Lucas Papademos: Address upon receiving the 2007 “Risk Manager of the Year” Award of the Global Association of Risk Professionals

Speech by Mr Lucas Papademos, Vice President of the European Central Bank, at the 9th Annual Risk Management Convention & Exhibition, New York, 26 February 2008.

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I. Introduction

Ladies and Gentlemen,

I would like to thank the Chairman of the Board of Trustees, Mr William Martin, for his kind words of praise for the European Central Bank (ECB). It is indeed a great pleasure for the ECB to receive the Risk Manager of the Year Award, which I gladly accept on behalf of the Governing Council and all my colleagues at the ECB. I am aware that, in receiving this award, the ECB finds itself in the privileged company of distinguished past recipients who have made important contributions to academic research and business practice in the area of risk management. This is the first time that the award has been given to an institution and, in particular, a central bank. Mr Martin explained why the Board of Trustees decided to honour the ECB for a number of its achievements. Indeed, given the inevitable uncertainty characterising our economies and the risks that can affect their performance, central banks may be seen as institutions whose tasks involve the prevention and management of risks that can impact on the achievement of their policy objectives. Preventing and managing such risks involves monitoring, analysis, assessments, decisions and actions that engage the entire institution: its decision-making bodies, its management and its staff.

Risk management has undergone fundamental changes over the past two decades. In the financial sector, it has had to deal with the unprecedented increase in the complexity of new financial instruments, as well as with multiple interactions between the different types of risk and different markets in the world economy. Responding to the challenge, the techniques used to analyse and manage risk have reached a level of sophistication that has made risk management an academic field of study in its own right. Equally importantly, it is now recognised that risk management plays a central role in the business model of any enterprise and that risk management expertise is an essential tool for senior managers. With almost 75,000 members in 100 countries, the Global Association of Risk Professionals (GARP) is undoubtedly the main force in the international community of risk managers. Its activities, which are aimed at the “advancement of the risk profession through education, training and the promotion of best practices globally” are making a valuable contribution to improving risk management across the world. This is especially important because the rapid pace of innovation and the increasing level of integration among our economies and financial systems necessitate better risk management – both in terms of systems and practices – in order to optimise economic performance, that is, achieve higher sustainable growth, preserve price stability and minimise financial volatility.

From the very beginning, the ECB, as an institution, has placed particular emphasis on risk management. As a new central bank, established only ten years ago, it has aimed to meet the highest governance standards in terms of organising its risk management function and has applied state-of-the-art tools. Moreover, in the context of our task to contribute to safeguarding the stability of the euro area financial system, we closely monitor and carefully analyse developments in risk transfer instruments, as well as the implementation of risk management strategies and methods by financial institutions.

For the remainder of my remarks this morning, I would like to focus on three issues pertaining to the ECB’s role and activities in assessing, preventing and managing the risks associated with achieving its primary objective of preserving price stability and fulfilling its responsibility to help safeguarding financial stability. I will do so by reviewing the Bank’s risk assessments, policy decisions and market operations in 2007 and by examining some policy challenges that we face this year. More specifically, I will first discuss the extent to which the ECB, other institutions and market participants managed to foresee the eruption of the financial market turmoil, and if they did not, why not? Second, I will explain the ECB's money market operations since last August, their rationale and their effects thus far. Finally, I will address some challenging issues concerning the economic outlook and the financial markets in the euro area.

II. The financial market turmoil: to what extent did we foresee, or could we have foreseen, it?

Since the financial market turmoil erupted last summer, the underlying causes, as well as the factors that have contributed to the propagation and spreading of initial triggers across markets and countries, have been the subject of extensive debate. And these issues will be discussed further by other speakers at this convention. What may be of greater interest and relevance to risk professionals are the answers to the following questions: Did we see it coming? To what extent did we see it coming? And if the answer is, at least in part, no: Could we, or should we, have seen it coming? In fact, the ECB, as well as other central banks, international institutions and some market participants, had identified a number of risks and vulnerabilities in the financial system well before the financial market tensions erupted in August last year.

