Assistant Secretary Anthony W. Ryan Remarks Before the Exchequer Club in Washington

Henry M. Paulson Jr.
Good afternoon. Thank you for inviting me to join you here today. The Exchequer Club has a rich history of fostering thoughtful discussion on key issues affecting our economy. The path to this podium is well worn by a long list of distinguished public servants whom you have invited to share their thoughts, and I am honored to be included among such an impressive list.

Our economy is the largest and most diverse in the world; but it is not immune to challenges. The difficulties in the housing market are the biggest threat to our economy, and the Treasury is focused on addressing this issue by enhancing efforts to help homeowners and by offering long term recommendations to get at the cause of these troubles.

We are working with HOPE NOW, a coalition of non-profit counselors, servicers, lenders and investors, so that we can help more homeowners, more quickly. Their progress reports show that modifications are rising, and those kinds of fast results are the direction we are taking at Treasury.

We've heard of proposals that would create new bureaucracies and will take years to implement. We've also seen proposals that will cause mortgages to be more expensive for borrowers in the future - not just those who are stressed today. But these types of proposals will do more harm than good. We need our colleagues in Congress to pass reform of the Federal Housing Administration and the Government Sponsored Enterprises.

In the long term, we are looking to get at the root causes of this stress by strengthening market discipline and oversight in the mortgage securitization process and by improving the future state of our capital markets.

Orderly financial markets are critical to the health of our economy – businesses rely on access to credit in order to invest and create jobs, and families draw on credit markets to finance their homes and borrow for education.

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 significantly challenged in recent months.

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. I have confidence in the resilience of our markets and that collectively, we will work through this period of stress, and make our markets even stronger.

At the U.S. Treasury Department, we are vigilant in monitoring the global capital markets, and the current period has provided us many issues to evaluate and address. These issues range from financial market preparedness, private pools of capital, market infrastructure, challenges in the housing sector, and the resulting implications for the capital markets.

Effective and efficient capital markets rely on private-sector representatives to play a complementary role. Investors and commercial institutions have influenced, and must continue to influence, market and business practices in a constructive manner.

As we continue to work through the current turmoil, we must also identify and address the weaknesses that caused, facilitated, and exacerbated the challenges in our capital markets. In doing so, we will collectively strengthen market discipline, mitigate systemic risk, restore investor confidence, and facilitate stable economic growth.

Background
After years of benign financial conditions around the globe, many providers of capital became complacent about risk. It manifested itself in many ways, including a significant loosening of credit standards and investors reaching ever further for yield.

For several months, we have witnessed our financial markets go through cycles where there have been real strains followed by periods of improvement. A great deal of de-leveraging is occurring, which has created liquidity challenges, thereby compromising our credit markets’ ability to facilitate economic activities.

It took a long time to build up the excesses, but we are working through the consequences. Market participants are adjusting, disclosures are being made, capital is being raised, and assets are being re-priced.

Finding examples of sectors, structures, or institutions that have experienced stress has been fairly easy. But as I tell my children: 10 points for identifying the problem – that’s the simple part; 90 points for finding the best solution.

In this case, it’s 10 points for identifying the conditions that enabled the market turmoil to start, and more importantly, spread. There’s 90 points for coming up with thoughtful recommendations, and extra credit for deft implementation.

Developing and implementing recommendations must happen thoughtfully as policy makers and market participants must seek to avoid exacerbating current strains.

Given the diversity of our capital markets and the breadth of global participants, we must begin with the recognition that no panacea exists to prevent the excesses of the past from re-occurring.

**Innovation / Securitization**

Successful capital markets continually innovate, and one of the greatest examples of financial innovation is the securitization of credit. Some have argued that securitization is the problem. It’s not that simple. The ability to securitize credit has expanded the availability of credit for consumers, homeowners, and businesses – both large and small. Securitization has stimulated competition, reduced the cost of capital, and created more choice and flexibility for borrowers.

Prudent policy responses require an examination not just of overall processes such as securitization, but a rigorous review of the underlying weaknesses. Working closely with our colleagues comprising the President’s Working Group on Financial Markets (PWG), that is exactly what we have done. Last week, Secretary Paulson, in his capacity as Chairman of the PWG, released a policy paper that diagnosed the underlying weaknesses contributing to the turmoil in our capital markets and specific recommendations to address them.

When implemented, these recommendations will change behavior and strengthen our markets through greater risk awareness, enhanced risk management, strong capital positions, prudent regulatory policies, and greater transparency.

**Root Causes**

This afternoon, I will briefly address the triggering events, but I will focus my remarks on three of the underlying weaknesses that enabled the market turmoil to spread.

The turmoil was triggered by an unexpected and alarming rate of mortgage delinquencies by loans originated from late 2004 through 2006. It is easy to identify the weakness that enabled the turmoil to start - a breakdown in underwriting standards for mortgage origination, particularly for sub-prime mortgages.

To address this weakness, the PWG recommended strengthening government oversight of all entities that originate mortgages, the implementation of strong nationwide licensing and enforcement standards for mortgage brokers, and a stronger set of national rules for consumer protection and disclosure.

Challenges, however, were not limited to sub-prime mortgages. Financial market innovation, interrelated markets, and broadening investment horizons – both from a geographic and asset class perspective – linked the challenges across capital structures and the globe. Every user or provider of capital has been impacted – either directly or indirectly.

Other underlying weaknesses enabled the market turmoil to spread, and the PWG has put forth specific recommendations to address each one, all of which call upon market participants and regulators to make changes. Let me highlight three areas where we need to see existing practices strengthened: credit ratings, disclosure, and risk management.

