



January 7, 2008  
HP-757

**Remarks by Treasury Secretary Henry M. Paulson, Jr.  
on Housing and Capital Markets  
before the New York Society of Securities Analysts**

**New York City, NY--** Good afternoon. I will provide an update on the U.S. housing and capital markets and, at the beginning of this new year, an outlook for the U.S. economy.

As I have said for some time, the housing and credit disruptions have slowed our economic growth, and the housing downturn remains the greatest risk to our economy. Yet, the U.S. economy remains diverse and resilient, even as it works through these current challenges.

**Foreclosure Prevention Efforts**

After years of unsustainable price appreciation and lax lending practices, a housing correction was inevitable and necessary. That correction is underway. Over the next two years, we also face an unprecedented wave of 1.8 million subprime mortgage resets, raising the potential of a market failure. Because the industry does not have the capacity to manage this volume, without action, unnecessary foreclosures would result.

To meet this challenge, this Administration – without committing any taxpayer money – helped foster an industry-wide effort to prevent this market failure. By preventing avoidable foreclosures, we will safeguard neighborhoods and communities, and fulfill our primary responsibility of protecting the broader U.S. economy. However, let me be clear: there is no single or simple solution that will undo the excesses of the last few years.

As part of our efforts, last fall we began working with mortgage market participants through the HOPE NOW alliance to implement a three-point plan to avoid preventable foreclosures. This Administration and Congress have provided significant funding for mortgage counseling, which will help organizations such as NeighborWorks America and others to assist homeowners.

The elements of the plan are straightforward. First, the alliance is aggressively reaching out to homeowners who are or will be struggling with their mortgages.

Second, industry and government are developing new mortgage products that will enable more people to stay in their homes.

Third, the industry has developed a systematic streamlining process that replicates normal market actions to fast-track borrowers towards a solution, when possible. The industry needs this streamlining to manage the unprecedented volume of resets that cannot be addressed through individual, loan-by-loan negotiations.

This third part of the plan has received the most attention; it has also received the most criticism due to the mistaken perception that it abrogates contracts. It does not. Mortgage servicers have contractual obligations to their investors, who are spread all over the world. Servicers will fulfill these contractual obligations by

pursuing all loss-mitigation options when it is in the best interest of investors, as they normally would. Investors are part of this industry-wide solution because they recognize the benefits of avoiding preventable foreclosures.

### **Implementation Update**

Now is an opportune time to provide a progress report on implementation efforts for this plan.

To meet the need for new mortgage products, HUD has implemented FHASecure, under which more borrowers can refinance into FHA mortgages. I congratulate Congress for passing the temporary mortgage-debt tax relief bill, which President Bush has signed into law, to help homeowners who have lost their homes from facing another financial setback due to the tax code.

The HOPE NOW alliance has grown. It represents over 90 percent of the subprime servicing market, including the top 20 subprime servicers, as well as major non-profit mortgage counseling organizations, trade associations and investors.

This multilayered approach is both a strength and a challenge. Entire industries do not adjust easily or quickly, even in times of market calm. Individual companies especially face resource and other limitations during times of turmoil. The alliance is making progress, but implementation will not be easy, and will require sustained effort over time.

The first step has been to contact troubled borrowers. In its first two months, the HOPE NOW alliance sent over 450,000 letters to at-risk borrowers who had not previously contacted their servicers. Servicers estimate that, as a result of this effort, approximately 10 percent, or 45,000 homeowners, have called their servicers to see if foreclosure can be avoided.

Servicers are also moving to quickly implement the framework for streamlined refinancings and modifications announced by the American Securitization Forum (ASF) – which represents mortgage market participants, including many of the largest investors. This is not simple; there are legal, accounting and operational considerations. Servicing departments need to link with mortgage originators; this can be difficult for independent servicers. And they must fully implement connections to FHA. Servicers are collaborating to share best practices so all borrowers and investors may benefit from the ASF framework, regardless of who their servicer happens to be.

Last Friday over 20 HOPE NOW alliance servicers gathered to work through implementation details, and will continue an intense pace in order to establish the necessary infrastructure and processes. We expect most servicers to begin fast-tracking borrowers in the next few weeks.

We are monitoring results on all aspects of the plan, to ensure participants are fulfilling their commitments and that homeowners are being contacted and, when possible, helped. The industry is developing definitive progress reports based on standard definitions, standardized metrics and a central monitoring and reporting system. In my judgment, accurately measuring and reporting progress is absolutely essential and time is of the essence. I will continue to press the industry to move quickly to fully implement this program and to announce metrics that fully evaluate their progress.

