



## REMARKS BY SECRETARY HENRY M. PAULSON, JR. ON BLUEPRINT FOR REGULATORY REFORM

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**Washington, DC**— Good morning. A strong financial system is vitally important - not for Wall Street, not for bankers, but for working Americans. When our markets work, people throughout our economy benefit – Americans seeking to buy a car or buy a home, families borrowing to pay for college, innovators borrowing on the strength of a good idea for a new product or technology, and businesses financing investments that create new jobs. And when our financial system is under stress, millions of working Americans bear the consequences. Government has a responsibility to make sure our financial system is regulated effectively. And in this area, we can do a better job. In sum, the ultimate beneficiaries from improved financial market regulation are America’s workers, families and businesses – both small and large.

Today I am pleased to release Treasury’s Blueprint for Financial Regulatory Reform. Or, perhaps I should say – given the last few days’ news coverage -- that I am pleased to provide additional details to accompany the release of this Blueprint for Regulatory Reform. We began the process leading to this final report a year ago, in March of 2007, after convening industry leaders and policymakers for a conference on capital markets competitiveness.

The conference participants concluded that our current financial regulatory system could more effectively promote stable and resilient markets and a more competitive financial services industry. So, in addition to our other capital markets initiatives, last June we began work on a Blueprint for a financial regulatory structure that would be more effective and more appropriate for modern financial markets.

When we announced that we would work on such a Blueprint, other than some enthusiastic academics, few noticed. Today, of course, capital markets and financial regulation are on everyone’s mind. As recent events have demonstrated, investor protection and market stability are critical elements of competitiveness. Far from being at odds with one another, they are mutually reinforcing.

We have been undergoing a period of financial market stress since last August. Markets are re-pricing and reassessing risk and as we should expect, there are always difficulties during periods such as this. We know that a housing correction has precipitated this turmoil, and housing remains by far the biggest downside risk to our economy. As we work through this period, our highest priority is limiting its impact on the real economy.

I have the greatest confidence in the resiliency, flexibility and strength of our economy and our capital markets. We are focused on maintaining stable, orderly and liquid financial markets and ensuring that our banks continue to support the economy by making credit available to consumers and businesses.

Our regulatory community is working cooperatively together through some very challenging times. Last week I reiterated my support for the important and consequential recent actions taken by the Federal Reserve. The Fed must have the necessary information to perform its role as it temporarily provides liquidity to non-banks. But it would be premature to assume these institutions should have permanent access to the Fed's discount window and permanent supervision by the Fed. We will learn lessons from the experience of this temporary facility, and those lessons will inform a path forward.

Our first and most urgent priority is working through this capital market turmoil and housing downturn, and that will be our priority until this situation is resolved. With a few exceptions, the recommendations in this Blueprint should not and will not be implemented until after the present market difficulties are past.

Some may view these recommendations as a response to the circumstances of the day; yet, that is not how they are intended. This Blueprint addresses complex, long-term issues that should not be decided in the midst of stressful situations and should not be implemented to add greater burden to a market already under strain. These long-term ideas require thoughtful discussion and will not be resolved this month or even this year.

Let me also remind you that two weeks ago, the President's Working Group on Financial Markets released a series of recommendations addressing issues including ratings agencies, securitization, mortgage origination, and OTC derivatives. They are a policy response to the current market turmoil, designed to reduce the likelihood that we will repeat our current problems. We are focused on seeing these recommendations implemented, to improve the workings of our financial markets. But we will not seek to implement them on a pace or in a manner that interferes with our first priority of working through this current period of market difficulty.

Before I describe our Regulatory Blueprint, I will briefly outline why updating our financial regulatory structure is essential.

## **Evolution of our Financial Regulatory System**

Our current regulatory structure was not built to address the modern financial system with its diversity of market participants, innovation, complexity of financial instruments, convergence of financial intermediaries and trading platforms, global integration and interconnectedness among financial institutions, investors and markets. Moreover, our major financial services companies are becoming larger, more complex and more difficult to manage. Much of our current regulatory system was developed after the Great Depression and it has developed through reaction -- a pattern of creating regulators as a response to market innovations or to market stress.

