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U.S. DEPARTMENT OF THE TREASURY

Press Center

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Dramatic changes have occurred in capital markets in recent years. Globalization and innovation are two of the most significant forces driving that evolution. Today, I would like to focus my remarks not just on the benefits and challenges resulting from the remarkable wave of financial innovation that is sweeping across global markets, but also to remind all participants that markets and practices must continue to evolve in order to remain competitive.

The pace of financial innovation has gathered momentum in recent years as information technology and financial engineering have significantly changed the global capital market environment. The influence of these catalysts is evidenced by the increased diversity of investment instruments such as structured credit, investment vehicles such as exchange traded funds and by the array of innovative investment strategies, many of which are deployed by hedge fund managers.

Rapid change is not constrained to the financial landscape. Scientists observe similar events in the natural world. The scientific theory of "punctuated equilibrium" suggests that lengthy periods of relative stability, or stasis are periodically interrupted or "punctuated" by shorter, rapid bursts of change. These rapid changes often result in specialization, increased complexity, and after some period of acclimation or adjustment, eventual integration into the larger system. The same is true in finance, as sudden "environmental" changes often result in specialized or customized products and business models, increased complexity and after a period of adjustment, eventual integration into the global marketplace.

Recently, market stress emanating from the subprime mortgage sector, a relatively minor segment of the overall financial markets, has sparked discussions about securitization as a whole, even causing some to question the benefits of such financial innovation. This questioning is not only fair, it is appropriate. Policy makers and market participants must continually assess the myriad implications of financial innovation.

Just as some species become extinct in nature, some new financing techniques may prove to be less successful than others. But let's recognize that over the long-term, financial innovation is integral to enhancing capital markets' competitiveness. Innovative markets become more efficient, ultimately strengthening the economies they serve by facilitating job growth and improving productivity.

### A Case of Financial Innovation

One example of innovation as it relates to financial instruments is the development of structured credit products. At their inception, the buyers of products such as credit derivatives were banks, who purchased protection from traditional insurers to manage their exposures to the corporate loans they retained on their balance sheets. Spurred largely by the 1988 Basel Accord, demand for credit derivatives grew as banks realized that they could transfer the credit risk of borrowers to entities not subject to bank capital requirements while at the same time retain the ownership of and revenue from such loans.

The market evolved from primarily a bank/insurer market to one with a much broader range of non-bank participants, including asset managers, hedge funds, pension funds, and securities firms. There are many additional positive externalities associated with this development. For example, market makers of corporate issuances can reduce their exposure to single name credits but at the same time increase their role as liquidity providers to particular issuances without taking on too much concentration risk in a single entity. As a result, users and providers of capital gain more efficient pricing. Moreover, through credit derivatives investors (or protection sellers) can isolate their investment solely to an entity's credit risk as opposed to risks associated with investing in a single debenture, such as liquidity risk.

The range of products also evolved from more traditional-type credit protection to single-name credit default swaps (CDS), to multi-name CDS, and more recently, to more complex securitized asset-backed instruments such as credit derivative indices (including those backed by commercial mortgages, subprime residential mortgages, and leveraged loans), collateralized debt obligations (CDOs), and collateralized loan obligations (CLOs). Whereas credit derivatives initially were hedging instruments whose prices were derived directly from the price of a single, less complex underlying asset (a corporate loan and its implied credit risk/default probability), credit derivatives now increasingly include more complex instruments whose prices are derived from a basket of underlying assets, securitized assets, or tranched assets.

**Benefits of Financial Innovation**

Credit derivatives are just one example of financial innovation. But before discussing the benefits of structured credit or other specific instruments, it is useful to recognize the broader benefits of such innovation at the market level from the perspective of capital providers and capital users.

Financial innovation benefits both suppliers of capital, or investors, as well as users of capital. Suppliers of capital benefit from the greater flexibility afforded by more choices. This ultimately facilitates greater diversification. Today, investors have a host of investment instruments, vehicles and strategies from which to choose.