Fast-tracking will move some troubled homeowners quickly into refinancings and interest rate freezes, which will free up time for servicers to focus on the more difficult cases.

Final success of this plan will be measured by the number of avoidable foreclosures that are prevented, not by the number of refinancings or modifications with an

interest rate freeze.

Major challenges still lay ahead. The volume of subprime mortgage resets will increase substantially in 2008, and most of these mortgages were originated in 2006 under the most lax underwriting standards.

We need to see all servicers reporting results to HOPE NOW to measure effectiveness and then make adjustments as needed. This may include using elements of a systematic approach for adjustable-rate mortgages other than subprime if it will benefit homeowners and investors.

### **Mortgage Credit Market Update**

Unsustainable home price appreciation in the past few years caused a large supply response, and it will take time for demand to catch-up. Housing starts have fallen by nearly half since their peak in early 2006, and new home sales are down just as sharply. House prices are falling in many parts of the country, and elevated housing inventories suggest that the price adjustment is not yet complete.

In this environment, buyers will be reluctant to commit to new purchases. Moreover, until investors have confidence that prices have stabilized, they will remain cautious about funding new mortgages. This is particularly true for new subprime mortgages, which are not currently being securitized by Fannie Mae or Freddie Mac, and for jumbo mortgages which do not qualify for Government Sponsored Enterprise (GSE) securitization. In these markets, securitization volume has fallen off significantly.

The reduced availability of non-conforming mortgages clearly has impacted the ability of some to buy or refinance a home. I heard this concern repeatedly as I traveled throughout the country last month. We have urged Congress to move quickly to address this issue by passing the FHA modernization bill to provide financing for approximately 250,000 borrowers and, as part of GSE reform legislation, to temporarily raise the loan limit to allow the GSEs to securitize jumbo mortgages.

Just as the HOPE NOW alliance, by preventing some foreclosures, will reduce the supply of homes to be sold, addressing stress in the non-agency mortgage market could increase the demand for homes by reducing mortgage financing costs and increasing financing availability. Therefore, it is important that Congress act quickly.

Fortunately, creditworthy borrowers looking for a conforming mortgage will find that Fannie Mae and Freddie Mac have remained active, and traditional conforming mortgage products are readily available. Fannie and Freddie's securitization volumes have risen dramatically since June of 2007, even as other mortgage markets slowed. However, they are also experiencing stress due to the housing downturn and both companies reported substantial third quarter losses. I am pleased that Fannie and Freddie have moved quickly to raise capital and, through their securitization activities, remain a positive force for home finance.

Another housing-related GSE, the Federal Home Loan Bank (FHLB) System, has provided a considerable amount of liquidity to financial institutions. In the third quarter alone, the twelve Federal Home Loan Banks provided an additional \$184 billion to borrowers within the system, funding that enables banks and thrifts to continue to lend.

### **Capital Markets Update**

Benign U.S. and global economic conditions, significant global imbalances, large international capital flows, lax lending standards and investors' aggressive appetite for yield extended beyond the U.S. housing market and have impacted our capital markets more broadly.

For the last five months, markets have been comprehensively reassessing risk, resulting in the re-pricing of securities across a number of asset classes and sectors. This is appropriate and a healthy return to fundamentals. Given the global nature of our markets and the complexity of the instruments involved, it will take additional time to work through this period of stress and volatility.

As markets reassess, we should not be surprised or disappointed to see financial institutions writing down assets and strengthening balance sheets. This is market discipline in action and should enhance market confidence over time. One thing I have learned over my career is that if a financial institution needs capital, it should move quickly to raise it. Moving to strengthen balance sheets better prepares financial institutions to exploit new opportunities and confront inevitable challenges.

As Treasury Secretary, I continue to firmly believe in the value of this approach; it is a positive for financial institutions, capital markets and our economy. Our financial institutions entered this period well-capitalized, and we expect them to remain so. There is a choice to be made here. Institutions that shrink balance sheets and curtail financing activities could make it more difficult for businesses and consumers to continue to finance growth. Alternatively, institutions that strengthen balance sheets can continue to play their vital role in financing businesses and individuals – thus minimizing the impact of market turmoil on the real economy.

