David Dodge: Credit market turbulence and policy challenges ahead

Remarks by Mr David Dodge, Governor of the Bank of Canada, to the Institute of International Finance, Washington DC, 21 October 2007.

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I'm delighted to have the opportunity to address the Institute as it celebrates 25 years of important contributions to the stability of the global financial system.

Given the Institute's membership and its focus on financial stability, I feel safe in saying that all of us here today watched this summer's turbulence in credit markets with interest, to put it mildly. What began in the spring as a repricing of credit risk turned into dislocations that have yet to fully run their course. Because of our shared interest in these events, what I thought I'd do today is discuss some of the challenges that these events have posed, not just for central bankers, but for policy-makers and private sector institutions more generally. My goal today is to try to identify some of the questions and issues that we need to consider.

Credit market turbulence – a brief review

As a point of departure, it would be useful to have a common understanding of the factors behind this summer's turbulence. I'll be brief here. Ten days ago, Charles Dallara did a nice job of summing up one of these factors in his letter to Tommaso Padoa-Schioppa, the new Chair of the International Monetary and Financial Committee (IMFC). Dallara wrote: "Strong global growth, plentiful liquidity, and a search for yield together led to a relaxation of credit standards and to pricing that was not commensurate with underlying risks and fundamentals."

There were other key factors that led to the events of this past summer. In a couple of previous speeches, I have noted the complexity and opacity of some of the structured products at the heart of the recent turbulence. Because of this complexity and opacity, it is extremely difficult for investors 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 did not understand the nature of the assets underlying these structured products.

The other factor I'd point to is the increasing use of securitization to meet the growing demand for structured products. This allowed higher-risk assets to appear to take on the qualities of lower-risk assets, fuelling the demand for the creation of higher-risk assets and leading to the relaxation of credit standards. To be clear, the problem was not the use of securitization per se; rather, it was that originators of the securitized loans at times did not have the proper incentives to carefully assess the creditworthiness of borrowers. In many cases, once the loan had been securitized and sold, the originator no longer faced the consequences if the borrower defaulted.

It seems to me that in recent years, we at the Bank of Canada and, I suspect, other monetary authorities as well, may not have fully appreciated just how much the increase in securitization represented an easing of credit conditions. Loans were being sold and, to a greater or lesser extent, moved off balance sheets, allowing more loans to be made. If securitization led to the creation of loans that would not otherwise have been made, then this was a source of demand in the economy that we as central bankers may have only partially taken into account. Any given policy rate would thus have been less restrictive than was earlier judged, implying that, in hindsight, interest rates globally might have been a little lower than would have been optimal. However, since both global and domestic inflation have been largely contained over this period, we should not exaggerate the magnitude of this effect.

But following recent events, a reduction in securitization globally is now likely, along with a degree of re-intermediation by financial institutions. Indeed, in the Bank of Canada's latest Monetary Policy Report, published on Thursday, we projected that the cost of credit for Canadian firms and households relative to our policy interest rate will be about 25 basis points higher over the projection horizon than it was prior to the summer. The challenge for monetary authorities is to determine the persistence of this tightening and re-intermediation, because it could affect the conduct of monetary policy going forward.

Policy challenges ahead

Aside from this issue for monetary authorities, this summer's events have led to policy challenges in other areas that are of mutual interest to central banks, regulators, and private sector financial institutions. Let me spend some time now discussing two of them: those related to transparency and those related to liquidity.

Transparency

Let me begin with transparency. Following the events of this summer, it may take awhile to achieve an appropriate pricing of risk, because it will take time to unravel some of the complex, opaque structured products to get to the underlying assets, and then find values for the assets themselves. Over time, market forces can be expected to work this out. But, to operate efficiently, markets need information. So, it is in the interest of market participants to make sure that parties have access to all the necessary information. Once again, Charles Dallara put it well in his letter to the IMFC. He wrote: "disclosure practices need to be improved so as to allow investors and other market participants to properly assess and price risk, thus effectively exercising market discipline."

The desired outcomes are clear enough: Investors should demand greater transparency where it is now lacking. Vendors of financial instruments will then need to structure them in such a way that market players can clearly see what they are buying and what leverage is embedded in the instrument. And credit-rating agencies will have to be clearer about the basis on which their ratings are assigned. But fundamentally, investors and investment advisers must take on more responsibility for diligent research, so that they can better understand the nature of their investments, instead of simply relying on the word of credit-rating agencies.

