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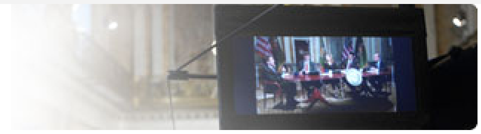
U.S. DEPARTMENT OF THE TREASURY

Press Center



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Boston- Good afternoon and thank you for inviting me to join you today. Before moving to Washington, D.C., I spent twenty years working in financial services here in Boston and so it's good to be back. As a Red Sox fan like many of you, I regularly read the great sports-writers of the *Boston Globe* as they contribute to the perennial sports debate about how offense sells tickets but defense wins championships. While the debate can make for good talk radio, successful coaches can attest that you need both to be competitive over the long run.

Good pitching and good hitting complement one another. Strong defensive players create opportunities for the offense. Likewise, the opposite is also true. Good offense helps defense. You can't tell me that when Big Papi hits a three run shot during the bottom of the 8th inning, that Jonathan Papelbon doesn't feel a bit more confident when he takes the mound to start the 9th inning. The reality is, they are complementary, and collectively they define a winning strategy.

Today, I would propose that the strategy for developing strong, competitive, sustainable and efficient franchises, is not limited to just sports teams, but can be applied to capital markets as well. The hallmarks of a successful player or sports franchise, innovation, flexibility, leadership and discipline, are also traits of successful financial institutions. These traits are also complemented by appropriate oversight and regulations. Collectively, these efforts create a system that delivers benefits to the broader group: in the case of a sports franchise, to the league and business, and in the case of capital markets, to our economy.

During the last several weeks, we unfortunately have seen the consequences of having large, innovative financial institutions without appropriate oversight. Fannie Mae and Freddie Mac are currently the largest sources of mortgage finance in the United States. Their operations grew exponentially over the last decade. This Administration has pushed hard for many years to update and strengthen the GSEs' regulator, so it has powers comparable to bank regulators.

There is little doubt Fannie Mae and Freddie Mac have an effect on overall market stability and must have improved oversight. To address market stability issues immediately, the Secretary has asked for temporary authority to extend an increased line of credit as a liquidity backstop and for the ability to provide a capital backstop to the GSEs. The second part of the Secretary's proposal is to include a consultative role for the Federal Reserve in the new GSE regulator's process to set capital requirements and other prudential standards. The Secretary has asked that these new provisions be included in the House- and Senate-passed GSE legislation. We have been working closely with Congress and expect this legislation to be completed soon.

Market Discipline

Effective capital markets and effective regulatory policy do not happen independently; quite the contrary. The fact is, success is inter-dependent, and the relationship requires cooperation, interaction, and some level of mutual dependence.

In seeking to achieve investment objectives, you and your clients confront many types of risk, ranging from counterparty and liquidity issues to reputational and even career risk. Successful investors must recognize and manage these and other risks effectively. When private-sector participants act in their own self-interests, they exercise their powers of analysis and reason, in turn defining and establishing market discipline. Market discipline is critically important and serves multiple purposes. It serves to aid investors individually, and it also serves to mitigate the likelihood and severity of a systemic event.

However, despite its many virtues, the presence of market 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.

In fact, 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.

In order to sustain a recovery, we need to see changes in market practices and today I want to discuss the reforms outlined by the President's Working Group on Financial Markets (PWG). However, recommendations alone will not fix this problem. Meaningful change is difficult and it will require leadership. As leaders within your field, you are the ones who can provide the necessary leadership to implement the reforms that are required to restore market disciple and help bring stability back to the financial markets.

After undertaking a rigorous review of the underlying causes of today's turmoil, the PWG released a policy statement in March that included specific recommendations to address the underlying weaknesses that caused the disruptions in our capital markets.

These recommendations cover the practices of a broad array of market practices and participants, including originators of credit, financial institutions, rating agencies, investors, and regulators. The implementation of these recommendations has already begun moving forward, with all parties playing a role. Let me share with you an interim status report.