In the four years to the summer of 2007, the exceptionally benign macroeconomic, financial and monetary conditions and the process of financial globalisation, including a "savings glut", had contributed to reducing risk aversion and market volatility, had fostered a "search for yield" and rising leverage, and had resulted in the emergence of imbalances and the possible underpricing of risk. Thanks to financial innovation, we witnessed an unprecedented growth in the securitisation of bank loans, in credit risk transfer instruments and in other complex structured finance products. Consequently, monitoring the distribution and identifying the concentration of credit risk in the financial system became increasingly difficult. These and other concerns had been expressed in various documents, speeches and statements back in 2006 and even before, for example, in the ECB's Financial Stability Reviews of June and December 2006.

In early 2007 the warnings became stronger and more specific. For example, the ECB's Financial Stability Review of June 2007 had warned (i) that the crisis in the US sub-prime mortgage market could deepen and spread to other markets; (ii) that financial market liquidity could vanish abruptly if investor uncertainty and risk aversion were to rise, revealing several vulnerabilities in the financial system; (iii) that investors may be relying excessively on credit rating agencies' risk assessment of structured products; and (iv) that it had become increasingly uncertain whether those who ultimately held the credit risk could manage it effectively.

But this, of course, is not the whole story. There were a number of other factors and mechanisms that played a role in the propagation and amplification of the market turmoil which neither we, nor other institutions, foresaw, at least not fully, notably: (i) the way various intertwined vulnerabilities would eventually combine; (ii) the speed and intensity with which tensions in one specific segment of the credit market in one country could spread so extensively to other markets and countries; (iii) the size of banks' off-balance sheet exposures to the US sub-prime related structured finance products; (iv) the activities, features and implications of new financial entities – conduits and other structured investment vehicles – that have been sponsored by banks and linked to them by liquidity commitments. Finally, it was impossible to predict the extent to which risks were transferred to market participants who were ultimately unable to bear them.

Should policy-makers and market participants have been able to foresee these weaknesses and risk propagation channels in the financial system? Of course, "hindsight is always twenty-twenty", as a well-known actor once remarked. But can we at least explain why we did not see them ex ante? There are several reasons. But let me point to two main ones. The first is that, to some extent, some of these factors were impossible to see. Insufficient transparency and disclosure on the part of financial institutions, especially as regards their (on- and off-balance sheet) exposures to complex structured finance products, are partly to blame and are issues that need to be addressed urgently in order to improve the functioning and resilience of the financial system. Similarly, inadequate information about the quality of the assets underlying complex structured finance products led to valuation problems, as did inappropriate accounting for the illiquid nature of many of these products. In the same vein, the lack of transparency regarding the models and methodologies and the information used by credit rating agencies in producing their credit ratings limited the understanding of those ratings and obscured the true risk characteristics of the complex structured finance products.

The second reason is that some market participants did not care to see. Here I am referring to the role and effects of distortions in the incentive structures embedded in the business models of banks and other financial market participants in the originate-and-distribute chain which have had a bearing on the provision of information about the quality of assets and the distribution, accumulation and containment of risks in the financial system. Even 2000 years ago, long before securitisation and credit risk transfer had been invented, Seneca had identified the problem of inappropriate incentives when he warned that one should "be wary of the man who urges an action in which he himself incurs no risk". Investors relied too heavily on credit rating agencies in assessing the value of complex structured finance instruments and were not fully aware of the true risk structure implied in their positions. The lack of appropriate incentives led many market participants to ignore the warning lights that had started flashing well before the summer of 2007 when the turmoil erupted.

