Jean-Claude Trichet: Financial stability risks

Intervention by Jean-Claude Trichet, President of the European Central Bank, at the International Monetary Conference Central Bankers panel, Frankfurt am Main, 5 June 2007.

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In my intervention I would like to focus on **financial stability risks**, based on the ECB Governing Council's most recent assessment. We have been pleased to observe that the external macro-financial environment for the euro area financial system is robust and it is also projected to continue to develop rather favourably. Credit quality in the euro area remains high, and it should be further underpinned by the favourable economic outlook. Although pockets of vulnerability in the euro area household and corporate sectors have increased, on average financial positions remain sound. Finally, financial institutions, including banks and insurance companies, have shown improving financial results and market participants expect profitability to remain strong also in the foreseeable future.

In late February and early March of the current year, the financial system has absorbed smoothly the third significant burst of market volatility in the past two years. This high degree of resilience of the financial system can be attributed also to the continuous improvement in the risk management practices of financial firms. All in all, recent developments and forward-looking indicators together allow us to conclude that the main scenario for the euro area financial stability remains favourable going forward.

The fact that the global and euro area financial systems have so far proven resilient to a series of adverse disturbances, while comforting, does not provide any ground for complacency. The episodes of market volatility throughout the past two years were triggered by relatively small and transitory disturbances in an environment of strong macroeconomic fundamentals and abundant financial market liquidity. Therefore, it is unlikely that these episodes would provide sufficient guidance on how the financial system would perform in the event of larger shocks that could trigger a more material reappraisal of risks, or a change in risk appetite, at a less favourable stage of the credit cycle. For instance, vulnerabilities could be quickly unearthed if market liquidity – hard to measure but currently seen by many market observers as more abundant than ever – were abruptly and sharply to decline, for example as a result of an unexpected deterioration in investors' risk appetite.

I would like to highlight briefly **three issues** that we currently see as important in assessing future risks to financial system stability: hedge funds, private equity sponsored buy-out activity and the markets for credit risk transfer. Starting from **hedge funds**, the industry has both grown (US$ 1.4 trillion of total assets managed at the end-2006, in accordance with some sources) and developed in sophistication considerably over the past decade. While we all recognize that the growth of hedge funds has had clearly a positive impact on the efficient functioning of financial markets, it can also pose threats to the stability of the financial system. These risks can take two main forms. First, hedge funds are a direct source of counterparty credit risk for a number of large banks for which hedge funds are also an increasing source of revenues. Second, hedge funds have become, through active trading, important drivers of liquidity in a number of markets, including credit and derivative markets, and it is uncertain whether this could make these markets less stable in some circumstances. A suitable way to address these risks remains a close scrutiny of hedge funds by their counterparties and investors. Therefore, I fully support the recommendations put forward in a report by the Financial Stability Forum, which are addressed to supervisors, hedge funds' counterparties and investors and the hedge fund industry itself. On the latter aspect, I strongly believe that the hedge fund industry should review and enhance sound practices benchmarks as recommended in the report by the FSF, and that a set of principles voluntarily prepared by the industry itself under its own responsibility could be a suitable tool to pursue this objective.

Over the past couple of years, **leveraged buy-out** (LBO) activity has intensified considerably, both globally and in the euro area. As in any fast-growing markets, and particularly in circumstances where credit market fundamentals are very strong and market liquidity is seen as abundant, the rapid expansion could raise some concerns from the financial stability point of view. In particular, risks could be building up if regulated financial institutions, which provide the debt financing to LBO undertakings, softened their lending standards in the pursuit of market share and fee income. While available evidence suggests that lenders are managing their risks broadly appropriately, it cannot be excluded

that some of the pricing models and risk management techniques currently applied could rely on overly benign assumptions. Moreover, some of the features of the recent LBO financing arrangements, such as loan contracts where covenant clauses have been all but eliminated, may limit the ability of creditors to intervene in the businesses of the LBO target firms even in case where there is a material change in the capability of the firm to service its debt.

A new characteristic of today's financial markets is that hedge funds, private equity firms and the banks financing these institutions all strongly rely on techniques for **credit risk transfer** (CRT) to manage their risks. While CRT markets have obvious benefits in terms of allowing effective risk sharing in the financial system, excessive reliance on the functioning of such mechanisms can lead to complacency on risks. In addition, CRT markets operate in a rather opaque manner which does not allow for monitoring of concentration and counterparty risks by other market participants or by public authorities. Moreover, the growing spreading of more complex structured credit products raises the issue that investors in such instruments may not be able to properly assess the risks they assume. Unanticipated changes in the macro-financial environment can cause model assumptions to fail and this may contribute to pricing dislocations and market liquidity problems if many investors decide to exit their positions simultaneously. All in all, I see scope for further cooperation between public and private sector entities to gather information on the CRT market to improve the ability to assess potential systemic risks.

The state of the fundamentals in the credit markets, CRT and unregulated financial institutions can together be described as a potential "**triangle of vulnerability**" in that a shock at any corner of this triangle could have implications for the other two. For instance, a significant turn in the credit cycle could mean that credit protection-sellers, such as hedge funds, could become unable to make due payments to banks. Similarly, if widespread problems were to emerge at hedge funds or private equity firms which are active in CRT markets, this could even spark a downturn in the credit cycle, if it were to impair the "originate and distribute" business model adopted by many banks involving securitisation and hedging of lending exposures.

Let me conclude by saying that ultimately the triggers for any potential adjustment cannot be predicted with any degree of certainty. All that we know is that the present state of global finance – where we are observing a level of risk pricing which is historically low – is not necessarily sustainable in the long run. All parties concerned should therefore contribute to an orderly and smooth adjustment, when the time comes, and avoid an abrupt and sharp adjustment which would be adverse for the global economy. All parties concerned, public and private, have in this respect a very important shared responsibility. I thank you for your attention.