Mortgage Origination

The first area addressed by the PWG was mortgage origination. In order to restore market discipline, the PWG called for several areas of reform: stronger government oversight of brokers and others involved in the origination process; stronger incentives for originators to use robust underwriting standards and procedures; and vigorous enforcement related to fraudulent transactions and schemes that take advantage of households facing foreclosure.

A Nationwide Mortgage Licensing System has been established to ensure strong, uniform licensing standards for mortgage brokers across all fifty states. Additionally, both the House and Senate have passed legislation that would set minimum standards for licensing and require states to participate in the licensing system or else be subject to a similar licensing database and registration system created and overseen by the Department of Housing and Urban Development.

Federal supervisory agencies have also adopted new policies that will improve mortgage origination. First, federal regulators have issued guidance to improve the underwriting of subprime mortgages, and state authorities have issued comparable guidance in this area. Second, the Federal Reserve has approved changes to Truth in Lending Act (TILA) rules to address concerns about incomplete or misleading mortgage loan advertisements and to require lenders to provide mortgage disclosures more quickly.

The Federal Reserve is also reviewing TILA rules relating to disclosure and is testing potential types of disclosures with consumer focus groups. This work will continue into early 2009. Additionally, under its HOEPA authority the Federal Reserve has finalized new rules that address abuses related to prepayment penalties, failure to escrow for taxes and insurance, stated-income and low-documentation lending, and failure to give adequate consideration to borrowers' ability to repay.

Finally, working together, federal and state authorities have initiated a pilot program to review compliance with consumer protection laws and regulations on underwriting and management oversight at selected non-depository lenders having significant subprime mortgage operations.

Ratings Practices

The second area the PWG addressed was ratings practices. Here we sought reforms to the processes for rating structured credit products to ensure integrity and greater transparency so that investors can make better-informed decisions. To achieve this goal, the PWG recommended that the credit rating agencies disclose their review of originators and underlying collateral, assumptions and models, performance measures, and any conflicts-of-interest. We also want clearer explanations of the meaning and methodology for ratings of structured products.

Actions are being taken here too. A group led by the Securities Industry and Financial Markets Association (SIFMA) is responding to the PWG recommendation with representatives of all constituents to develop further steps that can be taken to ensure the integrity and transparency of ratings, and to foster appropriate use of ratings in risk assessment.

On the supervisory front, the SEC recently issued three sets of proposed rules. The first two bring increased transparency and integrity to the credit ratings process. The third set encourages independent risk analysis by investors and makes clear the purposes and limits of credit ratings for structured products. Taken together, these proposed rules will bring a number of specific improvements to the ratings process. First, they address conflicts of interest by prohibiting credit rating agencies from rating products that they structure. Second, they require rating agencies to review and publicly disclose information on the underlying assets before a rating is released on a structured product.

Next, the proposed rules will require public disclosure of ratings actions and ratings performance measures. In addition, the rules specify disclosure of the way that rating agencies rely on third-party due diligence, how frequently credit ratings are reviewed, whether different models are used for surveillance than for initial ratings, and whether changes made to models are applied retroactively to existing ratings.

Notably, the rules also call for differentiation of ratings for structured products from ratings for corporate and municipal securities. This may be accomplished either through different symbols or by issuing a report disclosing the differences between ratings of structured products and other securities. Finally, other rules seek to ensure that the SEC's own regulations do not encourage investor over-reliance on ratings issued by ratings agencies. The SEC currently is accepting comments on these rule proposals and likely will promulgate final rules later this year.

The PWG is reviewing these changes to determine if these reforms are sufficient to ensure the integrity and transparency of ratings.

Investor Awareness of Risk

With the erosion of market discipline many market participants lost sight of the need for robust risk awareness, and so the PWG also made several recommendations in this area. First, the PWG called for stronger independent assessment of information by investors, fiduciaries, and asset managers to reduce the reliance on ratings agencies. In order to facilitate this independent risk assessment, the PWG also called for enhanced disclosure by originators, underwriters, and sponsors about the collateral used in structured credit products. Finally, the PWG recommended that firms need to improve their disclosure about exposure to off-balance sheet vehicles such as asset-backed commercial paper conduits.

