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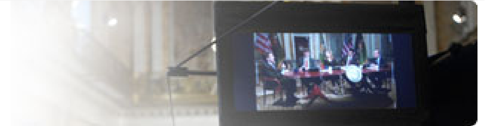

Weiss Op-Ed: Regulatory Rollback Is Wrong for Financial Markets

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WASHINGTON – In an op-ed published in the July 13, 2015 edition of the Wall Street Journal, Counselor to the Secretary Antonio Weiss outlines the rapidly evolving structure of the Treasury Market and the need to adapt to the dynamics of the new marketplace without rolling back the reforms that have made the system far safer and more resilient.

Read the piece online.

The text of the piece follows:

Regulatory Rollback Is Wrong for Financial Markets

Complaints about illiquidity are prompting talk about reforms is simplistic and even dangerous.

By: Antonio Weiss

For months everyone in financial markets has been talking about liquidity. Some say regulation has killed it, and the answer is to roll back financial reform. The reality is not so simple, and that prescription is dangerous. The marketplace is rapidly evolving. We must address future challenges without rekindling crises of the past.

Are our financial markets liquid? Primary markets—where companies issue securities to start, operate and grow—are functioning exceptionally well. Through six years of economic expansion, companies have raised record amounts of capital. By some measures, many secondary markets are also operating well.

However, market participants report difficulty in executing large orders across various asset classes. And there are concerns over whether the growing ownership of corporate bonds by mutual funds could overwhelm market capacity if there were a sudden wave of redemptions. Moreover, the “flash rally” last Oct. 15 in U.S. Treasurys, our deepest and most liquid market, saw yields drop dramatically and snap back within minutes, with no clear catalyst.

At the Treasury Department, we have been undertaking a comprehensive review of market structure and liquidity, consulting with a wide array of policy makers, market participants and academics. While we may come to the issue with different perspectives, we share a goal of well-functioning markets that promote stable economic growth. And everyone agrees that the marketplace is undergoing fundamental changes that need to be closely monitored and better understood.

First, we are emerging from a period of historically low interest rates and low volatility. As conditions normalize, an increase in volatility should be expected. Price movements, even significant ones, in response to changes in economic and policy outlooks are not necessarily a result of illiquidity.

Second, this cyclical change is taking place against a backdrop of longer-term shifts in market structure and the types of intermediaries who match buyers and sellers. Both the playing field and the players have changed. Markets increasingly operate on electronic platforms, and nontraditional intermediaries, such as high-frequency traders, are playing a far greater role and driving markets toward smaller trade sizes.

These technology-driven trends stretch back to the 1990s, starting in equities and then spreading to futures, foreign exchange, and other markets. For example, high-frequency trading now accounts for a majority of volume on the primary venues for trading Treasury securities. Meanwhile, many of the banks and broker dealers who sustained large trading losses in the crisis are scaling back, with some exiting certain markets altogether.

Third, these traditional players are reinventing their business models for many reasons, including shareholder demands, risk appetite, competitive pressures and the effects of technology, as well as the new rules of the road. Much-needed financial reform has reduced leverage in the system and forced traditional intermediaries to rely on more stable funding. Critics of regulation often cite the lower level of securities held in inventory today by the largest financial institutions as evidence that reforms have damaged market liquidity. Before reform, the argument goes, these stockpiles served as shock absorbers, cushioning investors from losses.

But that is doubtful. While research on the topic is ongoing, a study by the Federal Reserve Bank of New York examined institution-by-institution adjustments in dealer inventories during the 2013 “taper tantrum” in response to Fed discussions of monetary policy and found that these adjustments were unrelated to regulatory constraints. Moreover, precrisis liquidity, built on excessive leverage and unstable funding, turned out to be available in good times but not in bad. During the crisis, those inventories did little to prevent financial markets or the broader economy from freezing up.

Our efforts to reform the financial sector have made the system far safer and more resilient. However, we cannot become complacent about potential sources of future stress. Our work to create a healthier financial system must continue and reflect the realities of the evolving marketplace. To this end, we are releasing an interagency report on the events of last October that highlights the evolution in the structure of the market for Treasury securities and will allow us to have a more substantive, and less speculative, discussion of a complex set of events and issues.

It is neither possible nor prudent to return to practices that were prevalent prior to the crisis. Our focus, in both the private and public sectors, should be on adapting to the dynamics of the new marketplace, not on returning to a past whose rules can’t reasonably apply to us now. We must not forget that only a financial system strong enough to withstand a major financial shock is capable of promoting sustainable economic growth.

Mr. Weiss serves as Counselor to the U.S. Treasury Department Secretary.

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