

Jean-Claude Trichet: Some lessons from the financial market correction

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the “European Banker of the Year 2007” award ceremony, Frankfurt am Main, 30 September 2008.

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Ladies and Gentlemen,

It is a great privilege for me to be awarded the “European Banker of the Year” in 2007. I am very grateful to receive it. Thank you for the honour you have bestowed on me. Let me also warmly thank Jean-Claude Juncker for having been so kind in his speech. For all reasons I am very touched.

At this stage, let me say that we are presently in the purdah period, namely within a week before the next decision meeting of the Governing Council. Nothing in what I will say should be interpreted in terms of our monetary policy stance and our future decision next Thursday.

In accepting this prestigious award, let me first reflect on what Jean-Claude Juncker just said. Indeed, the turbulence on the global financial markets over the last year has posed particular challenges for financial institutions, investors, supervisory authorities and central banks alike. The European Central Bank has made, and continues to make, substantial efforts to address the weaknesses and to promote the smooth functioning of the financial markets. Today, I would like to share with you a few thoughts on the lessons that we have drawn thus far from the financial market correction in the context of monetary policy and financial stability.

I. The ECB’s reactions as regards the management of the money markets

In its ten-year history the ECB has had to conduct monetary policy under particularly challenging circumstances in a number of occasions: the global correction in equity markets after the bursting of the “New Economy” bubble and the terrorist attacks in September 2001 are cases in point. The emergence of the financial market tensions in early August 2007 is certainly the most challenging experience to date.

As other major central banks in the world the ECB has reacted promptly and consistently during the various phases of the market turbulences to ensure the smooth functioning of the money market. In order to fully understand this role of the ECB let me start by explaining the so-called separation principle. The ECB makes a clear separation between, on the one hand, the determination of the monetary policy stance and, on the other hand, its implementation using liquidity operations. The monetary policy stance is determined so as to serve the primary objective of the ECB, namely the maintenance of price stability. The implementation of the stance through liquidity operations aims at steering very short-term money market rates close to the ECB’s key policy rate (the minimum bid rate in the Eurosystem’s main refinancing operations).

The monetary policy stance is made concrete through the Governing Council’s decision taken at the beginning of each month on the appropriate level of key ECB interest rates that will best serve the achievement of price stability in the euro area.

The ECB’s Executive Board is then responsible for implementing these decisions. To this end, it has at its disposal a set of operational instruments and procedures which are used to bring the money market interest rates at the very short end of the money market yield curve in line with the interest rate level set by the Governing Council. A key element of this process is the conduct of so called liquidity operations, through which the ECB can as the exclusive

supplier of euro central bank money, determine the amount of funds supplied to the banking system and thereby steer the short term money market interest rates.

In this context it goes without saying that, from the central bank perspective, the orderly functioning of the money market is of the utmost importance for the transmission of the key policy rates to the economy in general and the price level in particular. Recent experience demonstrates that disturbances in the money market may interfere with the monetary policy transmission process, particularly during periods of stress stemming from heightened uncertainty and a lack of confidence among banks and investors. In such an environment, we can use liquidity operations to support the smooth functioning of money markets – and thus their role in the transmission of monetary policy – while recognising that ultimately only the private sector itself can address the concerns over creditworthiness, lack of transparency and resulting mutual mistrust that underpin the current money market tensions.

Therefore, within the context of the separation principle mentioned above, the ECB has used in a flexible way its operational instruments and procedures in order to contribute to the smooth functioning of the money market. In particular, the ECB has applied three measures in order to support solvent banks' access to liquidity and the general functioning of the money market:

First, the ECB has frontloaded the supply of liquidity over the reserve maintenance periods. This has been achieved by increasing the allotment amounts in main refinancing operations at the beginning of the maintenance period while reducing them towards the end of the period so that the average supply of liquidity has remained unchanged over the entire maintenance period.

Second, the ECB has used the flexibility offered by its operational framework and has broadened the modalities according to which the liquidity was allocated to the banking system. Specifically, the ECB:

1. has made more frequent use of fine-tuning operations;
2. has conducted supplementary long term refinancing operations and consequently has lengthened the average maturity of open market operations, and
3. has applied on few instances a special tender procedure with full allotment.

Third, the ECB has strengthened its cooperation with other central banks, in particular by coordinated steps to provide USD liquidity. As you know, we have decided yesterday to engage with the Federal Reserve System in a swap agreement of an amount of USD 240 billion.

As a result of all these actions, the average level of EONIA, the euro overnight index, has remained close to the minimum bid rate despite higher than usual volatility from a historical perspective. While refraining from being complacent, developments over past months show that the ECB's operations have positively impacted money market conditions in the Euro area.

Let me emphasise that the ECB will continue to support solvent banks' access to liquidity and the functioning of the money market as long as necessary.

II. Lessons and recommendations to be drawn in terms of financial stability and supervision

I would like to discuss some lessons that we have drawn in terms of financial stability and supervision from the present turbulences. Let me start by providing you with a broad-brush picture of the main weaknesses of the financial system and the regulatory framework that have been revealed by recent events on global financial markets. A thorough understanding of the underlying developments as well as the identification of the nature and scope of shortcomings in the financial system are key for providing proper guidance for policy makers,

responsible for promoting financial stability. In particular, the fact that the financial system is globally integrated and that developments in various markets are often strongly interwoven and even mutually reinforcing, makes this task particularly challenging for all of us.