We have five federal depository institution regulators in addition to state-based supervision. We bifurcate securities and futures regulation. And regulation of one of our largest financial services industries, insurance, is based almost entirely at the state level. The bulk of these regulatory responses made sense at the time they were created, but as we look at today's financial markets, the lack of a comprehensive design is clear.

The 1991 Bush Administration study, known as the "Green Book," made the case for many of the changes adopted in the last comprehensive financial regulatory overhaul, the Gramm-Leach-Bliley Act (GLBA) of 1999. That Act made important changes to our financial regulatory structure by allowing broader affiliations of financial services firms through a Financial Holding Company structure. But, it also maintained separate regulatory agencies across the traditional securities, futures, insurance and banking industry segments. This functional division is at odds with the increasing convergence of financial service providers and products. It creates jurisdictional disputes among regulators, and a likely result is that some financial services and products are exported to more adaptive foreign markets.

This complex structure can invite regulatory arbitrage, where business models are chosen based on regulatory structure, or even worse, based on the regulator itself. Regulators have adapted to keep pace with innovation, but they do so within a rigid structure that can not readily adapt as the financial services industry evolves. The current system fosters duplicative requirements and can allow important regulatory matters to fall through the cracks.

That said, I do not believe it is fair or accurate to blame our regulatory structure for the current market turmoil. As we work through this period, our regulators are cooperating to the extent appropriate, recognizing their different roles, responsibilities and authorities. They are also working cooperatively with their global counterparts. They share information when appropriate, minimize duplication and try to avoid jurisdictional conflict. We are fortunate to have experienced professionals acting out of a shared sense of responsibility for the public good.

I am not suggesting that more regulation is the answer, or even that more effective regulation can prevent the periods of financial market stress that seem to occur every five to ten years. I am suggesting that we should and can have a structure that is designed for the world we live in, one that is more flexible, one that can better adapt to change, one that will allow us to more effectively deal with inevitable market disruptions, one that

will better protect investors and consumers, and one that will enable US capital markets to remain the most competitive in the world.

This is a complex subject deserving serious attention. Those who want to quickly label the Blueprint as advocating “more” or “less” regulation are over-simplifying this critical and inevitable debate. The Blueprint is about structure and responsibilities – not the regulations each entity would write. The benefit of the structure we outline is the accountability that stems from having one agency responsible for each regulatory objective. Few, if any, will defend our current balkanized system as optimal.

I also want to make clear that today's recommendations will not alter how we continue to set policy and coordinate the implementation of rules designed to protect the financial system from money laundering, terrorist financing and other illicit activities. Our challenge is to thoughtfully evolve to a more flexible, efficient and effective safety and soundness regulatory framework – and that is the purpose of this Blueprint.

### **The Optimal Financial Regulatory Model**

We concluded we could only do justice to this topic by asking a rather theoretical question: If we could start over, which of course we can't, what regulatory model would we build? The idea here was to put forward an aspirational model, which could only be achieved after many years. But the model would serve as a beacon guiding us as we take necessary steps to modernize our financial regulatory structure to reflect today's market realities. Several difficult but unavoidable issues must be confronted, and we have put forward specific intermediate term recommendations to address these transitional issues over a two to eight year period. And we have a few recommendations for the near-term. But let's begin with the optimal or aspirational model.

We took a deliberative approach to developing this Blueprint. We met extensively with US and international financial regulators. We considered several models currently used in other global financial centers. We requested public comment on a broad range of issues and received hundreds of thoughtful and constructive comments. We interviewed thought leaders, industry, academics, and advocates of all political persuasion, including former Treasury leaders from both sides of the aisle. To a person, everyone agreed with two things: first, it was a difficult task and second, we must do this to retain our competitive advantage.

