Hermann Remsperger: Current financial stability issues from a European viewpoint

Speech by Professor Dr Hermann Remsperger, Member of the Executive Board of the Deutsche Bundesbank, at the representative office of the Federal State of Hesse at the European Union, Brussels, 27 June 2007.

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Ladies and gentlemen

I have chosen to give this lecture the title "Current financial stability issues from a European viewpoint" for the simple reason that it allows me to elaborate on a whole bundle of burning questions concerning financial stability. Needless to say, these issues are highly complex in their nature.

I Summary

In order to make matters more understandable I used last Sunday to go through my speech again and completely rework it. I shall begin at the end – that is to say, by focusing on the six comments that I had originally intended to use in my final summary.

1. Despite some risks in the financial markets – particularly in the credit markets – I consider the international financial system to be remarkably robust, not least on account of the very good performance and ample capitalisation of systemically important banks
2. With the arrival of new financial market instruments for credit risk transfer and thanks to the growing influence of unregulated financial investors, credit risks are not necessarily located in the kind of places where they would have traditionally been expected. This not only makes it more difficult for market participants to manage risk. The task of assessing stability risks relating to the international financial system is also made more difficult for the official agencies responsible.
3. When evaluating the stability situation in future, it will be even more important than in the past to combine a proper examination and assessment of new instruments with an analysis of the behaviour of new market participants. This would appear to be the best way to deal with the fact that the financial system is not only expanding but also becoming increasingly complex.
4. The transparency of the distribution of risks across the financial system has tended to decrease, thus presenting the official agencies with the question of how it might be possible to increase this transparency again. Much of the recent discussion on hedge funds has revolved around this point.
5. The remarkable initiative by London-based hedge-fund managers to consider introducing improved, and possibly also binding, sectoral standards is an indication of the real potential that exists for agreement between official agencies and market players on the urgent need for greater transparency.
6. The fact that financial markets are becoming more complex is partly explained by their growing geographical integration. At the same time, the emergence of closer links between European banks raises the question of how banking supervision should be structured. Bearing in mind the political and legal conditions that apply in Europe, the “cooperation model”, as it is called, offers a good framework for further developing the kind of convergence that is needed in supervisory practice.

If you were to ask me how I arrived at this six-point conclusion, the simple answer would have to be that I started with a definition.

II Monetary and financial stability

We view a financial system as being stable when it is able to efficiently perform its key functions of allocating capital and risks as well as settling payments and securities transactions, and can do so in stress situations and during periods of structural adjustment. There are three aspects that deserve particular emphasis in this connection.

1. Disturbances in core functions of the financial system generally come at an economic cost, in the form of loss of growth and, in some circumstances, direct fiscal aid to help prop up financial institutions. This is something to be avoided.
2. In the event of a shock there may be a sudden and dramatic rise in the liquidity needs of individual financial market participants. In integrated financial markets, such shortages of liquidity can be passed on quickly and, especially if they reach systemically important market participants, can have a negative impact on the financial system as a whole. Once again, this is something that is best avoided.
3. Last but not least, it must be emphasised that price stability and financial stability go hand in hand. Disruptions in the financial system can delay or otherwise impair the transmission of monetary policy impulses to the real economy. It follows that central banks have a special interest in maintaining a stable financial system.

III Current stability situation

Against this backdrop, most central banks have, in recent years, extended and refined their financial stability analysis. The main focus here is on risks, that is to say not the likeliest of events but possible unfavourable developments that may arise.

If you were to ask me about the current situation concerning risks for the international financial system, I would start by pointing out that for about two years macroeconomic developments have surpassed expectations. The global economy is forging ahead on its expansionary course, with an increasingly more balanced regional growth pattern. This has improved the outlook for a gradual reduction of financial imbalances – with the US current account deficit serving as one of the crystallisation points.

The USA seems as if it is enjoying a soft landing while European countries are experiencing larger growth than expected. In the emerging market economies, especially in Asia, there is no end in sight to the ongoing boom.

