Jean-Claude Trichet: Global capital – surrender of national policies? Lessons from the recent events in credit markets

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the 17th Frankfurt European Banking Congress "Global Capital – Threat or Salvation?", Frankfurt am Main, 23 November 2007.

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Ladies and Gentlemen,

Let me start off with one general remark: The present significant market correction with episodes of turbulences should not come as a surprise to us. The ECB, as well as the other central banks, has issued warnings in the past on the global phenomenon of under-pricing of risks. In many respects the present episode can be interpreted as bringing to the forefront anomalies and structural deficiencies which we have identified earlier.

While it is too early to make a full assessment, I believe there are some first provisional lessons which can already be drawn at the current stage.

A lesson that can be drawn is that the growing complexity of instruments has to be monitored very closely. Structured credit markets are exposed to valuation problems, which make the market very vulnerable to a shift in investor sentiment.

In the absence of reliable market prices, instruments need to be valued by models. But estimates which the models produce are highly sensitive to underlying assumptions. Mounting losses in residential mortgage backed securities (RMBS) backed by US sub-prime loans have seemed to trigger a wide loss of confidence in the correctness of underlying assumptions and therefore in the valuation of structured credit products more generally. This apparently has set a vicious circle in force in which heightened uncertainty about the future value of complex assets and rising risk aversion caused many investors to withdraw from the market. Prices dropped massively, and investors incurred large unexpected losses, contributing to further pressure to sell.

A second lesson that can be drawn is that structured credit markets provide a pressing example of the need to increase transparency in financial markets.

That the market disruption spilled over into interbank markets can be explained by another key shortcoming of structured credit markets, namely the opacity of exposures of financial institutions to complex instruments and off-balance sheet vehicles. This lack of transparency about exposures of other banks exacerbated counterparty risk concerns, impairing the well functioning of interbank markets. In periods of turbulences, whatever the origin of those turbulences, opacity and absence of transparency are a recipe for propagation of turmoil and generalised contagion.

Third, the recent events have stressed again the particular role rating agencies play in structured credit markets.

The growing complexity of **instruments has** clearly induced some investors to overly rely on ratings. This is the more risky as ratings in structured finance are not yet as much tested as those of corporate issuers. Some investors may also have misinterpreted the risk dimensions covered by a rating. Against this background there is probably scope to improve the information content of ratings and to make the monitoring process more transparent. It also needs to be investigated further to what extent conflicts of interest may have arisen for rating agencies in their credit risk assessment of structured credit instruments. Several international fora are currently looking at those issues.

Fourth, the turmoil has revealed some challenges for the liquidity management of banks.

Banks, including those in continental Europe, have increasingly relied on secured funding, both via securitisation and off-balance sheet vehicles. This has rendered them more vulnerable to a sudden disruption of structured credit markets. Let me recall that the regulatory framework requires EU banks to have policies and procedures for the measurement and management of net funding positions on an ongoing and forward-looking basis and have in place contingency funding plans. In this context, recent events have demonstrated that banks need to further strengthen their liquidity risk stress-tests, encompassing for example scenarios such as a protracted closure of a broad range of securitisation markets and the drawing of contingent liquidity obligations by commercial paper programmes. Moreover, those elements should also be incorporated into their contingency funding plans. The ECB, together with the ESCB Banking Supervision Committee, is carrying out work on this important topic.

Indeed, the current turmoil has underscored the importance of robust liquidity management by banks, as well as the need for supervisory approaches which keep pace with structural market developments. Many initiatives with a view to addressing issues and risks arising from the recent financial market turbulence that go into the right direction have already been launched, both at the international level, namely by the Financial Stability Forum, and at the EU level, with the ECOFIN agreeing to a roadmap for action by 2008, and also by the private sector. They must be pursued now with even stronger impetus. In this respect, co-ordination at the global level should be ensured. In closely interlinked financial markets, any policy measure should be agreed to and consistently applied at the international level.

Fifth, in the same vein, there is a need to reflect carefully on the "originate-and-distribute" business model.

The period ahead is likely to provide a first material test of changing banking business models and the increased reliance on secured funding. Although currently profitable and well capitalised, many banks will experience income and credit losses, which may trigger a re assessment by some of them of the suitability of the so-called originate-and-distribute business model. The current episode has also shown that the transfer of credit risk outside the banking sector may ultimately not be effective. This is related with reputational and other concerns, which induce banks to take credit risk back onto their balance sheets.

Sixth, with respect to our own crisis mitigation tools, a lesson that we can draw at this stage is that the operational framework of the Eurosystem has proved able to cope with stressed market conditions.

So far, the Eurosystem has been able to manage the turmoil in an effective and flexible manner. Two ingredients of its operational framework have been particularly important:

The first is the clear separation between on one hand the ECB's management of the aggregate liquidity conditions and on the other hand the setting of its monetary policy stance, which is signalled by the minimum bid rate in main refinancing operations. This separation has been extremely valuable under present circumstances. Looking ahead, and in line with its previous communications and actions, the ECB will continue to steer very short term interbank rates close the minimum bid rate.

The second ingredient is the Eurosystem's collateral framework. The broad list of eligible assets has ensured that a broad range of counterparties could access the credit operations of the Eurosystem during the turmoil. This has helped counterparties to effectively mitigate funding liquidity risk when interbank markets stopped functioning properly. As a side effect, the acceptance of ABS in the sizeable refinancing operations has allowed to address also asset refinancing needs of counterparties effectively. This has certainly contributed to a better functioning of the money market since counterparties know that they can turn to the Eurosystem to refinance these assets.

And finally the ongoing process of significant market correction which we experience since August should trigger a very deep and candid review in all the areas which have a substantial influence on the functioning of the global financial markets.

This review process should concentrate on what could be done to promote financial stability and to diminish to the maximum extent possible the elements of procyclicality that may be inbuilt in a large number of fields.

The financial stability forum, which has been set up by the G7, under the proposal of Hans Tietmeyer, to draw the lessons of the Asian crisis, is in an ideal position to identify the areas where appropriate improvements could be introduced.

I encourage very strongly the Financial Stability Forum and all the Committees that are actively working at a global level, including the Basel Committee, to draw all the lessons of the present turbulences and to examine the situation without any complacency.

In my view no single area should be put aside from this review which should concentrate on the ways and means to foster financial stability, prevent propagation of disturbances and contagion, improve risk management at all levels, and diminish procyclicality, in particular, in the domains of accounting rules and accounting practices of rating agencies, of supervisory banking rules – the first duty being to implement globally Basel II which is largely superior to Basel I – including harmonisation of liquidity rules and requirements, of supervisory insurance rules, of market supervisory authorities regulations, of regulated and non regulated private institutions (whether highly leveraged institutions or so-called S.I.V. and conduits), and of market practices.

This does not mean necessarily dramatic changes of rules and overloading of new regulations. I am of the firm opinion that voluntary code of best practices, the set up of voluntary “Principles” and the working out of voluntary benchmark best practices are most of the time preferable to the addition of new layers of rules and regulations.

But we have, in any case, the duty to be effective in working out the lessons of the present market correction. This is no time for complacency in any respect.

Thank you very much for your attention.