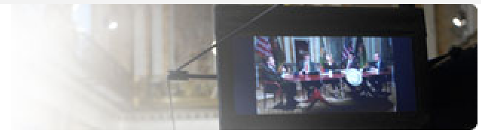
U.S. DEPARTMENT OF THE TREASURY

Press Center



Remarks of Under Secretary Nathan Sheets on Systemic Risk, Regulation, and Market-Based Finance at the NYU Money Marketeers Event

7/23/2015

As prepared for delivery

I thank the Money Marketeers for hosting me today. I'd like to discuss a critical element of the global financial reform agenda: Identifying, assessing, and mitigating systemic risks that may arise in the non-bank financial sector. The non-bank sector is a large and vibrant part of many countries' financial systems, but some segments of it are still not fully understood. Our limited understanding of the interconnectedness of non-bank finance with the rest of the financial system, and a corresponding lack of prudential oversight, were crucial deficits in the run-up to the global financial crisis. These blind spots hampered policymakers' ability to evaluate and respond to the systemic vulnerabilities and stresses that arose.

The G-20 recognized this problem in 2009, when it called for "all systemically important financial institutions, markets, and instruments to be subject to an appropriate degree of regulation and oversight."

I want to delve into this G-20 mandate today. To do so, I'll review some broad trends and developments in the non-bank sector around the world, discuss two approaches for thinking about potential systemic risks arising from non-bank finance, and raise some critical policy questions. I will then reflect on the way forward for international policy, particularly on how to mitigate these risks through regulation and oversight.

1. Defining Market-Based Finance

Financial intermediation outside of the traditional banking sector has generally been labeled "shadow banking." This phrase was not intended to be pejorative; rather, it sought to capture the idea that certain activities replicated the same functions and kinds of risks as banking – issuing short-term safe liabilities to finance longer-term riskier assets – without the prudential oversight or regulation applied to banks. Another distinguishing feature – at least in the United States – is that commercial banks have regular access to the central bank's lender of last resort funding.

We became acutely aware of the nature of the risks facing the non-bank sector during the global financial crisis. There were runs – much like traditional bank runs in previous crises – on the short-term liabilities of non-bank financial entities, including money-market funds and broker-dealers. In the aftermath of the crisis, we have dedicated substantial resources to assessing this part of the financial system, and our language ought to reflect this fact. "Market-based finance" is an apt description of non-bank credit intermediation, in all its forms and varieties, and policymakers both here and abroad are increasingly using this term to describe shadow banking activity.

Let's define market-based finance broadly as financial activities involving maturity, credit, or liquidity transformation, and/or leverage which are conducted by entities that are not prudentially regulated. Market-based finance may involve issuing liabilities that mature or can be redeemed rapidly, similar to banks' deposit liabilities. The proceeds from these transactions may, in turn, be used to invest in risky assets. Together these activities create mismatches between assets and liabilities similar to traditional bank finance, and are vulnerable to similar kinds of risks. I will argue today that this could give rise to risks that should be carefully identified.

2. Assessing Risks and Benefits

While recognizing that market-based finance does entail risk, I also emphasize that it should not be seen as inherently risky or undesirable. Indeed, market-based finance can provide alternative sources of credit to the economy when traditional bank lending is constrained. This diversity in the financial ecosystem can increase resiliency to shocks and allow the financial system to contribute more consistently to long-run economic growth.

To wit, the ability of the euro area to recover from the post-crisis recession has been dampened by a heavy structural reliance on traditional bank-based credit. Euro-area banks are continuing to work out problem loans and boost their equity capital. Conversely, large market-based finance sectors helped the United States and the United Kingdom recover more quickly from the crisis, by continuing to provide financing while banks rebuilt their stores of equity capital. For this reason, the focus of our reform agenda for non-banks has been on enhancing the sector's contribution to financial stability, while ensuring that it continues to play a vibrant role in financing the economy.

3. The Changing Landscape of Financial Intermediation

Market-based finance is a critical part of the financial system in many advanced and emerging-market economies. At the end of 2013, the last year for which all data are available, the Financial Stability Board (FSB) estimated that assets in the market-based finance sector totaled $35 trillion in a group of 23 large economies. Market-based finance was equivalent to about 60 percent of their combined GDP. To add some texture, let's examine market-based finance in the United States, where the composition has changed notably in recent years, and China, where the size of the sector has grown rapidly.