However, this situation should not lead us to view things through rose-tinted spectacles. Macroeconomic risks continue to exist. Contrary to my own expectations it is quite possible that the US economy will cool down even more. Over and above this, a disorderly dissolution of financial imbalances in the global economy still cannot be ruled out altogether. Should the downturn in residential construction in the USA spill over into other sectors, this could lead to a reversal in the credit cycle as well as to pessimism in the financial markets, which in turn would test the resilience of market participants.

Certainly, the large and complex international financial institutions that are based in Europe and the USA, in other words, those which are systemically important for the international financial system, are in a fairly robust state. The favourable cyclical background and the propitious capital market environment play a major role in this connection. In the fiscal year 2006, the large international financial institutions posted record results. They were able to record an average year-on-year earnings growth of around 30%. Volatile income sources such as proprietary trading are proving particularly productive while the need for risk provisioning is modest. The positive yield trend seems to be continuing in the current year.

Owing to their extremely good performance, ample capitalisation and the continuous improvement in their management of risks, the resilience of these financial intermediaries, that is, their ability to absorb external shocks, is to be considered strong.

There will, of course, be cyclical risks in the medium term, and these will mostly be in the form of the turn-around in the credit (quality) cycle, which has already been expected for some time. We are observing quite high and/or rising levels of debt in households in the USA as well as in a number of European countries. This is compounded by the heavy indebtedness of some non-listed enterprises. A deterioration in macro-financial conditions could place a strain on them and therefore their creditors as well. At the same time, in a depressed environment the increasingly homogeneous focus of large financial institutions could have the effect of reinforcing unfavourable financial market developments

In the international financial markets pricing and risk assessment are being determined largely by positive macroeconomic expectations. This said, in some parts of the credit markets there are signs of overheating. In the market for risky syndicated loans, for example, providers of capital have considerably eased their conditions. In the case of financing for leveraged buyouts (LBOs), there has been a further rise in the leverage. The trend towards more relaxed loan terms and conditions is continuing, owing to the favourable economic environment and strong competition.

The easing of credit standards witnessed in recent years has for some time left its mark on the US mortgage market in the form of rising default rates among debtors with poorer credit ratings. A large part of the credit risk arising from subprime mortgages is to be found in securitised and structured form at institutional investors. These include hedge funds. News reports over the past few days have made this patently clear. It is my view , however, that in terms of the market as a whole such relatively minor distortions do not yet constitute a systemic risk. Nevertheless, they do raise the fundamental question of how these securitised credit risks should be assessed.

A phase of fundamental re-assessment in the markets and therefore also in the corporate credit markets would present risk managers with special challenges. This would typically involve changes in the correlation between financial market prices and burdens on market liquidity.

The rapid recovery that followed this year's spring turbulences and the as yet limited impact of the crisis in the sub-prime mortgage business in the USA would appear to have bolstered the confidence of market participants. Even before this, the somewhat more turbulent financial market episodes experienced in the springs of 2005 and 2006 proved to be very short-lived. Bearing all of this in mind, I believe there is a certain risk in the fact that not enough consideration is being given to the time when this period of market calm comes to an end.

On balance, however, I would say that the international financial system is now in a robust state. I rest this assessment mainly on the resilience exhibited by the financial institutions as I still see risks in the kind of things that are happening in the financial markets. These risks are not only of a cyclical nature. In some cases they are closely linked to structural changes occurring in the financial sector.

IV Structural change in the financial system

In the light of these conclusions I would now like to talk in greater detail about two structural trends which are relevant to the question of stability in the international financial system. The first of these is the trend towards new financial instruments, especially in the credit markets. The second is the growing importance of new financial market participants or categories of investor.

Innovative financial instruments and new categories of investor have resulted in even greater differentiation in the financial markets. In terms of efficiency this is definitely a positive development, as it enables a better allocation of capital and financial risks. This should have the effect of enhancing the financial system's ability to absorb shocks.

At the same time, however, it is possible that investors with volatile investment habits and financial instruments with an inherent leverage effect will generate risks. Please note that I am only saying this is a possibility.

