David Dodge: A clear case for transparency

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Canada-UK Chamber of Commerce, London, UK, 12 September 2007.

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It has been about 26 months since I last spoke to you here in London and certainly, much has changed in the world since then. We have seen a remarkable continuation of robust global growth, fuelled by increases in international trade and facilitated by the continuing evolution and expansion of capital markets. Domestic demand began to grow more strongly in Europe and Asia and to slow in the United States, and this began to ease some of the concerns related to global imbalances that I spoke about during my last visit.

However, credit spreads continued to narrow, and lending standards loosened through the early part of 2007, while the growing use of structured financial products increased the distance between investors and underlying credits. Although central bankers raised concerns over the past 18 months or so about the pricing of credit and whether it appropriately reflected risk, it was not until the late spring of this year that spreads on risky assets began to widen, triggered largely by concerns related to the market for U.S. subprime mortgages. In August, concern turned into consternation, as investors in structured products – especially asset-backed commercial paper (ABCP) – "discovered" that U.S. subprime mortgages might be included in the assets underlying their products. Compounding this consternation was the worry that counterparties might be in a weaker financial state than previously anticipated, because of their own exposure to these assets. This led to a tightening of conditions and to dislocations in money markets more generally.

One key factor behind the recent troubles in the money markets was, I believe, a lack of transparency. Transparency can, of course, mean different things in different contexts. In terms of financial markets, I am referring to the ability – as well as the willingness – of participants to obtain and use full and timely knowledge of market activity, including the precise nature of what is being traded. It was living through the events of August, in combination with ongoing efforts by the Bank of Canada to strengthen the functioning of international financial institutions, that has led me to use my remarks today to make a clear case for transparency. In doing so, I will not limit my comments to financial markets. Transparency is an underlying theme that pervades much of what policy-makers should do, both domestically and internationally.

So, I will begin my remarks with a discussion of financial markets and how a lack of transparency has contributed to the market dislocations that we have seen recently. I will then return to a theme I spoke about when I was last here – the importance of strengthening our international financial institutions and increasing the transparency of their advice and operations. Finally, I'll say a few words about the health of the Canadian economy.

Financial markets: the need for transparency

Let me begin my remarks by recalling the 2005-06 period, when many central bankers – including me – were becoming concerned with what appeared to be an excessive easing of credit conditions, or what was described as a "wall of liquidity" building up around the globe. What was creating this wall of liquidity? Well, as I mentioned the last time I was here, at its very base was a global excess of desired savings relative to desired investment. These excess savings were acting to drive down real longer-term interest rates, even during a time when many central bankers were raising policy interest rates.

As longer-term interest rates declined, investors intensified their search for better returns. This search for yield led to a narrowing of spreads on risky assets. As well, there was a loosening of lending standards in some markets, as lenders became more willing to take on risk. It also provided the opportunity for an increase in the issuance of structured products. Packaging and selling loans with a structure that allowed higher-risk assets to take on the qualities of a lower-risk loan fuelled the demand for higher-risk assets and embedded significant leverage. This financial engineering was a factor that spurred merger and acquisition activity, including corporate takeovers by private equity firms, as well as lending in markets such as the market for subprime mortgages in the United States.

In many cases, these structured products have become increasingly complex and more difficult for investors to understand. The securities often made use of leverage and contained layers of derivatives on top of various types of assets; assets that were packaged and repackaged, sold and resold, in a myriad of forms. In this complex process, transparency about the underlying credit was often lost. Because the originators of the loans intended to securitize them rather than leaving them on their balance sheets, they lacked the incentives to carefully assess the creditworthiness of the borrower. And investors often lacked the ability, or did not make the effort, to see through the complexity of the instrument. Thus, investors were unaware of the creditworthiness of the root asset and the potential difficulties with the liquidity of the instrument itself. Compounding the problems was the fact that the models upon which these structured products were valued assumed that they could be readily traded in a liquid market. In August, that assumption was tested and found not to be fully warranted.

I do want to emphasize that there were significant benefits to the development of these new, complex instruments. They provided the ability to separate different types of risk, such as credit or market risk. This promoted better risk management and allowed these risks to be borne by those best able to do so. Both banks and non-banking institutions created different types of loans that could be packaged and sold to different investors across the global economy. And taking many loans off balance sheets enhanced the ability of the banking sector to originate new loans while remaining well capitalized.

As I mentioned earlier, central bankers had been worried for quite some time that credit spreads were not appropriately reflecting risk. So, we welcomed the re-pricing of risk that began in the spring of this year. Indeed, by May, we saw spreads on high-yield corporate bonds and emerging-market bonds beginning to widen to levels closer to historical norms. We also saw a re-pricing of U.S. subprime mortgages to reflect rising delinquency rates. This process meant that some people who had taken on a great deal of risk had to face losses. But in general, the necessary re-pricing of risk was proceeding, and markets were functioning properly.

