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Anthony W. Ryan

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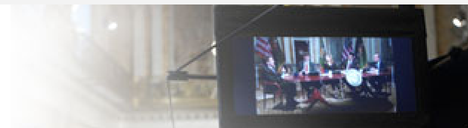

Assistant Secretary Anthony W. Ryan Remarks at Euromoney's Global Borrowers Investors Forum

6/24/2008

London- Good afternoon and thank you for inviting me to join you today. I appreciate the opportunity to be here in London, the capital of a nation with a rich history of producing thought leaders whose ideas we often return to over time. For example, just 30 miles northeast of here in Essex, in the churchyard of the village of High Laver, the great English philosopher John Locke was buried in 1704.

Locke is perhaps best renowned for his influential work, *Two Treatises of Government*, which outlines the "social contract." In essence, Locke postulated that individuals essentially exchange their "natural" rights for the sake of protection or to jointly preserve social order. This contract offered an escape from a constant state of war. Otherwise, according to Locke, man "however free, is full of fears and continual dangers: and it is not without reason, that he seeks out, and is willing to join in society with others, who are already united, or have a mind to unite, for the mutual preservation of their lives, liberties and estates (1)."

Three centuries and several revolutions later, the political theory behind Locke's "social contract" continues to be debated, and most importantly, applied. We can borrow liberally from this concept of a social contract, and apply it to current deliberations regarding financial markets. We need to collectively undertake efforts that seek to facilitate market stability, offer protections against known and unknown risks, reduce uncertainty but yet not eliminate natural risk taking, and unite to further strengthen and deepen our capital markets. Today, I would like to provide an update on some of the collective actions being taken to implement the policy statement released in March by the U.S. President's Working Group on Financial Markets.

Private Sector / Public Sector

More often than not, multiple perspectives on a particular issue offer us a better understanding and a better decision-making framework from which to work. We have likely all witnessed situations where one's perspective on an issue is often a function of where one sits. Such a perspective is in itself limiting. 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. Few stakeholders would disagree with those statements; however, there exists a robust debate reflecting different perspectives as to what, where, when, and how each party should fulfill its respective commitment.

Private Sector

Allow me to begin with the private sector's role in the capital markets. First, we must recognize that the private sector is quite a diverse community. It is global in scope and includes both users and providers of capital. Users include those seeking 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. Providers include individuals investing their savings and institutional pension plans. These users and providers interact with many other participants in the markets including originators of credit, financial intermediaries, firms that securitize credit, rating agencies, and others.

In seeking to accomplish their respective objectives, participants confront risk. Such risk includes credit, counterparty, operational, liquidity and reputational risk, amongst others. Successful market participants must be aware of these risks, be able to identify and assess such risks, and manage them effectively. Private-sector participants act in their own self interest, and as they exercise their powers of analysis and reason, they define and establish market discipline. Market discipline is critically important and serves multiple purposes. It serves to aid investors and lenders not just individually, but it also serves to mitigate the likelihood and severity of a systemic event.

However, despite its many virtues, the establishment and continuous deployment of robust discipline should not be taken for granted. Simply put, it can be compromised and undermined. Potential costs, complacency, and the search for fast and easy rewards can weaken such self-restraint. This is not unique to financial markets. If in doubt, just ask parents, school teachers or military leaders.

As the fog enveloping our markets continues to dissipate, we must all recognize that the erosion of market discipline contributed greatly to the challenges we are addressing today. These breakdowns in the system will continue to occupy policy makers and market participants

for years to come.

It is also clear that complacency about risk manifested itself in many ways and affected a broad array of market participants, including originators of credit, financial firms that securitize credit, rating agencies, and investors.

Each group needs to be part of the rebuilding process. Efforts must be made to strengthen market practices by enhancing 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. One of the best antidotes to mitigating opacity is better and more useful disclosure and increased transparency.

In the United States this past March, the President's Working Group on Financial Markets (PWG), an inter-agency policy group chaired by Secretary Paulson, set forth in a policy statement a broad array of recommendations to strengthen capital markets. Similarly, the Financial Stability Forum (FSF), an international forum that includes the U.S. Treasury Department and several other U.S. government agencies, issued a complementary report in April. The PWG and FSF each expects to issue a status report before the end of this year.

