José Manuel González-Páramo: The euro money and financial markets – where do we stand?

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at the Spanish Capital Markets Forum, Madrid, 24 October 2007.

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I am very grateful to the organisers for inviting me to address such a distinguished audience on the occasion of this interesting forum on Spanish Capital Markets. In my intervention I will focus on the developments of the euro area money and financial markets into which the Spanish capital markets are highly integrated.

Outbreak of the turmoil[1]

As you are well aware, in July and early August a series of events led to an intensification of the tensions in the US sub-prime mortgage market and a sharp decline in the degree of risk appetite of global investors. Market volatility increased across almost all financial asset classes. Stock prices declined as investors sold equities and moved funds into safe-haven investment assets, such as government bonds. In this context, several investment funds holding asset-backed securities suspended withdrawals from their clients. At the same time, a number of European banks made public their direct or indirect exposures to the US mortgage market, particularly to its sub-prime component.

In the money markets the impact of the turmoil was initially felt mainly in the longer-dated unsecured inter-bank market and in non-government repurchase agreement (repo) transactions: trading in these two segments became increasingly thin. These frictions eventually spilled over to the very short-term money markets (i.e. below one-week), at first in the US dollar market where banks – particularly, the European ones – encountered difficulties in raising short-term liquidity.

Early in the morning of Thursday 9 August, the tensions spread to the short-term euro money market and also to other money markets such as those related to the British pound and the Swiss franc. The tensions were also felt in the foreign exchange swap market, which is very important for banks managing liquidity in different currencies.

Interventions of the ECB

After it became clear that there was the risk of an imminent gridlock in the euro money market, the ECB released a communication stating its readiness to contribute to orderly conditions in the euro money market. Subsequently, the ECB conducted a first fine-tuning operation with an overnight maturity to inject liquidity. The operation was conducted as a fixed rate tender at 4.00% and the full bid amount of EUR 95 billion was allotted. This operation was followed by similar fine tuning operations on the following 3 days, which were however conducted as variable rate tenders and with declining allotment amounts.

These fine-tuning operations together with the following abundant weekly refinancing operation (EUR 73.5 billion above the benchmark) succeeded in stabilising the very short-

[1] I am very grateful to Trevor Fitzpatrick, Edward O'Brien, Fatima Pires and Ralph Weidenfeller for their valuable inputs and contributions.

term interest rates.[2] The subsequent regular weekly operations in this reserve maintenance period aimed at gradually reabsorbing banks' accumulated reserve surpluses by the end of the maintenance period on 11 September.

In the following reserve maintenance period the ECB followed a broadly similar approach, allotting significant excess liquidity at the beginning of the maintenance period, which was then gradually re-absorbed over the following weeks.

However, as the activity in the term money market – in particular, unsecured lending – remained limited, the ECB satisfied some demand by banks for diversified funding by conducting two supplementary three-month refinancing operations for EUR 40 billion and EUR 75 billion, respectively. These operations aimed at indirectly supporting the normalisation in the functioning of the euro money market. Nevertheless, liquidity in the term money markets continued to be limited.

All in all, it should be emphasised that over the entire two months following the outbreak of tensions, the ECB did not provide more liquidity than in earlier maintenance periods, in which the demand by banks was mainly driven by reserve requirements. What was different was the pattern of liquidity provision (with significant frontloading of the liquidity needs) and its maturity composition, with much larger weight for 3-month refinancing operations relative to 1-week refinancing operations.

