Malcolm D Knight: European financial integration in the context of current financial market turbulence

Keynote remarks by Mr Malcolm D Knight, General Manager of the Bank for International Settlements, at the 2007 Eurofi Conference "Achieving the integration of European financial markets in a global context", Brussels, 3 December 2007.

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Let me thank you for the opportunity to address this distinguished group of executives and policymakers. Eurofi is playing a leading role in identifying key strategic issues that need to be addressed to advance further towards the fundamental goal of achieving comprehensive financial integration in Europe, and of promoting a closer dialogue between market participants and policymakers and in particular financial regulators.

In my brief remarks tonight I want first to underscore several important achievements of financial integration in Europe thus far that are key to its further progress. Then I will outline several features of the current international financial market turmoil that have implications for the future progress of European financial integration. Finally, I will comment on how the preliminary lessons from the financial disturbances we are currently witnessing may be important in shaping the ongoing process of financial integration in coming years.

European financial integration

The achievements of European financial integration over the past two decades are truly impressive. Prior to the advent of the euro in 1999, European authorities took deep and successful steps to stabilise cross-country exchange rates and eliminate controls on international capital movements within what is now the euro zone. The introduction of the single currency less than nine years ago has led to an acceleration of financial integration by eliminating intra-zone exchange rate risk and achieving low and stable inflation. Indeed, the establishment of a common currency backed by a European Central Bank with a clear monetary policy mandate and underpinned by firm fiscal rules has helped to clarify policy responsibilities and make more transparent the structure of this huge multi-country economic region. This has had the expected positive effect on European economies and, indeed, on global markets. Over the past two decades, inflation in what are now the euro area countries has come down substantially, nominal interest rates have fallen, and inflation expectations have become well anchored at low and stable levels. As a result of these achievements, the European Central Bank has rapidly established itself as a key and credible institution in global financial markets.

In itself, this move towards greater macroeconomic stability has boosted European financial integration. From the earliest years of the euro, issuance of corporate debt securities surged, supported by the elimination of exchange rate risk within the currency zone and higher demand from a larger pool of investors. Likewise, a deep euro area-wide interbank money market developed rapidly. This is a key component – indeed, perhaps *the* key component – of the financial infrastructure of the euro zone. Its rapid development owes much to the major efforts of the European Central Bank in elaborating its monetary policy procedures and its liquidity operations. To be sure, European financial integration has not proceeded at the same pace across all sectors and markets. Integration of the retail banking markets, for instance, has remained limited, reflecting the persistence of legal, institutional and regulatory differences. But things are moving. Even a cursory reading of the financial press shows that financial integration is making visible progress almost day by day.

The current financial market turmoil

But how does the current turmoil in global financial markets impact on the positive picture that I have just sketched for you? Let me recall that this turmoil follows a prolonged period of broadly based and aggressive risk-taking that was reflected in unusually low risk premia and low volatility across many asset classes. Thus, prior to last summer, many careful observers believed that the price of risk was too low – so an increase in risk premia was widely seen as healthy from a financial stability perspective.

There was a large element of wisdom in this point of view. Nevertheless, when risk aversion suddenly jumped last summer there were major surprises. A first surprise was that a shock in one specific segment of the mortgage sector in the United States led to severe adverse effects not only in that country, but also in the euro zone, the United Kingdom and Canada. The impact in the euro zone was a surprise to many observers because increasing financial integration had greatly strengthened the European financial system.

A second surprise was the sudden evaporation of liquidity in the major interbank markets, which has persisted since the summer and which has transmitted the tensions in credit markets to the very heart of the international financial system. The distortions in the interbank money markets have occurred mainly in the United States, the euro zone and a few other key economies, such as the United Kingdom. They are much less severe in Japan; and major emerging market economies have weathered the global turmoil relatively well so far. In the euro area, the spread between the market expectation of the overnight interest rate during the next three months (the EONIA swap interest rate) and the rate at which commercial banks can borrow from each other over the same period – the three-month Libor rate – suddenly jumped in August and has stayed elevated since, while it is usually a few basis points only. Indeed, this spread has been widening again since early November, to around 75 bp today. Since the interbank credit markets are uncollateralised, this large premium presumably reflects increased liquidity and credit risk concerns, even among the largest banks.