Investors also benefit from the ability to more explicitly target their capital. For example, securitization enables investors to improve their risk management, achieve better risk adjusted returns, access more liquidity, and lower the cost of implementation.

Users of capital, therefore also benefit from securitization. Historically, users of capital had only a few instruments that they could issue or choose from to access capital. Today, they can access capital from a broad array of investors, each with unique return and risk objectives. Thus, investors can be more optimally matched to meet the needs of each user's specific needs and objectives. Users of capital, therefore, benefit from a lower cost of capital, which in turn results in higher returns. Innovation makes the movement of capital more efficient, risk management more targeted, and trading less costly.

That is all true at the broader market level. Yet, as we focus our assessment to the impact of a specific set of instruments such as credit derivatives, the many benefits of innovation remain clear. Credit derivatives have improved the management and transfer of credit risk, the unbundling and tranching of risk, enhanced liquidity, created greater portfolio diversification, and broadened credit risk dispersion. Users of capital hold that these instruments enhance the efficiency and stability of the credit markets and the resiliency of the broader financial markets.

Over time, there can be little doubt that consumers and market participants around the world benefit from financial innovation in the area of securitization and the corresponding increases in credit availability. The ability to securitize credit has expanded the sources of capital and credit for homeowners, business owners, and other borrowers throughout the global economy.

For example, if one evaluates mortgage securitization, even in spite of recent market challenges which I will address in a moment, it would be difficult to suggest that the net benefits are not real. Securitization has fundamentally improved the mortgage industry. Over the past few decades, instead of holding a mortgage and collecting payments every month from the homeowner, originators have used capital markets to pool mortgages into mortgage-backed securities, selling tranches to investors. This activity distributed the risks across a broader spectrum of investors, and freed originators to issue new loans. The result has been an increased availability of capital at lower cost and today, more Americans have access to homeownership - up from 64% in 1994 to 69% today. The same process of securitization has targeted other asset classes such as credit card receivables, auto loans, home equity loans, which in turn reduces risk as well as benefits the ultimate end users of capital.

**Challenges of Financial Innovation**

While there are numerous benefits to financial innovation such as securitized credit, we must also recognize the real challenges such innovation poses to investors, regulators and other market participants. Recall, that while rapid changes often result in increased specialization and increased complexity, they are often followed by a period of acclimation, prior to becoming accepted in the mainstream marketplace.

Financial incentives, coupled with advancements in technology and financial engineering skills, can result in situations where new instruments, vehicles and strategies outpace the existing market and regulatory infrastructures. Such developments have the potential to present challenges for both market participants and supervisors.

Challenges often emerge during periods of change, as participants acclimate to the specialization and increased complexity. When these traits emerge in a relatively benign environment the adjustment period may appear smooth, but as we know, environments change. Just as in nature, when the environment changes, the success of a species can alter dramatically.

The development of some instruments such as credit derivatives illustrates how innovation leads to greater complexity. As we have witnessed, the rapid growth of complex new products can strain not just the infrastructure for processing, clearing and settling trades, but also introduce additional challenges for market participants including valuation and risk management.

Many investors are grappling with this increasing complexity in the markets, and in particular securitized products. In some cases, risk evaluation can be difficult. While complexity may be a very legitimate reason a potential investor decides not to invest, it can be no excuse for an existing investor or buyer of such a security to justify a loss. Investors and their fiduciaries must understand the risks associated with a potential investment. This is true of any investment – whether it is an underlying asset, such as an equity, or a derivative product, such as a CDO.

Insufficient understanding or failure to perform independent and adequate due diligence prior to making an investment decision is simply unacceptable. That's not investing…..that's gambling.

Investors must also monitor their holdings and exposures, which includes reassessing their risks after making their initial investments. Recently, many of these assets have gone from AAA: alluring, attractive and acceptable to CCC, complicated, challenged and contaminated. Could such a change in so short a period of time suggest the need for stronger market discipline?

**Responding to the Challenges**

In recent years, we have witnessed fundamental change in capital markets. In order to continue to strengthen our markets and secure the tangible benefits of such financial innovation, we must acknowledge the challenges. As markets evolve, market participants and public policies must also adapt. As leaders, we must possess both judgment and confidence: judgment to recognize when additional changes are necessary and confidence to make needed changes.

