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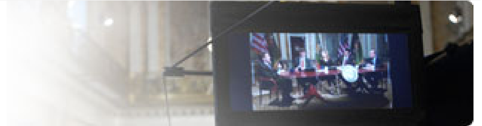

Remarks by Under Secretary Nathan Sheets at the Institute of International Bankers

3/7/2016

WASHINGTON – Thank you for inviting me here today. I returned last week from the G-20 meeting where most of the headlines focused on the macroeconomic issues facing the global economy. But today I would like to highlight the G-20's major achievements and ongoing work on international financial stability and regulatory reform. I will also address some potential interactions between our regulatory agenda and the functioning of financial markets, including market liquidity, as well as financial inclusion and de-risking.

Since the global financial crisis, we have taken important steps to foster a more resilient financial system. But getting something so important right is a continuous process, and Treasury, the U.S. regulators, the G-20, the Financial Stability Board (FSB), and the international standard setting bodies remain focused on this important work.

G20 FINANCIAL REGULATION AGENDA: PROGRESS AND PRIORITIES

The G20's financial regulatory agenda has included four core areas of reform: (1) bank capital and leverage, (2) resolution, (3) market-based finance – sometimes called "shadow banking," and (4) derivatives.

Bank capital and leverage

Following the crisis, our top priority was shoring up bank balance sheets. As you well know, we have made important strides under Basel III to improve both the quantity and quality of capital for internationally active banks. We have also introduced internationally consistent leverage and liquidity ratios. As a result, banks now hold significantly more and higher quality capital, and regulators expect the global systemically important banks (G-SIBs) to hold more capital than smaller banks. We have also set internationally consistent liquidity standards so that banks are less reliant on relatively unstable sources of funding like short-term wholesale borrowing and thus less vulnerable to run dynamics. The FSB reports that 80 percent of internationally active banks now meet or exceed the new liquidity standards.

These reforms are already making the financial system safer. Throughout the market turbulence seen in recent months, there has been widespread agreement that the core of the U.S. financial system is much safer than was previously the case. The reforms have also prompted banks to reassess the risks that they are able to take on. Investors are more appropriately pricing the risk of debt instruments and coming to terms with new expectations for banks' return on equity. My assessment is that these important steps greatly reduce the risk of systemic crises, while allowing banks to continue to play a critical role in intermediating credit for the real economy.

My sense is that most of the heavy lifting on these reforms has been completed. However, standard-setters will continue to refine and calibrate the capital and liquidity framework to promote coherence and effectiveness. For example, efforts are underway to enhance consistency in calculations of risk-weighted assets. But the Basel Committee has signaled that it does not envision significantly increasing overall capital standards.

Resolution

We have also developed tools and prepared plans to resolve failing financial institutions and to address Too Big to Fail. Our task now is to ensure that the necessary components are in place to enable systemically important financial institutions to be resolved in an orderly manner, without relying on the taxpayer. Central to this effort, coordinated by the FSB, is an international standard for Total Loss Absorbing Capacity (TLAC) for G-SIBs, which was endorsed by the G-20 Leaders in November 2015, and is due to be phased in starting in 2019. Relevant authorities are now rolling out TLAC requirements nationally. The Federal Reserve and the Bank of England released their proposals at the end of last year. France and Germany are changing their domestic laws to implement a TLAC-compliant creditor hierarchy for their banks.

Looking ahead, some banks will need to increase their loss-absorbing capacity by issuing TLAC-eligible instruments or increasing capital. BIS analysis concludes that there will be sufficient demand for the TLAC instruments that must be issued to satisfy the standard, although the standard recognizes that emerging market G-SIBs may need additional time to come into compliance (due to their less developed domestic bond markets). The Basel Committee's analyses as well as industry comments, including from stakeholders such as many of you in the room today, have provided valuable feedback on how to structure these requirements, which I believe will improve the resiliency and resolvability of G-SIBs.

