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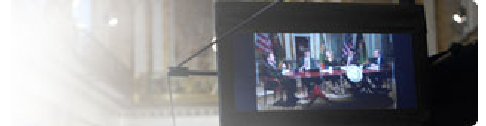

Remarks by Counselor Antonio Weiss at the U.S. Chamber of Commerce Capital Markets Summit

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As Prepared for Delivery

WASHINGTON - Thank you J.J. for that kind introduction. And thank you to the Chamber's Center for Capital Markets Competitiveness for inviting me and for hosting this event.

Since last summer, financial markets have undergone several periods of turbulence. Volatility has not approached the levels of the crisis period. But it has provided a real-world test of U.S. economic strength, the resilience of our financial institutions, and the orderly functioning of our markets. Today I would like to review performance across all three of those areas, and lay out the Treasury Department's priorities, particularly with respect to market functioning.

What's our assessment? On the whole, the U.S. economy and financial system have demonstrated resilience. U.S. financial institutions weathered recent events with no material signs of distress, and for the most part markets functioned in an orderly manner, even as they repriced sharply in the face of rapidly changing conditions. It is clear that the U.S. response to the crisis has built a more stable foundation for the economy.

Financial reform has been a buffer in volatile times.

But there are significant transitions underway that policy makers will need to understand and potentially address. Standardized financial products—such as equities, futures, foreign exchange and Treasuries—are increasingly traded algorithmically. Credit is increasingly intermediated by asset managers. A growing portion of financial transactions employ derivatives and cash securities as ready substitutes. And liquidity provision is changing in response to an ever-evolving market structure.

Going forward, our priority must be to safeguard the gains we've made since the crisis, while adapting to a continuously changing economic and financial landscape. Growing the economy and broadening the gains to all Americans will provide a bulwark against future economic shocks. Completing and protecting financial reform will reduce both the frequency and severity of future financial shocks. And building resilience in market structures will help to prevent minor shocks from turning into major ones.

Recent Market Volatility

Let's remind ourselves of the recent volatility and the key drivers.

Last August, market volatility spiked amidst an abrupt sell-off in global markets. On the morning of August 24, U.S. futures and equities rapidly sold off, causing a delayed opening for many stocks and over a thousand individual trading halts. Some of the most widely-held ETFs and stocks—including such household names as General Electric and JPMorgan — dropped more than 20 percent, only to recover most of those losses within an hour.

This January and February, markets once again sold off sharply—this time over a period of weeks rather than hours. Stock markets and oil prices fell in tandem, trading down 10 and 25 percent, respectively. Corporate bond spreads spiked.

In each of these episodes, volatility reached levels that, since the crisis, had only been exceeded during the debt limit brinksmanship and European sovereign crisis of 2011.

Market participants point to many specific causes, most notably questions about China's growth and the collapse of oil prices.

Volatility in China's stock markets and poorly-communicated shifts in exchange rate policy caused investors to question China's ability to successfully navigate the transition from a manufacturing and export-led economy to a consumption-based economy.

Oil prices continued to ratchet lower, as inventories reached record highs, and questions about China fed concerns about slowing global demand. Moreover, market participants questioned the overall impact of low oil prices on U.S. producers and investment, versus the obvious benefits to consumers and the broader economy. Falling oil prices also drove fears of widespread bankruptcies in the energy sector and contagion to other sectors. High yield bond spreads increased, and new issuance—at record levels in recent years—slowed, at times halting altogether.

All of this occurred against a backdrop in which the U.S. is transitioning to a path of normalization from an unprecedented period of extraordinary monetary policy. Market participants have always predicted that this period of adjustment would be accompanied by volatility. But this expectation has done little to calm investors as the transition begins.

A Resilient U.S. Economy

Many observers concluded that the market turmoil was a harbinger of impending recession. Some went so far as to ask whether we were on the verge of another financial crisis.

What does the evidence show?

Despite global uncertainties, the U.S. economy is once again demonstrating strength and durability. Throughout this period, GDP continued to grow at a solid pace, led by private demand. And each month the economy extends the longest stretch of job growth on record, with 14.3 million new private sector jobs over 72 consecutive months. Unemployment remains under 5 percent—half of its post-crisis peak and the lowest level since February 2008. Critically, we are beginning to see signs of a pickup in wage growth.