Many, indeed, perhaps most, of these desired outcomes can, and should, be accomplished through natural market forces responding to these events. For example, when investors demand much higher rates of return for opaque products, there will be a strong incentive for vendors to provide products that are more transparent. However, markets will work only if issuers follow the basic principle of providing clear, straightforward, pertinent information about the security that they are selling. Further, this information needs to be provided in a way that is understandable to the reasonably informed investor. Put another way, the prospectus or term sheet should inform, not obfuscate. If I can draw an analogy, just as food companies are required to list all ingredients on their labels, so should issuers list the "ingredients" of a security. And just as food companies are required to provide that information in a sufficiently clear manner, so that people who can't tolerate peanuts, for example, know that there are peanuts in a product, so should securities issuers be sufficiently clear. But I want to emphasize my key point – the best route to increased transparency is the use of market forces, rather than detailed, prescriptive, and potentially burdensome regulations.

Similar principles of transparency should apply in terms of the role of credit-rating agencies. And again, market forces can be quite useful in achieving appropriate levels of transparency. Let me elaborate on this point by referencing our experience with ratings for asset-backed securities in Canada. We had a situation where the same rating system was being used for very different types of securities. At one end of the spectrum were the most basic, plain-vanilla asset-backed securities, where the nature of and risks associated with the underlying assets were clear. At the other end of the spectrum were the most complex securities, where the risks were less clear, the underlying assets could be synthetic and could not be readily traded, and where significant leverage may have been embedded.

It seems obvious that the same rating system is not appropriate in these different cases. So credit-rating agencies should make it clear that their ratings for complex, opaque securities ought not to be used in the same manner as ratings for conventional bonds issued by single-names.

There have been calls for stricter regulations for credit-rating agencies. After significant market events, it's always appropriate to review the regulations and our roles as governments, central banks, and regulators in terms of these ratings. But I would caution against any knee-jerk regulatory response. Given recent events, it seems likely that those credit-rating agencies that do not work harder to ensure that users understand the nature of their ratings will soon have fewer clients willing to pay for their services. The general principle in securities markets is that disclosure should be clear and transparent. And insofar as credit-rating agencies observe this principle, the use of market forces is once again the preferred route to the desired outcome, rather than burdensome regulation.

Liquidity issues

Now let me discuss some issues related to liquidity. I'll start with a point that may appear to be obvious, but is quite important, given this summer's events. Ultimately, it is banks, and only banks, that can provide liquidity throughout the financial system, because it is only banks that have access to the ultimate source of liquidity: the central bank. Why is this important? The financial system has evolved steadily over the past few decades. If you think back about 50 years or so, the lion's share of financing was provided through banks. Now, most financing is done through markets. But securities markets do not access central bank liquidity facilities. And so, when market liquidity dries up, as it did in money markets this summer, it falls to the banking sector to provide liquidity. The recent market turbulence has shown that this re-intermediation back to banks has had implications that had not been anticipated. Indeed, these events have highlighted the increased importance of liquidity in a market-based financial system and the risks to the system when there is a rapid erosion of market liquidity and banks are called upon to quickly provide liquidity and credit.

This re-intermediation has taken place following a period that saw an expanding use of securitization, where assets such as loans, credit card receivables, and derivatives were bundled and sold as asset-backed securities, often with significant amounts of leverage embedded. As I mentioned earlier, this process allowed banks and, in particular, non-deposit-taking financial institutions, to originate more loans than they would have if it had been necessary for them to hold these assets on their balance sheets. And it is the greatly expanded use of this securitization process, where loans were being originated for the purpose of distribution, that led to the relaxation of credit standards that Charles Dallara referred to.

Again, this does not mean that the expanded use of securitization per se is a bad thing. Indeed, there are many examples of well-structured products that have dealt with the principal-agent problem that was, in many ways, the root cause of the relaxation of standards in the U.S. subprime-mortgage market. But the question can be asked: "Are there ways to encourage the more appropriate use of securitization?" It may be possible, for example, to have asset-backed securities carry some manner of "branding" or "certificate of origination" that would provide a clear incentive for the loan originator to exercise due diligence in extending the loan before it is securitized. Or, we can look for ways to encourage more originators or conduits to keep a portion of the product they are selling on their books – in particular, a portion of the riskiest tranche.

So, there are market-based ways that could help to resolve the problems in the market for asset-backed securities. Given time and increased transparency, the market for asset-backed securities should normalize, since it serves an important function for market participants by helping to distribute and diversify risk. This entire market is not dead. But it seems clear that investors will, at the very least, seek greater returns for opaque, complex instruments than for well-branded, plain-vanilla asset-backed securities.

