David Clementi: Recent developments in securities markets and the implications for financial stability

Speech by David Clementi, Deputy Governor of the Bank of England, to the Euromoney International Bond Congress, London, 21 February 2001.

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Introduction

Let me begin by saying how pleased I am to be giving the closing address at this Conference. I know, in previous years, the Governor has done the honours. While he is engaged elsewhere today, I am glad to keep up the association with the Bank. Especially now we have joined the ranks of issuers in the Euro markets in our own name. If you did not have a chance to subscribe to our euronotes in January, the issue - the 4.5% of 2004 - will reopen in April, July and October. But I have not come to plug our paper.

Nor have I come to talk about monetary policy. The minutes of the February meeting, published this morning, are designed to set out the MPC's considered view as well as the vote itself. On the voting front, you will find there was a rare outbreak of unanimity in the Committee with a nine to nothing vote for the recent ¼% cut in rates. But there is little on this front that I can add that is not already in the minutes or in the Inflation Report we published last week.

I want to talk instead about recent developments in bond markets that impinge on the Bank's role in relation to financial stability. First I want to talk about credit derivatives and the new markets for the transfer of credit risk. Second about the revised Basel Accord and what this implies for securities firms and securities markets. And finally about the implications of the shrinking share of government bonds in issue.

The Bank's financial stability role

But I ought to start by saying something about the Bank's role in relation to financial stability. As most of you will know, regulatory responsibility for individual UK financial institutions is now consolidated in the Financial Services Authority. The Bank is no longer a regulator of individual firms but as a central bank we retain a vital interest in the system as a whole. We are the ultimate provider of liquidity to banks and markets. This interest is reflected in a formal responsibility for the overall stability of the financial system set out in a Memorandum of Understanding between the Treasury, Bank and FSA.

Responsibility for the overall stability of the UK financial system as a whole sounds a huge and slightly fuzzy task. It requires the Central Bank to try to see the wood from the trees - to identify and assess potential shocks, to understand how risk is distributed within the system, and to look for interlinkages that might cause a problem in one institution or market to spread and trigger wider difficulties. Given the importance of London as an international financial centre, for a full assessment of UK financial stability, we must look beyond this country. So we also have to take a close interest in developments in overseas and international financial markets. The international bond market is of course a key example. We try to analyse the information in market prices and other data. But the real understanding of the latest developments comes from talking to market participants.

Credit risk transfer markets

This is particularly important when it comes to financial innovation. In recent years, instruments and markets for the transfer of credit risk have been a particular focus of change. New ways have been found to securitise cashflows which could not previously be traded, to unbundle the credit risk from loans and bonds, and to re-bundle credit exposures in different ways to create securities with different pay-offs.

The distinction between a loan and a bond is becoming increasingly blurred. Individual loans are sold into the secondary loan market, although some companies remain reluctant to see their debt traded in this way. And portfolios of loans and other cash flows, ranging from mortgage payments to recording royalties, are sold to special purpose vehicles for securitisation into tranches with different risk characteristics and maturities, from AAA to junk, and from commercial paper to long-term bonds. Portfolios of bonds are also repackaged, sliced and diced in a similar way to create collateralised bond obligations.

The new area of growth at present, however, is not in these sales of assets to remove them from the balance sheet. Rather it is in the use of credit derivatives that leave the underlying asset on the balance sheet but transfer some or all of the credit risk. The market in credit default swaps on individual investment-grade corporate and country issuers is becoming more liquid, in some cases, we have been told, more liquid than the underlying bond market. And investment banks pricing new bond issues can increasingly look to credit default swap premia as well as to the spread over the relevant benchmark on any existing debt. Increasingly, also, banks use derivatives to transfer some portion of the credit risk on a loan portfolio rather than selling the portfolio outright, creating so-called 'synthetic' collateralised debt obligations. Data on the size of the market are difficult to come by. But a survey by the British Bankers' Association last year found that outstanding notional principal of all credit derivatives had increased more than three times since 1997 to around $600 billion. Some contacts suggest the market may now be even larger than this. But I think it safe to conclude that it is already large and has been growing quickly.

In a wider sense, the development of these markets for the transfer of credit risk is highly desirable. The institution best placed to originate a loan is not necessarily best placed to bear the risk. Markets in credit risk allow financial institutions to diversify their exposures across different sectors and geographic regions while maintaining customer relationships. Just as important, prices from liquid markets are valuable information, which can help market participants to allocate resources and manage risk more efficiently. If they work well, markets in credit risk transfer have the potential to enhance financial stability and efficiency by ensuring that exposures to shocks are diffused throughout the system, with no single player excessively exposed.

Unfortunately, however, where there is innovation, there are generally questions and I have three. My first is a concern about lack of transparency. These markets mean that a bank need no longer remain exposed to its main customers but can rapidly take on large exposures to other credits without any new borrowing by the underlying entities. This could make it more difficult for creditors, shareholders and regulators to assess risk. From the point of view of financial stability, the concern is that these instruments might equally be used to concentrate risk as to disperse it. Careful monitoring and management of counterparty risk exposures by firms is an important market mechanism to limit this risk. But any individual firm does not know how much total exposure a counterparty has to a particular credit through its transactions with other market participants. These concerns underline the importance of the disclosure elements of the new Basel proposals intended to promote market discipline - I have more to say on the Basel package in a moment.

