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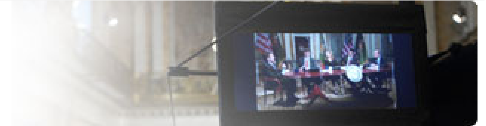

# Remarks by Under Secretary Nathan Sheets at the Institute of International and European Affairs

11/16/2016

**DUBLIN** - In the years since the global financial crisis, significant steps have been taken to enhance the resilience of markets and strengthen the balance sheets of large financial institutions. However, as we get further from the crisis, there is a risk that people may forget the underlying impetus for these reform initiatives and that the commitment to finish the reform agenda may diminish. For these reasons, and in deference to my Irish hosts, it is worth briefly reviewing Ireland's experience during the crisis, and then moving on to discuss the progress made in implementing the global financial reform agenda.

The Irish experience illustrates our reform objectives and also highlights some areas where additional work is needed so that the financial sector can support economic growth during good times and bad.

During the six years prior to the fall of Lehman Brothers, assets in the Irish banking sector almost tripled in size. As investors pulled back from wholesale funding markets following Lehman's collapse, banks around the world, including those in Ireland, came under severe funding pressure. In response, the Irish government introduced a blanket guarantee covering virtually all Irish bank liabilities. In the years that followed, Ireland launched four rounds of bank recapitalization, which cost the government over €60 billion (about 35 percent of GDP), and eventually two banks were nationalized.

Of course the causes of the crisis and the initial response by the authorities were by no means unique to Ireland. Authorities in Ireland, as elsewhere, were constrained in their policy options. They lacked tools to deal with a run on the entire banking system and to resolve or recapitalize large institutions without putting at risk significant public resources. To their credit, the Irish authorities took decisive action. However, the lack of appropriate tools and the ultimate cost in both economic and human terms underscored the need to reform the regulatory framework to foster a more resilient financial system to support growth.

We have made significant progress, but the work is not yet finished. Today, I will emphasize the importance of all G-20 countries taking timely action to complete and implement financial regulatory standards, consistent with our ongoing efforts to achieve a robust global financial system. To that end, I will also highlight the importance of U.S.-EU cooperation in this area consistent with our common interests.

## G-20 FINANCIAL REGULATORY REFORM AGENDA: PROGRESS AND REMAINING TASKS

The G-20's financial regulatory agenda has included four core areas of reform: (1) bank capital and liquidity, (2) resolution, (3) market-based finance – also sometimes called "shadow banking," and (4) OTC derivatives transactions.
Let me briefly highlight what we have accomplished in each of these areas and our remaining tasks.

### *Bank capital and liquidity*

On bank capital and liquidity, the G-20 and Basel Committee members have made important strides under Basel III to improve both the quantity and quality of capital for internationally active banks and have introduced internationally consistent leverage and liquidity ratios. Banks are now less reliant on relatively unstable sources of financing, especially short-term wholesale funding. These steps greatly reduce the risk of systemic crises while ameliorating the possible consequences of such crises, thus allowing banks to continue to play a critical role in intermediating credit for the real economy.

Our current priority in the Basel Committee is to finalize the Basel III framework, including measures to enhance consistency in calculations of risk-weighted assets. Over time, different approaches to calculating risk-weighted assets have led to excessive and unwarranted differences in capital buffers across jurisdictions and institutions. In addition to raising questions about an uneven playing field for banks, these differences threaten to undermine market confidence in the adequacy of bank capital.

Basel III is the cornerstone achievement of the post-crisis G-20 financial reform agenda, and we must continue efforts to achieve robust and consistent global standards for internationally active banks. The risk that over time various jurisdictions might step back from global standards due to competitiveness concerns or reform fatigue, underscores the importance of completing these efforts in a timely manner.

***Resolution***

On bank resolution, our task now is to ensure that the necessary components are in place, and properly operationalized, to enable a systemically important financial institution to be resolved in an orderly fashion.  This requires sufficient capacity for backstop funding and loss absorption.

Through the Financial Stability Board (FSB), we have made important progress in developing new standards for effective resolution regimes.  These standards have already helped countries identify approaches that should allow banks to fail without creating broader disruptions for the economy.  The FSB's finalization of its total loss absorbing capacity (TLAC) standard in November 2015 is an important milestone for establishing a framework that allows for the resolution of global systemically important banks.  A failing global bank going through resolution can draw on its TLAC to continue its important economic functions, which should limit knock-on effects to broader financial markets.  It is now up to regulatory and political authorities to adopt these requirements nationally.  The Bank of England has recently done so, and we expect the Federal Reserve to finalize its rule this year.  The European Commission is expected to release its proposal soon.
It is also important that we have the ability to facilitate the orderly resolution of systemically important non-bank financial institutions, work that is ongoing in the FSB.

While these regulatory improvements are useful and necessary, it is vital that the authorities here in Europe continue to press banks to clean up their balance sheets – to disgorge non-performing loans (NPLs).  Many euro-area banking systems, including Ireland, remain burdened with NPLs in excess of 10 percent of GDP.  The emerging picture is that while banks in Europe have stabilized, many are still avoiding fully writing down bad loans and releasing the underlying assets into the market.  This overhang appears to be constraining the supply of credit to the economy and limiting the banking system's ability to support economic growth.

