Christian Noyer: A review of the financial crisis

Speech by Mr Christian Noyer, Governor of the Bank of France, at the Hearing before the Finance Commission of the Assemblée nationale, Paris, 7 October 2008 (updated 15 October 2008).

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1. A number of comments on the developments of the past month

The bankruptcy of the investment bank Lehman Brothers on 15 September 2008 marked a *crucial turning point* in the crisis. The direct consequences of this failure, involving over USD 600 billion in assets, appear to have been correctly contained and managed up to now. Nevertheless, it exacerbated the crisis of confidence, with the following major repercussions:

- first, interbank markets increasingly seized up, because banks perceived there to be a rise in counterparty risk. Overnight dollar interbank rates rose to particularly high levels of close to 7%;
- second, significant pressure on other money market segments, in particular the US commercial paper market, where yields on 30-day paper have been climbing since mid-September to reach levels close to those observed at the end of last year;
- lastly, the deterioration in the financial position of AIG, the largest US insurer, followed by its exceptional bailout. A two-pronged rescue plan was implemented: on the one hand, the Fed made an USD 85 billion loan at a penalty rate of three-month Libor plus 850 basis points and, on the other, the US government took a 79.9% stake in the company. This exceptional intervention was necessary because AIG had engaged in the highly risky business of selling credit protection over the past few years, which left it vulnerable and very exposed to a turnaround in the US housing market.

The uncertainty stemming from this situation gave rise to the risk of a *domino effect,* affecting one financial institution after the next. Fears that this effect could be fuelled by price manipulations and speculation resulted in a restriction of short selling, first in the United States and then in many other countries including France, the United Kingdom, Belgium, the Netherlands, Italy, Germany, Austria and Australia.

It was against this backdrop that the idea of an "overall solution" emerged*,* marking a change in strategy compared to the case-by-case approach that had prevailed until then. This was the underlying rationale for the Paulson Plan adopted on 3 October. Three remarks on the latter:

- The general idea behind the Plan is for the Treasury to purchase currently illiquid assets. It aims to rid banks of the bad assets weighing on their balance sheets, and to eliminate uncertainty about their real value and, in turn, about that of the banks themselves. Indeed, under the current accounting framework, these assets are marked to market, which means that any uncertainty about their value affects that of the financial institutions themselves.
- The way in which the Plan is to be implemented still remains vague. One essential aspect is the price at which assets are to be purchased. The setting of such a price may be driven by two opposing concerns. On the one hand, bolstering banks' solvency and capital base, which would call for a high price. On the other hand, minimising the cost for public finances, which would call for a low price and the intervention would mainly aim to ease liquidity constraints.
- The consequences for Europe are generally positive. The rapid implementation of the Plan may help to reduce pressure on markets and restore confidence among

banks. However, it is important to pay close attention to the way in which it is rolled out. Indeed, by contagion, low prices could lead to further write-downs in the balance sheets of European banks.

2. A major shift in the direction of public policy

Liquidity problems remain crucial at this stage of the crisis. Interbank markets remain strained. Central banks have considerable firepower to deal with this. In this respect, a wide range of actions has been taken over the past few days.

In addition to increasing allotment amounts and enhancing the provision of longer-term refinancing, recent actions enable the Eurosystem to provide *unlimited* euro and dollar liquidity through *fixed-rate* tenders. Furthermore, the expansion of the list of assets eligible as collateral considerably enhances the access of counterparties to Eurosystem liquidity. These exceptional measures aim to restore confidence and the smooth functioning of money markets. Central banks are closely monitoring this situation and remain ready to act. They have clearly demonstrated their will to take action when necessary.

But governments are also intervening to bolster banks' solvency and soundness. In this context and in order to ensure that national measures for dealing with the crisis are consistent, the international community is taking a collective stand. The G7 plan of action is a major step forward. It sets out clear principles to be applied by the whole international community – in particular the IMF's International Monetary and Financial Committee – with a view to giving structure to national actions.

