Systemic Risk Centre

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

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Financial Regulation: back to the future?

Timothy G. Massad
Chairman of the U.S. Commodity Futures Trading Commission

London School of Economics and Political Science

Tuesday 10 January 2017

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Introduction

Thank you, Eva, for that warm introduction. I'm very pleased to be here.

I join you at a time of uncertainty. A time when the United States, the United Kingdom and Europe are all entering uncharted political waters. In the United States, we are 10 days away from the inauguration of a new president whose election defied all political predictions and conventions. What Mr. Trump's presidency will mean for both domestic policy and the role of the United States in the world is difficult to predict. Here in Britain, the vote to exit the European Union will take the United Kingdom and Europe on a path that is not yet known— to a new relationship that has not yet been defined.

We find ourselves in a very different position than eight years ago when President Obama was about to take office. In January of 2009, the world was in the depths of the worst financial crisis since the Great Depression. Financial institutions across the globe were on the brink of collapse. In the United States alone, we were losing more than 750,000 jobs a month. Over time, nearly nine million people lost their jobs, over five million lost their homes, and thirteen trillion dollars in family wealth was destroyed. Many lives were shattered, and many opportunities were lost.

Worldwide, the damage was similar. In the UK and the EU, unemployment soared to record levels. And 25 percent of global gross domestic product was lost.

It has been quite a transformation in the last eight years. In the U.S., since 2010 we have added 15.5 million jobs, the unemployment rate has been halved, and home prices have recovered. The Dow Jones Industrial Average was less than 8,500 on January 12, 2009. Today, it is nearing 20,000.

This climb back from the brink of disaster was the result of a massive government response in the U.S., the UK, the EU, and around the world. Governments and their central banks took unprecedented actions to stabilize their economies. And this was followed by actions to address the underlying causes of the crisis that were similarly unprecedented in their scope as well as in their degree of international coordination.

But the presidential election in the U.S. and the Brexit vote here in the UK have been interpreted as evidence of deep discontent with governmental policies and economic conditions, particularly by working class voters. To many commentators, these votes called into question assumed wisdom about the benefits of international trade and globalization. In the United States, there is talk of repealing many of the reforms taken in response to the crisis, as they have been said to hinder economic growth. And in the UK, the Brexit vote raises questions about the future of London as an international financial center.

So what may lie ahead when it comes to regulation of our financial markets and institutions?

I will not make predictions, but rather offer some suggestions about the way forward. And that is, we should not reverse the reforms made since the crisis. I do not believe the discontent that may have driven recent elections would be remedied by dismantling these reforms. Reducing the risk of financial instability in the future contributes to economic security for all. But at the same time, we should recognize that addressing the causes of that discontent in full requires a broader response.

Let’s first go back to the crisis, and how we climbed out of it.

There were many causes of the crisis—a bubble in house and other asset prices; excessive risk taking by banks; mounting corporate and household debt; and a regulatory system that had major gaps and deficiencies.

The U.S. government launched an all-out effort to prevent the crisis from becoming a global depression. Initially, at least, this was a bipartisan effort. A key part of the response to the crisis in the United States was the Troubled Asset Relief Program, or TARP. Through TARP, we provided capital to banks—not just the big banks, but hundreds of small and community banks. We implemented a housing program that helped millions of Americans stay in their homes. We took action to restart the frozen credit markets. And we prevented the U.S. auto industry from collapsing.

The U.S. government took many other actions, including economic stimulus measures. Other governments took action as well.

Central banks around the world used their monetary policy muscle to prevent a worldwide great depression. It was a war fought on many fronts, and it succeeded.

And as the fire was extinguished, we turned to addressing the causes of the crisis, in order to prevent it from happening again.

This too has been a war fought on many fronts. It has included stronger capital requirements for banks, limits on leverage, reforms of the derivatives market, and the creation of tools to deal with failing financial institutions without using taxpayer funds.

This evening, I will focus on derivatives reform—not only because I have been most involved in that work, but also because it is the area where, in some ways, we have traveled the farthest. We have gone from a world in which there was essentially no regulation, by any jurisdiction, of certain activities to a remarkable level of international cooperation in the implementation of a sensible, common framework.