And if disclosure is an issue at the level of individual firms, you can imagine that in aggregate, for the financial system as a whole, the gaps in the data can be large. It is a major challenge for the authorities to keep pace with financial innovation in the collection of financial statistics. The Asian Crisis revealed the importance of derivatives exposures in assessing a country's financial position but these were not included in BIS statistics on cross-border lending, even though derivatives had been a common feature of financial markets for at least fifteen years.

My second question is a concern that some participants in this market may not fully understand, or may have differing understandings of, the transactions into which they have entered; and that uncertainties may remain about how the courts in some countries would treat these agreements. This is always an issue in new markets, until market standards and legal precedents are clear. But some aspects of the credit transfer market make it particularly relevant. Purchasers of asset-backed securities and creditors of firms that securitise assets need to take care to assure themselves that this transfer is legally robust - a true sale. An unexpected consolidation of the assets of a securitisation vehicle with those of the original lender could lead to potential losses for either party. Lawyers do, of course, pay great attention to this issue and I am neither questioning their opinions nor suggesting that this is necessarily a problem. But transactions differ and investors must do their own due diligence. I do think that there is too great a tendency to rely unthinkingly on the rating agencies in this area.

Regulators have signalled their intent in this area in the new Basel Consultative package. Not only will banks need to demonstrate a clean break to earn a reduction in their capital requirements, but they will also need to consider the operational and reputational risks involved in securitisations and derivative deals.

My third question is whether we collectively yet have a proper understanding of the way the credit transfer business is bridging the lending, securities and insurance markets. Contracts in banking, on the one hand, and insurance markets, on the other, are in some respects different animals. In securities markets, timing of payments is of the essence. An insurance contract, by contrast, is not typically a commitment to timely payment. If insurance companies are participating in this market, in part using reinsurance-type agreements and in part using derivative agreements, there may be imperfect hedges or liquidity risks.

The relationship a borrower has with its lending banks has also traditionally been different to that with its bondholders. Any problems the borrower may have in servicing the debt are typically addressed in different ways by lenders and bondholders. This problem has surfaced recently with the debate about whether restructuring should be included within the definition of a credit event. ISDA is addressing the question and it is clearly desirable that a market standard agreement and set of defnitions should exist. I do think, though, that it is intrinsically more difficult to standardise the definition of a credit event compared to that of a price or interest rate - the underlying for most other derivative products - where data can be taken off screens or lifted from the pages of the FT.

Market participants will therefore have to pay even greater attention to documentation - reviewing new and existing transactions regularly to see whether changes in market practice might leave them with imperfect hedges or basis risks. The 1999 ISDA standard documentation was a great advance. But firms will need to review carefully transactions into which they entered prior to 1999; and, of course, documentation is valid only if both parties have signed the agreement and confirmations have been exchanged. It is not a happy position if back and middle offices are struggling to keep up with traders, in particular to deal with unsigned master agreements or backlogs of confirmations.

Basel proposals

I have mentioned the new consultative package from the Basel Committee a couple of times. The Bank is of course a member of the Basel Committee, alongside the FSA, and we are keen to hear views from the market on the proposals. As the second theme of my address today, I would like to discuss the possible impact of the revised Accord on securities markets and capital flows.

While the Basel Accord ostensibly applies only to international banks, directly and indirectly it will have a significant impact on securities firms. Indirectly, in the same way that the change in banks' behaviour in response to the original Basel Accord had a profound effect in shaping developments in securities markets in the last decade. Directly to the extent that EU investment firms, under the Capital Adequacy Directive, are subject to the same capital requirements as banks.

One of the principal goals of the new Basel framework is, of course, greater risk sensitivity. The lack of sensitivity of the existing Accord has been one of the drivers of increased capital market activity: both through disintermediation, as companies have accessed the capital markets for funding directly instead of relatively more expensive bank loans, and through securitisation, as banks themselves have sought to continue originating credit but not incur the capital costs of holding it on their balance sheet. The new Basel proposals to the extent they succeed in aligning capital more closely with the underlying risk, will we hope significantly reduce incentives for pure regulatory arbitrage.

While the original Accord created an incentive to securitise or, by other means, move exposures off balance sheet, it is too simplistic to assume that adoption of the new proposals will result in a swing back to more traditional bank lending. The wider use of internal ratings, coupled with greater transparency regarding their compilation and some assurance of quality control by the regulators, may in fact contribute to further 'commoditisation' of bank loans. It is conceivable that this development could reduce the cost of due diligence on loan portfolios by rating agencies and buyers. And, in turn, it could mean a reduction in the costs of risk transfer through securitisation or credit derivatives, with beneficial effects on banks' balance sheets and liquidity.