The United States has a robust market-based finance sector that held assets summing to about 100 percent of GDP in 2013. This ratio rose in the pre-crisis period, but has moved back down in recent years to below pre-crisis levels. The sector is remarkably heterogeneous, and is dynamically evolving. No single type of market-based finance accounts for more than about 30 percent of total non-bank credit intermediation. While maintaining its heterogeneity, the composition of market-based financial assets has evolved over the years, driven by a shift in investor risk appetites for various financial products, changes in technology, and regulatory reforms. More specifically, over the past ten years, the combined assets in U.S. money market funds, finance companies, and asset-backed securities have fallen by about 15 percentage points of GDP, offset by a similar increase in assets at fixed income investment funds.

I turn now to China. Market-based finance has emerged there as a significant source of funding for credit-hungry sectors such as real estate and infrastructure, particularly at the local level and during periods when the authorities have sought to limit bank credit growth. The expansion of market-based finance has far outstripped growth of traditional banking. Since 2010, Chinese bank assets have increased at a pace of just over 15 percent a year, while market-based finance has grown more than twice as fast. As one important example, assets of Chinese trust companies more than doubled in the three years ending in 2013 to roughly 20 percent of GDP, with financing from trust companies now accounting for approximately two-thirds of non-bank credit intermediation in China. These trust companies offer financial products with complex liability structures, and often carry explicit or implicit guarantees from affiliated banks. On the asset side, these companies invest in an opaque mix of financial and real estate investments.

The growth of market-based finance in China has presented challenges to supervisors, but it also provides credit to a broader set of small and medium-sized enterprises that lack access to the large state-owned banks, and introduces competition in the financial sector. The tremendous rate of growth in Chinese market-based finance, compared with the shifting composition of activity in the United States, illustrates the heterogeneous ways in which non-bank products may develop under diverse regulatory regimes and in response to unique financing needs.

4. The growth and evolution of market-based finance

Why has market-based finance become such an important component of the global financial system and why has it remained dynamic in the wake of the financial crisis? I will focus on four key factors that have increased the quantity of market-based finance by affecting the supply of or demand for non-bank finance.

First, a key supply-side driver of the growth in market-based finance has been insufficient bank lending capacity, due to both cyclical and structural factors. The sharp decline in many asset prices amid the financial crisis impaired the banking sector's balance sheet, leaving it unable to satisfy demands for credit when economic activity picked back up. This sharp, and only partially transitory, reduction in lending capacity opened the door for existing non-banks to expand intermediation activities, as well as for new entities to enter the field.

Second, increased demand for market-based finance can be attributed, in part, to investors' search for yield. The low interest rate environment prevailing in advanced economies has created incentives for investors to look for higher-yielding assets, and markets have often supplied those assets. Low interest rates have accelerated flows into hedge funds and riskier bond funds and stimulated the rapid growth of investment funds focusing on risky assets. In the euro area, low sovereign yields and ample liquidity in financial markets were important factors prompting investors to rebalance their portfolios, seeking higher returns.

Third, technological innovation and the corresponding development of financial markets has increased the structural supply of market-based finance. The financial sector adopts technology rapidly, and innovation of new products and services is common. New technology has closed information gaps and enabled more savers to directly channel funds to borrowers without the need for traditional bank intermediation. As one example, marketplace lenders, also known as peer-to-peer lenders, use the internet to directly connect borrowers with lenders.

Finally, changes in the supervisory landscape have resulted in banks and other regulated financial institutions reducing their leverage and better internalizing the social costs of their intermediation activities. As a result, borrowers are looking to the non-bank sector for better terms, while lenders have incentives to shift some financial activities out of the traditional banking sector. This phenomenon is often referred to as "regulatory arbitrage."

5. The Regulatory Challenge

I've argued today that market-based finance is important: It is large and growing in many jurisdictions and remains deeply interconnected with the rest of the financial system. Its role in the financial crisis makes clear the risks it can pose to financial stability. Our primary goal should be to develop the tools to spot and mitigate systemic risks without compromising sustainable, balanced economic growth.

