U.S. DEPARTMENT OF THE TREASURY

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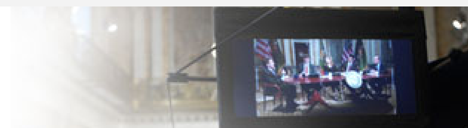

Remarks of Under Secretary Miller at an event hosted by the Bretton Woods Committee, Deloitte, University of Maryland: "Navigating Transformational Change of the Global Financial Landscape: Realizing Systemic Stability, Avoiding Unintended Consequences"

7/26/2012

As prepared for delivery

WASHINGTON - Thank you very much for the invitation to join you today.

Meetings like this are important opportunities for global leaders in the public and private sectors to collaborate and learn from each other. I am joined today by my colleagues from the Financial Stability Oversight Council and the Office of Financial Research. As we work to get the rules of regulatory reform right and to address threats to financial stability, we need broad engagement. Every rule I work on benefits from public input.

Today I want to build on your constructive dialogue by talking about our progress implementing regulatory reform and the challenges that remain, particularly in connection with identifying and addressing risks to financial stability. Then I look forward to answering your questions.

For the last two years, Treasury and financial regulators have been hard at work creating a more resilient financial system. We were given a big assignment, and we have made tremendous progress. Nine out of 10 rules with deadlines before mid-July have been proposed or finalized. New institutions are up and running and already hard at work, including the Consumer Financial Protection Bureau, the Financial Stability Oversight Council, and the Office of Financial Research, or better known to you as the CFPB, the FSOC, and the OFR. The framework of our new system is in place.

Financial reform has significantly improved our ability to monitor and contain risks to financial stability. Financial institutions are much stronger, making them better able to withstand shocks. Increased trading on exchanges and new trade repositories and reporting are bringing transparency to markets. The FSOC and OFR are actively monitoring threats to financial stability and strengthening coordination among regulators. Every day I see more evidence of this progress.

But even with the benefit of these new rules and institutions, we approach the task of identifying and addressing risks to financial stability with humility. In my experience, you are never handed the same script for a financial crisis or shock. The next financial crisis is unlikely to look like the last. Problems can surface in unexpected ways that will challenge even the most sophisticated tools and the smartest regulators.

The reforms we have put in place have made our financial system less vulnerable, but we all have more to do.

PROGRESS

A Strengthening Economy

As a result of this Administration's efforts, we've made considerable progress in repairing the economic damage from the crisis and putting our financial system on sounder footing.

- The U.S. economy is gradually getting stronger. GDP is back to its pre-crisis levels. The private sector has added more than 4.4 million jobs over the last 28 months.
- Not only is credit expanding, but the cost of credit has fallen significantly from the peaks of the crisis. Commercial and industrial lending at banks increased 10 percent in 2011 and increased at an annual rate of 11 percent in the first five months of this year.
- Our national deficit peaked three years ago in 2009, both in dollars and as a share of GDP.

- The government has closed most of the emergency programs put in place during the crisis and recovered most of its financial sector investments. For example, the Troubled Asset Relief Program is expected to cost taxpayers a small fraction of original forecasts. Most of the expected cost will be a result of the support provided to the housing market, which is showing signs of stabilizing.

But challenges remain. Although the U.S. economy is still expanding, the pace of economic growth has slowed during the last two quarters. Headwinds from Europe are partly to blame. In addition, the rise in oil prices earlier this year, the ongoing government spending reduction, and slow rates of growth in income have all adversely affected U.S. growth.

The slowdown in U.S. growth could be exacerbated by uncertainty about fiscal matters. The United States faces unsustainable fiscal deficits. To restore fiscal responsibility, policy makers must take action but there is significant uncertainty about the shape of the reforms to tax policy and spending to come.

Further, global economic growth has slowed in recent months and forecasts for future growth have been reduced. The continuing crisis in Europe is the key factor behind the slowdown. Growth in China, India, Brazil and other large emerging economies has also slowed as a result of weaker external demand combined with the effects of past policy tightening and an increase in risk aversion.

In summary, U.S. economic activity has moderated in recent months, with growth held back by a number of temporary factors. Looking ahead, the fundamentals for the private sector are generally supportive, and the housing market appears to be stabilizing. We continue to expect growth to strengthen gradually going forward.

