

Christian Noyer: Some thoughts on the crisis

Address by Mr Christian Noyer, Governor of the Bank of France, to the Congress of the National Federation of the Crédit Agricole, Nice, 21 October 2008.

* * *

Mr Chairman, Ladies and Gentlemen,

It is a great pleasure for me to participate in the Congress of the National Federation of the Crédit Agricole. I am happy to be here, surrounded by colleagues and friends in the unique atmosphere that characterises your meetings. Nowhere else is there such a blend of conviviality and the greatest professionalism. That is why I would like to take this opportunity to present to you some thoughts on the current situation.

For over a year, the global financial system has been in crisis. The crisis is not over. But, as you know, everything is being done to contain its effects. And central banks are at the very forefront of this combat.

It is still too early to draw all the lessons from these events. It is however vital to start reflecting on the experience of the last few months. Even more in periods of tension than in normal times, action and reflection should reinforce one another. It is at the very moment of managing the current crisis that we lay the foundations for the future financial system. I am very happy to be able to share a few thoughts with you and in your company.

I propose to explore four avenues:

- The nature of the financial crisis
- The policies implemented to address it
- The macroeconomic outlook
- The outlook for financial regulation

The nature of the crisis

The crisis first emerged as a liquidity crisis. The first symptoms appeared as pressures on liquidity, which we can trace back to the beginning of August 2007 when serious disruptions appeared on the interbank market. More than a year later, these tensions are still present on money markets. This is demonstrated by the abnormal level of spreads, the shortening of maturities, and the contraction, or even closure, of some market segments. Through contagion, these tensions are also affecting non-financial corporations and the financing of the economy: in the United States for example, even more than in Europe, issuing of commercial paper remains very difficult.

The crisis also emerged as a crisis of securitisation. Securitisation is a very old technique, which has been successfully used for 30 years for refinancing automobile loans, consumer credit, and (yes!) housing loans. For the past 10 years, however, it has also been used in more debatable circumstances, i.e. in the very short-term financing of complex and structured products that are wholly illiquid and whose value is very uncertain as it is mostly determined by theoretical models.

Such structures are intrinsically vulnerable and fragile. This fragility was doubly masked by the abundance of liquidity and the actions of some market intermediaries, particularly rating agencies and monocline insurers.

When money was abundant, even debt of poor quality or uncertain value could be refinanced easily. This was especially the case since the quality of this debt was artificially boosted by a favourable rating and an insurance guarantee. With the first defaults on subprime loans, all of

these protections quickly fell apart. Liquidity – and this is one of its characteristics – dried up much more quickly than it had appeared. There was a flood of rating downgrades by agencies, which occurred at a speed and above all suddenness that nothing, in the metrics or methodology used, could have suggested. Lastly, it quickly emerged that the capital of monoline insurers was highly insufficient to enable them to honour the commitments they had entered into.

It then became apparent that, far from being spread across the whole system, credit risk was implicitly or explicitly concentrated in the hands of specific institutions, foremost among which were the major investment banks. Hence the successive waves of depreciations of structured products, imposed by the accounting rules in force, with these depreciations in turn fuelling doubts about banks' solvency, liquidity constraints and further falls in asset prices. This negative spiral is still continuing today.

The collapse of structured securitisation has highlighted a fundamental reality. To a great extent, the financial innovation of the past few years has served not to manage and spread risk better, but to increase the volume of credit per unit of capital, referred to as leverage. The increase in leverage has appeared everywhere: in the expansion of banks' balance sheets; in the proliferation of off-balance sheet vehicles that for the most part operate without own funds, i.e. with infinite leverage; lastly, as I have said, in the use of the limited capital of monoline insurers to guarantee a large volume of structured products.

One well-known feature of leverage is that it amplifies both gains and losses. For many years, the US property boom provided substantial returns on investment. But with the turnaround in the market, very considerable depreciations have been recorded on structured products, which, for many banks, have exceeded their level of capital. Their inability to recapitalise has led to the failure of some of them.

How, in this environment, can we assess the state and performance of our banks? They are, of course, not immune to the crisis. They have direct or indirect exposures (notably via US monolines) to structured products. They have had to make write-downs, sometimes substantial ones. They are also suffering the impact of the drying up of liquidity, the seizing up of some markets and, more generally, the rise in their refinancing costs.

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

First, the solvency ratios of French banks are high, well above the minimum requirements set by prudential regulation and the levels of their European competitors;

Second, overall our banks remain profitable: over EUR 7 billion in the first half of 2008. We are ensuring that these earnings are reported using the strictest standards. In all likelihood, this trend – of lower but positive profits – should continue for the rest of the year.

Third, 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 the financial markets. Our banks have sound and revolving sources of future profits. This is a vital asset at a time when it is difficult to raise capital by issuing shares on the market.

Lastly, the “manoeuvrability” of our banks remains excellent and they are now ready to play their role in the possible restructuring of the international financial sector.