**Credit Rating Agencies and Ratings Practices**

Credit rating agencies have been long-standing and important participants in the financial markets, but their practices, particularly surrounding structured credit products, warrant attention. That being said, the need for change regarding ratings practices is not constrained to just the credit rating agencies. The weaknesses of the rating agencies were compounded by investors over-relying on the rating agencies' assessments and by the practices of other market participants, including originators and securitizers.

The PWG put forth a series of recommendations regarding ratings practices that focused on improving the quality and integrity of underlying data and models, independence of the ratings process, and participant awareness of the purpose, risk, and limits in utilizing...
ratings.

To start, rating assessments are dependent on the quality and integrity of the underlying data received from both the originator of credit and the packager of securitized products. As a result, the PWG has called for rating agencies to disclose what qualitative reviews they perform on originators and for rating agencies to require securitizers to represent the level and scope of due diligence performed on the underlying assets.

Second, given the role they play, the rating agencies must have and enforce policies and procedures that disclose and manage conflicts of interest.

There also exists the need for rating agencies to produce rating products that provide the information investors need to make better informed decisions about risk. The use of the same rating categories for both structured products and corporate bonds facilitated investors’ complacency. Investors acted as if they did not appreciate that risk characteristics differed. They most certainly do differ, and we need to see a clearer distinction made by the rating agencies, investors, and regulators. One way of doing so could be a separate nomenclature, an identifying suffix, or other information that highlights the unique risk characteristics of structured credit products.

The PWG will facilitate the formation of a private-sector committee comprised of investors, issuers, and rating agencies to develop additional recommendations that issuers, rating agencies, and policymakers could implement to ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment.

We must also reduce investors’ reliance on ratings. Investors also have a responsibility to conduct independent analysis and must not rely solely on ratings.

Additionally, regulators must avoid creating an over-reliance on ratings through regulations and supervisory rules. At a minimum, regulators should systematically distinguish between ratings of structured credit products and ratings of corporate bonds in regulatory and supervisory policies, including regulatory capital requirements that reference ratings. We need to see these recommendations implemented, which will result in stronger rating processes and practices.

Disclosure

Markets also are challenged by the complexity and opacity of many securitized products. Additional and clearer disclosure can enhance transparency, but disclosure for the sake of disclosure is insufficient. The PWG has called for additional disclosure by originators, underwriters, and credit rating agencies so that investors have information available to better assess risk.

Part of good risk management is having good information. Let me share some specific recommendations the PWG made with respect to disclosure.

Securitizers need to enhance disclosure regarding the originators of assets, including, for example, assessing the originator’s experience, quality of management, underwriting standards, process by which loans are sourced, and track record of providing accurate and robust information on originated assets. They should also publicly disclose whether they engage in ratings shopping, and if they do, disclose the reason for not publishing preliminary ratings.

The PWG also called on financial institutions to make more detailed and comprehensive disclosures of off-balance sheet commitments, including commitments to support ABCP conduits and other off-balance sheet vehicles.

To facilitate better disclosure, the PWG will ask a private-sector committee made up of investors, rating agencies, and issuers to develop best practices regarding disclosure.

Disclosure is only useful if it is understandable and acted upon. We must remember that most of the buyers of these complex securities were professional, institutional investors. Given the characteristics of many of the structures and securities, investors must seek to excel in risk analysis and risk management as much as return management.

Investors must obtain from issuers of securitized credits better information about the risk characteristics of such credits, including the information about the underlying asset pools, on both an initial and ongoing basis. Investing without having the knowledge, expertise, systems, or personnel to assess risk, or not receiving the information needed to overcome opacity, is a surefire way to lose a lot of money. That’s a game for speculators, not prudent investors.

Financial Institutions / Risk Management

One of the most important implications of the capital market turmoil has been the balance-sheet pressure felt by our financial institutions. Bank capital has been squeezed by losses associated with the value of securities they held; by balance sheets swollen with credit products they were unable to sell; and by commitments to provide liquidity and financing.

These developments can lead to a reduction in the supply of capital that financial institutions provide to borrowers. Still, we are fortunate that financial institutions came into this episode with healthy capital ratios and that many have raised additional capital in recent weeks. We encourage them to continue doing so where appropriate.

Much of this comes back to risk management. Again, identifying the root cause is the easier part. We had regulatory policies, including capital requirements that failed to mitigate certain risk management weaknesses. Here, market participants and regulators at all levels need to be part of the solution. We need to see global financial institutions promptly identify and address any weaknesses in risk management practices that the current turmoil has revealed.

U.S. banking regulators and the SEC are developing common guidance to address risk management weaknesses, including improving stress testing, the governance of the risk management and control framework, and internal risk reporting and measurement.

We need to see improved risk management practices by investors, issuers, rating agencies, and regulators alike. Risk management is everyone's business.

**Conclusion**

We will continually assess conditions and monitor how practices are changing. We may put forward additional recommendations as events unfold and new insights are gained.

Looking ahead, we expect practices to be different. Financial products will be less complex and more transparent, and the mechanisms for dealing with complexity will improve. This will include better credit rating practices, improved capital cushions, better liquidity management, and enhanced disclosure and due diligence.

The recently released PWG policy recommendations represent our latest efforts, and we remain engaged on other issues as well. In the weeks ahead, we will be releasing a financial regulatory blueprint, and we anticipate that the private-sector committees that the PWG established last September to develop best practices for investors and hedge fund managers will publish their guidelines for public comment. Collectively, these efforts will serve to enhance market efficiency and investor protection, and help mitigate systemic risk.

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. We encourage the private sector to do the same. Thank you.

-30-