Financial markets are globally linked; therefore, many of the PWG recommendations will serve all market participants, not just those in the United States. Over the past several months the PWG member agencies have been actively engaged with market participants to implement these recommendations.

Recognizing the benefit and need for improved market practices and stronger market discipline, the PWG has engaged with several private-sector committees. To address disclosure and transparency issues, a private-sector committee is developing best practices regarding disclosure to investors in securitized credits, including asset-backed securities and collateralized debt obligations of asset backed securities.

The American Securitization Forum and the Securities Industry and Financial Markets Association (SIFMA) are leading this group. They are covering transparency and disclosure practices, including standardized templates, price discovery and valuation tools, and credit rating practices. They expect to issue a report later this summer.

Another area in which we need to witness a much greater awareness and appreciation of risk by market participants is the use of ratings. While we must see changes to credit rating agency practices, the users of their services must rely less on, and appreciate more, the limitations of ratings products.

To aid in accomplishing this goal, a second private-sector group is outlining further steps that issuers, underwriters, and credit rating agencies can take to ensure the integrity and transparency of ratings, and to foster the appropriate use of ratings in risk assessment. The Asset Managers' Group at SIFMA is leading this effort. They are exploring issues including: use and quality of ratings; business models; and credit rating agency independence. We expect their work to be completed by the end of July.

Once identified and assessed, risks must be better managed. During the past year, many financial institutions, money managers, and investors simply failed to appreciate the magnitude and nature of risks on their books. This inability to aggregate risk and transparently address public concerns led to even further uncertainty, volatility, and dislocations. We need improved risk management practices by investors and financial institutions.

The Senior Supervisors' Group, comprised of supervisors from five countries, issued a report highlighting the risk management practices that worked well for better-run firms. Simply put, the stronger firms invested in risk management systems – and it was capital well spent. They recognize that professional investors should not rely on disparate systems to identify, monitor and manage risk. Furthermore, they know that risk needs to be in the day-to-day routines of senior-most management – centralized, well understood, and acted upon.

Risk monitoring and management is not a function to be left solely to a back office or a set of quants – it is the senior-most management's responsibility to be fully aware of the risk they are taking on daily basis. Firms that employed such practices fared better than others.

By better assessing risks, financial institutions are better placed to manage capital, liquidity and leverage. Strong, well-capitalized financial institutions with robust risk management systems are better positioned to deal with bumps down the road. Such institutions will be able to take advantage of new opportunities, capture greater market share, and secure the confidence of creditors, shareholders, investors and regulators.

A third private-sector group is reassessing the implementation of the Counterparty Risk Management Policy Group II's existing guiding principles and recommendations regarding risk management, risk monitoring, and transparency. They are modifying and developing new recommendations to incorporate lessons from the recent turmoil, including lessons learned regarding valuation practices. This group intends to issue a report in late July that focuses on four areas of reform: financial institutions' risk management practices; structured financial products; off-balance sheet activities, including accounting policy and disclosure; and market infrastructure.

Market infrastructure is another area where we need to see further progress. This includes market-making capacity and systems for processing, clearing, and settling financial transactions. Effective market infrastructures are critical to the operating integrity and functioning of our markets and help inspire confidence in market participants. Just as innovation facilitates new financial products and instruments, innovation and technology also must be applied to facilitate more robust and efficient market infrastructure. We have seen all too often that when the back office fails, the front office fails with it.

Two large markets that play important roles in our capital markets deserve special attention: the OTC derivatives and the secured lending markets. The functioning of these markets, not only under normal market conditions, but also during turbulent periods, is critically important for the long-term health of our financial system.

Having a market infrastructure that works for all participants at all times is a key component of achieving a market with proper discipline on creditors and counterparties.

We need to continue efforts to enhance OTC market infrastructure, efforts that include implementing an integrated life-cycle processing infrastructure for all products and all participants and firmly establishing cash settlement and novation protocols.

We need complementary efforts to mitigate risks to the financial system in the event that services, including Tri-Party Repo, provide by one of the two major clearing banks for government securities were suddenly disrupted or terminated. A related challenge is the vulnerability of the repo markets, including Tri-Party Repo, as a continuous funding source. As we have witnessed, liquidity in the repo markets can evaporate suddenly if counterparties become unwilling to provide even short-term secured financing because of uncertainty. Efforts are needed to ensure that both borrowers and lenders strengthen their credit, operational and liquidity risk management practices.