In August, however, the process hit a fairly major bump in the road. To begin with, we saw that the spread of the risks inherent in structured products also meant a wide dissemination of any underlying problems associated with the assets at the root of these instruments. Moreover, the complexity and lack of transparency in many of the structured products added to the market dislocations. It was extremely difficult for investors to peel back the layers of these securities and derivatives to determine, with confidence, both the creditworthiness of the assets backing a particular security and the market value of the security itself. Even supposedly sophisticated investors became extremely uncertain and that, in turn, led to fear. Such fear made markets less liquid – the money market in particular – and the "wall of liquidity" evaporated under the summer sun. Investors sought shelter and security in the least risky, shortest-term, and most transparent assets.

The re-pricing of credit risk is an ongoing process. Unfortunately, it may take somewhat longer than in previous periods, because of the opacity and legal complexity of so many of these structured products. All of this implies that it's too early to draw any definitive conclusions from the current experience. But one lesson, which I hope will be clear to everyone, is the absolute importance of transparency if markets are to function properly. Vendors of financial instruments need to structure these investments in such a way that market players can clearly see what they are buying. Credit-rating agencies need to clearly indicate that their ratings for highly structured products should not be used with the same degree of certainty as their ratings for conventional, single-name issuers. At the same time, investors will have to take on more responsibility for diligent research, so that they can better understand the nature of their investments and demand greater transparency where it is now lacking. Investors should not rely simply on the pronouncements of rating agencies to deliver their seal of approval! Instead, they must do their own homework and make a concerted effort to understand what they are buying. However, this process can be successful only if they have access to all the information they need.

Now I want to spend just a few minutes discussing the role of central banks, and the Bank of Canada in particular, during August. As liquidity dried up, central bankers in many parts of the world quite appropriately became involved. Many central banks injected short-term liquidity into money markets where required, fulfilling two fundamental roles.

First, it is absolutely normal and proper that central banks should provide liquidity when banks that are quite solvent are faced with markets that have become illiquid – a point that Walter Bagehot recognized more than a century ago. Banks need to know that they can access the central bank's liquidity facilities when required. At the Bank of Canada, our Standing Liquidity Facility is available at the end of day, and can be accessed at a penalty rate of 25 basis points above our target for the overnight rate, by institutions that can pledge a broad range of easily priced securities as collateral. Following the onset of the market dislocations, we increased our supply of settlement balances as we normally do when we see increased demand for cash balances.

Our second very fundamental role is to conduct our monetary policy in a transparent way to keep our policy interest rate close to its target, in order to control inflation. The events of August put strong upward pressure on the key overnight rate that we use in the conduct of monetary policy. And so we carried out open market buyback operations to inject liquidity in order to maintain that rate. We also temporarily expanded the list of securities eligible for use by market participants in these buyback operations.

All told, our actions in these roles were effective in improving the functioning of the overnight money market. So we have now restored our original list of securities eligible for use in buyback operations, and we have gradually reduced the level of settlement balances.

I want to be absolutely clear on one point: The actions that we took to provide liquidity to support the smooth operation of financial markets did not in any way signal a change in our monetary policy. In fact, it was a step in maintaining our monetary policy stance by keeping our target for the overnight rate at 4 1/2 per cent, which we judged appropriate for keeping inflation on target over the medium term.

But while the overnight market in Canada is well on its way back to normal operations, this does not mean that all of the problems in money markets have been resolved. Term funding remains somewhat expensive, and the yield spread between bankers' acceptances and treasury bills remains abnormally wide. With respect to the market for asset-backed commercial paper, Canada – like other countries – has seen some problems. One specific segment of the Canadian ABCP market – the market for third-party, or non-bank-sponsored, structured finance, asset-backed commercial paper – has had particular problems. This represents roughly one-third of Canada's about $120 billion ABCP market. At the core of the difficulty are the guarantees of liquidity behind these securities, which differ from the guarantees provided in the United States and Europe. Canadian third-party ABCP tends to include a clause that guarantees liquidity only in the event of a "general market disruption." Many, but not all, of the liquidity providers have declined to step in as this paper has come due, essentially saying that the continued operation of some parts of the commercial paper market indicates that there has not been a general market disruption. Efforts to resolve problems in the market for third-party ABCP are under way. Discussions between investors and liquidity providers – most of whom are international banks – are continuing in Montréal. And I remain hopeful that, over time, we will see useful results.

The balance of Canada's ABCP is composed of conduits sponsored by Canada's major banks. These banks have agreed to provide global-style liquidity support to their conduits. But they have not been immune to both global and local problems. As a result, the banks' conduits have been rolling over at shorter terms and higher interest rates and, in some instances, the banks have been taking some maturing paper onto their balance sheets. Nevertheless, the major banks appear to be well placed to deal with the current dislocations. In a joint statement last month, these institutions said that their commitment to support the ABCP market is underpinned by the strength of their financial positions, their confidence in the underlying assets, and their ongoing commitment to provide liquidity for their conduits upon maturity. Further, data published by Canada's Superintendent of Financial Institutions show that our domestic banking sector is well capitalized. At the Bank of Canada, we welcomed this effort to help re-establish well-functioning money markets in Canada. And we are confident that our banks have the capacity to continue to support their conduits as necessary.