No doubt, the economy will continue to face headwinds as weak global demand and low oil prices have held some sectors back domestically. Manufacturing output has clearly slowed. And the energy sector has slashed investment in drilling, and cut employment.

But, on balance, U.S. economic data have continued to show real progress, and financial markets have recovered most of their losses. The U.S. stock market is now essentially flat on the year, and credit spreads, with the exception of energy, no longer appear distressed.

A Resilient U.S. Financial System

The U.S. financial system has demonstrated resilience throughout the market turmoil. This was no accident. Without question, the reforms adopted following the crisis have created a stronger, more resilient system, while establishing the strongest consumer protections in history.

U.S. financial institutions weathered the storms of last August and the first quarter of this year without material signs of stress. In the U.S., bank stocks declined due to concerns over earnings growth and credit exposures. But funding rates and market expectations of default did not show concerns about the safety and soundness of our banks.

By comparison, European banks have been slower to build capital. As a result, questions about the impact of negative rates on bank profitability were sufficient to cause European bank stocks to tumble, and investors to demand much higher premiums for protection against default.

In the U.S., increased capital across the banking system, more stable funding profiles, and forward-looking steps by regulators to reign in risky lending practices have all contributed to stability. The reforms we've put in place have led the largest banks to increase the amount of capital available to absorb losses by nearly $700 billion—more than double pre-crisis levels.

For context, analysts estimate that even if oil prices remain at depressed levels the six largest U.S. banks could incur total energy-related loan losses of about $60 billion—under 5 percent of those banks' current tier 1 capital and less than their 2015 profits.

Stable, well-capitalized banks bring much-needed confidence to the financial system. Confidence is further bolstered by the stress tests regulators now routinely conduct, such as the Comprehensive Capital Analysis and Review (CCAR) exercise the Federal Reserve requires of the largest bank holding companies. The Federal Reserve's scenarios incorporate shocks far more severe than anything experienced since the crisis. For example, the most recent stress tests assumed stock price declines of 60 percent, home price declines of 25 percent, and commercial real estate declines of 35 percent.

Banks' liquidity profiles are also far more robust. They are less reliant on short-term funding and have a larger deposit base. For the five most active trading banks, reliance on short-term wholesale debt has decreased from 26 percent of total assets in 2009 to 17 percent in 2015. In addition, the largest and most complex banks have doubled their holdings of high-quality liquid assets since 2009.

Stronger balance sheets have allowed banks to support the growth of our economy through increased lending, which has risen by 4 percent annually over the last five years.

Banks have also reined in their risk appetites following the crisis, and reforms have restricted proprietary risk-taking. Notably, recent market sell-offs do not appear to have been triggered or exacerbated by banks that were over-leveraged, or were forced to liquidate large positions, or backstop off-balance sheet risks.

Regulators have also been wary of a return to pre-crisis lending practices. For example, in 2014 the banking regulators jointly issued guidance on leveraged lending and began to increase the frequency of their examination of such loans. This has helped to curb a trend toward more aggressive underwriting.

Finally, large swaths of the derivatives markets that were previously traded bilaterally are now centrally cleared, reducing the tangled web of counterparty risks that existed prior to the crisis. Commodity Futures Trading Commission (CFTC) Chairman Massad noted that 75 percent of swap transactions are now centrally cleared, compared to 15 percent in 2007. Rules requiring margin for uncleared swaps should also drive more activity toward central clearing.

The Road Ahead—Promoting Stronger Growth and More Resilient Markets

Looking ahead, the Administration is working to build on this progress. The President's budget and economic policy agenda lay out a broad strategy for more inclusive growth and for reversing decades of growing inequality and stagnant middle-class wages.

And at the recent G-20 meetings in China, Secretary Lew urged our international partners to use all policy levers, including fiscal and structural tools, to increase global demand rather than rely on the United States as the consumer of last resort.

In the remainder of my remarks, I would like to address our work to complete and safeguard financial reform and to build more stable markets by addressing changes in market structure.