The derivatives markets are comprised of futures, options, and swaps. Most people do not participate in these markets directly. And yet they profoundly affect the prices we all pay for food, energy, and most other goods and services.

If you are a farmer, you want to know what price you will get for your crop in the fall in order to decide how much to plant in the spring. The derivatives markets allow you to lock in that price, in advance. You may give up some upside, but you protect yourself on the downside.

These markets enable utility companies and airlines to hedge the cost of fuel. An auto manufacturer can fix the cost of its aluminum supply. Exporters can manage fluctuations in foreign currencies, and businesses of all types can lock-in their borrowing costs. A pension fund that wants to make sure it can pay out benefits over a very long horizon can use these markets to help lock in its ability to do so. In the simplest terms, derivatives help businesses throughout the world, up and down the economic value chain, manage price volatility. In short, derivatives help manage risk.

While most of the derivatives markets worked well during the crisis, one large and unregulated segment intensified the damage. This was the over-the-counter swaps market, and in particular credit default swaps. At the time of the crisis, the swaps market was a tangled spider web of bilateral transactions, particularly among the world's largest financial institutions, with no transparency and nothing to ensure adequate capital or collateral. Therefore, a default by one institution could easily lead to a cascade of defaults with devastating consequences.

This very scenario brought global financial companies, such as AIG, to the brink of collapse. Had it collapsed, it would probably have taken the U.S. economy down with it. Therefore, our government committed a total of $182 billion dollars over the course of several months to prevent that from happening—an unfathomable sum.

And though we recovered all AIG funds at a profit, such a commitment rightly caused public outrage.

Reforming the Financial System

In 2009 in Pittsburgh, President Obama, then-Prime Minister Brown and the other leaders of the G20 nations agreed to make a number of reforms to the OTC swaps market. They agreed that standardized swaps would be cleared through central clearinghouses—which is a means to mitigate and monitor the risk. They agreed that there would be capital and margin–or collateral—requirements for uncleared contracts, again to reduce the risk. They agreed that standardized swaps would be traded on regulated platforms and that all contracts would be reported to trade repositories, in order to bring transparency and greater integrity to the market. In the United States, these derivatives measures and many other reforms were codified in sweeping legislation entitled the Wall Street Reform and Consumer Protection Act—commonly known as "Dodd-Frank."

My agency was given the primary responsibility for implementing the swaps reforms. And we have put the regulatory framework in place. We now require collateral and capital to stand behind swap transactions. We have mandated central clearing for most swaps, and we require that trading take place on regulated platforms. Swap dealers must abide by basic oversight requirements, and we have increased transparency in this market through increased reporting.

Over the last several years, regulators from around the world, including in particular the UK and the EU, have also been implementing these measures. And they are working. For example, over 80 percent of swap transactions are being cleared today, as compared to only about 15 percent in 2007. And margin is being posted and collected for uncleared swaps.

A significant focus of our efforts during my tenure as CFTC chairman has been to increase international coordination and harmonization of these reforms. The lack of harmonization was a major criticism when I took office, and we have made tremendous progress there as well.

For example, we've harmonized collateral requirements, also referred to as bilateral margin, for uncleared swaps worldwide. We are coordinating clearing requirements. Last year, the U.S. and EU reached a landmark agreement that resolved critical issues regarding the supervision and recognition of clearinghouses—one which brought our regulatory regimes closer together. And there are many joint international efforts taking place with regard to clearinghouse resilience, standards for data reporting, and in a number of other areas.

The derivatives reforms are just one part of the global efforts to strengthen the financial system in the wake of the crisis. The G20 leaders agreed to many other actions, including establishing the Financial Stability Board (FSB), with a mandate to promote financial stability and assess vulnerabilities in the global financial system.