It expounds the following principles:

- taking decisive action to prevent the failure of financial institutions;
- taking all necessary steps to unfreeze credit and money markets;
- ensuring that banks and other major financial intermediaries can raise capital as needed;
- ensuring that national deposit insurance and guarantee programmes are robust;
- ensuring accurate valuation and transparent disclosure of assets, as well as consistent implementation of high quality accounting standards.

Thanks, in particular, to France's leading role in discussions, Europe is organising itself. The meeting of the Heads of State and Government of the euro area, held at the Elysée Palace on 12 October, with the participation of the President of the ECB, provides Europe with a structured and coherent framework:

- possibility of recapitalising banks;
- guaranteeing new medium-term bank debt (1-5 years), via, in France, a EUR 320 billion funding vehicle;
- revisiting the accounting rules, with the recent reforms of the IASB – international accounting standard-setters – and introducing greater flexibility in mark-to-market accounting rules, allowing assets for which there is no longer a market to be valued at amortised historical cost.

Moreover, the European Investment Bank will be mobilised to support European SMEs. Lastly, long-term discussions will commence on the best way to regulate finance and how it may better serve economic development.

3. The position of French banks and credit

Our banks are not immune to the crisis. They have direct exposures, in particular through US monoline insurers. They have had to make sometimes substantial write-downs. They are also impacted indirectly by the seizing up of certain markets and the rise in their refinancing costs.

That said, our banks are sound and profitable. It is worth recalling four facts that, in the current period of turmoil, are often overlooked:

- The solvency ratios of French banks are high, and much higher than the minima imposed by the prudential regulation.
- Our banks, overall, remain profitable: over EUR 7 billion in the first half of the year. We ensure, contrary to certain rumours, that these earnings are reported using the strictest standards. In all probability, this trend – of lower but positive profits – should continue for the rest of this year.
- One reason for this profitability is that our banks have regular sources of income. They are universal banks. This sets them apart from banks in some other countries that depend exclusively, or for the most part, on financial markets. Our banks have a sound and recurrent source of future profits. This is a vital asset in periods when it is impossible to raise capital by issuing shares on the market.
- Lastly, the "manoeuvrability" of our banks remains excellent, as the recent takeover of Fortis' assets by BNP Paribas shows.
- It should be recalled that almost all money-market mutual funds (SICAV *de trésorerie*) are offered by major banks. Everything that the President of the Republic has said and everything that I have just said about the soundness of our banks also applies to these funds.

Credit developments are the subject of much focus in the current period. A cautious and balanced approach is required in their analysis and excessive optimism or pessimism should be avoided. The main facts can be resumed as follows:

- As a snapshot, credit growth remains strong (over 10% per year for companies and 9% for households). But this partly reflects the weight of past decisions and specific factors relating to the reintermediation, by banks, of previously securitised loans.
- All surveys point to a tightening of credit standards going forward. "Tightening" does not mean that credit will dry up, but rather that it will be more expensive and more selective. Banks are gradually passing on to their customers the increase in the cost of financing that they incur.
- We are closely monitoring this development that, at present, does not appear to be, in itself, a threat to growth. Indeed, the recent period had been characterised by an extremely high credit growth rate. As you know, the government has implemented measures to facilitate the financing of SMEs.

To conclude, in the longer term, and in accordance with the guidelines laid down by European governments on 4 and 12 October 2008, I believe that it would be useful to *revisit the foundations of our financial regulation*. This should be done without haste, but no stone should be left unturned.

We must be willing to address all the questions and challenges that this crisis has raised. These include the role of credit ratings agencies, the management of risk, market infrastructures, the scope of financial regulation and the question of remuneration. As regards the latter, we should not seek to over-regulate or punish, but rather to instil a sense of responsibility. Pay structures should not encourage short-termism or, as was the case, excessive risk taking.