Market-based Finance

G-20 members are also working to promote consistent and robust frameworks for systemic stability outside the banking system. This form of financial intermediation, often called market-based finance or shadow banking, has grown in importance since the financial crisis. As we know from the U.S. context, market-based finance can play an important role in promoting investment, trade, and growth, especially when financial markets are deep and heterogeneous. But we are also aware that market-based finance may bring risks of its own. With this in mind, FSB members are focusing this year on assessing potential structural vulnerabilities and the adequacy of existing policy tools related to asset management activities. Going forward, we will evaluate whether additional policy recommendations should be considered to mitigate financial stability risks from market-based finance.

OTC Derivatives and CCPs

As the global financial crisis erupted, OTC derivatives presented a toxic combination of underlying opacity with increased uncertainty, leading to a massive sell-off of assets in many markets and presenting a systemic threat to the global financial system. At the Pittsburgh Summit in 2009, the G-20 Leaders set out a comprehensive approach to improve clearing, trading, and reporting of OTC derivatives contracts. While we have made important progress globally toward these objectives, implementation outside the United States remains uneven and behind schedule. We continue to urge our fellow G-20 members to act on these critical reforms to foster financial stability, reduce market fragmentation, and support a level playing field for global firms.

I would also like to flag here the significance of the regulatory equivalence determination that was recently reached by the CFTC and the European Commission. This determination will allow U.S. central counterparties (CCPs), which are increasingly becoming lynchpins for systemic stability, to continue providing clearing services to European market participants. It should also help facilitate global market integration and support the expansion of central clearing, which is one of the key objectives of the derivatives reform agenda.

The FSB will also continue to coordinate efforts to enhance the resilience, recovery, and resolvability of CCPs, so that these crucial parts of the financial architecture are not themselves Too Big To Fail. Work underway includes deeper analysis of CCP resilience and recovery tools such as stress testing, "skin-in-the-game," margin methodologies, and recovery plans. I expect that before the G-20 Leaders' Summit in September, CPMI-IOSCO will have issued for public consultation additional granular guidance on CCP resilience and recovery. The FSB will also publish high-level guidance on resolution issues relating to CCPs.

THE BROADER MARKET CONTEXT

Even with all the work that we have completed toward reforming the financial system, more work remains to be done, particularly as we seek to implement the measures that have been agreed. I have touched on some of the important next steps in this agenda, but we must also remain vigilant to new risks and, more broadly, to the smooth and efficient functioning of financial markets.

Market Liquidity

For example, market participants and the financial press have focused on the evolving features of market liquidity. Liquidity may seem to be a fairly straightforward concept – the ability to transact swiftly at large scale without a material effect on price. In practice, however, liquidity is often difficult to define precisely and even harder to measure. Some have expressed the view that broad market liquidity has declined and have attributed the decline to factors including a shift in the composition of market participants, technological advancements, regulatory changes, and decreased risk appetite.

I am not inclined to focus on any one particular factor. All of these, to one extent or another, may have affected market behavior and could contribute to a new landscape for liquidity. Market structure has shifted to include rising participation by non-traditional intermediaries, like high-frequency traders. Such trading is a large and growing portion of activity in some markets, with important implications for the resilience of market liquidity. High-frequency trading now accounts for over 50 percent of secondary market trading in on-the-run Treasury securities, and electronic trading is growing—though from a tiny base—in U.S. corporate bond markets. In addition, banks and broker dealers who sustained large trading losses during the financial crisis are exercising tighter risk controls, while regulatory reforms have appropriately reduced leverage in the system and in some cases eliminated proprietary trading altogether.

In considering these developments, context matters. The years before the crisis saw extraordinarily liquid market conditions in which there was excessive risk taking. Accordingly, I am skeptical that the period before the crisis provides the appropriate benchmark for assessing current market performance. As the market evolves and adapts to changing conditions, we should expect to see a new equilibrium emerge in market liquidity. Because markets are fluid, Treasury will monitor these changes, with an eye toward spotting nodes of risk that may develop. Internationally, the FSB will discuss these issues for global markets more broadly. Our work must focus on forward-looking solutions—we cannot afford to return to the policies and practices that led to the crisis.

Financial Inclusion

We are also focused on expanding the reach of the global financial system, including by increasing the number of individuals who have access to that system.