Our work led us to recommend a regulatory model based on objectives, to more closely link the regulatory structure to the reasons why we regulate. This model would have three regulators: a regulator focused solely on market stability across the entire financial sector, a regulator focused on safety and soundness of those institutions supported by a federal guarantee, and a regulator focused on protecting consumers and investors. A major advantage of this structure is its timelessness and its flexibility. It can more easily respond and adapt to the ever-changing marketplace because it is organized by regulatory objective rather than by financial institution category.

### ***Market Stability Regulator***

Given its traditional central bank role of promoting overall macroeconomic stability, the Federal Reserve is the natural choice for the important task of market stability regulator. In our model, the Federal Reserve's market stability role would continue through traditional channels of implementing monetary policy and providing liquidity to the financial system. In addition, the Federal Reserve would be provided with a different, yet critically important regulatory role with broad powers focusing on the overall financial system.

This role would replace the Fed's more limited role of bank holding company supervision because we recognize the need for enhanced regulatory authority to complement market discipline to deal with systemic risk. To do its job as the market stability regulator, the Fed would have to be able to evaluate the capital, liquidity, and margin practices across the financial system and their potential impact on overall financial stability. The Fed would have the authority to go wherever in the system it thinks it needs to go for a deeper look to preserve stability.

To do this effectively, the Fed will collect information from commercial banks, investment banks, insurance companies, hedge funds, commodity pool operators, but rather than focus on the health of a particular organization, it will focus on whether a firm's or industry's practices threaten overall financial stability. It will have broad powers and the necessary corrective authorities to deal with deficiencies that pose threats to our financial stability.

To illustrate, consider that our current regulatory regime is almost solely focused above ground at the tree level. But, the real threat to market stability is below ground, at the root level where the health of financial firms is intertwined. Obvious root systems requiring the attention of our market stability regulator would include the interconnected OTC derivatives markets with their lack of a cohesive design for clearing, settlement, and novation protocols. Similarly, a market stability regulator would have the authority to review certain private pools of capital, such as hedge funds and private equity, which have the potential to contribute to a systemic event.

This market stability regulator's job sounds difficult, and it is. No regulator can prevent all instability and market turmoil, and this one won't either. I would expect that we will continue to go through periods of market stress every five to ten years. But hopefully with the proper tools and authorities, greater transparency and better information flow, we will be better able to avoid some problems and more effectively work through others. As a nation we have placed great faith in the powers of market discipline and this regulator is designed to better harness those forces.

### ***Prudential Financial Regulator***

Our second regulator combines all federal bank charters into one charter and consolidates all federal bank regulators into a single prudential regulator. For further regulatory efficiency, we recommend a federal insurance charter and put oversight of these guaranteed products within the jurisdiction of our federal prudential regulator. By its

singular focus on prudential regulation that ensures the safety and soundness of institutions with federal guarantees, this regulator would serve a role similar to the current Office of the Comptroller of the Currency (OCC).

### ***Conduct of Business Regulator***

Third, we propose a dedicated business conduct regulator with the responsibility to vigorously protect consumers and investors, one which will focus on achieving greater consistency across products. This regulator would monitor business conduct regulation across all types of financial firms. Business conduct regulation in this context includes key aspects of consumer protection such as disclosures, business practices, chartering and licensing of certain types of financial firms, and rigorous enforcement programs. This agency would assume many of the roles of the CFTC, the SEC, and the consumer protection and enforcement roles of our insurance and banking regulators. Having one agency responsible for these critically important issues for all financial products should bring greater consistency to regulation where overlapping requirements currently exist. Mortgages are an example of a consumer financial product that has suffered from uneven and inadequate treatment in our current regulatory and enforcement regime.

The premise of our optimal structure is that clarity of mission and objective will lead to strengthened regulation and improved capital markets efficiency.

