Jean-Claude Trichet: Reflections on the current financial market correction

Keynote address by Mr Jean-Claude Trichet, President of the European Central Bank, at the International Capital Market Association's Annual Conference, Vienna, 15 May 2008.

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Ladies and Gentlemen,

It is a great pleasure for me to speak at the invitation of the renowned International Capital Market Association on the occasion of its 40th Annual Conference. Little did you know back in June 2007, when the invitation was extended, that the recent financial turbulence and volatility would provide such an important backdrop to my reflections on the subject today.

I need not remind this audience that we are still some way away from having the full benefit of hindsight on the ongoing turmoil in global financial markets. Both private and public institutions across the globe are still deeply immersed in tackling all the consequences on the financial system of the continuing process of financial deleveraging.

Let me first recall that public authorities – and I would include here the European Central Bank (ECB) through its semi-annual Financial Stability Review – issued clear warnings on the vulnerabiliies that were building up on account of a significant under-pricing of risks in some segments of the financial markets already in early 2007. Equivalent warnings were largely communicated by other central banks, and I had myself, as Chairperson of the global economy meeting of Central Bank Governors, regularly expressed the view, in 2006 and at the beginning of 2007, on behalf of my fellow Governors, that our judgement was that there was a significant under-pricing of risks in general in global finance.

We do all what we can at the ECB to be equally forward-looking in both our actions and in helping delineate the solutions to the present quagmire. I trust that in the process of characterising the nature of the turmoil it will also become clear what the rationale has been behind the response of the central banking community since its eruption early in the summer of 2007, and how a consensus is being built on the key policy lessons and initiatives that will guide the efforts of private institutions, market participants, central bankers and government agencies in the period ahead.

Factors underlying the recent financial market turmoil

Whilst the trigger for the turmoil was clearly a myriad of problems associated with the US housing market correction, the sharpness and speed of the contagion to unrelated market segments revealed vulnerabilities with a nature and complexity that had not always been well understood. A constellation of – in my view – three broad factors already individually known to market participants and policy makers alike well in advance of the turmoil have reinforced one another in a way that almost nobody could have foreseen. These factors are an abundance of liquidity that underpinned a build up of leverage in the financial system, an increasingly interwoven and complex financial system the growth of which was fed by financial innovation, and some financial agents' incentives that were aligned against prudent practices.

We should not lose sight of the fact that the **first factor** – and the driving force behind the substantial rise in financial leverage – was a significant excess of savings over investment in the global economy. In time, this abundance of capital chasing investment drove an increasingly aggressive "hunt for yield" which was reflected in a surge of demand for and supply of, among other assets, highly complex financial products. As has been argued by many in the international community, the period preceding the current financial turmoil shares many of the characteristics of previous historical episodes, whereby there is a sudden recognition and recoil from underlying credits whose quality was in fact worsening for years.

Clearly, however, there has been much more to the current episode than simply a surge of asset prices in an environment of steadily rising financial market liquidity. A **second element** in the constellation of vulnerabilities was the ubiquity of interlinkages both within and across financial systems. Testimony of this evolution, even when compared to just a decade ago, are the speed and degree of complexity of today's capital flows; the relative variety, obscurity and interrelationship of many classes of financial instruments; and the intertwined relationship of a growing variety of financial institutions. This clearly placed a heavy burden on the risk management procedures of large financial intermediaries.

I share the view that modern financial intermediation has proven that it has the potential to effectively spread risk and it has undoubtedly promoted economic efficiency and made capital available to productive sectors that would have otherwise not had access to any. Alas, the evolution of the financial system not only facilitated an expansion of the array of financial assets available to investors, it also seeded the fragility that later materialised in the unprecedented speed and reach of contagion during the unwinding of leverage. The challenge lies in preventing the system from feeding on itself through a spiralling process of leveraging. Financial complexity is an inevitable consequence of increasingly complex and global economic activity, and we must find ways of working out the necessary checks and balances.