Expanding access to the formal financial system – particularly services such as bank accounts, credit, insurance, and payment services – enhances economic outcomes for all parts of the global economy. At the household level, these services help individuals and families transfer money, receive social benefits and wages, and make payments safely and affordably. It allows people to manage life's unexpected financial shocks, build long-term financial security, and take advantage of economic opportunities, like starting a business or pursuing higher education. At the macro level, financial inclusion improves economic growth by connecting consumers and small businesses to the financial system and channeling resources more efficiently.

We are working closely with China, this year's G-20 Chair, to promote financial inclusion. Pursuant to country plans submitted to the G-20, we – along with other G-20 countries – are developing policy guidance that should reduce the costs of remittances and improve the supervision of remittance providers. We are advocating for greater financial education, transparency, and disclosure guidelines, particularly for those services designed to reach traditionally excluded and underserved groups. And perhaps most importantly, we are working to incorporate financial inclusion considerations into the work of the international standard setting bodies, so that the implementation of global standards supports efforts to expand accessibility.

De-Risking

Finally, I would like to turn to two global trends that are now affecting relationships among financial institutions around the world. First, banks are restructuring and reallocating their capital to fund core businesses, which has led some to sell off entire lines of business and reduce their global footprint.

At the same time, some large global banks are withdrawing from correspondent banking relationships and restricting the access of money services businesses to bank accounts, with regulatory obligations often cited as a key driver. The term "de-risking" is often used to describe this activity. While this means different things to different people, I see de-risking as a situation in which a financial institution indiscriminately terminates or restricts broad classes of customer relationships without a careful assessment of the risks. The available evidence suggests that de-risking has resulted, in certain jurisdictions, in a decline in the number of correspondent bank relationships and in a loss of access to bank services by money service businesses, both of which play an important role in channeling financial resources within and across economies.

The Treasury Department is focused on this issue, and work is ongoing in the global financial community as well. The Financial Stability Board recently established a group to coordinate its ongoing efforts. Work is also being carried out by the Financial Action Task Force (FATF), World Bank, and IMF.

U.S. and international efforts to address de-risking are focusing on the following four areas:

First, we are improving our understanding of the scope, nature, and drivers of de-risking. The FSB, in coordination with the World Bank, IMF, and national authorities, is working to identify gaps in our knowledge. We are also considering the feasibility and benefits of developing a global framework for more systematic data collection at the national level and a more effective capacity to monitor trends at the global level.

Second, we are exploring the scope to further clarify regulatory expectations regarding AML/CFT, including ways to improve the effectiveness of our communication on this issue. In this regard, FATF recently published guidance for the application of AML/CFT standards for transactions involving money service businesses, and is preparing a guidance paper on correspondent banking, both of these documents address when "enhanced due diligence" may be necessary.

Third, we are working to improve compliance with AML/CFT regulations globally, including through technical assistance. Many countries have deficiencies in their supervisory regimes for AML/CFT compliance. In response to these deficiencies, we are supporting coordination among providers of technical assistance, including the IMF, World Bank, FATF-style regional bodies, and national supervisors to support countries in better identifying and addressing their weaknesses in AML/CFT compliance. In addition, Treasury's Office of Technical Assistance is working with seventeen countries in Africa, Southeast Asia, Latin America, the Caribbean, and the Middle East to help them improve their compliance with global

standards. Also, Treasury is directly engaging with countries around the world to ensure that stakeholders across borders understand one another's expectations, including by continuing to convene our successful public-private dialogues with key regions, such as the Middle East and Central America, as well as our bilateral dialogue with Mexico.

Finally, we are exploring creative ways to use new technologies to facilitate AML/CFT compliance and reap potential benefits.

We take the challenges presented by the reduction of correspondent banking and money service business relationships seriously, and we are committed to addressing them in a way that accomplishes our joint goals of supporting financial connectivity and inclusion and protecting the financial system from abuse. I am optimistic that this approach will help us better understand de-risking and guide our actions to preserve, and perhaps even enhance, the interconnectedness of the financial sector.

CONCLUSION

As you have heard today, our financial regulatory agenda is broad. We are striving for an efficient, stable, and inclusive financial system that is capable of supporting sustainable economic growth. I would like to thank the IIB and all of you here for your support and partnership in these important endeavors.

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