These facts give me reason for confidence. Beyond the sometimes serious tensions and incidents that have affected the recent period, our banks may be justly proud of the progress in terms of productivity and innovation that they have made in the last two decades, which now positions them to cope effectively with turmoil that may occur in the future.

Public policy during the crisis

Over the past two weeks, we have witnessed a marked change in public policy with regard to financial institutions. Having hitherto been exclusively geared to providing liquidity, public intervention is now also aiming to support banks' financing and own funds. This shift in stance is significant.

The problem of liquidity remains crucial at this stage of the crisis. Interbank markets have started to return to normal, but there is still some way to go. To this end, central banks have mobilised considerable firepower.

The action taken in the past two days represents the culmination of a process that has been underway for over a year. Central banks have adjusted their operational frameworks in four different areas:

First, the maturity of their facilities has been extended, to help to unfreeze the money market beyond the short-term segment.

Second, the range of eligible counterparties has been broadened to allow adequate provision of liquidity throughout the system.

Third, the range of assets eligible as collateral for refinancing operations has been expanded.

Lastly, extremely close international coordination between the different monetary authorities is ensuring that the actions taken by each of them is part of a consistent overall strategy, while taking account of the specific features of each monetary area.

These exceptional measures should greatly contribute to restoring confidence and the smooth functioning of money markets. All in all, combined with the coordinated cut in policy rates on 8 October, they are now enabling European banks to obtain short-term refinancing at a rate that is 120 basis points below that of just 10 days ago.

Governments are also now intervening to support banks' solvency and resilience. Thanks, in particular, to France's leading role, Europe is organising itself. Since the Paris Declaration issued by the member countries of the euro area, Europe has a sound and consistent action plan. It is already being applied and comprises three main aspects.

First, the authorities are supporting the refinancing of banks by providing them with guarantees so that they can, in turn, properly finance the economy.

Second, very significant reforms of accounting rules are in the process of being finalised. The first reform aims to bring the current framework in line with what is best practice in the world today: it will allow banks to transfer instruments hitherto booked at market value to portfolios where that will no longer be the case. The second will introduce greater flexibility in marked-to-market accounting rules, allowing assets, whose market is no longer active to be valued at amortised historical cost. This will ensure that the valuation of these products is better suited to the market conditions that have prevailed for the last few months.

Lastly, governments have confirmed their support for the recapitalisation of banks.

In the case of France, the Government and Parliament very quickly fleshed out these European principles as follows:

New legislation provides for the creation of a funding vehicle, created to guarantee the refinancing of banks for medium-term maturities (up to five years). This vehicle, which is strictly supervised by the French Government and the Banque de France, has a credit capacity of EUR 320 billion. The guarantee is granted for a fee, so that the banks requesting it pay costs corresponding to normal market conditions.

The law stipulates that a state-owned company has the possibility of subscribing to subordinated debt issues or preferred shares.

Work is now underway in the Paris financial centre to prepare the implementation of the new internationally accepted accounting rules.

This framework will enable our banks to increase their solvency ratios and their capitalisation. Did they really need this? I think it is important to make a clear distinction between two situations.

The first concerns the specific case of DEXIA, which was hit by its exposure to US monoline risks, and for which the recapitalisation with public funds was absolutely necessary.

The second regards all the other French banks, without exception, whose own funds are sufficient both in terms of prudential requirements and in comparison with standards and situations in other developed countries. For our banks, and in contrast with other countries, the aim of public recapitalisation is not to make up for any faults or weaknesses, but to anticipate potential problems. We are experiencing exceptional circumstances in which even the most financially sound and profitable banks, as in the case of French banks, are not certain to find the necessary resources on the market. As long as this uncertainty persists, we have to protect our credit system from hazards and preserve its role in the financing of the economy.

The macroeconomic outlook

Major worries have recently surfaced in public opinion and among analysts concerning the economic consequences of the crisis. I understand these worries, but I do not totally share them.

In the short term, I must admit, the outlook is unfavourable. All indicators point to a general decline in confidence, both of consumers and investors. This decline is not unique to France; on the contrary, it is much stronger in our partner countries and particularly in the United States.

Indicators, however, only provide information on the near future. Beyond one or two quarters, forecasts are based more on analysis, debate and judgement. In the present circumstances, this is particularly difficult. This is perhaps why, over the past few days, a current of opinion bordering on an intellectual vogue has prevailed, with a view that any banking crisis is bound to have far-reaching and long-lasting consequences. Along these lines, the optimists refer to the Swedish experience in the 1980s, which was marked by almost three years without economic growth, and the pessimists allude to Japan's "lost decade" following its banking crisis.

However, a comparison is misleading. The situation today is profoundly different. First, as I have said, our banks, and particularly French banks, are financially sound. Furthermore, the reaction in terms of economic policy has been particularly rapid and vigorous. I would like to reiterate:

- that all European banks now have unlimited access to short-term liquidity, denominated in both euro and dollars, at a fixed rate;
- that in all countries there are guarantee mechanisms enabling banks to ensure their financing and therefore to maintain their credit activities;
- that banking systems are all being recapitalised at equivalent or higher levels than those prevailing before the crisis;
- and lastly, that macroeconomic policy instruments are still available and could be used if economic activity were to decline durably.