An important element of sustainable growth is a financial system that works to support the broader economy, and avoids excessive risk-taking. Financial crises are particularly damaging, as they have the capacity not only to cause sudden and deep recessions, but also to inflict lasting harm on the economy. The Administration is working with regulators to implement all remaining material elements of Dodd-Frank by the end of this year, including derivatives and executive compensation rules.

Just last week, the President met with the regulators responsible for financial reform. He emphasized both the tremendous accomplishments of reform and the need to complete the job.

We are also addressing potential vulnerabilities in financial market structure. Some of these weaknesses were exposed over the past year, while others remain prospective in nature.

All require our attention today.

The spike in volatility last August 24 was the first real test of rules put in place after the “flash crash” of 2010. Overall, the new trading rules may have prevented the occurrence of a broad flash crash, but trading was discontinuous, and halts appeared to both exacerbate the sell-off and impede the recovery. A key issue was the lack of uniform circuit breakers across trading centers. The initial selloff in futures raised concern that trading might be halted, and selling pressure flooded stocks and ETFs. Market participants and the Securities and Exchange Commission (SEC) have since adopted improvements, but work remains to establish a more coordinated regime across markets in periods of extreme volatility.

The interconnection between markets is an area that will receive heightened attention from regulators and policy makers. So is the increased prevalence of algorithmic trading in markets for standardized products. These themes are especially salient in the Treasury market. On October 15, 2014, Treasuries experienced a sudden and sharp drop in yield that quickly retraced, all in a span of just 12 minutes. In order to produce a comprehensive analysis of that event, five agencies—Treasury, the SEC, the CFTC, the Federal Reserve Board and the Federal Reserve Bank of New York—collaborated to review cash and futures data. We issued a joint staff report, highlighting the growing role of algorithmic trading. Treasury recently followed up that report by issuing a request for information seeking public comment on the evolution of Treasury market structure. This represents the first fundamental review of Treasury markets since 1998.

Another potential fault line concerns the growth of mutual funds that offer daily redemption to their investors but invest in less-liquid assets. Last fall, deteriorating conditions in the high-yield market exposed this vulnerability when the Third Avenue Focused Credit Fund suspended redemptions. It could not sell assets quickly enough to satisfy investor demands. Third Avenue’s actions came in the midst of overall stress in the high-yield market, contributing to pressure that led investors to pull nearly $10 billion—4 percent of assets under management—from high-yield funds during a three week period in December.

These events highlight the importance of the review the Financial Stability Oversight Council (FSOC) has undertaken to examine potential risks to financial stability from asset management activities, in particular liquidity and redemption risks in mutual funds. The SEC has pending proposals in this area, and more are expected. FSOC is also examining risks posed by asset managers’ use of leverage, primarily in non-registered funds.

As noted earlier, a key achievement of financial reform was to push a major portion of the derivatives market to central clearing. This, of course, increases the importance of robust risk management by central counterparties, and effective recovery and resolution tools. Treasury is collaborating with our partners, domestically and internationally, to advance this work.

We are also continuing to conduct a thorough examination of market liquidity in the context of an ever-evolving market structure. Market liquidity is an important element in a well-functioning financial system, especially during times of stress, and is essential for the efficient allocation of capital.

Technology, financial product innovation, much-needed regulatory reform, changing business models and risk appetite all play a role in shaping the new landscape. Treasury is engaged in a deeper analysis of all of these issues, and additional work will be forthcoming.

But we will not chase a ghost: abundant pre-crisis liquidity was more apparent than real, disappearing exactly when it was needed most.

Those who want to engage to find solutions that address the new market structure will find a willing partner in Treasury. We will be fact-based in our analysis, and forward-looking in our solutions.

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The U.S. financial system has been tested several times since the crisis: from the taper tantrum to debt limit showdowns, and from last August through the early months of this year. Financial institutions have remained strong, supporting growth instead of working against it. In short, financial reform has passed its first series of tests. But, inevitably, the tests become more difficult, and we cannot be complacent. We must protect and build on the important progress made following the crisis, while adapting to a rapidly-evolving marketplace.

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