There are many actions are being taken on this front as well. The PWG recommended the formation of another private-sector group to develop recommendations and best practices for improved disclosures for structured products. A group led by the American Securitization Forum (ASF) has developed a draft template for information that should be disclosed to investors that will serve as the basis for disclosure templates for other structured products. The industry already has a template for the disclosure of critical information to asset backed commercial paper investors that is gaining widespread acceptance and is being rapidly adopted by industry participants. Other recommendations from this broad coalition of industry participants are expected later this year.

Overseers of institutional investors are providing guidance for investors and asset managers regarding obtaining sufficient information from sponsors and underwriters about the risk characteristics of structured products. Supervisors are planning on issuing guidance for underwriters and sponsors of structured finance products requiring them to publicly disclose ratings shopping.

Risk Management

Risk management is another area where we must have improved risk management practices. Strengthened risk management practices at financial institutions, increased oversight of institutions' risk management practices, and more robust valuation models for complex, mortgage-related, and structured products are requirements for strong capital markets.

Global financial institutions are already identifying and are working to address weaknesses in risk management practices. The PWG supported the formation of a private-sector group to reassess implementation of the Counterparty Risk Management Policy Group II's existing guiding principles and recommendations regarding risk management, risk monitoring, and transparency, and to modify or develop new principles and recommendations as necessary to incorporate lessons from the recent turmoil, including lessons regarding valuation practices. This new group intends to issue a report later this summer that focuses on four areas of reform: financial institutions' risk management practices; complex financial products; off-balance sheet activities, including accounting policy and disclosure; and financial market infrastructure, including OTC derivatives.

Supervisors of global financial institutions are closely monitoring the firms' efforts to address risk management weaknesses and taking action if necessary to ensure that weaknesses are addressed. U.S. banking regulators and the SEC are assessing current guidance and developing common guidance to address risk management, including improvements to management information systems; concentration risk management, liquidity risk management, stress testing, and other risk management practices that are necessary to ensure that liquidity and capital cushions are sufficiently robust to absorb extreme system-wide shocks.

U.S. authorities are encouraging other supervisors of global firms to make complementary efforts to develop guidance along the same lines.

Regulatory Practices and Market Infrastructure

The PWG also is working on implementing initiatives regarding two other areas: regulatory practices and market infrastructure. Here we are enhancing regulatory policies to ensure strong risk management practices. We are addressing regulatory capital requirements for firm-wide exposures and both on- and off-balance sheet exposures, and ensuring liquidity cushions are forward looking and adjust appropriately through credit cycles. We also are engaged in efforts to ensure that reporting and disclosure of off-balance sheet vehicles is enhanced.

With respect to market infrastructure, we are encouraging the development of an integrated operational infrastructure for the over-the-counter (OTC) derivatives market that ensures accuracy and timeliness of trade data submission, resolution of trade matching errors, and integrated processing. We are calling for a cash settlement protocol adopted by market participants and incorporated into standard documentation, and for netting, novation and clearing of OTC derivatives contracts by a centralized counterparty. In addition, we are addressing the risks surrounding tri-party repurchase agreements, and the short-term financing and systemic risk implications for capital markets.

Hedge Funds

As hedge fund managers, there is a special role you must play. 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, an Asset Managers' Committee and an Investors' Committee, to develop best practices for their respective groups. Their draft practices were released for public comment in April, and the groups will release final reports this summer.

Similar to your "Sound Practices for Hedge Fund Managers," the draft "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. The report recommended innovative and far-reaching practices that exceed existing industry standards, and calls 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 the investment portfolio. These best practices offer a guide for responsible investment in hedge funds. It is critical to see them implemented.

There also is a need to move forward on a longer-term, strategic basis. Treasury released a Blueprint for Financial Regulatory Reform in March 2008. The current U.S. 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 have the ability to 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.

Conclusion

We have a great deal to accomplish in the months ahead. As stakeholders in the asset management industry you must continually uphold and enhance the highest quality standards of excellence. Failure to do so only compromises an industry with deep roots and a proud legacy. It is a privilege to be entrusted with the public's interest and capital. With such a privilege comes great 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 our capital markets.

Thank you again for the opportunity to speak here today.

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