Jean-Claude Trichet: A paradigm change for the global financial system

Remarks by Mr Jean-Claude Trichet, President of the European Central Bank, at the International Colloquium "Nouveau Monde, Nouveau Capitalisme" roundtable, Paris, 9 January 2009.

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Ladies and gentlemen,

The current crisis stands out because it is affecting the heart of the global financial system. Its root cause was a widespread undervaluation of risk in the global financial system, especially in the most advanced economies. This included an underestimation of the quantity of risk financial institutions took upon themselves and an underpricing of the unit of risk. Risk was underpriced because, among other things, financial market participants largely extrapolated ongoing trends and the very low levels of volatility in financial markets and in the real economies going forward.

A number of policy-makers indicated at the time that these trends and low volatility could not be taken for granted. As chairman of the Global Economy Meetings of central bank governors in Basel, I myself reported my colleagues' sentiments on this matter. We also said publicly, long before the difficult time we are going through today, that the private sector had to prepare for a market correction, because such a correction was inevitable. The aim of our urging was to try to ensure that the correction itself would be as orderly as possible. Yet, one of the main reasons for the lack of preparation had its basis in the widely held view that regulation should not stifle financial innovation and that markets knew best and could – for the most part – regulate themselves adequately.

The turmoil has shown how complacent and misleading this attitude was. When the turmoil set in, many financial institutions realised that their risk management systems were not as reliable and robust as they had believed them to be and, indeed, should have been. Most importantly at the time, market liquidity, that is the ability of financial markets to express appropriate prices at all times, which had wrongly been taken for granted, evaporated in large segments of the financial markets.

Investment-banking business models typically featured high-leverage, marking-to-market accounting, large maturity mismatches and relatively limited liquidity and capital reserves. This model was efficient as long as markets kept booming and functioned properly, but left those banks with little or no shock-absorption capacity. We have seen the result: investment banking, as we knew it, has disappeared before our eyes, and all banking institutions have come under severe pressure.

The financial authorities – both in Europe and in other parts of the world – reacted promptly. Central banks, including prominently – and from the very start of the turmoil – the ECB, provided short-term liquidity support to prevent contagion. A number of the central banks' actions were coordinated internationally. Regulators gave priority to comprehensive policy responses, addressing the more fundamental weaknesses. Coordinated guidelines were put forward at the European and international level by the Financial Stability Forum, the Eurogroup and the European Council, in particular, and were reflected in the declaration of the G20 summit. This bears witness to the importance of measures to be applied consistently in all countries. A global financial system requires a globally coordinated response, and the official sector has been providing just such a response.

Looking ahead, we should correct the substantial flaws in the financial system that have now become evident. Of course, we should not throw the baby out with the bath water by discarding the market economy setup that underlies the system. It is the only setup that has proved able over time and globally to deliver sustained prosperity, and it has no equal in overall efficiency. But our basic aim should be to improve very significantly the resilience of the financial system: the fragility that has become apparent since August 2007 and more acute since mid-September last year is not acceptable. We have to draw lessons from the present situation without any complacency.

To be specific in terms of avenues for reform, I would like to highlight three areas where change is particularly needed: 1) short-termism, 2) pro-cyclicality and 3) transparency. I believe that shortcomings in these areas were instrumental in creating the conditions for this crisis and amplifying its severity.

1. *First,* among financial market participants (traders, managers, risk committees and boards of directors alike) for a long time there has been an excessive focus on short-term profits to the detriment of longer-term business performance. This has resulted in excessive risk-taking and, particularly, an underestimation of low probability risks stemming from excessive leverage and concentration. We now need to create more balanced and forward-looking incentive frameworks for management compensation and more effective internal risk measurement and control systems that take into account not only near-term profitability but also sustainability and durable financial strength. This is an area where improvement will depend crucially on private decisions, in addition to public action.

2. *Second*, we need to re-examine all aspects of the current regulatory framework to ensure it does not contribute to the intrinsic cyclicality of banking. A number of potential sources of pro-cyclicality need to be investigated, including fair value accounting and leverage, capital requirements and provisioning regimes. Looking forward, new mechanisms should be devised to ensure that banks accumulate resources in good times to cushion the shock when the cycle turns. Measures could include requiring banks to hold additional capital and liquidity buffers and introducing dynamic provisioning systems that require banks to build up a general reserve that can be drawn on in downturns. Market economies inevitably entail cyclical swings; it is up to regulatory and supervisory bodies to ensure that their regulations and actions do not amplify those swings.

3. *Third,* in recent decades transparency has not matched the increasing level of sophistication and complexity of financial instruments, creating significant gaps in investor information and financial education. These need to be filled with enhanced risk disclosure at all levels, particularly in institutions and markets that are currently unregulated but can – as recent experience has shown – exert a relevant systemic impact. Financial regulation should be reviewed to better reflect the role of highly leveraged institutions in particular – namely private equity, hedge funds and special purpose vehicles – and of derivatives markets in general, including, but not exclusively, credit derivatives. Regarding the latter, I welcome in particular the initiative to improve the infrastructure of over-the-counter markets by establishing central counterparty clearing for the CDS market.

Let me conclude.

In the current, very demanding situation, the swiftness and the magnitude of the decisions taken by central banks as regards the supply of liquidity and the decisive actions taken by governments and parliaments as regards recapitalisation in the financial sector and the provision of guarantees have proved effective in avoiding a meltdown of global finance. But it would be a mistake to underestimate the structural fragility of the present state of global finance and, consequently, of the global economy.

This is the heart of the matter: we need a paradigm change in the global economy. The previous paradigm was based on the concept of relatively short-term financial market equilibrium. What we need is a new paradigm. A paradigm based upon the following three fundamental notions. First, the notion of *medium and long-term sustainability*, which will require us to be much more resolute in distinguishing between the stable equilibria on the one hand and the unstable equilibria on the other hand, which should not be accepted.

Second, the notion of *resilience* to shocks, taking into account the fact that whatever the level of sustainability of a particular financial situation, we can never eliminate the occurrence of unpredictable shocks. These shocks can come not only from the economic and financial sphere – the present stress test is a very powerful example – but also from the geopolitical sphere, or they can be triggered by natural catastrophes. Resilience is therefore essential; it is a necessary complement to sustainability. The third notion is *holism*: the present global financial system depends on the appropriate handling of a very large number of factors: prudential practices, accounting rules, audit quality, liquidity management, risk management and credit assessment, to mention but a few. This holistic approach must also comprehend a fundamental factor, namely the long-term sustainability and resilience of public macro policies – whether in particular fiscal or structural – and the associated progressive but resolute elimination of those large domestic and external imbalances that are one of the major causes of global economic and financial instability.

Such a paradigm change, including the three notions of *medium and long-term sustainability*, *resilience* and a *holistic approach* of the global financial system, is now absolutely essential to correct the fragility of the market economy which we are presently experiencing.

Thank you for your attention.