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Remarks by U.S. Treasury Secretary Henry M. Paulson, Jr. on the U.S., the World Economy and Markets before the Chatham House

London - Thank you, Robin. I am pleased to be in London again. Today I will provide my perspective on current U.S. and global economic conditions and then look forward to your questions.

When President Bush visited the United Kingdom last month, Prime Minister Brown remarked on the similarities between our countries -- that both are "founded upon liberty, our histories forged through democracy, our shared values expressed by a commitment to opportunity for all." And indeed our countries are loyal and true allies, our people are friends and we stand and work together on the world economic stage.

U.S. Economy

Today, the U.S. economy is going through a rough period. And while we have seen better growth in Europe over the last few quarters, there are signs of a slowdown in Europe in general and the UK specifically. However, emerging economies are expected to continue a period of strong growth, which will support global growth overall.

Early this year, President Bush and the U.S. Congress enacted an economic stimulus package that is injecting $150 billion into the U.S. economy now when it's most needed. To date, almost 95 million payments totaling over $78 billion have been sent. Consumer spending data in May show these payments are helping families weather this period of slow growth and higher food and gas prices.

Still, the U.S. economy is facing a trio of headwinds: high energy prices, capital markets turmoil and a continuing housing correction.

U.S. Housing Market

While we have implemented several public and private initiatives to prevent avoidable foreclosures, the housing correction continues to pose a significant downside risk to the U.S. economy. As the market works through past excesses, U.S. foreclosures will remain elevated and we should not be surprised at continued reports of falling home prices. Our policy continues to be to work to avoid preventable foreclosures while not impeding the necessary correction because the sooner housing prices stabilize and more buyers return to the market the sooner housing will begin to contribute to economic growth.

U.S. and Global Capital Markets

Today I will focus on our capital markets – where the United States and the United Kingdom face similar challenges and are pursuing similar approaches. I see our work in three tranches; first and foremost, our number one priority continues to be promoting market stability and limiting the impact on the broader economy as we work through today's institutional and markets stresses. Second, implementing the appropriate policy responses to recent events to address the deficiencies in our markets which the current problems have exposed. Third, improving our overall financial regulatory structure to better prevent and address future turmoil.

Working through the current turmoil will take additional time, as markets and financial institutions continue to reassess risk, and re-price securities across a number of asset classes and sectors. I have encouraged financial institutions to de-lever, recognize and disclose losses and raise capital, so they can continue to play their vital role in supporting economic growth. Even in this difficult environment, financial institutions worldwide have raised over $338 billion. Institutions in the U.S. and the U.K. have raised capital equal to 95 and 96 percent of their recognized losses, respectively. In continental Europe, the gap is wider; there, institutions have raised only 56 percent of their recognized losses so far. I encourage financial institutions to continue to strengthen balance sheets by raising capital, de-leveraging or reviewing dividend policies.

Today's markets are difficult and this is a tough earnings environment for our financial institutions as they work through the present market turmoil and adjust to the underlying challenges in our economy. For example, high oil prices will in all likelihood prolong our economic slowdown and housing continues to pose a significant downside risk.

U.S. Response to Policy Issues Arising from Market Turmoil

As the United States and international capital markets work through the immediate turmoil, policymakers around the world have been focused on addressing the policy implications.

In the United States, the Treasury Department, the Federal Reserve, the Securities and Exchange Commission and the Commodities Futures Trading Commission worked together through the President's Working Group on Financial Markets, the PWG, to recommend and implement specific near-term policy actions. U.S. regulators, investors, financial institutions and credit ratings agencies have begun to implement these and other recommendations, which include stronger mortgage origination oversight, national licensing standards for mortgage brokers, and actions to improve market infrastructure, regulatory oversight, risk management practices, steps to address valuation issues, and policies and practices related to the credit ratings agencies and the mortgage securitization chain.

International Policy Response to Market Turmoil

From the outset, U.S. and world policymakers knew that the interconnectedness of U.S. and global markets required an internationally coordinated response. Throughout this process, we have been in regular contact and worked closely with our international colleagues, particularly with the UK. At our meeting last October, the G7 tasked the Financial Stability Forum, the FSF, to analyze the underlying causes of the turbulence and offer proposals for change. The FSF, which brings together the supervisors, central banks, and finance ministries of major financial centers, has done its work quickly and effectively, and recently produced 67 recommendations. These are consistent with and complement efforts in the United States.