First, the root of the problems for many financial institutions affected by the market distress was their inability to adequately assess the risks associated with the exposures they held, either directly in their books, or indirectly, via off-balance sheet entities. Imperfections in risk management systems as well as in risk governance proved to be substantial contributing factors to the accumulation of exposures whose long-term risk characteristics were not properly identified in advance. With the reversion of the housing and credit cycles, and the drying up of liquidity in certain market segments, a substantial part of these exposures turned out to be overpriced, pressing financial institutions to book substantial losses. Clearly, risk management failed to provide accurate signals for institutions to build up sufficient cushions that could absorb losses, when materialized.

Second, financial institutions came short of addressing the flawed incentives created by the originate-and-distribute model. Recent events have revealed again that sound underwriting standards are key for preserving stability both at firm and systemic levels. Over the period preceding the market correction we had seen credit standards declining substantially across the board, triggering an unprecedented surge in delinquencies on sub-prime mortgages recently. As unfavourable events continue to unfold, with house prices declining and economic growth decelerating in many countries worldwide, financial institutions have to face further write-downs on their low quality exposures.

Third, the lack of transparency throughout the securitisation process that engineered the underlying mortgages into complex structured products made it difficult for market participants to identify where the risks were accumulating in the financial system and to assess the possible losses from these exposures. This opaqueness of the securitisation process, accompanied by investors' over-reliance on, and poor understanding of, external ratings, seriously undermined investor confidence and continue to put strain on the financial markets.

Fourth, with liquidity strains characterising certain market segments, it became impossible for firms to properly value a range of financial assets and off-balance sheet exposures. Admittedly, the existing standards on valuation and accounting proved to be inadequate for illiquid markets.

The sources of the current turbulence on financial markets are manifold. So are the consequences. What we can see now is that financial institutions are becoming increasingly under pressure to clean their portfolios and to strengthen their capital base, reinforcing the rapid de-leveraging process already underway. These tendencies, accompanied by increasing risk-aversion and the tightening of credit standards, may have substantial impacts on the real-economy that policy makers should be aware of. In this context, regulators and supervisors have to face the challenge of finding the narrow path between giving prompt and adequate responses to current developments in the short run, and mitigating the mechanisms that may fuel the downward spiral of financial and economic contraction in the longer term.

Since the very beginning of the financial market turmoil, public authorities at the international, European and national level have been very active in identifying measures aiming at restoring confidence and enhancing the resilience of the financial system. At the European level, the ECOFIN Roadmap defines the actions to be taken by authorities over the course of 2008 and beyond, while at the international level policy initiatives are co-ordinated by the Financial Stability Forum, whose recommendations were endorsed by G7 ministers and central bank governors in April this year. Among the many issues covered by these initiatives, I will briefly touch upon a few selected ones that I deem of particular importance.

First, strengthening risk management techniques and procedures as well as enhancing firm-wide oversight are cornerstones for any policy response. In this context, improving the

management of risk concentrations on a group level, revising banks' stress testing practices both in the context of liquidity and credit risk management as well as addressing the weaknesses in the management of securitised assets and other off-balance sheet exposures are only a few examples. Notwithstanding the important role to be played by public authorities in this field, the primary responsibility to address the serious weaknesses in business practices should rest with the financial services industry. In this connection, the effective and timely implementation of the principles and best practice recommendations defined by the industry [in the reports of the Institute of International Finance and the Counterparty Risk Management Policy Group III ("Corrigan report")], and a regular assessment of their compliance therewith, are of paramount importance.

Second, enhancing transparency and improving the reliability of information disclosed by firms are crucial for regaining confidence in financial markets. Work is underway as regards reviewing the disclosure requirements under the current regulatory framework, especially with respect to complex securitisation exposures and off balance sheet vehicles. In addition, the compliance of banks' reporting practices with the recommendations of the Financial Stability Forum on public disclosure is being evaluated by authorities.

Third, strengthening liquidity buffers of financial institutions. In this context, let me point out that the Basel Committee is about to finalise its guidance on Sound Liquidity Risk Management and Supervision, and once published, the supervisory community will assess banks' compliance with the principles.

Finally, strengthening regulation on capital adequacy is key for promoting financial stability. In this regard, extensive international cooperation is already on track, under the auspices of the Basel Committee. Proposals addressing certain topical issues of capital regulation have already been published and are envisioned to be phased in over 2010 and 2011.

In this connection, the importance of the capital monitoring exercises, conducted by various international fora, including the Basel Committee, should be highlighted. These exercises are seeking to analyse the developments of the minimum capital requirements under the Basel II framework with the aim of assessing the level and cyclical nature of capital requirements. This is the basis for exploring their possible impacts on banks' behaviour and the business cycle. Since the complete elimination of cyclical variations in banks' lending activity would be an unrealistic goal, regulators should instead focus on reducing the occurrence and severity of systemic crises. To this end, the regulatory framework should be revised so as to restrain the build-up of excessive risks during the expansion phase and to dampen the costs of financial distress in the contraction phase. A major challenge for authorities, however, is the proper definition of a regulatory framework that would allow banks' capital buffers to shrink in downturns (i.e. to absorb losses), without creating moral hazard and regulatory arbitrage.

I thank you for your attention.