U.S. Treasury Department Office of Public Affairs

Remarks by Treasury Under Secretary for International Affairs David H. McCormick at Future of Consumer Payments Conference

Washington, DC – Good afternoon. Thank you for that kind introduction, Martin. And thanks to you, to Bob and to Ken Chenault for the invitation to be here today. I am pleased to join with you for this conference on "the quiet revolution in money," the implications for our citizens, our economy, and financial system of the dramatic change in consumer payments.

I'd like to begin by passing along the regrets of Secretary Paulson who is focused today on market developments and has asked me to speak on his behalf.

Financial Markets

I will begin my remarks on a broader issue. As you know, we are going through a difficult period in our financial markets right now as we work through past excesses. After years of unsustainable home price appreciation, we are undergoing a necessary, difficult, and prolonged housing correction. In addition, 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.

We are working to minimize the impact of the housing correction on the rest of the economy, but we do not want to impede its progress --- because the sooner we turn the corner on housing, the sooner we will see home values stabilize, the sooner we will see more people buying homes, and the sooner housing will again contribute to economic growth. Still, it will take time to work through these stresses. Progress will not come in a straight line, and there will be bumps in the road as we make progress. The events of the last few weeks are evidence of this and are important and necessary steps to work through the uncertainty and turmoil in our markets and minimize their impact on the rest of the economy.

This past weekend, Secretary Paulson and the Treasury team worked with the Federal Reserve and the Securities and Exchange Commission (SEC) to convene financial institution leaders from around the world to discuss particular areas of market weakness and how to work through managing the broader impact of those issues on financial market stability. The weekend culminated with a series of significant events. To mitigate disruption surrounding the bankruptcy of Lehman Brothers, the SEC, the Federal Reserve, and major global financial institutions each took a series of extraordinary steps.

The Federal Reserve has broadened the eligible collateral of certain lending facilities, and the SEC has taken steps to protect customer accounts at Lehman Brothers. Moreover, in

an important show of leadership, major market participants have stepped up to their responsibility to support stable and orderly markets as well. The extraordinary commitments will be critical to facilitating liquid, smooth functioning markets and addressing potential credit concerns.

This past weekend, regulators and market participants mitigated the systemic risk that might have otherwise occurred due to the bankruptcy of the fourth largest U.S. investment bank. And as Secretary Paulson said yesterday, while what's happening is not easy -- and significant challenges remain -- the American people can remain confident in the soundness and resilience of our banking and financial system.

Healthy capital markets are the backbone of a vibrant U.S. economy, and they are critical to the well-being of our families. Capital market stress continues to weigh on our economy, but the housing correction is at the root of the challenges facing our financial institutions and our markets. These factors, along with high energy prices, present ongoing challenges. But we are also confident in the resilience and diversity of the U.S. economy and that we will move through these difficulties, just as we have moved through difficult periods in the past. We expect our economy to continue growing this year, although at a moderate pace as these challenges persist.

U.S. Economy and Housing Market

The current soft labor market reflects our slow rate of growth. The unemployment rate increased to 6.1 percent in August, and although Americans' average wages have increased, higher food and energy prices are absorbing those gains.

Energy prices, while still much higher than a year ago, have declined recently. A gallon of regular gas costs about 30 cents less now than in early summer, even in the face of hurricane-related disruptions, which should help relieve some pressure on family finances and business costs.

Clearly, the economic slowdown is hurting American families. The stimulus package proposed by President Bush and passed by Congress earlier this year has provided some relief --- $93 billion in payments have been sent to American households. We saw the impact of this in the second quarter, when the U.S economy expanded at a solid 3.3 percent, supported by increases in trade and consumer spending. And we expect that the stimulus package will continue to boost growth above where it would have been otherwise through the end of the year.

As Secretary Hank Paulson, Chairman Ben Bernanke, and others have said from the outset of these challenges over a year ago, housing poses the biggest downside risk to our economy and continues to be a drag on growth. Yet, there are signs of progress. Fewer new homes are being built, and this means the total number of new single-family homes on the market is down 27 percent from a July 2006 peak. And though it is early, new and existing home sales show tentative signs of stabilizing.

Treasury has worked closely with lenders and key industry participants on an aggressive strategy to do everything possible to help avoid preventable foreclosures. We supported the creation of the HOPE NOW Alliance last October, which to date has helped over 2 million homeowners avoid foreclosure through loan workouts.

But we have much further to go. Turning the corner on the housing correction requires that prices stabilize and affordable mortgage financing be available so buyers can return to the market. And so while we are working to stabilize capital markets, it is also vital that the Government Sponsored Enterprises (GSEs) Fannie Mae and Freddie Mac continue to play their role in supporting the housing market.

Actions to Stabilize Housing and Financial Markets

The GSEs have become the largest sources of mortgage finance, touching 70 percent of mortgages originated in the first quarter. Their continued activity is critical to turning the corner on the housing situation and removing the underlying uncertainty in our financial markets and financial institutions.

Not surprisingly, the prolonged housing correction weakened the financial condition of both of these enterprises, and they faced a significant loss of confidence among investors. Fannie Mae and Freddie Mac are so large and so interwoven in our financial system that if either of them were to fail, it would be harder for Americans to get home loans, auto loans and other consumer credit. Business finance would be even harder to obtain, constraining job creation and our overall economic growth.

