THE BROOKINGS INSTITUTION

THE FUTURE OF CONSUMER PAYMENTS: AN INITIATIVE ON BUSINESS AND PUBLIC POLICY DISCUSSION

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P R O C E E D I N G S

MR. BAILY: As you know, the times are a little troubled and financial markets are being a little rocked. Secretary Paulson was not able to come today. I know he was – sent his regrets, and also, more to the point, he sent David McCormick, his Under Secretary for International Affairs, and we are very pleased, thank you so much for filling in.

David McCormick was sworn in as Under Secretary in August of 2007, and he has been a principal advisor to the Secretary on international economic issues. Before being in this role, he was Deputy National Security Advisor to the President responsible for U.S. international economic policy, and also the President's personal representative to the group of the – the G8 group.

He also served as Under Secretary of Commerce for Export Administration. And early in his career, he was President and CEO of Free Markets and President of Ariba. So he has had both a lot of government and a lot of business experience, and we are delighted to have you come talk to us. Thank you so much.

Oh, sorry, there's one more thing I wanted to say. The Under Secretary has – we would like the questions to come from the conference participants, not from the press. You will have – obviously, you have other opportunities to question. Thank you.

MR. McCORMICK: Great, thank you. Good afternoon, thanks for that kind introduction, Martin. And thanks to Bob also for the kind invitation to be here today. I'm pleased to be able to join you for the conference on the quiet revolution of money, the implications for our citizens, our economy and financial system of the dramatic changes in consumer payments.

Let me begin by passing along the regrets of Secretary Paulson. He's sorry he couldn't be here. He is focused on market developments today, and he asked me this morning to speak on his behalf.

And as I was walking in this morning, I was reminded of my in-laws recently coming for a visit. We have young kids; whenever the in-laws come, they're always very excited and waiting because they bring presents with them whenever they come, and I made the mistake the other night of coming home early, they thought I was the in-laws with the presents, and when I walked in, the look of disappointment was palpable, and I felt a little bit the same way when I walked in today. I'm not Hank Paulson and I don't have presents, but I'm going to try to do my best today to share with you some thoughts on recent market developments. As you know, we're going through a very difficult period in our financial markets 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, flax lending standards, and aggressive appetite for higher yields extended beyond the U.S. housing market and have impacted our capital markets more broadly and globally.

We're working to minimize the impact of the housing correction on the rest of the economy, but we don't want to impede its progress, because the sooner we turn the corner on housing, the sooner we will see house prices stabilize, the sooner we will see more people buying homes, and the sooner housing will, again, contribute to economic growth.

Still, it will take some time to work through these stresses. Progress, as we've already seen, will not come in a straight line, and there will be bumps along the road as we make progress. The events of the last few weeks are evidence and are important and necessary steps to work through the uncertainty and turmoil in our markets and to 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 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, something we all have a stake in.

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 set of necessary and 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 their responsibility to support stable and orderly markets. The extraordinary commitments will be critical to facilitating liquid, smooth, functioning markets and to addressing potential credit concerns. This past weekend's regulators and market participants mitigated the systemic risk that might otherwise have occurred due to the bankruptcy of the fourth largest U.S. investment bank. And as Secretary Paulson said publicly 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 financial markets.

These factors, along with high energy prices, present ongoing challenges. But we're also confident, we're 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 these difficult periods in the past. We expect our economy to continue growing this year, although at a moderate pace, as these challenges persist. 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 higher energy prices are absorbing those gains. Energy prices, still much higher than a year ago, have declined recently. A gallon of regular gas cost about 30 cents less than it did earlier this summer, even in the face of hurricane related disruptions, and this should help relieve some pressure on family finances and business costs.

But 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. Ninety-three billion dollars in payments has been sent to American households. And 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 increases in 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 this year.

Secretary Hank Paulson, Chairman Bernanke and others have said from the outset over the last year, these challenges posed by housing are the biggest downsize risk to our economy and continue to drag in our 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 although it's 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 two million home owners avoid foreclosure through loan work-outs. 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's also vital that government sponsored enterprises, the GSE's, Fannie Mae and Freddie Mac, continue to play their important role in supporting the housing market.

The GSE's have become the largest source of mortgage finance, touching 70 percent of all 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 our financial institutions. Not surprisingly, the prolonged housing correction weakens 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 forms of 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, the new GSE regulator, Director Lockhart, Fed Chairman Bernanke, and Secretary Paulson conducted a rigorous analysis of the situation, which led to an unpleasant, but necessary decision to utilize these authorities. We had no choice but to act. Waiting for the precipitating event would have been far 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 to protect tax payers to the maximum extent possible.

First, treasuries in the GSE's, under the control of a conservator, FHFA, the new regulator, have established contractual preferred stock purchase agreements. Under these agreements, the Treasury has committed up to $100 billion per institution to ensure that each GSE maintains a positive net worth.

In return, to protect the tax payers to the maximum extent, Treasury has received from the company's $1 billion worth of senior preferred stock and warrants providing an option to purchase up to 79 percent of the company's 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 our agency.