However for this to happen, banks' internal ratings will need to carry credibility in the market and, for this, transparency is essential. The transparency proposals from the Basel Committee have come under a certain amount of fire for their volume and detail. But I would like the critics to dwell for a

moment on the alternative: a world in which banks effectively set their own capital, with no assurance of consistency or comparability from one bank to another. This is an important debate and we are keen to listen to others' views before the proposals are finalised.

Turning to the possible effect of Basel on capital flows more generally, including bank lending, undoubtedly the new risk sensitivity will tend towards changing conditions for certain borrowers and issuers. This is particularly marked in the sovereign context, where, based on current ratings, approximately twenty seven sovereign borrowers will incur a lower bank capital charge versus eleven incurring a higher one. Again I would stress that the cushion of capital which most banks maintain over and above their regulatory minimum will blur the impact of the Basel changes, since in these circumstances banks' lending and pricing decisions will not be constrained by the regulatory standard. However, in some sense the Basel proposals will have failed in their purpose unless the pricing of bank credit better reflects the riskiness of borrowers. By removing perverse incentives for banks, we also wish to establish better incentives for borrowers.

Greater risk sensitivity does, however, carry with it a possible danger, and that is the introduction of potential 'procyclicality' into the capital framework. I have touched on this concern more than once in the past, and make no apology for doing so again. To counteract this danger, regulators should not allow banks' internal ratings to reflect the optimistic prospects of borrowers during an economic upswing: rather, ratings need to be genuinely forward-looking, and to factor in borrowers' likely performance during economic stress. Long runs of performance records will be invaluable in establishing how robust borrowers are to different economic circumstances. In this way, economic downturns when they come should not prove too much of a shock to the ratings scales.

Of course, I do not wish to sound complacent regarding the avoidance of 'procyclicality'. Capital is after all meant to be a cushion against volatility, also referred to as 'unexpected' loss, but measuring the unexpected is something of an oxymoron. Some of our researchers at the Bank of England recently reviewed the usefulness of various predictive models of banking problems, but unfortunately our conclusion at the moment is that banking crises are each unique in its own way. In the area of financial stability at least, there appears to be some merit in Sam Goldwyn's admonition that one should 'never make forecasts, particularly about the future'. So whilst we may be able to ensure that the banking system is protected against the normal ups and downs of a developed economy, more extreme events will continue to require tailored solutions.

Changing composition of bond markets

I have speculated on the possible long-term effect of the new Basel framework on securities markets. I want briefly to touch on a third topic and that is the significant change that the markets seem likely to face in the composition of the bonds being issued. A recent BIS report on trends in collateral in wholesale financial markets shows that the share of US government bonds within the dollar bond markets decreased from over 44% to under 29% between March 1994 and September 2000, with the increase mainly in bonds issued by financial institutions and government sponsored agencies. Worldwide, the share of government bonds decline from 53% to under 45%. Of the G10 countries, only in Japan is the share of government bonds on the increase. In the US, the Congressional Budget Office recently projected that the government debt might be repaid as early as 2006.

From a macro-economic perspective, sound government finances are clearly desirable. Smaller government borrowing requirements can also encourage private sector issuance or "crowding in" to revert to the terminology of a similar debate from the early 1980s.

For financial markets, however, shrinking government bond markets have a number of potential implications that could be relevant to financial stability.

First, government bond markets have tended to be more volatile in recent years. Volatility makes government bonds less reliable as a hedge and as a benchmark for pricing, and market participants have been exploring other instruments, such as swaps and securities issued by public sector agencies. Indeed, US, European and prospectively Japanese agencies are playing an increasingly important role in the bond markets, with for example, Freddie Mac's €2 billion annual debt programme in Europe and European agencies such as KfW also bidding to position their issues as substitutes for government debt. Given this trend, the Bank continues to follow closely the debate in the US over the credit status of the US federal agencies, which are not in fact government-guaranteed.

A second issue is that the growth of private sector debt relative to government debt puts a greater premium on credit risk management. This of course brings us back full circle to my earlier remarks about credit transfer markets. More generally, though, bond investing seems likely to be a higher risk and higher return business than before. The growth of a European high yield market over the past few years and the fall in prices of many of those issues in the second half of last year, mean many of you will need no reminding of this.

Finally, a reduced supply of government bonds could have important implications for collateral markets, in which they currently play a key role. Wider use of non-government securities as collateral could have the result that a flight to quality in a crisis might leave lenders exposed to credit risk, or borrowers to liquidity risk as they try to meet margin calls. Larger haircuts can address this risk in part. More generally, wider use of exposure netting through well-managed and prudently designed central counterparties may be desirable in future.

Conclusion

I think it is too early to judge how material these issues will become or whether private sector solutions could emerge. Bringing together my themes, however, it is clear that credit risk management will become an even more important issue for the securities markets. Your challenge will be to understand and manage these risks prudently and profitably. Our challenge, at the Bank of England, will be to follow market developments closely as part of our financial stability role.