Regulators around the world have strengthened the capital and liquidity standards for banks. Common equity levels are ten times higher than pre-crisis, leverage is much lower, and reliance on short-term funding has declined. So-called “shadow banking” is being addressed. There also has been substantial work done to give governments the tools to resolve or shut down failing institutions without taxpayer funds--to create a system in which a major institution can fail without causing a broader systemic problem.

In all these areas, there is still work to do. There are sometimes disagreements over the best path, even among those who support the basic objectives. But I believe we are in a much better place today than eight years ago.

Impact of Recent Events on International Regulatory Framework

So what effect will recent political events have on the regulation of financial markets? Will we see an abrupt halt, or a reversal, in the actions taken to reform the global financial system? What about the prospects for continued international cooperation in these matters? If, in fact, these recent political events signal opposition to certain aspects of globalization, in particular to the free movement of people and goods across borders, are we entering a period when nations will be so focused on domestic priorities that we should expect less international cooperation when it comes to regulation of the financial system? And will competing nations end up racing toward lower regulatory standards in order to attract capital or business?

It is too early to know or even reasonably predict what exactly will happen.

But I want to offer a few observations and suggestions for what I believe is the proper way forward, particularly as it applies to the area under my jurisdiction, derivatives. My belief is that to repeal or dismantle the reforms we have implemented would be a major mistake. These reforms have made the financial system more resilient, which contributes to a strong economy. Their repeal would not contribute to improving the economic conditions that might have given rise to populist discontent expressed in recent elections. But at the same time, these reforms are not perfect—they can surely be improved upon. And more importantly, the goal of building economies that create opportunity for all requires more than just preventing financial instability. On that score, we have more to do.

I want to focus first on whether we will see less international cooperation in implementing reforms. I certainly hope not, because I believe it is actually necessary to address the concerns about economic opportunity and growth that may have been expressed in these recent votes.

Let me explain that. I noted that when I took office, there were many complaints about the lack of harmonization of these derivatives reforms across international borders.

In response, I would point out that there are very few areas of financial regulation that are harmonized across national boundaries. Consider securities laws: if a company wants to make a public offering of securities, compliance with U.S. law does not entitle it to do a public offering here in the UK. It must instead comply with local laws in each jurisdiction. There are significant differences in national regulatory regimes when it comes to secured lending, corporate tax policy or just about any other area you might name.

I believe many in the derivatives industry presumed that there should be harmonization because they were used to a world in which there was no regulation before the crisis. Global banks were able to transact swaps across borders without worrying about differences in rules, because there were no rules to worry about. But that's in part what led to the problems we faced in the financial crisis. AIG built up its excessive risk through an operation here in London into which U.S. regulators had no visibility. And the crisis spread from its origins in the U.S. mortgage industry in large part because investors around the world purchased mortgage-backed securities and derivatives that were not regulated in the U.S. or in their home countries.

In short, the global nature of the financial system had outstripped the ability of national regulators to oversee it. This was not only true in derivatives, it was true in other areas as well. There is a global market for finance—capital moves in a microsecond from one jurisdiction to another, and with it the investment that can create jobs. But we still regulate the system through nation-states; there is no global regulator. And what we have been doing since the crisis is trying to catch up—working, as individual nations, to plug the regulatory holes and deficiencies that contributed to the causes of the crisis, and to do it in a coordinated way so that we have effective regulation of the global financial system.

If we enter a period when there is less international cooperation in regulating the global financial system, or worse, regulatory competition, that is likely to increase the risk of financial instability, which can in turn lead to another crisis that causes the type of suffering we saw last time.

Clearly though, these recent political events may lead to some changes in the current regulatory framework.

Implications of Brexit

I want to offer a few observations first on possible implications of Brexit, from the point of view of an American financial regulator. Whatever the terms of the future relationship between the U.K. and Europe, I hope it does not reduce the commitment to these financial market reforms generally, and does not trigger a competition to attract business that lowers standards. To date, there has been a deep commitment to these reforms here in London, as well as in other European capitals. It has been reported that the U.K. plans to repeal the European Union financial regulation rules and then adopt equivalent measures as UK law. Such a path would mean that the UK would continue to have laws and regulations equivalent to those in the EU.