The specific market for asset-backed commercial paper is a somewhat different story. Because this short-term paper must be redeemable at maturity, despite the longer-term assets that back it, it must carry a guarantee from a liquidity provider. So, there is a question of how liquidity providers should take into account the potential for liquidity calls to be made, both in terms of the capital they hold against this potential, and the liquidity of the assets on their balance sheet. This issue, which came to the fore this summer, represents a key challenge for the members of the IIF. How do you make provisions for liquidity calls that may come against the guarantees that your institutions provide, and for the support of products that represent a reputational risk should they fail? These are not easy questions to answer, but it is important that you provide your own answers and be prepared to discuss them with your regulator in the context of the implementation of Basel II. And I am pleased to see that the IIF has been working hard on these particular issues.

Finally, this summer's turbulence has raised a number of system-wide issues related to liquidity. In the event of a serious disruption in securities markets that would threaten financial stability, are there policies that would be helpful? The Financial Stability Forum has been looking at this issue. And of course it is not only commercial banks that need to worry about this, it is also a problem for central banks in their role as the ultimate providers of liquidity to the banking system.

Over the summer, central banks have seen that their standing liquidity facilities have worked quite well with respect to the market for overnight funds. Different central banks have different practices and facilities in place to provide liquidity to the banking sector.

In Canada, we have clear rules for accessing our Standing Liquidity Facility to cover routine overnight liquidity needs. And we have clear rules regarding emergency lending assistance for individual solvent banks with acute liquidity problems. But are there principles that would suggest that some market failures would be best dealt with if we had a readily accessible facility that would provide liquidity to banks at terms longer than overnight, collateralized with a possibly wider range of securities? Such a facility would have to allow for suitable term premiums and penalties.

The types of market failure that such a facility would be designed to deal with would obviously need to be thoroughly examined and discussed, as would the pros and cons of any specific proposal, including a consideration of all other issues that might be generated. The experience of other countries suggests that it is difficult to avoid having a stigma attached to the users of such a facility. But such a facility would be designed to help to mitigate system-wide tightness. And such a facility would have to be set up so that it is clear that the Bank would not use it as a backdoor route to easing monetary policy. I would be very interested in hearing your views on this topic.

Of course, the events of this summer have raised concerns beyond the issues I have just mentioned. The Bank of Canada is working closely with the Department of Finance and other Canadian regulatory authorities in reviewing this summer's events and the issues that they have raised.

I hope the IIF will address these liquidity issues, because I truly believe that effective, private sector, market-based solutions are more likely to be efficient and are more likely to provide scope for institutions such as yours to achieve the desired outcomes without choking off the innovations that have proven so helpful to the financial system over the years.

Conclusion

Let me conclude. The challenges that have been posed by the recent market turbulence are global in nature. And so it follows that the responses to these challenges should also be global in nature.

The logical forum for policy-makers to deal with this issue is the Financial Stability Forum. And indeed, the FSF has formed a working group to look at the risk-management practices of financial institutions in terms of liquidity, market, and credit risk, including how complex credit products and investment vehicles are treated and disclosed. The group will look at a number of issues, including accounting and valuation procedures for financial derivatives, particularly those that are narrowly traded or difficult to price in times of stress. They will also look at the role of credit-rating agencies in evaluating and rating structured products. The FSF working group is also looking at the basic principles of prudential oversight for regulated financial entities, especially relating to exposures and contingent claims and liabilities, both on- and off-balance sheet. The working group hopes to complete an interim report in the next few months, and then present a final report to G-7 ministers and central bankers at the spring meetings of the IMF next year.

But, as I noted throughout my remarks, it may well be that the best responses to the challenges I've mentioned come, not from policy-makers, but from the financial institutions at the heart of the turbulence. And so I ask the membership of the IIF to continue to think about and work on the challenges I've mentioned today. Is there a way to accomplish the outcomes we all desire primarily through the use of market forces?

Much of the groundwork may have already been laid. I know that, back in March, the IIF put out a report on the principles of liquidity-risk management. This report touches on many of the challenges and issues I outlined today, and makes recommendations for both the private sector and policy-makers. The report also says that the IIF hopes to generate a constructive dialogue. I applaud this sentiment, and I hope that my comments today can further that dialogue, so that we can move forward together to find answers to the challenges that face us all.