Market-based finance is not starting from the same institutional structure as banking and has been regulated differently. Pre-crisis, regulation for much of the non-bank sector was based on investor protection – that is, disclosure and enforcement – and not on institutional safety and soundness. Some non-bank activities were indirectly monitored when that activity was linked directly to banks, such as hedge funds' repo transactions. Other non-bank activities including asset-backed securities origination, provision of credit enhancements, and credit default swap underwriting had no prudential oversight at all.

In contrast, banks have a supervisory infrastructure that has been built through decades of regulation, subsequent innovation by the banks, and then re-regulation by authorities. The creation of a deposit insurance system, designed to protect depositors and financial stability more generally, reinforces discipline in the banking system through supervision, regulation, and well-established accounting guidelines. Although this infrastructure fell short during the crisis, it was mobilized thereafter in pursuit of intensive reforms. Regulators increased the loss-absorbing capacity of large financial entities, pushed banks to rely on more stable sources of funding, and developed plans to resolve systemically important banks. A central issue is that these oversight frameworks or approaches were not designed with no-bank finance in mind.

As I have noted, non-bank finance is very diverse in provider types and activities, both on the asset side and in its liability structure. The formidable challenge for oversight and regulation is to monitor and mitigate systemic risks in this heterogeneous sector.

To add to the challenge, relevant data for market-based finance that could aid in examining potential risks are often absent. When such data are available, they tend to be insufficiently granular, timely, or comparable across firms, markets, and jurisdictions.

Ensuring that our regulatory framework is fit to assess and mitigate systemic risks, while allowing this important part of the financial system to continue to contribute to sustainable growth, is at the frontier of our post-crisis reform efforts. One approach the FSB has considered for addressing systemic risk in market-based finance is to identify systemically important non-bank entities using a framework parallel to that used for banking and insurance. While such an approach may be effective for certain types of risks, it seems less applicable for others. Because market-based financial firms are markedly heterogeneous, and because the potential risks in market-based finance are often not limited to individual firms, an entity-based framework may not be a sufficient solution.

The principal, complementary alternative to entity-based regulation is activity-based regulation. In response to the financial crisis, we have already taken some steps in this direction. For example, we now have developed central clearing requirements for certain derivatives: central clearing requirements for certain derivatives contracts, minimum margin rules for uncleared derivatives, redemption provisions for money-market funds, and trading processes to reduce intra-day financing in tri-party repo markets.

However, a framework that looks at systemic risks only activity-by-activity may not address the accumulation of risks at firms that operate across interconnected areas of the financial system. The footprint of a non-bank financial group, for example, could extend beyond market making into insurance, asset management, and specialty lending activities. We cannot afford to miss systemic vulnerabilities that may arise from the cumulative scale, complexity, and interconnectedness of such firms. Our regulatory approach to addressing systemic risks through entities and activities should not be seen as an either-or question. The important thing is that the approach is tailored according to the nature of the risks.

6. Implications for Policy

In the United States, we have taken many steps to improve the safety and soundness of the non-bank sector of our financial system. In broad terms, we have expanded prudential regulation to cover large, complex financial firms whose distress or failure could threaten financial stability, and designed new tools to resolve financial firms. We have created a comprehensive approach to derivatives regulation, emphasized the oversight and use of central counterparties, and addressed risks that are unique to non-bank activities, for example, through the SEC's reforms of money-market funds. We also are collecting more granular data to give us a better understanding of the size, activities, and interconnections of financial intermediation. But much more work is required.

We continue to pair our domestic reforms efforts with international cooperation to discourage risks from moving to more lightly regulated jurisdictions. We are moving forward, as I noted earlier, with our objective that all systemically important financial institutions, markets, and instruments are subject to an appropriate degree of regulation and oversight. At the Treasury

Department, we are working to identify and understand the range of potential risks in the financial sector and to ensure a fair and level playing field for U.S. institutions, investors, and consumers.

Ensuring that market-based finance, a large and vibrant part of the global financial system, continues to contribute to growth while avoiding systemic risk is at the forefront of our post-crisis reform efforts. As this discussion progresses, we must continue to ask ourselves whether we have the tools needed to adequately assess potential vulnerabilities, and, as importantly, the nimbleness to mitigate the risks that may arise as the landscape evolves. Given the diversity of the changing landscape for financial intermediation, we must remain attentive to emerging systemic risks and keep in mind all available approaches for addressing these issues.