Already, encouraging signs of improvement are emerging. Impressive progress has been made in addressing some of these challenges. International Swaps and Derivatives Association, Depository Trust and Clearing Corporation, Federal Reserve Bank of New York, the Counterparty Risk Management Policy Group, and others should all be commended for their leadership and efforts towards ensuring such progress. ISDA's novation protocol, cash settlement auction protocol, and documentation efforts contributed significantly to resolving processing backlogs, physical shortages, and other issues facing these markets. Still, we must not be complacent. Further collective and cooperative action is necessary to prevent and resolve other challenges. Some of the necessary adaptations will take additional time to implement. Some will be easier to implement than others, but none will be easy.

Capital markets are a microcosm of the natural world, rich in history and ever adapting in response to changing environmental conditions. In the financial world, while we are already beginning to see some positive adaptation in the wake of recent market issues, we need to do more. With respect to addressing complexity, both issuers, investors, and rating agencies all have important roles and responsibilities. We should encourage more transparency, better information and disclosure, less complacency, and stronger fiduciary practices. Financial industry bodies around the world are now launching initiatives to address some of the challenges including calls for transparency and encouraging disclosure so investors have the information they need to make more informed decisions.

A process of investor education or "adaptation" should also be encouraged. The importance of investor diligence cannot be overemphasized in the context of financial innovation and the need for strong market discipline. As new instruments and strategies emerge, investors need to evaluate new opportunities through rigorous due diligence. Following the crowds or accepting conventional practice and investing in something they do not fully understand is a recipe for failure.

**Hedge Funds**

Financial innovation has manifested itself not just in regard to new instruments, but also in the emergence of new investment strategies, many of which are often deployed by hedge fund managers. Here too, the growth and development of such pools of capital has brought many benefits and yes, some challenges. In February, the President's Working Group on Financial Markets (PWG) released principles and guidelines to address the challenges these strategies pose; namely investor protection and systemic risk.

Yesterday, Secretary Paulson announced the next steps in the formation of two separate, yet complementary private sector committees. One is comprised of asset managers and the other is made up of investors. Each committee will define a set of "best practices" that will help to strengthen market discipline, mitigate systemic risk, augment regulatory safeguards regarding investor protection, and complement regulatory efforts to enhance market integrity. These "best practices" will have as a foundation and be consistent with the PWG principles and guidelines, and will complement the ongoing reviews of counterparties' and creditors' practices by supervisors globally.

I should note that the PWG stated that investors, creditors, counterparties, asset managers, and supervisors must be aware of the challenges, including those related to over-the-counter derivatives and must work to address them. Public policies that support market discipline, participant awareness of risk, and prudent risk management are the best means of protecting investors and limiting systemic risk. All stakeholders should implement and comply with industry sound practices to strengthen processing, clearing, and settlement arrangements for credit derivatives and other over-the-counter derivatives. These practices include protocols for issuing and completing trade confirmations, obtaining prior written consent for assignments, and using cash-settlement procedures for over-the-counter credit derivatives following a credit event.

The PWG has also commenced an examination of some of the issues underlying the recent market events, including the impact of securitization and the role of rating agencies in the credit and mortgage markets. These efforts were included as part of a broader initiative President Bush recently announced to help homeowners facing mortgage delinquencies and foreclosures.

**Conclusion**

We must continually evaluate changing market conditions and practices. And while being ever prepared to adapt, we should do so with prudence, examining root causes and considering possible unintended consequences, before making lasting changes.

It is a privilege to be entrusted with the public's interest and capital. And with such a privilege comes responsibility. To achieve our goals we need to recognize that the responsibility is borne by both the private and public sectors. Building upon the efforts to date, all stakeholders must continue to do more. Collectively, we can strengthen the vitality, stability and integrity of the public's investments and our capital markets. The system works when all stakeholders recognize the benefits, mitigate the risks, and choose to participate.

Thank you for the opportunity to speak here today.