We cannot tell for sure whether such structural changes will in fact improve or worsen the stability of the financial system. This said, ladies and gentlemen, we surely all agree on one point and that is that these developments present market participants, financial supervisors and policy-makers with some major challenges.

1 New financial instruments

Although I myself come from the banking business, the financial markets' capacity for change never ceases to amaze me. The credit markets are the most recent example of this. For a long time, the lending business was an exchange merely between lenders and borrowers, what we now refer to as "buy and hold".

Since then, a large market with many new instruments has evolved around this bread and butter business. Loans can now be sold on the secondary market. Loans can also be bundled and tranched to be treated as structured products. And, finally, a debtor's credit risk can be traded via derivatives completely separately from a credit relationship.

With all of these possibilities, a new business model has been born. The maxim is "originate and distribute". Of course, the basics of lending are still being carried out as before. However, instead of keeping loans in own books, the loans, or at least the isolated credit risks, are often quickly passed on to investors.

These new forms of credit markets are growing dramatically, whereby the structural trend has been boosted significantly by the global economic situation – strong economic growth coupled with low interest rates.

The outstanding volume of credit default swaps, the backbone of most credit derivatives, doubled in both 2005 and 2006, according to BIS statistics. In December 2006, the nominal volume amounted to USD 29 trillion. The incentive to achieve balance sheet relief by insuring against default risk has long since become less important than the incentive to trade or to design new financial products.

By appropriate structuring, even a portfolio which includes loans to borrowers with a less than perfect credit rating can produce investment securities with an AAA rating. Despite having the same rating classification, these instruments are riskier than the best government bonds and have a much higher coupon. The interest rate premium makes these instruments attractive to institutional investors geared to rating-based investment criteria. However, market participants express doubt as to whether the legal risks can be evaluated appropriately. The arranging banks currently earn a large proportion of their commission from their structuring business.

At the same time, the banks that originally granted the loans create new scope for granting loans by passing on their loans. The option of selling on loans plays a significant role in lending – especially for debt-financed acquisitions. Exercising all due caution, this suggests that the large demand for structured products increases primary lending.

With the new instruments, credit risks are not just being reallocated but additional risks are also being created. For example, operational risks arise if the expansion of the market's technical infrastructure lags behind the development of business volume. Up until the start of last year, trade confirmations for credit default swaps were often written weeks after the transaction had been concluded.

For me, the most important factor here is the simple realisation that it is precisely in the new credit markets that two types of financial investor play an important role: private equity funds and hedge funds. I can imagine what you are thinking, and you are right: these are not "new" financial market participants per se. I personally had many a dealing with hedge funds long before my time at the Bundesbank. But the significance that they have now achieved for financial markets has reached new heights owing to the capital constantly accruing to these funds and increasingly, too, from regulated institutional investors such as insurance companies and pension funds. I therefore see them as "new" players on the international financial stage.

In some credit market segments, for example, hedge funds now generate more than half of turnover volume. At the same time, loans for debt-financed acquisitions conducted by private equity funds promote the international large exposure business. In short, the dynamics of the credit markets and the new financial instruments are closely connected with the growth in hedge funds and private equity funds.

2 Hedge funds

The speed with which hedge funds[1] have developed shows that the volume of assets managed by them has tripled over the past six years from almost USD 500 billion to just over USD 1,500 billion. At the same time, the number of funds – with a high degree of fluctuation – more than doubled from almost 4,000 to approximately 9,500.

Of course, the term "hedge funds" refers to a very heterogeneous group with a wide range of market strategies. However, all hedge funds have one thing in common, the use of high financial leverage, which they also apply by means of short selling or derivatives. The volumes of capital shifted by hedge funds therefore far exceed their reported assets. We closely observe hedge funds from a financial stability perspective for two reasons.