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 mortgage backed securities 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 by the breadth of the holdings of GSE debt and agency mortgage backed securities.

The terms of these purchase agreements provide significant tax payer protection. The existing shareholders of the GSE's will lose 100 percent of their investment before the American tax payers 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 purely to serve as an ultimate liquidity backstop that will be available until the temporary authority provided by Congress expires at the end of 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 GSE's. This will provide additional capital to the mortgage marketplace. And there's no reason to expect taxpayer losses from this program, which will also expire in December of 2009. Together, Treasury and FHFA steps are the best means for protecting tax payers and our markets from the systemic risk posed by the current financial condition of the GSE's, and to provide the support for these enterprises, currently an important role in the housing market.

At the same time, we face some very fundamental decisions about the role and the structure of these enterprises in the future. Policymakers must resolve the inherent conflict in their charter. That requires both they serve the interest of private investors and the public mission.

Our recent actions have afforded a time-out, a time-out that provides the stability, time, and flexibility for Congress and the current and the next administration to address both the needs for affordable mortgage finance and the systemic risk presented by the scale and breath of existing GSE holdings. We will make a grave error if we don't use this time to permanently address these structural issues.

Now, 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 our groceries, our bills, our clothes, and our taxes. And between 2003 and 2006, Americans wrote seven billion fewer checks and made 19 billion more electronic payments.

Treasury is very interested in this transformation on a macroeconomic level. One study estimates, for example, that the growth in electronic payments added .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 one 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 many Treasury professionals to become an all-electronic Treasury Department. To put the scale of this in perspective, Treasury manages a daily cash flow of nearly $60 billion, and every year we collect more than 3.1 trillion and disburse nearly one billion payments worth 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. tax payer. It costs Treasury approximately ten cents to issue an electronic payment versus 98 cents to issue a check. And when you consider the millions of annual federal payments made, the savings are substantial.

And there are savings also on the collection side. Processing a tax payer's check cost $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 the payment, it's with a paper check.

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

So just as all of you and this conference are looking forward, so are we. It will take time to work through the excesses that have been built up over a number of years, and the administration and the financial regulators remain vigilant. We are focused on measures and policies that address our short-term economic challenges and build a stronger, longer-term foundation. And the American economy has a record of innovation

and adjustment to challenges, to risk, and to changing demands that is 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's this spirit that will keep us so in the years ahead. Thanks very much for your time, and I'd be happy to take a few questions. Yes, please.

SPEAKER: There are two – Dick – from MIT. There are two basic ways to – obvious ways to –

DR. BAILY: Can you pause for a second while the mic comes down?

SPEAKER: I was trying to shout. There are two basic ways to resolve the ambiguity that you mention; one is to make them private entities, and one is to make them government agencies. Can you say a little bit about the thinking within Treasury about the pluses and minuses of those two routes?

MR. McCORMICK: Yeah; thank you for that question. I think given where we were in terms of time and where we were in terms of the financial market, Secretary Paulson thought it was very important to create a window, a window of opportunity. This, as you may know, is an issue that's not without controversy, and it's going to be very important

that a consensus is built among leaders in this administration, but also the next administration, as well as in Congress, and so we purposely not laid out a perspective on what the future model might be.

We have purposely said, I think with a fair amount of evidence, that the current model is not sustainable, and so what we've tried to do is, in a very agnostic and open-ended way, create a framework for that decision-making process, that consensus process that ultimately lead to a solution that will have the right balance in terms of some of the challenges that I mentioned.

So I really can't comment on Treasury's position, but I think having that window of opportunity is very important, and I think urgency around resolving some of these fundamental questions over the next 18 months is really a priority.

DR. LITAN: I apologize, this might be a stupid question, but I'm aware that, you know, that Treasury is going to provide financing to Fannie Mae and also going to purchase the mortgage backed securities, where does it get the money? I thought there was a federal debt limit, and the Treasury is not the fed; how does it pay for this?

MR. McCORMICK: Well, the statute that Congress passed required that the Secretary exercise his authorities within the debt limit. And so the funding would be provided by issuing treasuries, which then

could be allocated as needed to the MBS purchase program or potentially the stock purchase program.

As you probably know, the stock purchase program does not have a specific target or number that it's based on, a specific set of conditions with each institution that ensures a positive net worth. So on an ongoing basis, the Treasury would provide the necessary equity to ensure those conditions remain.

DR. BAILY: Can I abuse my position and ask you a question? In the blueprint of financial regulatory reform, you pointed to some of the advantages of the UK system of principals based regulation, you also pointed to Australia. Given that those countries are now experiencing some difficulties of their own, I wonder if you've had any sort of further reflections or second thoughts about the lessons from those countries?

MR. McCORMICK: You know, I don't think I could call on any specific lessons from either. I think what we certainly can say with some confidence is that the blueprint was a very conscience and focused straw man of the outlines of a potential regulatory structure which address some of the underlying holes and conflicts within our current system, and I think that what we've seen develop over the last 12 months has only reaffirmed the importance of moving expeditiously on that new regulatory

framework and highlighted some of the challenges in the current regulatory structure.