Economies benefit from the greater variety of financial instruments and financing approaches. At the same time, this expansion of financial firms and the interconnected nature of their business activities and exposures coupled with more opaque and complex instruments can pose an ever-broadening array of risks to the larger financial system, and thus the broader economy.

The question of whether an institution could be "too big" to fail has evolved to whether an institution could be "too interconnected" to fail. Collectively, we must all seek to reduce the likelihood of such a failure through more robust market discipline, enhanced market infrastructure, reduced interdependence, improved transparency, and more robust awareness and management of risk. Having diverse instruments and interconnected market participants is not a problem. What we must have are mechanisms and facilities that allow a market participant to fail without compromising the broader system. Strong post-trade practices, centralized clearing, standardized practices and protocols, greater transparency, timeliness and quality of information, and better risk management systems all help.

We all need to do the hard work to address these complex challenges. We need market leaders to support strengthening practices. Changes must occur, and there is a great deal to be said when it originates within the private sector.

Public Sector

Policy makers will welcome such constructive developments by the private sector, but robust regulatory practices must complement private-sector efforts. Here, too, change is necessary. Private-sector responses and actions to address weaknesses through changed market practices will not be wholly adequate. Endorsing the status quo or hoping that the financial pain – even though it is staggering in real terms – will be sufficient enough to provide incentives for markets to operate in a safe and orderly fashion and for financial institutions to remain sound is simply not an option.

Regulatory responses are necessary to complement improved market practices. The challenge -- whether it is for parents, teachers, military leaders or regulators -- is determining the appropriate balance. Curfews for children, trips to the principal's office, and extra K.P. duty all ultimately served the purpose of fostering better discipline.

What should regulatory guidance address? Where and how should it be applied? When should changes take effect? Do regulators have the necessary authorities to fulfill their respective missions? These questions need to be asked, debated and answered.

In doing so, stakeholders must move past the rhetoric. Policy makers must certainly be aware that regulations to address risks might have not only intended consequences, but also potential unintended consequences. But dire predictions by market participants that regulatory changes or significant changes to market practices will result in the evaporation of liquidity tend to obfuscate reality.

The PWG's Policy Statement acknowledged that some regulatory policies failed to mitigate some of the weaknesses, and that regulators have an important role here, including reforming credit origination and distribution processes, reforming ratings practices and uses, strengthening global financial institutions' risk management practices, improving investor awareness of risk and due diligence, and enhancing financial market infrastructure. Regulators are engaged on all of these issues.

Our efforts need to reflect the fact that our financial system has evolved over time. Today, a significant part of lending and financial intermediation occurs outside of the traditional banking channel. The debate about regulation must address such change.

Let me be clear - our job is not to eliminate risk. Our job is to ensure that financial markets operate effectively in times of stress and in times of calm. We seek to fulfill our responsibility and accomplish these objectives. We desire and expect market participants to fulfill their responsibility by enhancing market discipline to complete the balance.

Conclusion

It is important that I stress a theme Secretary Paulson emphasized in remarks last week about our financial regulatory system. As we resolve the challenges of today, federal regulators must balance the need for market stability with concerns about the likelihood of increased moral hazard. While firm failures are painful, as a policy matter, we must be in a place where firms are allowed to fail.

We continue to work through the vestiges of the prior environment in which market discipline was compromised. Learning from the past is important, but we must also look ahead. We need to ask questions and address challenges. We might not have all the answers, but we need to address the root causes of the problems and move to strengthen the overall financial markets given their interconnected and global nature.

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 over the past year.

These are important issues, and all stakeholders, including regulators, must not just define solutions, but implement them, and continually seek to strengthen both our market and regulatory practices. By positively changing practices, we help strengthen market discipline, reduce uncertainty, mitigate systemic risk, restore investor confidence, and facilitate stable economic growth. In my view, this is the essence of John Locke's "social contract" from a financial markets' perspective.

At the U.S. Treasury Department, we are addressing both the current and strategic challenges, and doing all we can to ensure high-quality, competitive, and orderly capital markets. Effective and efficient capital markets rely on private-sector representatives to play a complementary role. To reap the benefits, both sectors must share responsibility and be actively engaged. Let's make sure we all do so -- there is much work to do, and much to be gained.

Thank you very much.

(1) *Two Treatises of Government*, S. 123.

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