Firstly, hedge funds are borrowers from and counterparties to systemically important financial institutions. Should a series of unfavourable developments arise, extensive business relationships with a risk-seeking group of investors could have a negative effect on systemically important financial institutions and therefore, in a worst-case scenario, on the functioning of the entire financial system. Intense competition for lucrative (prime brokerage) business with hedge funds can result in large concessions being granted to this important group of customers, for example, in collateral.

Secondly, hedge funds can both trigger and intensify disruptions to financial markets. Not only the characteristic high leverage of these funds but also the increasing investment in illiquid and complex instruments give observers food for thought. This is all the more true considering relaxed margin requirements during unfavourable market developments can give rise to margin calls with corresponding pressure to backtrack. In such a situation, tension can build up in the market and market liquidity can decrease considerably or even dry up completely.

However, I would also like to stress that precisely hedge funds, as long as their positions allow, often identify such situations as good business opportunities, go against the trend and consequently stabilise the market. A range of market participants with different positions has a stabilising effect on the market. In other words, market liquidity is enhanced by the heterogeneity of market participants.

However, this conclusion does not change my opinion that hedge funds need to become more transparent. Without transparency how can investors and counterparties correctly assess the risk profile of a fund and make sound investment decisions?

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[1] See: Axel A Weber, "Hedge funds: a central bank perspective", in Banque de France, Financial Stability Review, Special Issue Hedge Funds, April 2007, p 161-168.

I therefore believe that it was right to include the topic of hedge funds on the agenda of the German G7/G8 presidency and to ask the Financial Stability Forum (FSF) for a statement. We in the FSF were unanimous in making a series of recommendations based on market discipline and indirect regulation of the already regulated hedge fund counterparties. These met with approval at the G8 summit in Heiligendamm. The recommendations ask all participants, that is investors, counterparties, supervisors and hedge funds, to work actively towards increasing transparency and risk awareness.

The hedge fund sector is called upon to review and enhance existing sound practice benchmarks, especially with regard to risk management, assessment and disclosure practice.

I therefore welcome the fact that more than a dozen large hedge funds, which are all managed in London, have launched a remarkable initiative. Under the leadership of Sir Andrew Large, the group plans to develop improved sectoral standards based on the various recommendations and best practices that already exist. These home-grown sectoral standards are to abide by the principle of "comply or explain". These standards are to cover assessment, disclosure and risk management and thereby the exact same areas identified by the FSF.

Of course, only time will tell if the group's project will bring us closer to a code of conduct with mandatory disclosure requirements which is on the to-do list of the G7/G8 presidency. I for one am taking this initiative seriously and see it as a good step in the right direction.

The FSF's recommendation to investors and counterparties is to actively obtain the information required so that market discipline has a chance to come into effect. This particularly concerns information on the risk profile.

The FSF's other three recommendations are addressed to financial supervisors. They should take an indirect approach to ensuring that systemically important financial intermediaries firstly strengthen their counterparty risk management practices and secondly prepare themselves for a sudden erosion of market liquidity. Thirdly, financial supervisors should also explore the extent to which systematically collecting data from systemically important intermediaries on their consolidated counterparty risks vis-à-vis hedge funds would be an effective complement to existing supervisory efforts. It should also be considered whether international cooperation between supervisory authorities should be strengthened.

I believe that the important factor now is for all parties to ensure that no time is lost in putting these recommendations into practice, especially as the macroeconomic and financial setting is not likely to remain as favourable as it is at the moment.

At this interim point, ladies and gentlemen, let me take a moment to recount a personal experience. In all of the discussions about new financial instruments and new market players, I have discovered that the Anglo-Saxon perspective is often quite different from that of continental Europe. Whilst the emphasis here is on risk, in the UK it is the stability of the financial system through innovations in the field of financial instruments and financial intermediaries that is promoted. I believe that both perspectives are justified.

And I am also of the opinion that both of these perspectives – that is, opportunities and risks – also play a role in the evaluation of financial integration but here I am jumping forward to another section of my speech.

The integration of financial markets and the banking systems are causing the structure of the financial system to change. Financial markets will become broader and deeper if market players look beyond national borders more and more and find a larger selection of financial instruments, greater turnover and higher liquidity. This indicates that an integrated financial system is more capable of absorbing shocks and that it is more resilient.

