growth, and thus have a vested interest in capital markets that enhance investor confidence and market liquidity - both of which have been challenged significantly in recent months.

These are important issues, and we need to see material steps taken towards our goals. Both market and regulatory practices will evolve from here. All stakeholders, including regulators, must remain on top of these issues. We must not just define solutions, but implement them, and continually seek to strengthen both our market and regulatory practices.

By positively changing market practices, you will help strengthen market discipline, mitigate systemic risk, restore investor confidence, and facilitate stable economic growth.

The health of our capital markets reflects the collective efforts of both the public and private sectors. To reap the benefits, both sectors must share responsibility and be actively engaged. So, as you return to Wall Street, know that there is much work to do, and that each of you has an important responsibility to strengthen the vitality, stability, and integrity of our capital markets.

Thank you very much.