

Hermann Remsperger: Financial market turbulences – some observations

Speech by Professor Dr Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, at the conference “Bond markets in emerging market economies – financial globalisation, vulnerabilities and data needs”, Frankfurt am Main, 31 January 2008.

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I Introduction

Ladies and gentlemen

First of all, let me welcome you to tonight’s dinner in the Japan Tower. I think this is a very suitable location, given the fact that Japan has recently taken over the G7/G8 presidency from Germany.

I hope you all enjoyed today’s presentations and discussions on bond markets in emerging economies. Tonight, I would like to take the opportunity to turn to a topic that is not directly related to the topic of our conference but is of key relevance, also for emerging markets.

I am going to discuss three aspects of the recent financial market turbulences that I find particularly important. First of all, I would like to talk about the originate-to-distribute model, a segment in financial markets that has grown dramatically over recent years and has played an important part in the turbulence. Second, I will look at the role of risk management, and, third, I am going to consider some regulatory issues.

But before addressing these three points, let me remind you that there had been early warnings that the benign conditions in global financial markets would not last forever.

Among many others, we at the Bundesbank had pointed to obvious risks, such as very low risk premiums, the complexity of financial instruments and of the models for their valuation. However, I do not want to pretend that we had foreseen exactly when and how the financial turmoil would emerge.

For instance, the very strong impact on the interbank money market came pretty much as a surprise. The provision of liquidity by the Eurosystem and operations in cooperation with other central banks have eased tensions in the money market. However, some of the underlying problems still persist. Actually, recent events show that confidence in financial markets has not yet returned to normality.

Meanwhile, banks had to take off-balance-sheet assets on board and make substantial write-downs. Some had to look out for fresh capital, which was partly provided by sovereign wealth funds from Asia and the Middle East, an aspect that may play a role in further discussions on sovereign wealth funds.

We have also seen spillovers into other market segments. For instance, the previously booming mergers and acquisitions business, above all leveraged buy-outs, has slowed down significantly.

Considerable uncertainty is now surrounding US monoline insurers, and this may have negative implications for the municipal bond market and other more complex instruments protected by monoline insurance.

In addition, I would like to emphasise that the global economic outlook is very uncertain. It may be adversely affected by the financial market problems. In turn, there may be a negative feedback from a possible economic slowdown on the financial markets. A worsening in the credit cycle in the US cannot be ruled out.

II Weaknesses in the originate-to-distribute model

After this short snapshot of the current situation let me now come a bit closer to the originate-and-distribute model. The basic idea is that loan “production” can be decoupled from holding assets and/or risks. In principle, this is a valid division of labour within the financial industry, if it is handled with a high degree of risk-awareness and sophistication.

However, it has now become clear that these requirements have often been disregarded. In many cases, the credit quality of underlying assets was low, not least as a result of doubtful practices in the US subprime market. Many of the loan originators were not regulated.

Shortcomings in banks’ risk management, also as regards off-balance-sheet exposures, and investors’ due diligence practices have become apparent. And all this played hand in hand with an over-reliance on credit ratings as well as difficulties regarding the valuation of complex financial instruments.

Moreover, pipeline risks were not managed well, leading to large warehouse exposures for originators and packagers, inflating their balance sheets and using up their capital.

The turbulence has resulted in a slowdown in credit repacking. Business in structured products has decreased significantly. Banks had to take SIVs and conduits into their balance sheets.

However, this does not mean that the originate-to-distribute model has become fully obsolete. If market participants draw the right conclusions with a view to higher safety standards, adequate incentive structures and perhaps a preference for financial instruments with less opaque financial structures, securitisation will continue to play an important role.

At this point I should add that the financial turmoil has revealed a number of weaknesses in the rating process. Overall, it seems fair to say that credit rating agencies have tended to underestimate the risks contained in structured credit products.

As the risk properties of such products differ considerably from those of traditional bonds, agencies should think about using a different rating scale for structured products.

Moreover, conflicts of interest need to be considered as rating agencies are paid both for advising the issuer on the best way to structure their products and for rating the same products.

To tackle these weaknesses, the rating industry has already indicated the readiness to develop some guidelines for “best practices”.

I believe it would be helpful if regulators discussed the necessary changes with rating agencies and other market participants. Such discussions could lead to a higher degree of transparency, including the assumptions underlying the ratings as well as methodologies used or minimum requirements for rating quality.