However, it should also be noted that disruptions in a highly integrated system can spread at a much faster pace over market segments, market players and countries, meaning that it is

much easier for an unfavourable self-perpetuating momentum to develop, which is likely to be much stronger than in a fragmented financial system.

V Integration of European financial markets

Europe is making headway towards a single market for financial services. This single financial market is a cornerstone of European economic and monetary union – and let's not forget that this is not just a monetary union but also an economic one. Tighter integration of further sub-markets would be desirable in order to take maximum advantage of the economic benefits which a shared currency has to offer.

1 Financial integration

Monetary union was followed virtually overnight by integration in the unsecured money market, which in turn led to uniform market interest rates applying to all euro-area countries.

Since EMU began, other segments of the financial market in Europe have become increasingly interlinked. The closer a financial market segment has been tied to monetary policy and the larger the volume of business, the faster integration has occurred.

Bond markets belong to the category of particularly well-integrated markets. In the case of government bonds, most interest rates have been brought into line.

The remaining interest rate differentials reflect differences in the degree of credit risk in individual countries as well as in the liquidity of specific instruments.

With regard to banking services, business with major corporate customers has likewise become very well integrated. To take the example of syndicated loans, there has been an increase in the proportion of financing that is arranged by a foreign bank, from the perspective of the borrower.

Integration is least developed in retail banking. Some experts complain about "fragmentation" in the retail banking business. My advice would be to take a more relaxed view.

Of course, the regulatory framework for convergence has to be right, and the FSAP along with its follow-up and the Lamfalussy procedure certainly have a helpful role to play here. But the market participants will definitely themselves find the right speed and identify the appropriate areas for action and the methods to be used. This applies in even greater measure to retail banking, where national traditions set natural limits to the degree and speed of integration. Integration cannot be achieved with force.

However, it is not just the financial markets that are integrating. The big banks and banking groups are following suit and becoming more and more European. Starting in 2001, the ESCB's Banking Supervision Committee has examined this process every two years (the most recent data relating to year-end 2005).They have been doing this on the basis of the cross-border activities of 46 European banking groups at the last count. Their latest survey clearly confirms the trend towards Europeanisation that had already been observed.

The European banking groups have grown considerably, mainly as a result of mergers, with 30% of the groups of institutions under review having assets of more than €500 billion.

The foreign presence of these groups is on the increase, both in terms of the number of EU countries where they have a foreign affiliate and in terms of their share of external assets. These average 38% of the consolidated group assets, 14 percentage points higher than the figure for 2003! Big differences exist between individual countries, with the share of external assets ranging from 16% in the case of Greece to 65% for Italy. The value for a total of eight countries is equal to or above the average.

In the EU15 countries, the aggregated market share of the banking groups under review stands at an average of 20%. Meanwhile, at 56%, the figure for new EU member countries is more than half of the total.

What we see here is a pronounced degree of Europeanisation at the level of the larger banking groups. I am sure there is little need for me to emphasise that this development is directly connected with the question of what kind of structure is best suited for banking supervisory purposes in Europe.

2 *Implications for financial supervision*

This question is anything but easy to answer.[2] This is because the large financial intermediaries active across Europe operate alongside a much larger number of nationally or even locally focused institutions. Also, the EU member states each have their own individual legal systems.

A European supervisory system must therefore take account of the financial reality of an increasingly integrated financial system as well as the political reality of national legal and administrative systems. Moreover, and I would like to place particular emphasis on this, the supervisory structure should also be competitively neutral. This means that a "level playing field" must be established not only between domestic institutions and their foreign competitors but also between nationally and internationally focused institutions. This is definitely no easy feat.

The EU has, however, developed a system which, in my opinion, has met these requirements. While the supervision of institutions is the responsibility of member states, a cooperation model between home and host supervisors applies for internationally active institutions. It is envisaged that the consolidated supervisor as defined in the Banking Directive will carry out supplementary supervision of an institution through the supervisory authorities of the bank's country of domicile in cooperation with the supervisory authorities of the host countries.