We chose an objectives-based structure because we believe it provides a flexible framework that fosters and embraces innovation, helps ensure competitiveness and better manages risk. Such a structure would be better able to adjust to market and institutional changes. It would allow for clearer focus on particular goals – how do we prevent market failures – and provide a clear view across the financial landscape of functions, products, practices and institutions to meet those goals. Establishing regulatory lines by objectives also has the potential for establishing and enforcing the greatest levels of market discipline by aiming regulation at the most vulnerable points.

An objectives-based model is substantially different from our current system and, realistically, will not and could not be implemented any time soon. However, we are anchoring our recommendations in a tangible, aspirational Blueprint even though it will take many years to evolve to this model. In the interim, the model can guide us as we consider and then take steps along the way.

### **Near Term Recommendations**

I will turn now to our near term recommendations.

#### ***PWG Executive Order***

I have a particularly high regard for the talented and dedicated professionals who today lead our regulatory agencies and, while recognizing their different roles, responsibilities and authorities, also collaborate to deal with current challenges. The President's Working Group on Financial Markets, the PWG, is a forum that is designed to help do just that. It was developed to coordinate across the current US structure, just as the

Financial Stability Forum has developed as the means of facilitating international cooperation. We should formalize the current informal coordinating practice among US regulatory community by amending and enhancing the Executive Order which created the PWG.

A new executive order will emphasize the importance of coordination and communication. It will clarify the PWG's mission of attempting to mitigate systemic financial risk, enhancing financial market integrity, promoting consumer and investor protection, and support capital markets efficiency and competitiveness. It will also increase the PGW membership to include all federal financial regulators so that information is shared in an appropriate, timely and efficient way.

One thing that the PWG will work on immediately is determining whether the government has all the tools and powers it needs to deal with a financial crisis. As part of this, as I mentioned in my remarks last week, the PWG should examine the lessons of the current temporary liquidity facility the Fed has established for investment banks, and examine a number of issues regarding the proper level of oversight that should apply.

### ***Mortgage Origination Process***

Another issue that needs attention is the mortgage origination process. Simply put, that process was broken. We are aggressively addressing the immediate problem, working to increase the availability of affordable mortgage financing, prevent avoidable foreclosures and to minimize the economic disruption of the housing correction. We concluded that it was also appropriate to put forward a proposal to address the policy issues arising from the current turmoil, to avoid a recurrence of recent events and to respond to the fact that a very large percentage of the problematic subprime mortgages originated in the past four years were originated by state-regulated entities.

Mortgage origination is one of the best case studies for the importance of regulatory structure. It raises the question of the proper balance between federal and state oversight, and requires a balancing of innovation, consumer choice and expanded access to credit with protecting consumers from predatory lending and deceptive or incomplete disclosure practices. I have reviewed and analyzed a number of ideas to deal with this process. We thought quite seriously about federal preemption of enforcement authority but concluded in this case it was best to focus on the immediately achievable.

We are recommending retaining state-level regulation of mortgage origination practices, but we are also recommending creating a new federal-level commission, the Mortgage Origination Commission. This commission, the MOC, would be led by a director appointed by the President. The Commission membership would include federal banking regulators and appropriate state representation. Legislation should either set forth or task this Commission to establish minimum standards which should include personal conduct and disciplinary history, minimum educational requirements, testing criteria and procedures, and appropriate license revocation standards.

In addition to standards, the MOC would provide important information to the marketplace about the strength of state's mortgage compliance standards. The MOC would evaluate, rate, and report on each state's adequacy for licensing and regulation of participants in the mortgage origination process. These evaluations would grade the overall adequacy of a state system by descriptive categories, indicating a system's strength or weakness. These evaluations could provide further information regarding whether mortgages originated in a state should be viewed cautiously before being securitized. This powerful Commission, coupled with the Federal Reserve's strong regulatory proposal regarding the HOEPA rules, should go a long way in preventing recent issues from recurring.