Financial Regulatory Reform: Stronger Financial Institutions and Financial Markets

Despite these challenges, we have remained focused on the need to complete financial regulatory reform, which we believe is a necessary foundation for sustained economic growth and financial stability. More resilient financial institutions and markets are less vulnerable to financial shocks and less likely to propagate risk.

I want to highlight a few specific areas where we believe reform is building stronger institutions and markets.

- More capital: We have forced banks to substantially increase the amount of capital they hold, so that they are able to provide credit to the economy and absorb losses in the future. Banks have added over $400 billion of high-quality capital, up 70 percent from three years ago.

- Reduced leverage: Overall leverage in the financial system has been reduced significantly. Financial sector debt has dropped by more than $3 trillion since the crisis, and household debt is down $900 billion.

- More stable funding models: Banks are funding themselves more conservatively, relying less on riskier short-term funding. As we learned during the financial crisis, reliance on short-term funding can quickly threaten a troubled firm. In addition, the use of the “shadow banking system”—a key source of financial stress during the crisis—has decreased substantially.

- Reducing risk: Regulators are limiting risk-taking at the largest financial institutions, recognizing the outsized threats they can pose in times of market stress. Federal regulators have imposed tougher standards on the largest banks, and we can now subject the largest non-banks to enhanced supervision and prudential standards. Eight large financial market utilities, such as clearinghouses, will now be subject to heightened risk management standards. High-risk trading strategies and investments at depository institutions will be more constrained by the Volcker Rule.

- Limiting contagion: Regulators are putting in place the framework for the “orderly liquidation authority,” a mechanism to unwind large, complex financial companies. Through this authority, which was sorely lacking during the crisis, we are protecting taxpayers and preserving financial stability in the event of a failure of a large financial firm. In addition, nine of the largest bank holding companies recently submitted their “living wills,” providing contingency plans for an orderly bankruptcy.

And finally,

- More transparent derivatives markets: The SEC and CFTC are putting in place a new framework for derivatives oversight, providing new safeguards for market participants. Following the adoption of swaps definitions this month, more than 20 key rulemakings can now move forward. This marks a major milestone in the implementation of derivatives reforms. As swaps move onto transparent trading venues and are centrally cleared, regulators and market participants will have much more insight into these exposures and potential risks in the derivatives markets.

Financial Regulatory Reform: Identifying and Addressing Risks to Financial Stability

FSOC

We are also building new institutions. The Financial Stability Oversight Council and the Office of Financial Research, both created by the Dodd-Frank Act, are actively monitoring and mitigating threats to the stability of the financial system.

Since its first meeting in October 2010, the FSOC has met regularly to discuss market developments and potential threats to stability. Most recently, the FSOC has focused on the situation in Europe, our housing market, and the lessons to be drawn from recent errors in

risk management at several major financial institutions, including the failure of MF Global and the trading losses at JPMorgan Chase.

One of the duties of the FSOC is to facilitate information-sharing and coordination among its member agencies. In the run-up to the crisis, fragmentation in our regulatory system allowed many risks to slip through the cracks. As Chair of the FSOC, Secretary Geithner continues to make it a priority that the work of the regulators is well-coordinated.

Last week, the FSOC released its second annual report, which includes a review of significant financial market and regulatory developments, potential emerging threats to financial stability, and recommendations to strengthen the financial system. As Under Secretary, I spend time working with the FSOC staff and agencies, and I can tell you that generating the report is an extraordinarily useful and demanding process.

OFR

The Dodd-Frank Act also established the OFR to collect and standardize financial data, perform essential research, and develop new tools for measuring and monitoring risk. In its first annual report, also released last week, the OFR noted that gaps in financial data and in our understanding of the financial system still represent risks.

Currently, the OFR is working on a number of projects with the FSOC, including developing metrics for and indicators of financial stability. The OFR is also providing analysis related to the FSOC's evaluation of nonbank financial companies for potential designation for Federal Reserve supervision and enhanced prudential standards.

One ongoing priority is establishing a legal entity identifier (LEI), or unique, global standard for identifying parties to financial transactions. The LEI can improve the quality of financial data, especially in identifying the largest and most complex firms' exposures, and thus help to detect a buildup of risk in the system.