Abundant liquidity and financial complexity embody in my view the driving force and the scene underlying the process of financial leveraging and its unwinding, but the full picture of the weaknesses that have been unearthed in the "originate-to-distribute" financial intermediation model is not complete without saying something about financial players' incentive structures – **the third factor**. Strictly speaking the purpose of the financial system is to write, manage and trade claims on future cash flows for the rest of the economy, a purpose that increasingly fell victim to a game for fees, very short-term apparent profits, and arbitraging regulation. The "shadow banking system" that rapidly emerged as an excrescence of the formal banking sector – unlike its better understood and regulated sibling – rested on a poorly understood system of credence (provided by rating agencies) and the false perception that the only way for asset prices was upward. Indeed, most remarkably ex-post, it did not have to set aside capital against the risk of things going wrong, as eventually they did when euphoria turned into sobriety.

Prior to the July 2007 rude awakening from a false sense of security of financial markets participants, observers and regulators at large, these three broad factors contrived a convergence of mechanisms that resulted in the upward spiralling of asset prices, further leveraging, increasing complexity and shrinking transparency. In closer immediacy, they together also shaped the particular mechanisms that unleashed the turmoil, First, it took one substantial shock to a single market segment (US sub-prime related credit) to trigger a broad-based drive to re-price credit risk across all classes of financial instruments and involving a wide range of financial institutions. Second, the process of adjusting risk positions in the financial sector was hindered by a – in some cases complete – breakdown in the price discovery process across instruments owing to the lack of understanding of the distribution and magnitude of risks underlying the various financial instruments. Third, the unprecedented system-wide dry-up of liquidity that resulted from reductions in position-taking by major financial intermediaries fed back into the overall uncertainty, thus escalating measured risk and frustrating the very same efforts towards risk reduction.

The response of the central banking community to the turmoil

Reflecting their different mandates and objectives, the central bank community responded to interbank market strains in various ways. We at the Eurosystem made the point at a very early stage that we strictly maintained the distinction between setting the monetary policy stance to maintain price stability in the medium term, and liquidity decisions taken in the course of implementing this stance. This distinction serves to isolate signals of the monetary policy stance from the impact on very short-term interest rates of the noise introduced by liquidity movements. At times of market stress, underlining this distinction is even more important than in “normal times”. In circumstances of market stress, liquidity management may need to be more active in order to contribute to the smooth functioning of the money market and to ensure that very short-term money market rates remain close to the minimum bid rate of the Eurosystem’s main refinancing operations.

Throughout the period of financial market turmoil, and since the very first hours of the start of the money market turbulences, the ECB has promptly communicated to the market its liquidity policy intentions and explained its actions.

It was evident from the start that credit institutions requirement to fulfil their reserve requirement on average throughout the maintenance period, the so-called averaging provision, was now used with a preference to do so early within the period. Liquidity on different days of a reserve maintenance period was no longer substitutable, and short-term interest rates tended rather to behave as if each individual bank perceived its distribution of liquidity shocks as strongly biased to the tight side, even if this was of course not the case at an aggregate level.

The **first** response of the Eurosystem during the turmoil was to try to keep very short-term money market rates near policy rates through more active liquidity management. With this objective in mind, the ECB adjusted the distribution of liquidity supply over the course of a maintenance period, by increasing the supply at the beginning of the period and reducing it later in the period (the so-called frontloading). The average supply of liquidity remained unchanged over the whole reserve maintenance period, in line with the Eurosystem’s aim to provide to the banking system over each maintenance period the exact amount of total liquidity it needs to fulfil its liquidity deficit. The average size of the Eurosystem’s refinancing operations for the maintenance periods since August 2007 remained at around €450 billion, as in the first semester of 2007.

Second, since the 9th of August 2007, the Eurosystem has made more frequent use of fine-tuning operations than in “normal times”, both in order to inject further liquidity early in the maintenance period in addition, when necessary, to that provided in the main refinancing operations but also to absorb excess liquidity, in order to steer the EONIA close to the minimum bid rate.