III. The ECB's money market operations during the financial market turmoil

As the market tensions spread from the US sub-prime mortgage market through the market for structured finance products and for asset-backed commercial paper to European money markets, how did the ECB react? The liquidity squeeze in the interbank money markets that was observed in early August 2007 was triggered by the larger-than-expected funding liquidity needs, or perceived needs, of some banks, while at the same time those financial institutions that had liquidity balances tended to hoard them because of uncertainty about their future liquidity position and increased counterparty risk. In the face of these information asymmetries and heightened uncertainty, the normal functioning of the euro money market was severely impaired. The ECB therefore stepped in and addressed these tensions, initially by launching a series of overnight fine-tuning operations, and subsequently by taking four specific measures to ensure that very short term money market rates remained close to the ECB's policy rate and to contain upward pressures in the longer-term money market.

First, the ECB shifted the time pattern of liquidity provision through its main refinancing operations in the interbank money market by providing more liquidity at the beginning of the reserve maintenance period and less towards the end of the period. This "frontloading" led to more balanced liquidity conditions and helped to keep very short-term rates close to the key policy rate, without changing the overall amount of liquidity provided. Second, responding to banks' greater preference for assuring the fulfilment of their liquidity needs on a longer-term basis, the ECB increased the share of refinancing provided via three-month longer-term refinancing operations and reduced the share provided via the one-week main refinancing operations. Again, the total amount of outstanding refinancing remained unchanged; however, the average maturity was extended. Third, the ECB undertook a number of specific measures designed to address expected money market tensions around the year-end. And fourth, to ensure the availability of funding denominated in US dollars, the ECB joined a concerted action with other central banks, notably the Federal Reserve System in December 2007, the aim of which was to improve global funding conditions.

It may be useful to clarify that the Eurosystem requires adequate collateral from its counterparties for its credit operations. Adequate collateral in this context has two dimensions: First, the Eurosystem should be protected from incurring losses in its credit operations. Second, sufficient collateral should be available to counterparties, so that the Eurosystem can provide the amount of liquidity deemed necessary for its monetary policy and payment systems operations. To facilitate this, the Eurosystem accepts a broad range of assets as collateral, which also reflects the variety of practices that had been applied by the National Central Banks of the euro area. This collateral framework remained unchanged during the recent market tensions. The diversity of eligible collateral had a stabilising effect during the financial market turmoil, allowing counterparties to obtain liquidity from the Eurosystem against adequate collateral.

Why did the ECB intervene in money markets? The objective was twofold. The interbank money market plays a crucial role in the transmission of the effects and signals of monetary policy. If money markets do not function in an orderly manner and very short-term money market rates deviate significantly from the central bank's policy rate, the effectiveness of monetary policy is impaired. The ECB therefore had to act swiftly and decisively in order to steer these rates close to the official ECB interest rates and contain upward pressures on the longer-term money market, in order to avoid the money market tensions feeding into the credit market, spreading to other markets and adversely affecting the real economy.

In this context, it is important to emphasise that the ECB conducted these money market operations without changing the overall monetary policy stance and, needless to say, without aiming to "bail out" any specific financial institution with a special liquidity need. We have clearly distinguished between two types of central banking action. On the one hand, the ECB, like other central banks, takes decisions on the monetary policy stance and the level of official interest rates. These have a clear medium-term orientation, they are geared towards preserving price stability and are based on our assessment of the risks to price stability. On the other hand, the ECB conducts money market operations that provide liquidity to ensure the orderly functioning of the interbank money market, with a view to fulfilling its task of safeguarding financial stability and to ensuring that the effects of its interest rate decisions are transmitted to the financial markets and the real economy effectively.

So, did we accomplish what we wanted to achieve? Very short-term money market rates have remained very close to the level of the ECB's key policy interest rates, and tensions in the term money markets have eased gradually for maturities up to three months. Moreover, banks now seem to be able to satisfy their US dollar liquidity needs, allowing the ECB to discontinue the US dollar swap arrangement for the time being. However, we clearly have not yet returned to the status quo ante. Central banks' liquidity operations cannot address the underlying causes of the money market tension reflecting a lack of confidence among market participants and uncertainty in other financial markets.