The nature and scope of this cooperation are defined in the "home/host guidelines" of the level 3 committee CEBS. This expert committee was established under the Lamfalussy framework and is designed to provide for a convergent application of European banking supervisory legislation among other things.

The "home/host guidelines" also describe the "supervisory colleges" in which the participating supervisory authorities responsible for a bank organise themselves. This facilitates the exchange of information and the coordination of supervision.

A whole range of measures such as exchanges of staff, joint training sessions or the option, currently being developed, of a mediation procedure in cases of dispute between supervisory authorities serve to increase cooperation and convergence in supervisory practice.

This cooperation model provides the best solution under the present political and legal conditions. The necessary and desired improvement in supervisory cooperation and convergence should be further developed within this framework.

But I know that this approach is criticised by some for not going far enough. Large European banks have been requesting a concentration of supervisory functions for some time. At the beginning of June, the IMF strongly criticised the existing arrangements for the supervision of institutions and crisis management in its concluding statement to Article IV consultation with the euro-area. Not only did they lag behind the market but they even prevented further integration.

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[2] See: Meister, Edgar, European financial supervision: next steps, Lecture given at the "Kangaroo group breakfast debate", European Parliament, Brussels, 29 March 2007.

In my opinion, however, the IMF's criticism of the European supervisory model can be qualified by the fact that, among other things, there are no appropriate legal and political provisions to enable the solution suggested by the IMF for large internationally operating financial institutions to be applied.

Most important is that a single supervision and bankruptcy law be established in all member states. Even then the question would remain as to whether a supervisory system which de facto is in two parts is consistent with the idea of the single market and the goal of a level playing field.

The IMF also criticised the sluggish progress in the preparations for the management of any financial crises in internationally active financial institutions.

Without doubt, the question of adequate crisis management in the financial sector is extremely important for financial stability. The aim of supervisory authorities and central banks is to avoid systemic consequences in the event of an incident.

In my opinion, two things are important, when preparing for a crisis: First, what market participants expect from the crisis management system and, second, the flexibility necessary to make the best of the individual circumstances of a critical situation.

The expectation that the central bank and the taxpayer will make funds available in a crisis situation reduces the financial institutions' own sense of responsibility. Such expectations could even lead to a careless attitude towards risk and would therefore be counterproductive. Owing to this moral hazard phenomenon, I believe advance detailed arrangements are not helpful.

The institutional system in the EU for crisis management has been expanded over the past few years and has been tested in several crisis simulations.[3] It addresses the expectation problems and offers the necessary flexibility.

At an EU level, two memoranda of understanding currently exist for cooperation in a crisis situation. The older one (2003) was agreed between supervisory bodies and central banks; the second (2005) includes the finance ministries. These agreements cover the principles and procedures for the exchange of information and assessments in crisis situations. Then there is the information exchange between the supervisory authorities already institutionalised in the "supervisory colleges".

Independent of this, the Eurosystem has arrangements and procedures in place for the effective performance of its functions in crisis situations as well as for the provision of emergency liquidity assistance by the national central banks.

With this institutional framework, Europe is, in my opinion, well prepared for a situation which could threaten the stability of the financial system. Some participants in the discussion on crisis management envisage further, more extensive agreements.

However, I see the danger that flexibility in financial crisis situations will be limited if such further, more extensive agreements are reached. Each crisis is unique. Predetermined contingency plans would restrict flexibility and could therefore impede an optimum solution being reached. This applies even more, as a private sector solution always has priority. Ex ante agreements on the sharing of the financial burdens of a crisis are, in my opinion, unfeasible and problematic.

To be honest ladies and gentlemen, I'm finding it difficult to think of an appropriate conclusion. I will, therefore, finish by asking you to bear my initial comments in mind.

Thank you very much for your attention.

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[3] See: ECB, The EU arrangements for financial crisis management, Monthly Bulletin, February 2007, p 73 ff.