As a **third** measure, the Eurosystem increased the share of refinancing provided via longer-term refinancing operations (LTROs), initially with a three-month maturity and, since April 2008, also with a six–month maturity, and reduced the share provided via the one-week main refinancing operations (MROs). Accordingly, the total amount of outstanding refinancing remained unchanged, while the average maturity was extended.

As a result of this liquidity policy, the Eurosystem maintained control over short-term money market rates, supported banks’ access to liquidity and the general functioning of the euro money market, without the need for making any structural change to its operational framework for monetary policy implementation.

Some central banks conducted additional actions, which mainly included expanding the range of eligible collateral and of counterparties. The ECB, which had accepted relatively broad ranges of collateral since the start of the euro, did not need to adjust their collateral framework. Indeed, owing to its acceptance of a broad range of collateral as well as the large number of eligible counterparties, the Eurosystem’s collateral framework has been well equipped to support the implementation of monetary policy during the ongoing market turbulence. The share of deposited collateral not used to cover credit from monetary policy operations has remained high. This suggests that availability of collateral has not been a constraint on the Euroystem’s counterparties in the wake of the turmoil.

As the turmoil went on, central banks strengthened their cooperation, first through enhanced information exchange and collective monitoring of market developments and later on by coordinated steps to provide liquidity. In response to a situation where some euro area banks were reported to be concerned about the limited availability of funding denominated in US dollars, the ECB agreed with the US Federal Reserve to grant loans in dollars to euro area banks in connection with the Federal Reserve new Term Auction Facility (TAF) in US dollar.[1] The first two operations, for an amount of USD 10 billion each, settled on 20 and 27 December 2007 and were renewed on 17 and 31 January 2008. Similar operations were also carried out by the Swiss National Bank. As continued pressure was observed in the money market, the ECB announced on 11 March 2008 its intention to resume carrying out US dollar liquidity providing operations in connection with the Federal Reserve Term Auction Facility, every second week for as long as needed, and for an increased amount of USD 15 billion each, which was further increased to USD 25 billion each, on 2 May 2008. These liquidity-providing operations did not have a direct effect on euro liquidity conditions, but aimed at improving global funding conditions.

The G-10 central banks have since continued to work very closely together and to consult regularly on liquidity pressures in funding markets. It is important to stress that the action in connection with the TAF marked the first multilateral central bank co-operation in the money market field, a market which is central to the implementation of a central bank's monetary policy.

Key lessons and policy initiatives

Substantial weaknesses in the functioning of financial institutions and markets were revealed by the episodes of turbulence, high level of volatility and overshooting on a number of markets. The convergence of such diverse factors embodies the first "real magnitude" stress-test of today's global financial system. In retrospect, the shock to the global financial system following the burst of the internet bubble was, all things considered, relatively modest.

Various streams of work co-ordinated at the EU level aim at strengthening the supervisory and financial stability arrangements – including the introduction of a European mandate to national supervisors, the clarification and strengthening of the functioning of the committees of supervisors at the level of the 27 nations, the wider use of colleges of supervisors to re-inforce the supervision of cross-border banking groups and the approval of a Memorandum of Understanding on cross-border cooperation in financial crisis situations between all relevant authorities in the EU (namely supervisory authorities, central banks and finance ministries). Similar reflections have been launched in the US, for example let me mention the recent proposals issued by U.S. Treasury Secretary Paulson to strengthen the US financial regulatory structure, and are being considered in other nations.

Equally or more importantly has been the agreement at an international level on the appropriate methodology to identify the common lessons on a co-ordinated basis on both sides of the Atlantic as well as on both sides of the Pacific. The present episode of turbulence is a global phenomenon, and thus only a global response can be effective. After the Asian crisis, at the initiative of G7 Finance Ministers and Central Bank Governors the Financial Stability Forum (FSF) was created as the informal grouping where a synthetic diagnosis of the state of global finance could be carried out with a view to identifying the potential weaknesses affecting the international financial system and areas for improvement. The FSF "Report on Enhancing Market and Institutional Resilience" recently presented to the