But there may still be challenges. One area where I see challenges for both sides is with respect to the regulation of clearinghouses and potentially other core market infrastructure, such as trading platforms. While this may seem somewhat technical, it could affect London's role as the pre-eminent financial center in Europe, so let me explain further.

Once the U.K. is no longer part of the European Union, European law today would require the EU to determine that the UK has an "equivalent" regulatory regime for its clearinghouses and trading platforms. This is the same equivalence process that every other non-EU country must go through. Failure to be found equivalent would mean European financial firms will face higher capital charges for transactions cleared in the UK.

But under current law, the process for deciding whether to grant equivalence would not start until after the UK exits. As a result, there would need to be a change in the process to avoid a gap between exit and recognition. And so negotiators will be faced with whether they can agree to a process or relationship for the post-Brexit world during the actual exit negotiations.

Second is whether Europe is willing to apply the same equivalence framework to the UK as it did with the U.S. and other countries. When the CFTC was in negotiations with the EU over clearinghouse equivalence, I felt the EU applied tougher conditions than what were being applied to other countries. This reflected the relative importance of the U.S. market to the EU. The London market is of course even more important to the EU, so it would not surprise me if the U.K. faced a similar situation.

Further, Europe may want greater ongoing oversight of UK clearinghouses and exchanges, given their importance to the European economy. The equivalence standard is largely a one-time decision, and therefore does not provide that type of oversight. This too could lead to changes in the process.

Moreover, there have been calls by European leaders to move the clearing of euro-denominated products from London to continental Europe. This would provide European central banks and regulators greater oversight for that activity, particularly as it relates to monetary policy. However, it would limit the efficiencies that investors otherwise obtain by managing euro-denominated transactions with the rest of their portfolios. This could raise costs for businesses transacting in such products, and it could affect the location decisions of some financial services firms.

Now many of you may know the UK successfully brought a legal challenge against the European Central Bank regarding this issue before the Brexit vote. But the issue has resurfaced following Brexit.

If Europe insists that clearing of euro-denominated products cannot occur in London, that could also give rise to questions as to whether such clearing can occur anywhere outside of Europe, including in the United States. This could lead to other countries considering whether to adopt similar policies regarding clearing of products in their own currencies.

The volume of euro-denominated products cleared in the U.S. is quite small. But the volume of dollar denominated derivatives clearing that takes place in London is very large. Indeed, there is more dollar swaps clearing in London than euro swaps clearing.

For our part, the CFTC has never insisted that dollar-denominated products be cleared in the U.S. But we do require overseas clearinghouses that do substantial U.S. business to register with us and provide us with access just like any U.S.-based clearinghouse. This framework gives us the ability to oversee what is going on at such foreign clearinghouses. We have oversight of major London clearinghouses as a result.

There are also pending private sector transactions that may affect these issues, most notably the proposed merger of the London Stock Exchange with Deutsche Borse.

So how does one balance these concerns—the desire to have oversight of important activity that is offshore, but also to preserve the efficiencies that may exist when clearing of multiple products is concentrated in one place? Could some sort of enhanced ability of European regulators to oversee activity that is offshore satisfy the call to relocate the clearing of euro-denominated products?

Of course, these are just a couple of the many challenging issues created by Brexit. The UK and the EU are very important partners and allies for us in the U.S. This obviously transcends issues of financial regulation and trade. And so I hope the parties can negotiate the exit, the transition, and the future relationship in a way that leads to a good result for all. And I hope our government can offer support toward that end.

The Future of Reform in the United States

Let me turn to the Unites States election. I noted that there have been calls to repeal or dismantle Dodd-Frank. The law covers a wide variety of subjects—the derivatives reforms are just one of 12 chapters. And there are many different views, even within the Republican Party and the financial sector, on what exactly to do. For example, there have been calls to raise capital and leverage requirements on banks in return for simplifying certain regulation. There have been calls to eliminate or ease the restrictions of the Volcker Rue—which restricts trading by banks—but at the same time some calls for reinstating the Glass-Steagall Act, which requires a separation between commercial and investment banking. Some have called for reform rather than repeal and have focused on particular provisions, such as whether the law unfairly burdens smaller banks. So in my view, it is unclear what will happen.