We have already seen progress on the implementation: an updated code of conduct for credit rating agencies has been issued and is being implemented; disclosure practices have been published and are being put in place; and the Basel Committee just issued updated bank liquidity guidance. A large number of other projects are well underway, and the FSF is closely monitoring progress. The United Kingdom and European nations are taking a number of other actions that support and reinforce the FSF recommendations.

There is no easy solution that will immediately relieve current financial market stress or protect against future problems and market challenges which will inevitably occur. Together, the United States, the United Kingdom, other nations and the FSF are addressing current challenges and the underlying weaknesses that contributed to present economic circumstances.

Vision for a Modern U.S. Financial Regulatory Structure

That said, I believe we in the United States need to go further – to address not only the specific policy issues that gave rise to recent turmoil, but also the outdated nature of the U.S. financial regulatory system. Few, if any, defend our current balkanized system as optimal.

Treasury made our recommendations for an optimal structure when we released our Blueprint for a Modernized Financial Regulatory Structure last March. We recommend a U.S. regulatory model based on objectives that more closely link the regulatory structure to the reasons why we regulate. Our model proposes three primary regulators: one focused on market stability across the entire financial sector, another focused on safety and soundness of institutions supported by a federal guarantee, and a third focused on protecting consumers and investors.

A major advantage of this structure is its timelessness and its flexibility. Because it is organized by regulatory objective rather than by financial institution category, it can more easily respond and adapt to the ever-changing marketplace. These recommendations eliminate regulatory competition that creates inefficiencies and can engender a race to the bottom.

We began work on this Blueprint well before our current challenges emerged. Our goal then, which has only accelerated now, is to modernize the U.S. financial regulatory structure to better reflect modern financial markets. Of course, regulation alone cannot fully protect the financial system. Market discipline must also constrain risk-taking. Finding the right balance between market discipline and market oversight is critical to maintaining the market stability and innovation necessary to support vibrant economic growth.

When we released the Blueprint, I was clear that it was a long-term vision that would take time to consider and implement. That is still the case, but today we have both a clear need and a unique opportunity to accelerate this process. The Bear Stearns episode and market turmoil more generally have placed in stark relief the outdated nature of our financial regulatory system. We are working with the Fed and the SEC on the immediate issues raised by the Fed's provision of liquidity to the primary dealers, an extraordinary step taken in the wake of Bear Stearns and one that was necessary to ensure the stability and orderliness of our financial system.

The Bear Stearns episode highlighted the need for the Fed and SEC to work constructively together including an MOU that should be helpful and inform future decisions as our Congress considers how to modernize and improve our regulatory structure.

In addition to the MOU, there are three important steps that the United States should take in the near term, all of which move us further in the direction of the optimal regulatory structure outlined in the Blueprint.

First, whether it was Long Term Capital Management in 1998 or Bear Stearns this year, it is clear that Americans have come to expect the Federal Reserve to step in to avert events that pose unacceptable systemic risk. But, as we noted in our Blueprint, the Fed has neither the clear statutory authority nor the mandate to attempt to anticipate and prevent risks across our entire financial system. Therefore we should consider how most appropriately to give the Federal Reserve the information and authority necessary to play its expected role of market stability regulator. The Fed would need the authority to access necessary information from complex financial institutions -- whether it is a commercial bank, an investment bank, a hedge fund, or another type of financial institution -- and the tools to intervene to mitigate systemic risk in advance of a crisis.

This is a tall order. History teaches us that in a dynamic market economy regulation alone cannot eliminate instability. To be clear, I do not believe that we can eliminate, by regulation or otherwise, all future bouts of market instability -- they are difficult to predict and past history may be a poor predictor of the future. However, just because the overall task is difficult, we should not stop trying to understand and mitigate instability.

To that end, we should create a system that gives us the best chance of foreseeing a crisis, including a market stability regulator with the authorities to avert systemic issues it foresees and providing the information, tools and authorities to deal better with unexpected events when they inevitably occur.

To complement this regulator's efforts, we must have strong market discipline to reinforce the stability of our markets. For market discipline to be effective it is imperative that market participants not have the expectation that lending from the Fed, or any other government support, is readily available. Otherwise, market discipline will be compromised severely. I know from first hand experience that normal or even presumed access to a government backstop has the potential to change behavior within financial institutions and with their creditors. It compromises market discipline and lowers risk premiums, ultimately putting the system at greater risk.