Liquidity and credit risk

What are the main causes behind this unexpected upsurge in liquidity risk and credit risk? I would stress two key factors: information failures in credit markets; and weaknesses in the "originate-and-distribute" business model adopted in recent years by large internationally active banks.

First, the opacity of certain parts of the global financial marketplace, particularly the markets for structured financial products and the off-balance sheet vehicles designed to hold them (the now famous "conduits" and SIVs), has led to a sudden collapse of confidence in asset valuations and a generalised distrust of counterparties. As a result, market participants now wonder about the size and character of banks' exposures – including those of large European banks – because of the existence of explicit or implicit backup credit lines to a wide variety of market players. Beginning last summer, this crisis of confidence triggered an evaporation of market liquidity for the instruments concerned and a funding liquidity squeeze for those institutions that were suspected of being vulnerable to them.

Second, weaknesses in the "originate-and-distribute" business model of the large banks, primarily in the United States and Europe. There are some very positive aspects of this model, since it helps to diversify banks' revenue streams and risks. But the operation of this model in recent years has been associated with an excessive relaxation in standards of credit origination and credit monitoring in the financial system as a whole. As a result of the current turmoil, the originators and securitisers of complex financial instruments have become – in many cases to their own surprise – the "holders of last resort" of the more exotic credit products. This development has also underlined weaknesses in the risk management practices of investors, who underpriced the risks concerned and relied excessively on external ratings for monitoring risk. And it has demonstrated that the wider distribution of risk across the financial system, if not supported by transparency and market discipline, makes it difficult to gauge the risk exposures of market participants.

The combination of these two factors – inadequate public information in credit markets and weaknesses in the way credit risk has been distributed in the market – helps to explain why the current turbulence has primarily affected the interbank markets at the core of our modern global financial system and why this weakness was not foreseen before last summer. Because they were focusing on the balance sheets of the regulated banking institutions, observers wrongly underestimated the actual degree of leverage in the financial system as a whole – I mean all the leverage generated not only by the activities of commercial banks, but also by highly leveraged institutions, SIVs, conduits, LBO-financed firms, etc; that is, the leverage of all institutions that, implicitly or not, was predicated on backup credit lines being provided by regulated institutions in times of stress.

Looking forward

I believe that the financial integration that has taken place in the euro zone since the advent of the euro in 1999 has contributed importantly to a remarkable rise in living standards and greater financial and economic stability. It follows that continued financial integration is essential to further the remarkable progress of Europe. So the question is: what lessons should we draw from the current financial turbulence that can help to make the future course of European financial integration both stronger and more immune to financial disturbances at its core?

I do not pretend to have an answer to this question – at least not yet. But in closing let me offer just four thoughts that are relevant to it. First, firm euro zone monetary policy will continue to play a key role in fostering further European financial integration. The European Central Bank has shown great success in maintaining an appropriate monetary stance while at the same time fine-tuning its liquidity operations in the interbank market so as to ensure that its overnight rate remains broadly on target, and that monetary conditions continue to be set effectively given prevailing macroeconomic conditions. And the ECB has also been a leading central bank in taking action to address dislocations in the longer-term interbank money markets, even though this has proven difficult to realise given that the term premium comes from banks' own uncertainties about liquidity and counterparty risks.

My second thought is that there is clearly a need for greater transparency in financial markets on both sides of the Atlantic. This can take many forms. One is to reduce product complexity: I expect to see more emphasis on financial assets – including structured products – that have simpler features to make them less illiquid in difficult market conditions. Another is more refined rating scales for these assets, giving investors a better sense of their risk characteristics. There are signs that this is already happening in the marketplace, as rating agencies and market participants adjust their methodologies for assessing and rating risk.

Third, there is a need for improvement in risk management practices – not least liquidity management by financial firms; standards of credit origination; and monitoring of the debt servicing performance of borrowers. Experience suggests that prior to the current turbulence investors underestimated the tail risks to which they were exposed, including the interdependencies between credit, market and liquidity risks. Improvements in stress testing can play a key role here. Needless to say, such stress tests should consider the cross-country nature of the euro area financial system.

Finally, greater financial stability calls for closer communication and cooperation among players in the financial system, not just within the official sector, but also between the official and private sectors. This is especially true in the euro area given its multiplicity of jurisdictions and layers of responsibility, which puts a premium on cooperation. Meetings like this suggest that the lesson is well understood by all the parties involved. This can only augur well for the future.