III Risk management

At the same time, I cannot repeat often enough that external ratings are no substitute for appropriate risk management within financial institutions. The turbulence has made it very clear that improvements in risk management practices are absolutely necessary.

This concerns in particular credit and liquidity risk. Stress tests are key, and their use should be enhanced to identify potentially excessive exposures.

Over recent years, liquidity risk has obviously been underestimated by financial institutions. It should receive more attention in the future. Currently, work is being done on international liquidity guidelines, but this seems to be a very difficult subject to put into practice.

IV Regulatory issues

So let me draw your attention to regulation that is already in place today. Basel II came into force in Europe at the beginning of this year. I expect it to prevent at least some of the problems that contributed to the financial market turbulence.

For instance, with the introduction of Pillar 1, financing facilities for special purpose vehicles will become subject to a capital charge. This will reduce the regulatory arbitrage that resulted in large off-balance-sheet exposures.

Financial institutions' internal control mechanisms will be strengthened by the supervisory review process in Pillar 2. Last but not least, Pillar 3 lays down disclosure requirements and will thus strengthen market discipline.

In the light of the current developments, some refinement of Basel II should not be ruled out. For instance, it may be worth reconsidering if the originally agreed risk weights and the conversion factors for off-balance-sheet exposure need readjusting.

Furthermore, I would like to stress that regulatory arbitrage needs to be avoided and loopholes should be identified quickly in the future.

In recent years, and in particular in the structured finance business, unregulated financial institutions have played an increasing role. The growing importance of hedge funds and private equity firms and the establishment of off-balance-sheet vehicles, such as conduits, are cases in point. At the end of the day, a significant share of financial market activities was outside the focus of regulators and supervisors.

This leads me directly to another issue with regard to supervision and financial stability. In my view, the constant and rapid development of new financial instruments, valuation models or legal structures poses a particular challenge to financial authorities. What we need is a speedy transfer of insights gained in international financial markets into our supervisory work.

And this is one of the many reasons why central banks should be involved in supervision. The current turmoil has clearly demonstrated how important the interaction between central banks and supervisors is.

Thanks to its direct contact with market participants, the Bundesbank has access to important details that are essential for the assessment of financial market turbulence and its impact on the German financial system.

Furthermore, such information is of key importance for central banks' responses to disturbances in the financial market, as we have seen with regard to the liquidity provision of the Eurosystem in the money market.

V Statistics

Last but not least, I'd like to mention another factor that might increase financial transparency and thus help to reduce, at least indirectly, the risk of future financial turbulences, and that is closing some statistical gaps.

An important aspect that is currently being considered by Eurosystem statisticians is how credit risk transfer by banks could be covered statistically. This could include both data on the traditional "true sale" and synthetic securitisation operations as well as on transactions in credit derivatives.

Some additional insight might also come from more data on the so-called Financial Vehicle Corporations issuing asset-backed and other securities in the process of securitisation. Collecting data on such entities is currently under discussion in the Eurosystem.

Moreover, it is essential to gather more information on the holders of financial assets. The Bundesbank has initiated a security-by-security data collection on the holdings of the various

sectors, as is also practised in some other countries of the euro area. The Centralised Securities Database that is being developed in the ESCB – and that will be presented at this conference – could bring us a step forward in these endeavours at the European level.

VI Conclusions

To sum up, let me emphasise six points.

First, the current financial turbulence has revealed weaknesses in the originate-to-distribute model. It needs careful handling and a high degree of sophistication and prudence from market participants. Therefore, strengthening banks' risk management practices must have priority.

Second, market participants should not rely exclusively on extremely complex models. While financial markets get increasingly complicated, the traditional principles of prudent banking are still not outdated. Thus, a re-pricing of risk is not enough. What we need is a re-evaluation of the way credit markets work.

Third, the role of ratings in the originate-to-distribute process must be reviewed.

Fourth, banks need to build up sufficient capital and liquidity buffers because financial crises are very hard to predict. It is primarily up to the market participants to deal with the risks they incur.

Fifth, we should only resort to additional regulation where market failures become obvious. Regulators should set incentives that promote institutional and market discipline.

Sixth, closing some statistical gaps might help to increase financial transparency and thus help to reduce the risk for future financial market turmoil, at least indirectly.