So how do we strengthen market discipline? Today's priority is clearly market stability. However, looking beyond the immediate turmoil, we need to design carefully and put in place a stronger capacity for resolution and crisis intervention that reinforces market discipline. In an optimal system, market discipline effectively constrains risk because the regulatory structure is strong enough that a financial institution can fail without threatening the overall system. For market discipline to constrain risk effectively, financial institutions must be allowed to fail. Under optimal financial regulatory and financial system infrastructures, such a failure would not threaten the overall system.

However, today two concerns underpin expectations of regulatory intervention to prevent a failure. They are that an institution may be too interconnected to fail or too big to fail. We must take steps to reduce the perception that this is so -- and that requires that we reduce the likelihood that it is so.

Strengthening market infrastructure will reduce the expectation that an institution is too interconnected to fail. We need to strengthen our practices and financial infrastructure in the OTC derivatives market and in the tri-party repo system. Important work is underway in each of these areas, and needs to be completed quickly.

To address the perception that some institutions are too big to fail, we must improve the tools at our disposal for facilitating the orderly failure of a large complex financial institution. As former Federal Reserve Chairman Greenspan often noted, the real issue is not that an institution is too big or too interconnected to fail, but that it is too big or interconnected to liquidate quickly.

Today, our tools are limited. We have the Fed's broad lender of last resort powers which are currently being used to help stabilize our markets. Current law also allows our President to declare a national economic emergency, and then dictate the actions of commercial banks. But this tool is both too blunt, in that exercising it would likely spur greater concern and too narrow, in that commercial banks are only one group of participants in today's broad financial markets. We also have specialized resolution provisions that apply solely to insured depository institutions, but these do not apply to a large group of complex financial companies.

In general, bankruptcy law serves as the resolution regime for non-depository financial institutions and most corporations. This regime has a long legal history, and is initiated by private-sector decisions to initiate bankruptcy proceedings, which then start a process to pay claims. In contrast, under the administrative procedures for insured depository institutions, regulators determine when and how to start the proceeding and in many ways regulators largely take the place of the courts in determining the allocation of claims.

These two very different approaches for resolution have advantages and disadvantages. Bankruptcy imposes market discipline on creditors, but in a time of crisis could involve undue market disruption. An administrative procedure under the control of regulators helps to mitigate market disruption, but can reduce market discipline. For insured depository institutions, this special insolvency regime was deemed necessary because of the role these institutions play in the overall financing of economic activity and the presence of a government guarantee.

As I have continually noted, the financial landscape has changed, and non-bank financial institutions play a significantly greater role. We need to consider broadly the resolution regime in light of these changes. It is clear that some institutions, if they fail, can have a systemic impact, so we must give regulators the authorities to limit that impact and facilitate an orderly failure. In my view, looking beyond the immediate market challenges of today, we need to create a resolution process that ensures the financial system can withstand the failure of a large complex financial firm. To do this, we will need to give our regulators additional emergency authority to limit temporary disruptions. These authorities should be flexible and -- to reinforce market discipline -- the trigger for invoking such authority should be very high, such as a bankruptcy filing. And as part of this process we should consider ways to ensure that costs are imposed on creditors and equity holders. Any commitment of government support should be an extraordinary event that requires the engagement of the Executive Branch. It should be focused on areas with the greatest potential for market instability and should contain sufficient criteria to ensure that the cost to the taxpayers is minimized.

In the United Kingdom, you gave recently proposed changes to your regulatory system as the United States is doing now. While your regulatory system is different from ours, we both recognize the direction our systems must take to better deal with market stability issues and today's financial markets. In the U.K., colleagues have recently proposed modifications to your regulatory structure and authorities similar to what Treasury envisioned in our Blueprint. Under this new proposal, the Bank of England would be given specific statutory responsibility for financial stability regulation. A new Financial Stability Committee, chaired by the Governor of the Bank of England, would oversee the Bank's functions as they relate to market stability. The Bank of England would also have new authorities to carry out this function, including access to firm-specific information related to market stability, formal oversight of payment systems, as we are recommending for the Federal Reserve in the U.S., and a lead role in working with the FSA to establish a new resolution regime.

As U.S. and global regulators respond to recent events, we must recognize that the stability and vitality of our markets require both robust oversight and market discipline.

Conclusion

The United States and the United Kingdom share a long history and a bright future. As we cooperate and work closely with you during this period of economic difficulty we look forward to emerging, as we always do, to a new day of promise and prosperity. Thank you.