Institutional transparency

I said earlier that one of the lessons of the events of August is the absolute importance of transparency if debt markets are to function properly. But the importance of transparency is not limited to money markets and debt instruments. In my view, there is a clear case for transparency more generally in the operation of all financial markets. In most countries there are fairly clear rules requiring transparency in the operation of mutual funds, so investors can tell what they are purchasing. Hedge funds, by their nature, are less transparent. But there is also, I believe, a clear case for increased transparency, at least with respect to their objectives, operating procedures, and governance.

The objective of accounting standards is also to increase transparency. But it is very difficult for firms to put a precise value on complex instruments for reporting purposes. For many of these instruments, there is no well-established market against which they can be marked. And the models against which these instruments are valued are simply that – statistical models that can only generate estimates of value within what is often a wide range. This means that it is very important for firms to be transparent about the methods used to estimate values and about the range of possible values around these estimates.

Let me now say just a few words about the importance of transparency in government-sponsored institutions, whether domestic or international. I will begin with a few words about sovereign wealth funds, which control increasingly large amounts of money and are significant global financial forces. Some of these funds, such as the public pension funds in Canada, already adhere to very high standards of transparency. But in other cases, there is often insufficient transparency in the operation of these funds. Too often, the objectives behind these funds are not clearly defined, and this can lead to misconceptions about their motives, particularly those that have their origins in foreign exchange reserves. As is the case with private pools of capital, high standards of transparency for reporting and governance, as well as objectives, would be helpful for these public pools of capital.

Finally, I would note that the same need for transparency applies to our international financial institutions. In this vein, we at the Bank of Canada, along with our colleagues at the Bank of England, have been working to promote a strengthening of the surveillance capacity and governance practices of the International Monetary Fund (IMF). As work continues to improve surveillance, we must also be expanding our efforts to help to make the IMF a truly representative institution for countries around the world, by ensuring that emerging-market economies have an appropriate voice within the institution. As well, we must ensure that the Fund is governed in a transparent way, and that the Managing Director and staff are accountable for the work that they do.

Canada's economic health

Before concluding, let me say a few words about Canada's economic situation. Canada has enjoyed roughly 15 years of sustained economic growth, with low and stable inflation and increasingly healthy public finances. Our unemployment rate is the lowest it has been in about 30 years, and a greater proportion of the population is now working than ever before. At least part of the credit for our continued economic performance should go to our sound framework for macroeconomic policy, which includes the transparent monetary policy of inflation targeting that I mentioned earlier, as well as a sound fiscal policy.

Over the past five years, robust global demand – particularly for energy and other primary products – has been a key contributor to solid economic growth in Canada and a significant improvement in our terms of trade. Overall, the Canadian economy has been adjusting well to changing relative prices, supported by our flexible exchange rate regime. Labour has shifted from areas and sectors where there is less demand to those where demand is greater. For about the past three years, the Canadian economy has been operating near, or above, its production potential. Strong economic growth has led to rising incomes across the country. The market for skilled labour is tight throughout Canada, but especially in the western provinces. In these circumstances, there has been some upward pressure on inflation. Against this backdrop of rising incomes and employment, it is not surprising that housing sales and prices have continued to rise, despite Canada's more conservative mortgage-lending practices.

What do we see as we look ahead? The Bank's last full economic projection was conducted for the *Monetary Policy Report Update* that we published in the middle of July. In that document, we projected continued strong economic growth outside North America and somewhat slower growth in the United States over the next several quarters. In that context, our base-case projection for Canada was for average annual economic growth of about 2 1/2 per cent through 2009, slightly below our estimate for the growth rate of potential. This would allow the economy to return to its production potential in 2009. Inflation was projected to return to its 2 per cent target by early 2009.

Recent developments suggest that the near-term economic prospects for the United States are weaker than earlier expected. It now seems likely that the adjustment in the U.S. housing sector will be more pronounced and more protracted, exacerbated by the dislocations in financial markets. This implies weaker demand for Canadian exports than had been earlier expected. However, economic growth in Canada in the first half of this year turned out to be stronger than we had projected. And so at our fixed announcement date last week, we said that the Canadian economy now appears to be operating further above its production potential than we had estimated in July. Domestic demand remains robust, buoyed by our continued strong labour market and higher-than-expected increases in housing sales and prices. But recent developments in financial markets have led to some tightening of credit conditions for Canadian borrowers, which should temper the growth of domestic demand. Against this background, we judged that the current level of our target for the overnight interest rate – 4 1/2 per cent – is appropriate.

However, there are significant upside and downside risks to the outlook for inflation. On the upside, there is a possibility that household demand in Canada could be stronger than anticipated, while on the downside, the ongoing adjustment in the U.S. housing sector could be more severe and spill over to the U.S. economy more broadly. In addition, there is uncertainty about the extent and duration of the tightening of credit conditions in Canada and, hence, about the tempering effect this will have on the growth of domestic demand.

Conclusion

Let me conclude. Dislocation in financial markets is not easy to deal with, and it is certainly not welcome. But if we can learn and retain the extremely valuable lessons from these events, particularly in terms of the critical importance of transparency, then global financial markets can emerge from these events stronger and more efficient than before, to the benefit of us all.