On 8 October, before the start of the current reserve maintenance period, we issued a communication stating that the ECB continues to closely monitor liquidity conditions and aims at further reducing the volatility of very short term rates around the MRO minimum bid rate. For this purpose, we have decided to reinforce our policy of allocating more liquidity than the benchmark amount in our weekly operations to accommodate the demand of counterparties to fulfil reserve requirements early within the maintenance period. In the refinancing operation on 9 October, which was the first of the current period, we allotted EUR 40 billion above the benchmark amount. In the following weekly operation on 16 October, the allotment exceeded the benchmark amount by EUR 18 billion, and in yesterday's tender we allotted more than EUR 14 billion above the benchmark amount. Indeed, the difference between the allotted and the benchmark amount is envisaged to decline gradually in the course of the maintenance period, taking into account the prevailing market conditions. And the ECB still aims at balanced liquidity conditions at the end of the maintenance period. Besides, the ECB intends to steer liquidity towards more balanced conditions also during the maintenance period, in a way which is consistent with the objective to keep very short term rates close to the minimum bid rate. We have also stated our commitment to keep this policy in place for as long as needed.

Before turning to the current situation in the market, let me stress a very important point. Through the liquidity operations just discussed, the ECB has contributed to the orderly functioning of the money market, which is one of its key responsibilities. It is worth emphasising, however, that the ECB's primary mandate calls for its monetary policy to deliver price stability. The two responsibilities are clearly distinct and should not be mixed. This is our concept. Only when kept separate, the fulfilment of both duties can reinforce each other.

Current situation

Let me now turn to the main issues that characterise the nature and dimension of the current tensions in some segments of the financial markets.

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[2] The so-called benchmark amount is the amount of liquidity that is needed for the banking sector to fulfill their reserve requirements in a smooth fashion over the course of a maintenance period. Usually, the ECB supplies roughly this amount in its weekly refinancing operations.

Although the ECB interventions have had a stabilising effect on the euro money market rates at the shorter end of the term structure and, more generally, the money market has recovered some of the lost ground, market participants continue to report limited trading activity, particularly in unsecured inter-bank term markets. Compared to the situation prior to the emerging of tensions, unsecured deposit rates beyond one month are in some cases (notably, three months) still significantly higher and turnover remains lower, despite some improvement during the past few weeks. This situation reflects two main factors.

- First, some banks' daily funding needs, especially in USD, have significantly increased at various points in time in the recent past. In addition, they have become more uncertain, since the credit lines that they had offered to various financial entities as back-up facilities have been largely utilised or appeared likely to be utilised. This is due to the fact that these entities have faced difficulties in tapping their usual market funding sources, in particular the US dollar-denominated asset-backed commercial paper market.
- Second, a number of financial institutions are still reluctant to lend money in the inter-bank market, particularly on an uncollateralized basis, because of uncertainty about the soundness of their counterparties. This reflects a problem of confidence and trust among banks, even in the presence of abundant liquidity in the banking system. Lack of confidence among banks leads to a sustained reduction in inter-bank activity.

As regards the funding markets most affected by the turmoil, anecdotal evidence and bilateral contacts with market participants indicate some recent improvements:

- In the FX swap market, the degree of market depth and liquidity has improved with turnover increasing again, while spreads have narrowed, particularly for short term periods up to one week. However, it seems that turnover may not yet have reverted to pre-crisis levels for periods beyond one week.
- In the Asset Backed Euro Commercial Paper (ABECP) market, the amount of paper maturing (currently about EUR 6.4 billion per day) is now in line with the amount issued (currently EUR 6.6 billion per day). In addition, there has been a recovery in the original maturities of ABECP; after falling from above 50 days in early August to below 25 days in mid September 2007, original maturities have recently returned to levels close to 45 days.
- The outstanding amount in the US Asset Backed Commercial Paper (ABCP) market has decreased from a peak of almost USD 1.2 trillion at the end of July to a current level of around USD 0.9 trillion, although the pace of decline has stabilised. The patterns in the US have been similar to those of the ABECP: shortening of roll-over maturities, issuance smaller than maturing amount and banks buying their own paper. The 3-month rates on highly rated US ABCPs, which rose up to 50 bps over LIBOR in August, have declined to pre-turmoil levels just below LIBOR.

Preliminary lessons to be drawn

Recent events have revealed some weaknesses in the organisation and functioning of the financial system, in particular regarding the market for complex structured products and the liquidity in this market under stressed conditions. Let me point out three key weaknesses:

- First, the ability of investors to assess the extent of concentrations among various types of collateral – including sub-prime – within the structured finance securities has clearly been shown to be less than adequate. Indeed, conducting adequate due diligence regarding the nature of underlying investment exposures cannot be replaced by decision-making based almost exclusively on ratings.

