Christian Noyer: Some thoughts on current financial turbulences

Speech by Mr Christian Noyer, Governor of the Bank of France, at the Euro Fixed Income Forum, Paris, 4 December 2007.

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These are difficult times for policy makers. Financial turmoil has created macro economic uncertainties. Events are still unfolding. In those circumstances, I thought best to have a look at the dynamics driving recent turbulences; then describe potential consequences for the economy; finally make remarks on challenges for Central Banks and best ways to preserve and restore international financial stability.

The dynamics of the crisis

- I will start with a paradox. By any measure, we are facing a huge shock in financial markets. Spreads in some segments of credit markets have widened with unprecedented speed and volatility. Even more significantly, interbank markets in large industrial countries have been severely disrupted, for the first time in fifty years, more disrupted in fact, and for a longer period, than after September 11, 2001.
- And yet, the losses themselves, while significant and spectacular for some institutions, would not seem to pose a major risk to the health of the financial system. Current median estimates put the direct cost of subprime defaults around 250 billions USD. This is a little less than one year of profits for the 40 major financial institutions in the world. Most notably, the turbulences occurred in a very favorable macro economic environment.

Why is there such a disproportion between the cause and the effect?

At the aggregate level, most observers – including the Banque de France – would point to a prolonged period of excessive risk taking in credit markets fueled by liquidity expansion at the world level. This was most apparent in the strong developments of LBOs, mostly financed through leveraged (i.e. with weak covenants) loans. According to this interpretation, we may be witnessing the burst of a credit bubble.

But there is also a deeper, more structural, element to the current turmoil. This crisis is the first in a disintermediated credit world. While, previously, loans were originated by banks, kept on their balance-sheet and monitored for the entire life of the loan, the process is to a large extent dissociated today: the loan is originated by a first entity, then bundled together with other loans as a structured product by another entity, then sold to final investors.

These developments were expected to bring important benefits to the financial system and the broader economy:

o As part of the securitisation process credit risk is now "sliced and diced" and more widely spread in the financial system to be sold to a wide spectrum of investors

o In theory, banks can offload those risks from their balance sheets to other financial investors – including hedge funds – and use their overall capital more efficiently

o In this way, also in theory, risk is allocated to those agents best equipped and most willing to take it

o So the overall capacity of the system to bear risks is, everything equal, increased

With hindsight, we now see some unanticipated problems and difficulties associated with those innovations:

- o There is no incentive for originators of loans to assess – let alone monitor – the creditworthiness of borrowers since they expect to transfer the totality to other investors. This explains the explosion of lending to subprime borrowers, with more and more "exotic" features during the last two years. This may also have fuelled the dynamism of the LBO market.
- o The process has gone with an increasing complexity of instruments, which combine an extensive use of derivatives with customization to individual investors' needs. This has made valuation and risk assessment more difficult.
- o Indeed, valuation of complex instruments is currently at the forefront of discussions between regulators, market participants and investors. There is, of course, a circularity involved, since liquidity depends on valuation, fair value must be based on a market price, and the ability to price an asset itself depends on sufficient liquidity in the market. The difficulty to get out of this circularity in periods of stress is currently creating significant uncertainty.
- o Hence a dependence of the whole market on the rating process. In a securitized world, investors heavily rely upon rating agencies to provide information about the risks attached to various instruments. These agencies have been strongly criticized recently. It is not my purpose to enter into any blame game. Suffice it to say that there has been a deep misunderstanding between investors and rating agencies as to the scope and true meaning of ratings. Most investors were not fully aware that rating did not encompass liquidity risk; nor did they realize that ratings for structured products were intrinsically more volatile than for more simple "plain vanilla" securities. The use of identical metrics for rating what are fundamentally different categories of assets certainly did not help and may have contributed to the confusion.
- o Finally the turmoil has revealed the fragility of off-balance sheet structures and vehicles which underpinned securitization. Conduits, especially SIVs, were not built to absorb shocks. Their relationships with sponsor banks are sometimes very ambiguous. There may be a gap between the legal commitments taken by the banks through liquidity support and credit enhancements, and the “true” level of responsibility they felt obliged to take to protect their reputation.