And so in July, Secretary Paulson asked the Congress for extraordinary authorities with regard to Fannie Mae and Freddie Mac in order to support our housing markets and the stability of our financial markets more broadly. Congress acted promptly and decisively. In the days and weeks that followed, the Federal Housing Finance Agency (FHFA) Director Lockhart, Fed Chairman Bernanke, and Secretary Paulson conducted a rigorous analysis of the situation, which led to the unpleasant but necessary decision to utilize these authorities. We had no choice but to act. Waiting for a precipitating event would have been too late.

We acted decisively to avert instability in our markets that would have harmed the overall financial well-being of Americans, and we acted to support the availability of mortgage credit and protect taxpayers to the maximum extent possible.

First, Treasury and the GSEs, under the control of the conservator FHFA, have established contractual Preferred Stock Purchase Agreements. Under these agreements, Treasury has committed up to $100 billion per institution to ensure that each GSE maintains a positive net worth. In return, to protect the taxpayers to the maximum extent, Treasury has received from the companies $1 billion in senior preferred stock and warrants providing an option to purchase up to 79 percent of the companies’ outstanding shares at a nominal price.

These Preferred Stock Purchase Agreements were made necessary by the ambiguities in the GSE Congressional charters, which have been perceived to indicate government support for agency debt. Our nation has tolerated these ambiguities for too long, and as a result, central banks and investors throughout the United States and around the world who hold GSE debt and MBS believe them to be virtually risk-free. Because the U.S. Government created these ambiguities, we have a responsibility to both avert and ultimately address the systemic risk now posed by the scale and breadth of the holdings of GSE debt and agency MBS.

The terms of these purchase agreements provide significant taxpayer protection. The existing shareholders of the GSEs will lose 100 percent of their investment before the American taxpayers lose a penny.

Second, Treasury has established a new, secured credit facility for Fannie Mae, Freddie Mac, and the Federal Home Loan Bank to fund, if necessary, their regular business activities in the capital markets. This facility is intended to serve purely as an ultimate liquidity backstop, and will be available until the temporary authority expires in December 2009.

And third, to further support the availability of mortgage financing for millions of Americans, Treasury is initiating a temporary program to purchase mortgage-backed securities issued by the GSEs. This will provide additional capital to the mortgage marketplace. There is no reason to expect taxpayer losses from this program, which will also expire in December 2009.

Together, Treasury and FHFA steps are the best means of protecting taxpayers and our markets from the systemic risk posed by the current financial condition of the GSEs and to provide support for these enterprises' current, important role in the housing market.

At the same time, we face fundamental policy decisions about the role and structure of these enterprises. Policymakers must resolve the inherent conflict in their charter that requires they serve both the interests of private investors and a public mission. Our recent actions have afforded a "time out" – providing the stability, time, and flexibility for Congress and the current and the next Administration to address both the need for affordable mortgage finance and the systemic risk presented by the scale and breadth of the existing GSE holdings. We will make a grave error if we don't use this time to permanently address these structural issues.

Electronic Payments

As we work through these financial and housing market issues, let me speak for a moment on one of the most constant aspects of our economic life -- change ---- and how this is evidenced in the topic of today's conference – consumer payments. This is evident in how we pay for our groceries, our bills, our clothes, and our taxes. Between

2003 and 2006, Americans wrote 7 billion fewer checks and made 19 billion more electronic payments.

Treasury is interested in this transformation on a macroeconomic level --- one study estimates that growth in electronic payments added 0.5 percent to real GDP per year in each of the last 20 years, or the equivalent of 1.3 million new jobs. The same study estimated that the increase in efficiency and velocity of electronic over paper-based payments saved at least 1 percent of GDP, or about $60 billion, annually.

We have a long-standing strategic vision, which is becoming a reality thanks to years of hard work by our many professionals, to become an all-electronic Treasury. To put the scale of this in perspective, Treasury manages a daily cash flow of nearly $60 billion.

Every year, we collect more than $3.1 trillion and disburse nearly one billion payments worth nearly $1.6 trillion. In 1996, 56 percent of federal benefit payments were made by electronic payment; today it's 82 percent.

Electronic payments provide real savings to the U.S. taxpayer. It costs Treasury approximately 10 cents to issue an electronic payment, versus 98 cents to issue a check --- when you consider the millions of annual federal payments made, the savings are substantial. There are savings on the collection side as well --- processing a taxpayer's check costs $1.30 versus 73 cents for an electronic payment.

We are encouraging more individuals to opt for direct deposit for their social security payments, because nine times out of ten when there's a problem with a payment, it's with a paper check.

Treasury also works closely with financial regulatory authorities on issues of infrastructure and data integrity so that consumers can trust that their information will be protected. Through a public-private partnership, we work with the intelligence community, law enforcement, and financial institutions to provide the latest information regarding cyber vulnerabilities and risk mitigation tactics.

Conclusion

Just as you are looking forward, so are we. It will take time to work through the excesses that were built up over a number of years, and the Administration and financial regulators remain vigilant. We are focused on measures and policies that address our short-term economic challenges and build a stronger long-term foundation. And the American economy has a record of innovation and adjustment --- to challenges, to risks, to changing demands --- second to none. That is the underlying spirit that has made the United States the economic envy of the world – even as we manage through our current problems --- and it will keep us so in the years ahead. Thank you.