We have seen positive developments in this regard. During the second half of 2007, financial institutions raised \$83 billion of equity, a more than 20 percent increase from the same period in 2006. Some may be concerned that much of this financing came from overseas investors; I am not. When the world invests in the United States, it is the ultimate vote of long-term confidence in our economy and our companies.

Our capital markets remain resilient and continue to show progress towards stability. Equity markets are functioning well and finished up for the year, across a broad range of indices. The Treasury market is operating well with elevated volumes at much lower yields than the first half of 2007. Our high grade debt market is performing satisfactorily and issuance has been solid with spreads in line with the last five years' historical averages. Our high yield market is impaired but operational. High yield issuance volume is down significantly and spreads are wider, but still within levels experienced just four years ago.

We did not expect markets to improve in a straight line as we worked through this volatility. And, not surprisingly, late in the year we saw a resurgence of risk aversion and impaired liquidity. This was felt most acutely in the inter-bank financing markets.

In response, central banks took a multitude of actions to facilitate liquidity, including currency swaps between central banks and the successful introduction of the auction of funds via the Term Auction Facility, extending liquidity injections over year-end. The short term inter-bank markets have shown signs of improvement as these coordinated actions are having their desired effect; the spread between LIBOR and fed funds futures has shrunk significantly.

Additionally, there has been progress in the asset-backed commercial paper (ABCP) market. ABCP markets are important vehicles for financing economic activity and enhancing liquidity in the broader capital markets. It is encouraging that many bank-sponsored structured investment vehicles (SIVs) have been moved on balance sheet and de-levered.

Non-bank-owned SIVs have sold assets, allowed assets to mature without reinvesting, secured other liquidity sources or restructured. Thus, outstanding SIV assets have been steadily reduced from a \$400 billion summer peak to less than \$150 billion as of early December. Although this orderly unwind of SIVs is a positive development, challenges remain in the ABCP market.

Markets will benefit from continued short-term credit market improvements in ABCP and other structured products. For this reason, the Treasury Department has focused on this market for many months. In December, I was pleased that several institutions announced a mechanism to provide additional liquidity and price discovery for the ABCP market if participants decide it is necessary.

Throughout this period of readjustment, Treasury's primary focus has been to facilitate improvement in the financial markets in an attempt to minimize spillover effects to the real economy.

I have great confidence in our markets. They have weathered similar stressful periods in the past – whether it was the Savings & Loan crisis, Latin American and Asian market turbulence or the tech bubble of the late 1990s. The private and public sectors responded and worked through these difficult periods. Markets recovered then, and they will again.

Concurrently, we are also seeking to better understand the causes of current credit market turmoil. We are still learning but we recognize some clear lessons already. We know that contributing factors included an abundant supply of easy credit, and a decline in lending standards in mortgage origination and other areas. Complex and opaque financial instruments and structures, such as the use of conduits and SIVs contributed, as did investor practices and rating agency issues.

Through the President's Working Group on Financial Markets, we are evaluating a number of the policy issues, including securitization – particularly accounting, valuation and investor practices – credit rating agencies, risk management and Over-the-Counter (OTC) market infrastructure.

Our most immediate goal is to minimize the impact on the real economy. At the same time, we recognize the importance of addressing these policy issues, and we are. This will require patience as we thoughtfully evaluate next steps. Working through the current situation and getting the policy right is more important than getting the policy announced quickly.

### **U.S. Economy**

Looking across the entire economic landscape, the housing downturn and credit disruption will, as I have said for some time, weigh on our economy and impose a penalty on our economic growth. We saw effects of this in last Friday's report of slower job growth and higher unemployment in December. It will take additional time for markets to regain confidence. We will likely have further indications of slower growth in the weeks and months ahead. The overhang of unsold houses will contribute to a prolonged adjustment, and poses by far the biggest downside risk.

At the same time, despite the housing downturn, credit market disruption and higher energy prices, we experienced nearly 5 percent GDP growth in the third quarter of last year. Consumer and business spending remained solid through the fall, and a strong global economy is boosting U.S. exports. Moreover, core inflation remains contained and historically high tax receipts have reduced the federal deficit. While growth looks to have slowed considerably in the last part of 2007, our economy remains resilient and I expect it to continue to grow.

Again, let me be clear that no single policy or action will undo the excesses of the last few years. President Bush and his Administration recognize the risks we face, and the primary importance of keeping the economy as strong as possible as we weather this housing correction.

We will remain vigilant and I look forward to providing timely updates as we move through this period. Thank you.