Potential consequences for the economy

Financial turbulences may affect the real economy through several channels.

- There is, obviously, a potential effect on confidence. We are currently seeing deterioration in business and consumer surveys in the Euro area, although from very high levels. This may put a question mark over our hopes that Europe could "decouple" its cyclical evolution from the evolution of financial markets and uncertainties in the US outlook.
- Most of the impact, however, will depend on how credit markets will evolve in the period to come. While some sectors – such as hedge funds – seem to have held up well, the increased turbulence of recent weeks has partly reversed the improvements in market dynamics seen in late September and in October. Funding uncertainties around year-end maintain inter-bank markets under pressure.
- Some tightening of financing conditions has already occurred through stricter lending standards and decreased credit availability for the weakest segments of the market. The sectors more concerned have been household's non-conforming mortgage loans (jumbo loans, subprime loans…).

- For the future, there will be pressures on Banks balance sheets and we must watch carefully for signs of quantitative restraint on credit distribution. There are talks, in some countries, of "capital shortages" in big financial institutions. We have absolutely no signs of this in France. But, in all countries, banks have been (or will be) exposed to a triple shock: unwanted expansion of their balance sheets through reintermediation; higher cost of capital as a consequence of the decrease in share prices; and, finally, a deterioration in the quality of their assets if the credit cycle turns downward or valuation problems appear for some securities (all this, according to Basel II, would mobilize additional capital). Tighter credit conditions might be desirable. Repricing of risky assets, better risk compensation and more attractive yields may ease some of the restrictions and bring in new investors into the markets. However, quantitative constraints on credit distribution could be very damaging – especially if corporate bond issuances were to stay, as they are now, extremely low.

Challenges for central banks

The most immediate was to restore the orderly functioning of the interbank market. This has been done by providing liquidity to the market. Actions by Central banks have raised some concerns about so called "moral hazard": would liquidity provision lead to "bailing out speculators"? In fact, we have responded to an exogenous and general increase in demand for Central Bank money and ensured smooth management of liquidity conditions. No more, no less. This is the job of Central Banks. Clearly, as experience in some countries has shown, it is not an easy one and we may have to think, in the future, about our modalities of intervention. I am personally very satisfied with the way we have operated. Our organisation has proved efficient and flexible. Inside the Eurosystem, we have reached the appropriate balance between centralisation and decentralisation. Most recently, we have announced that the maturity of the main refinancing operation settling on 19 December 2007 will be lengthened to two weeks to cover the end of the year, and the operation settling on 28 December 2007 will allow potential further liquidity demands to be satisfied. For France, having banking supervision inside the Central Bank has proved a big advantage and enabled us to react quickly and with flexibility in fast changing circumstances.

A broader challenge relates to the policy reaction. To which extent should it be influenced by financial turbulences? Obviously, action by Central Banks has to be fully consistent with their mandate, which, for the Eurosystem, means preserving, first and foremost, price stability. Past episodes of financial turbulences have occurred in an environment of low and stable inflation, with expectations solidly anchored. We live today in a less benign environment. Strong growth in big emerging economies is increasingly putting pressures on the price of oil, food and other commodities. While labour supply in emerging countries will remain abundant, it is not all that clear it will remain cheap and inflation pressures are piling up in many emerging countries. This translates into higher import prices for developed economies. That said, the Governing Council has judged, in its last two meetings, that the ongoing reappraisal of risk in financial markets has led to continued uncertainty. This, in the judgment of the Governing Council, warranted a thorough examination of additional information before drawing further conclusions for monetary policy in the context of our medium term-oriented monetary policy strategy focused on maintaining price stability.