[1] The Eurosystem loans were financed through a currency arrangement (swap line) between the Federal Reserve and the ECB, according to which the Eurosystem provided US dollar loans with a maturity of one month, at a fixed rate equal to the marginal rate of the simultaneous Federal Reserve tenders, to its counterparties against collateral eligible for Eurosystem credit operations.

international community – and in particular to the G7 and to the International Monetary and Financial Committee of the International Monetary Fund – presents a number of policy recommendations to avoid the recurrence in the future of similar financial stresses. It is remarkable that we have a consensus at international community level on implementing these recommendations with determination and in line with the recommended timeline. The community of central banks will be particularly alert for these recommendations to enter into force. In this context, allow me to recall those recommendations that have been identified as immediate priorities:

- Financial institutions should fully and promptly disclose their risk exposures, write-downs and fair value estimates for complex and illiquid instruments in their upcoming mid-year reporting. They should do so consistently with leading disclosure practices as set out in the FSF report.
- The International Accounting Standards Board (IASB) and other relevant standard setters should take urgent action to improve the accounting and disclosure standards for off-balance sheet entities and to enhance guidance on fair value accounting, particularly on valuing financial instruments in periods of stress.
- Financial institutions should strengthen their risk management practices, including rigorous stress testing, under the support of supervisors' oversight. Financial institutions should also strengthen their capital positions as needed.
- By mid-2008, the Basel Committee should issue revised liquidity risk management guidelines and IOSCO should revise its code of conduct for credit rating agencies.

I should also recall those main areas where important recommendations have to be implemented either by end-2008 or at the latest by 2009, namely revising capital requirements under Pillar I of Basel II (e.g. certain aspects of the securitisation framework), strengthening supervision and management of liquidity risk for banks, ensuring effective supervisory review under Pillar II, enhancing transparency and valuation, improving the quality of credit ratings for structured products, strengthening authorities' responsiveness to risk and enhancing robust arrangements for dealing with stress in the financial system.

Now, expeditious and effective implementation is of the essence. Both should be facilitated by the fact that many recommendations are made by those authorities and entities mandated to apply them.

Overall, I would like to underline two broad lines of actions which cut across many recommendations by the FSF.

Firstly, augment transparency, as it is not only necessary to make the markets more efficient and to optimise the allocation of capital, but it is also the best insurance policy against irrational herd behaviour and unjustified contagion in times of stress. The present turbulences have, once more, demonstrated that opacity regarding the stance of markets, financial instruments or financial institutions is a recipe for catastrophe. In the prelude to an episode of uncertainty and turbulence, absence of transparency inevitably triggers contagion and negative herd behaviour – we saw this at the heart of the Asian crisis, we very much also see it at the heart of the present episode. Transparency is essential both for financial instruments – sophisticated structured products, asset-backed securities, etc. – and for the financial institutions themselves. The absence of pertinent, credible and reliable information drives market participants to assume the worst possible hypothesis on those financial instruments or institutions at stake and to act accordingly.

Secondly, reduce pro-cyclicality, as it embodies two important features of global finance that are particularly adverse from a financial stability stand point, namely an emphasis to short-term considerations and an asymmetry in the response given to booms and busts. While in normal times the elements of pro-cyclicality built into global finance are less obvious, acute episodes of boom and bust make these factors particularly visible. Human nature being human nature, it is probably at the heart of the spontaneous pro-cyclical attitude of market participants triggering successive bipolar phases of exuberance and despair. But it is also true that some elements of the regulatory framework for the financial system as well as the behaviour of public authorities may contribute to augmenting the amplitude of the fluctuations. We can find such elements of pro-cyclicality in the set of new rules for capital adequacy for banks as well as for insurance companies which are more risk-sensitive, in the accounting rules and in the attitude of the supervisory authorities inclined to tighten prudential standards more in times of difficulty than during the preceeding boom phases. I expect that the planned work of the international community in this area will provide a welcome contribution to reducing the degree of potential pro-cyclicality associated with the functioning of global finance.

I thank you for your attention.