So in many ways, for example, the authorities that Secretary Paulson requested to include a much strengthened GSE regulator were, in part, a reflection of the current market conditions and challenges, but also a reflection of some of the current shortcomings in the existing regulatory model. So I think the blueprint continues to be a very productive starting point for the discussion.

DR. BAILY: Okay.

MR. ECONOMIDES: I'm Nicholas Economides from New York University. Given the situation, how difficult it is right now, I think the Treasury did the best it could. But the crisis at the sector, for example, at Lehman, was well known for many months, almost a year. And I wonder, you know, why there were no measures to try to figure it out, to try to figure a solution earlier, because when you gave people two days to look at the books, they weren't so – they couldn't really do the job in a couple of days. If they were given a week, maybe they could, and maybe Lehman would be still around.

I wonder what you think of, in general, of the idea of trying to take steps to avoid the crisis rather than, you know, trying to deal with the crisis when it's at its full strength?

MR. McCORMICK: Thanks for the question. I think, just to go back to something I said in my remarks, which is the context I think with all of these specific institutions and their challenges needs to be viewed within is the significant decline in the housing market. So that is at the root of the challenges that we see across institutions, the challenges we see within the financial markets, that combined with a number of the excesses that I mentioned earlier, so it's not solely that, but certainly that is at the heart of this. And as I think Secretary Paulson and the other regulators think through the policy response, they're very mindfully trying to balance two very significant objectives.

One, as in the case of the GSE's, was to promote and take steps to reinforce the importance of systemic stability and ensuring that we are addressing risk to that; and the second is ensuring that the underlying focus of institutions and market participants and market discipline remains intact, and that's I think an important balancing act that this group of policy makers has tried to strike throughout recent events and I suspect will be the focus on going forward.

So I don't want to refer and talk about any specific institution, but I think that's the framework and the mind set that is the basis for how we've thought about these issues.

DR. BAILY: Yes, a question in the back.

MR. YU: Thank you – with China Press. In a context of the soft credit crisis and U.S. government taking over the Freddie Mac and Fannie Mae, when you talk to Chinese official in the future, how will you persuade them to liberalize the financial market more quickly and not to interfere in the market? Thank you.

MR. McCORMICK: Well, you know, I think as a starting point, we have had a great deal of focus on ongoing communications with key counterparts around the world, both in industrialized economies and emerging economies because our financial markets are more interdependent now than ever.

So what is happening here really does have implications for most major economies around the world and vice-versa. So I think I can say with some confidence that the key policymakers really do have a very good sense of the thought process and ultimately the actions we've taken and why they have been taken, and I think, for the most part, there has been a very favorable response to those steps.

In terms of justifying or laying the ground work for how we've thought about this process, I think I'd go back to my earlier point, which is, we have thought about the policy response within the context of systemic ability and systemic risk, as well as market discipline, and trying to strike a balance where we are ensuring that market participants feel the

appropriate market discipline, but also taking steps to avoid systemic risk when we view a risk to the financial system. And so without getting into a case by case discussion of that, I think that's the overarching framework and that's the way policy makers have tried to think about events over the last 12 months. I think I'll take one more question, if you don't mind.

SPEAKER: Thank you. Whenever America is faced with any sort of recessionary activity, we've always relied on the resilience of the American consumer. But the American consumer has never really been faced with such high commodity prices or such a housing slope of this magnitude. So in light of all this, what exactly inspires your confidence or your optimism?

MR. McCORMICK: Well, you know, what I've tried to describe here is what I hope was a balanced presentation of some of the challenges we have, but also some of the underlying dynamics in the economy. I mean I think there's a couple things that I'd point to; one is that there is I think a pretty well demonstrated track record of innovation, challenges that, in some cases, have arisen in the past due to both innovation and excess, and a very deliberate and successful ability to deal with those challenges and emerge stronger by industry and within the global economy. So we've been here before in different contexts, and I think we have emerged as a stronger economy in the past, and that

innovation ultimately has been very beneficial to the overall strength of the economy.

If you look at what's happened over the last two or three quarters, I think it's been very interesting to see that the economy has continued to grow when I think many expected that it wouldn't grow, both in the first quarter and the second quarter. As I cited in my remarks, the second quarter was 3.3 percent GDP, which I think probably surpassed just about everybody's expectations. That was driven, in large part, by exports, it was driven, in part, by consumption.

And, you know, I think we continue to see as corporate profits, because so much of them is global, continue to be strong, that there are very positive signs in the U.S. economy despite some very significant challenges on commodity prices and housing and capital markets.

So I think we see both good and bad in the U.S. economy, and I think it's also fair to say there's clearly challenges the remainder of this year and in 2009 that are going to ensure that, if we have positive growth, it's not going to be the kind of growth we'd aspire to. But the economy has been more resilient than many expected.

MR. BAILY: Thank you so much for stepping in.

MR. McCORMICK: Thank you very much.

MR. BAILY: And that concludes our conference. Thank you, everyone, for participating, and the presentations, so thank you very much.

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CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

/s/Carleton J. Anderson, III

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