***Market-based Finance***

Outside the banking sector, the G-20 and FSB are working to promote consistent and robust frameworks for sustainable market-based finance.  Market-based finance can supplement bank financing to foster investment, trade, and growth, but it also brings risks of its own.  And these risks must be appropriately assessed and monitored.

With this in mind, the Financial Stability Board has worked to identify and address potential financial stability risks that may arise from financing activities that take place outside traditional banking channels.  For example, the FSB is working on recommendations to address liquidity and leverage risks in asset management activities that could amplify stresses in the financial system.  Securities regulators plan to operationalize the FSB's recommendations in this area, with liquidity measures expected by end-2017 and those for leverage by 2018.

***OTC Derivatives and CCPs***

Let me note one area, in particular, where we still have work to do: over the counter (OTC) derivatives and central counterparties (CCPs).  As the global financial crisis erupted, OTC derivatives presented a toxic combination of opacity and interconnectedness.  These factors, along with intensified counterparty risk, created a systemic threat to the global financial system.  In response, the G-20 Leaders set out a comprehensive approach to promote clearing, trading, and reporting of OTC derivatives contracts.

While we have made important progress toward global standards in these areas, implementation in some jurisdictions outside of the United States remains uneven and behind schedule.  It is critical for all G-20 members to act on these reforms; such efforts will foster financial stability, reduce the risk of market fragmentation, and support a level playing field for global firms.

In particular, derivatives contracts should be traded on regulated exchanges to the extent possible.  Where this is not feasible, derivatives should be centrally cleared or subject to margin requirements.  At this point, let me welcome the EU's recently redoubled efforts to implement margin rules for non-centrally cleared derivatives.  The EU now appears to be back on track toward implementing rules similar to those already in effect in other major jurisdictions.  These rules represent an important component of managing risk and incentivizing central clearing.
As the volume of centrally cleared derivatives grows, we must also be vigilant to the potential risks posed by the CCPs themselves.  We have stepped up our efforts at the FSB and with our European counterparts to enhance the resilience, recovery, and resolvability of CCPs, so that these critical elements of the financial architecture are robust and, in the extreme case, resolvable.

**U.S.-EU FINANCIAL REGULATORY COOPERATION**

Our work in these core areas of reform has important implications for financial markets in the United States and Europe. The large size and interconnectedness of trans-Atlantic markets underscores why it is necessary for our two sides to cooperate closely and provide global leadership on financial regulatory reform.  Past financial crises have led to bouts of market fragmentation and reduced liquidity, reflecting in part global policy responses that were not well-coordinated.  Our shared interest is in maintaining open, integrated, and well-functioning global markets.

The United States is a major host to European banks; their activities include credit intermediation in the U.S. economy, trade finance, and wholesale banking activity, including the sourcing of U.S. dollar funding.  U.S. banks operate in the EU with similar purposes.  The experience of the financial crisis highlights that globally integrated firms should be closely regulated, so that we all benefit from their capacity to serve corporates, small businesses, and individuals.  This in turn helps support jobs and growth in both the host and home country.

Over the years, our trans-Atlantic engagement has been fruitful.  We have helped solidify the EU equivalence determination processes for accounting standards, credit rating agencies, and CCPs.  We have made progress toward a U.S.-EU “covered agreement” on insurance.  And we have improved oversight for firms performing cross-border audits.

The benefits from international regulatory cooperation are clear.  My colleagues and I invest a significant amount of time working with our European counterparts to help make sure that our implementation of the G-20 financial regulatory agenda is prudentially robust as well as practical for cross-border firms.

In July, we upgraded our long standing bilateral regulatory dialogue with the European Union, launching the Joint U.S.-EU Regulatory Forum.  This intensified dialogue should facilitate efforts of U.S. and EU financial supervisors and regulators to exchange information, explore significant financial regulatory issues in our respective jurisdictions, identify potential regulatory conflicts, and proactively develop solutions.

**CONCLUSION**

On my way in from the airport, my cab driver said, “Oh, the weather was grand last week. It only rained twice.  Once for three days and once for four days.”   I offer this anecdote for two reasons:  first to illustrate the cheerful optimism that characterizes this country.  It is this optimism and hard work that has enabled Ireland to return to a path of strong economic growth.  But secondly because challenges to financial stability – like rain in Ireland – are probably unavoidable.

The global financial system today is demonstrably safer and more resilient than it was ten years ago.  However, there will always be exogenous events, like the UK’s referendum vote in June, which could become challenges for financial stability.  For this reason, we must continue to work together to fully implement our shared vision of a stronger regulatory and supervisory environment.  Stronger banks, closer cooperation on supervision, and more effective resolution regimes will enable us to meet future challenges without saddling taxpayers with a financial burden.

But we need to finish the job and complete the initiatives we have launched.  International cooperation is key to this effort; we need to work together to fix the fault lines that led to the global financial crisis and to monitor for emerging threats.  We also need to be humble and continue to enhance our understanding of financial markets and institutions.  Markets are global and dynamic; for example, technology changes at a speed unimaginable just a few years ago.  We need to continue to strive for an efficient, globally-integrated, and inclusive financial system that fosters economic growth and financial stability.  I would like to thank the IIEA and all of you here today for your partnership in these important endeavors.

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