### **Intermediate Term Recommendations**

As these near term steps are taken, we also recommend action on a number of intermediate steps after the current market stress has passed. We should focus on a critical part of our economy: payment and settlement systems. Also, there are two areas where our regulatory structure severely inhibits our competitiveness – futures and securities, and insurance. Our recommendations in each area also call for fundamental changes that move us toward the longer-term, objectives-based structure and, consequently, will take a number of years to complete.

#### ***Payment and Settlement Systems***

Payment systems are critically important for overall market stability. On a typical business day, US payment and settlement systems settle transactions valued at over \$13 trillion. Every American relies on a payment system in one way or another, everyday. Yet, our government is behind the curve in payment system oversight. I am not intending to raise an alarm. There is no crisis, but we should be proactive and address this issue. In our Blueprint, we recommend the creation of a federal charter for systemically important payment and settlement systems and that these systems should be overseen by the Federal Reserve. This will allow the Federal Reserve to guard the integrity of this vital part of the nation's economy.

#### ***Merge SEC and CFTC***

When the topic of regulatory structure comes up, people often rush to the assumption that the SEC and the CFTC should be merged. We agree that the realities of the current marketplace for securities and futures markets make it increasingly difficult to rationalize a separate regulatory regime. And, we believe that we should pursue moving our regulation in the direction that the markets are taking us.

As you will see in the Blueprint, process is just as important as substance in this case. The market benefits achieved in the futures area should be preserved and we do not want to lose the CFTC's principles-based process for market exchange oversight. Accordingly, instead of simply recommending merging the SEC and CFTC with the expectation that all will work out, we recommend a number of steps and an evolutionary approach to shape the merger process so as to preserve the best aspects of each regulator.

In fact, the SEC and the CFTC have recently signed a mutual cooperation agreement that embodies the spirit of what the Blueprint is trying to achieve.

### ***Optional Federal Charter for Insurance***

Insurance presents a clear need for regulatory modernization. States have been the primary regulator for insurance for over 135 years. While a completely state-based regulatory system for insurance may have been appropriate at one time, insurance market changes have put increasing strains on the system.

A state-based regulatory system is quite burdensome. It allows price controls to create market distortions. It can hinder development of national products and can directly impact the competitiveness of US insurers. There have been numerous attempts to modernize the regulatory structure for insurance. At this time, it seems clear that the way forward is to give insurers the ability to elect for federal regulation. Therefore, in the Blueprint we recommend the establishment of a federal insurance regulatory structure to provide for the creation of an Optional Federal Charter for insurance firms, similar to the current dual-chartering system for banking. This system would be built on a proven model and we recommend, as in the banking sector, that this federal agency be housed within the Treasury Department. This is the most effective way to address these issues and we outline the critical elements to this legislation.

### ***Revocation of the Federal Thrift Charter***

In some cases, the market develops so quickly as to render parts of our regulatory structure relatively obsolete. This is the case with the federal thrift charter and the Office of Thrift Supervision (OTS). The thrift charter is no longer necessary to ensure sufficient residential mortgage loans availability for US consumers. In the Blueprint, we have concluded that the thrift charter has run its course and should be phased out. With the elimination of the federal thrift charter, the OTS would be closed and its operations would be assumed by the OCC.

### **Conclusion**

We recognize that these ideas will generate some controversy and healthy debate. This is not unlike the circumstances surrounding the 1991 “Green Book,” which after a period of constructive discussion resulted in the passage of the Gramm-Leach-Bliley Act, modernizing our financial services industry.

One of the most constant aspects of American life is change – and nowhere is it more evident than in our financial markets. If private sector institutions don’t change, they become obsolete. Our regulatory structure also needs to change and evolve to one which will stand the test of time. Once we are through this period of market stress we need to begin the serious work of modernizing and reforming the structure, which will require a great deal of discussion and many years to complete.

This will not be a small or easy effort – transformative efforts rarely are. But this is a subject we must debate, and ultimately address, for our long-term economic growth and prosperity.