Moreover, for the past two months we have witnessed a reversal of the oil and food shock which strongly penalised economic growth during the first half of the year. Prices are now falling. If this trend continues, or even if it just stabilises, we can expect a gradual but marked

slowdown in inflation. This should spontaneously give households extra purchasing power, contributing to a possible pick up in consumption.

Together, these developments could stabilise the economy and allow a recovery in economic growth during 2009. We cannot, of course, predict a precise date or forecast the extent of this recovery. However, in my opinion, the prospect of a significant recovery in economic growth in 2009 is not being sufficiently taken into account, either by analysts or markets.

The latest forecasts by the IMF envisage for the euro zone, and even more for France, a rebound in growth in the second half of 2009 [*respectively +0.6% and +0.8% in 2009Q4 / 2008Q4*]. As regards inflation in 2009, the IMF is forecasting 1.9% and 1.6% for the euro area and France respectively. This is not the dark scenario that some people are predicting. Moreover, the IMF forecasts are based on the rather pessimistic hypothesis of oil prices 30% higher than at present and do not factor in the action plans announced over the last ten days.

The outlook for financial regulation

The crisis has highlighted the need to take a fresh look at the foundations of financial system regulations and has rekindled concerns about the structure of their supervision. At the French President's instigation, Europeans are calling for the creation of a new "Bretton Woods", to establish a new international financial order. I believe it would be useful to revisit the foundations of our financial regulation. This must be done without haste, but no stone should be left unturned. Improved regulation appears to be necessary in several domains, from rating agencies to risk management, the organisation of financial markets and even the question of remuneration.

As a contribution to this ambitious debate, I would like to make two sets of remarks. One involves the fluctuations of financial systems, the other concerns financial supervision.

Financial systems that operate in the framework of a developed market economy are, by nature, subject to cyclical forces. Financial institutions' capital moves in parallel with the price fluctuations of assets when these fluctuations result in capital gains or losses. The pursuit of a constant capital adequacy ratio (leverage) tends to reinforce this effect, by sustaining the demand for assets when their prices increase, and vice versa.

The challenge for the authorities is to assess whether and to what extent the regulatory framework reinforces these dynamics. In other words, whether the financial regulations determined from a micro-economic viewpoint produce effects that impact the entire financial system. With these questions in mind, work is being undertaken to examine the impact of prudential standards. It is also on this basis that the accounting adjustments that I mentioned earlier have been made.

More generally speaking, we will have to set up supervision systems that are more suited to economic developments. The need to develop a "macro-prudential" policy is now under debate. The general principle is straightforward, consisting in ensuring that supervision manages to limit risks for the stability not only of a particular institution, but also of the entire financial system. Its implementation, however, is complex. For the moment, we are only at a preliminary stage, contemplating which tools a macro-prudential policy could be based on, and how these tools could be used.

As regards supervision, this crisis has shown the clear advantage in having the banking supervisor close to the central bank. This is a conclusion that is now shared by all central bankers, whatever the regulatory environment they are operating in. In-depth knowledge of the banking sector and the various financial institutions is extremely useful when it comes to reacting and making decisions during periods of turmoil in the credit and money markets. Since the beginning of the crisis, central banks have had to judge almost instantly the appropriateness of injecting liquidity in different forms and for different timeframes. It is therefore particularly important to be able to assess the quality of the market participants and

the reality of their needs. More generally, it is crucial during periods of crisis to distinguish between liquidity problems and solvency problems. Therefore it is a considerable advantage to have all the cards in one's hands.

As regards the infrastructure of supervision, it seems clear to me that simple, robust and pragmatic plans have shown their efficiency compared to more sophisticated and complex schemes. During the last few months, at no time have I felt that our organisation was deficient or was preventing me from obtaining adequate information needed to make the necessary decisions. We have managed to deal with all situations, and I have observed the efficiency of our supervision system on a daily basis.

Nonetheless, it is clear that an in-depth and comprehensive debate on the optimum structure of financial supervision in Europe is necessary. Structures have to adapt to the rapid integration of the markets. I firmly support the Lamfalussy process and I am convinced that the current efforts to improve and develop this process deserve our full attention. I also firmly believe that the process must be carried out with pragmatism and completely in tune with reality rather than based on a theoretical scheme or vision.

*

Mr Chairman, ladies and gentlemen, we are living through an extremely difficult period of economic history.

I am nonetheless firmly convinced that in France and Europe we have both the tools necessary to help us out of this crisis and the necessary vision to guide our actions.

The public authorities have shown their willingness to shore up the financial system. It is now essential that the system proves to be dynamic and takes the initiative, as it has in the past, so that the credit that is essential to the economy is available in sufficient quantity and quality.

I am sure that Crédit Agricole will, as it has in the past, muster the necessary energy for the benefit of our economy.

Thank you very much.