I believe that wholesale repeal of Dodd Frank would be a big mistake. And particularly, when it comes to the reforms of the swaps market, I believe there's a wide consensus that the reforms made sense.

This, however, does not mean that are not good faith differences about how to implement this framework. Nor does it mean we cannot improve upon the existing rules. We surely can. I and my fellow commissioners at the CFTC took office after many of the rules had been issued and we worked hard to fine-tune and improve them. We worked to make sure the rules focused on areas of greatest risk and did not create unintended consequences. We worked to strengthen relationships with international regulators and harmonize regulations across borders. And we did much of this work on a bipartisan, unanimous basis.

There is more that can be done to improve the rules. So I would hope that we continue to improve them, not repeal them. And that should involve continuing to analyze the impact of these reforms and the conditions of our markets.

Nowhere is it more important to look at the consequences of the derivatives reforms than with central clearing. Because we mandated increased use of clearinghouses, some have raised concerns that we have simply created new systemic points of potential failure. So we must make sure clearinghouses are strong and resilient.

In this area my agency has been doing a great deal, both domestically and with other international regulators.

Recently, for example, our staff published a report on a series of supervisory stress tests we performed on the five largest clearinghouses under our jurisdiction, located in the U.S. and the United Kingdom. These tests were possible because of the oversight we have, even across national borders, which I mentioned earlier. The results were very positive, but we need to continue this type of work.

Another area that has been and should continue to get attention is market liquidity. There has been a lot of discussion about whether various reforms outside the derivatives space to enhance the capital of our largest banks, and put limits on certain activities, have adversely affected liquidity. This is worth examining. But let's remember that liquidity may have been underpriced before the crisis; the reforms were meant to correct that. And in addition, liquidity is shaped by many factors beyond regulation, such as market structure, technological change, and general economic conditions. It can be very hard to separate the effects of these various factors.

In addition, over the last several years, the nature of liquidity has changed as a result of the vastly increased amount of automated trading in our markets. Both the composition of who trades, and the way that firms trade, has changed enormously.

As regulators we are behind the curve in understanding all the implications of automated trading. We have been making this a priority at the CFTC, and more needs to be done so that we make sure our markets still function with integrity and serve the businesses that need them.

Looking to the Future

These examples—clearinghouse resilience, as well as market liquidity and its relationship to automated trading—remind us that markets evolve constantly. They change in response to regulation, but also, and perhaps more importantly, they evolve as a result of technological advances, macroeconomic conditions, and other factors.

So as regulators, we must make sure we are not just looking backwards, addressing the causes of past problems, such as the financial crisis. We must be looking forward as well. There is no greater example of this than the need to focus on the risk of cyberattack. This is probably the greatest single threat to financial stability today. It has been a priority of mine, and I hope it will continue to be so for the CFTC. And I hope that any debate over the reforms we have already made does not distract us from facing the new challenges and opportunities ahead.

Let me conclude with this. We are unlikely to predict what will cause the next financial crisis. But the measures we have implemented in response to the 2008 financial crisis have made the global financial system more resilient. The international cooperation in their implementation has been unprecedented. We are responding to the fact that the global financial system had outstripped the ability of national regulators to oversee it. All this work helps reduce the likelihood of a repetition of the terrible economic damage and suffering we experienced just a few years ago, suffering which surely contributed to the discontent witnessed at the polls.

But that discontent also reflects other forces, in particular the broader challenges facing our economies as a result of structural shifts due to decades of globalization and automation. And addressing those issues requires additional, potentially much broader, responses. Whether that involves job retraining, infrastructure funding, tax reform or other policy changes is beyond the scope of my speech. Regardless of how you voted in the American election or the Brexit referendum, those economic concerns deserve to be fully addressed. I hope our political systems and leaders can meet that challenge while maintaining reasonable regulation of the global financial marketplace.

Thank you for your time today.

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