- Second, market participants were not sufficiently alert to the possibility that liquidity could dry up in structured finance markets, even though secondary market liquidity in the various structured finance markets has been traditionally thin. As you know, there are several reasons for this, inter alia: the specificity of these instruments, which are often tailor-made; the "buy-and-hold" strategies followed by a large number of investors (including, pension funds, insurers, and banks); and the limited comparability of mark-to-model valuations, stemming from the complexity of these instruments.
- Third, the Asset Backed Commercial Paper (ABCP) structures had intrinsic liquidity risk because they invested the proceeds of short term liabilities into longer maturity structured finance assets. In some cases, certain types of ABCP structures such as Structured Investment Vehicles (SIVs) faced increased pressure resulting from an inability to roll-over. This came both from investor anxiety concerning the underlying collateral and the inability to value adequately the collateral as they were forced to sell assets. There are indications that the liquidity strains associated to these structures are not yet over.

Three key weaknesses of credit markets

Whilst it is too early to make a definitive assessment, certain supervisory and regulatory issues can already be identified as warranting further attention or action. Initiatives are already underway at the international and EU level to address these various issues, but for our exchange of views here today I would like to focus on three key issues: transparency, valuation of complex structured products, and liquidity risk management practices, including liquidity risk stress-testing.

- First, **transparency for markets, investors and regulators**. Adequate transparency is a necessary basis for an efficient functioning of financial markets. Recent experience has shown how perceived opaqueness or uncertainty regarding the underlying exposures, in particular of financial institutions, has translated into a loss of confidence with a resulting disruption in the interbank market. There have been recently many calls for enhanced market transparency both from banks (e.g. enhanced disclosure of banks' liquidity lines to conduits) and non-regulated entities (e.g. voluntary disclosure of portfolio holdings in order to assess where the US sub-prime risk lies, and the development of guidelines for the consistent disclosure of methodologies used to value portfolio holdings). In this context I would like to note that improvements are expected from the implementation of the Basel II framework, namely of the Pillar III requirements, in particular regarding disclosure of risk positions for banks; with regard to the non-regulated entities, a recent industry initiative (dated 10 September) from the European Securitisation Forum and the Securities Industry and Financial Markets Association (SIFMA) calling for additional disclosures in the structured product market should be mentioned and welcomed.
- Second, **valuation of illiquid complex structured products**. Given present market conditions and the uncertainty concerning the underlying quality of the assets, there are currently no quotes or market prices for many structured finance products. However, year-end financial statements including valuations of structured finance products will have to be prepared soon. The room for discretion under existing accounting rules and the use of marking-to-model valuations (in the absence of market prices), may result in very different valuations for similar assets. This lack of comparability and consistency in the valuation of similar assets should be addressed in order to restore confidence in this market.
- Third, **liquidity risk management, in particular liquidity risk stress-testing and contingency funding plans**. The complexity of structured finance products requires

banks to have in place commensurately sophisticated risk management systems. Recent events have shown that significant efforts remain to be done in this respect. Furthermore, carrying out liquidity risk stress-testing and having in place adequate contingency funding plans are particularly important given their ability to significantly improve the preparedness of banks to deal with liquidity events.

Finally, there are other areas of relevance for the recent financial market developments that deserve further study, such as the role of credit rating agencies. However, I have already exceeded the number of issues than can be conveniently addressed in ten minutes.

Let me conclude by noting that the recent market developments have not only revealed weaknesses and challenges to be addressed, but also the strength of some of the institutional arrangements in place. As a member of the ECB's Executive Board, I take especial pride in the flexibility and effectiveness that the Eurosystem's operational framework has exhibited in managing liquidity in the euro money market under stress conditions. But this is an issue that I leave for the next occasion in which I will have the pleasure to meet again this audience.

Thanks very much for your attention.