Current Threats to Financial Stability

So where do we see threats to financial stability today? I would like to highlight just a couple of areas raised in the FSOC's report.

Risks in Wholesale Funding Markets

The FSOC recommended a set of reforms to address structural vulnerabilities, particularly in wholesale short-term funding markets such as money market funds and the tri-party repurchase agreement market. As we saw during the financial crisis, these sources of funding were particularly vulnerable to disruption, which quickly spread through the markets.

Firms should closely monitor their reliance on wholesale short-term funding. Maturity transformation, which entails funding longer-term assets with short-term debt, is a core function of the financial system, but overreliance can create additional vulnerabilities in stressed environments.

The SEC adopted a number of reforms to the regulation of money market funds in 2010 that provided additional safeguards. However, money market funds continue to lack a mechanism to absorb a sudden loss in value of a portfolio security, and investors have an incentive to redeem at the first indication of any perceived threat to the value or liquidity of the fund, potentially disadvantaging remaining shareholders. The FSOC recommends that the SEC publish structural reform options for public comment and ultimately adopt additional reforms.

In the tri-party repo markets, the FSOC supports additional steps toward reducing intraday credit exposure between clearing banks and market participants. In addition, the FSOC recommends that regulators and industry participants work together to better define standards for collateral management in the tri-party repo market, particularly for lenders (such as money market funds) that have certain restrictions on the instruments that they can hold.

Risk Management and Supervisory Attention

The FSOC also recommends that financial institutions establish strong risk management and reporting structures to help ensure that risks are evaluated independently and at appropriately senior levels. This means prudent risk management practices for complex trading strategies. Financial institutions also need to maintain disciplined credit underwriting standards and vet emerging financial products.

The report notes, for example, that high-speed trading is an area where increased speed and automation of trade execution may require a parallel increase in trading risk management and controls. The Flash Crash in May 2010 highlighted system-wide vulnerabilities in the equities and futures markets. Since then, the regulators have taken a number of steps to address potential risks.

For example, the SEC put in place a dynamic single-stock circuit breaker called the limit up/limit down rule. In addition, they recently approved a plan to create a consolidated audit trail that would allow regulators to monitor and respond to events in the equity markets in a more robust and timely manner. However, more work needs to be done as financial markets evolve and high speed trading becomes more prevalent. We must continue to track developments and analyze risks with real-time policy responses.

GOING FORWARD: PARTNERING IN FINANCIAL STABILITY

As you can see, reform is improving the way we identify threats to financial stability. We have made tremendous strides. Our financial system is stronger and safer. A number of important reforms are in place. The FSOC and the OFR are on the job.

While the government will continue to work diligently to strengthen the financial system against potential threats, we cannot do this alone. The financial services industry must become a stronger partner in both regulatory reform and initiatives aimed at financial stability.

During the financial crisis, some in the private sector acted irresponsibly. Risk built up where we did not have visibility or the tools to contain it. Taking risk is an important engine of financial returns, but it must be managed.

I would like to share a few suggestions on how the private sector can do its part.

First of all, reward people for both realizing profit and constraining risk. A culture that primarily rewards short-term profits should be set aside in favor of one that strives for long-term gains and stability.

Implement best-in-class risk management practices.

- Run rigorous stress tests and scenario analyses. Consider how investments and activities can have unintended consequences for financial markets.
- Increase transparency in financial reporting beyond existing requirements.
- Empower, recognize, and reward effective risk managers. Signal to the organization that risk management is valued.
- Participate in industry forums to share lessons learned and develop best practices.

These initiatives are not only good for the financial system but also benefit financial firms by promoting client, customer, bondholder, and stockholder confidence.

I would also add that the relentless efforts of some in the financial industry to undermine, work around, or stall reform are short-sighted. I strongly believe that such efforts will further undermine trust in financial firms – trust that is essential for the functioning of the industry.

Regulatory reform benefits, not disadvantages, financial firms.

We look forward to continued engagement to make our financial system more vibrant and safe. To achieve that, the financial services industry and the government each have a lot of work to do. We share responsibility for protecting Americans from the extraordinary damage – lost jobs, lost homes, lost businesses, and lost wealth – that a financial crisis can cause. Americans deserve a financial system that is the foundation for sustained growth and economic security.

Thank you.

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