IV. The economic outlook and the adjustment of financial markets

Let me conclude by addressing some policy issues that we are facing this year. The economic outlook for the euro area is surrounded by an unusually high level of uncertainty and is subject to several risks. The ECB's latest assessment confirmed that risks to price stability remain on the upside and that risks to economic growth continue to lie on the downside. The ongoing process of risk reappraisal and balance sheet adjustment in financial markets is likely to last for some time, and it is highly uncertain what impact it will have on the real economy. Indeed, the risks to the outlook for economic growth are linked to and are interacting with the uncertainty surrounding the ongoing risk reappraisal in financial markets.

Although the impact of the financial market turmoil on the euro area economic activity is difficult to measure and forecast, the latest available information and analysis suggest that it is not likely to be sizeable. Real GDP is expected to grow in 2008 at a more moderate pace than previously projected, but most recent forecasts from international organisations and the private sector point to GDP growth of between 1.6% and 1.8% in 2008. The upper end of this range is not far below the euro area's potential rate of growth. The sound fundamentals of the euro area economy and the absence of major macroeconomic imbalances should help cushion the adverse effects of the financial market tensions and the deceleration of global economic growth. Nevertheless, we cannot be complacent, as risks to euro area growth remain on the downside.

An important and relevant question is whether the ongoing process of de-leveraging and re-intermediation and the impact of the financial market turmoil on banks' balance sheets are likely to lead to a credit crunch. The evidence so far is reassuring. On the basis of the available data, there have been no signs of a credit crunch or even indications of a deceleration in the rate of loan credit growth to the private sector which has remained strong, in particular the pace of credit expansion to non-financial corporations. It is, of course, true that we have witnessed a tightening of financing conditions and credit standards in the euro area. However, the increase in the average real cost of financing has been relatively modest over the past few months, although credit spreads for parts of the corporate sector have widened substantially. Moreover, the considerable tightening of credit standards reported by banks (in the January 2008 bank lending survey for the euro area) has taken place from a very "loose" level and has not significantly constrained the availability of credit. The available information suggests that the decline in securitisation activity and the re-intermediation of off-balance sheet assets onto banks' balance sheets have not affected substantially the supply of bank loans, and, for the time being, the re-intermediation of non-bank credit has not artificially distorted upwards the figures for credit growth.

Nevertheless, caution is warranted before reaching any conclusions on the likely effects of the financial market turmoil on the cost and availability of bank credit. The impact of the market turmoil on some banks' balance sheets has been considerable and a number of credit institutions will have to strengthen their capital positions and be more cautious in their lending policies. Moreover, the time lags in the effects of a change in credit standards by banks on loan demand imply that it could be some time before their cumulative impact becomes observable. More data and further analysis are required before a better assessment can be made of the extent to which the ongoing process of risk reappraisal and banks' balance sheet adjustment will affect credit growth in the future.

With regard to the prospects for price stability, the short-term inflation outlook is not satisfactory. The annual inflation rate in the euro area, which was 3.2% in January 2008, is likely to remain at such an elevated level significantly above 2% in the coming months and moderate towards 2% very gradually, and more slowly than previously envisaged. The likelihood that inflation will remain at a high level for a prolonged period underscores the importance of this temporary but protracted upward pressure on inflation not spilling over to the medium term. The assessment derived from economic analysis that there are upside risks to price stability over the medium term is confirmed by the continuing vigorous money and credit growth.

It is therefore imperative that the risk of second-round effects on wage and price setting stemming from short-term inflation pressure be avoided. It is also essential that medium and long-term inflation expectations remain well anchored to price stability. The ECB remains committed to preventing second-round effects and the materialisation of upside risks to price stability over the medium term. This commitment will guide the determination of the monetary policy stance. At the same time, the ECB stands ready to respond flexibly, effectively and in a timely manner, in order to address potential money market liquidity pressures, so as to support its monetary policy objective and mitigate the risks to the financial system and the real economy. If necessary, this will be carried out in close concertation with other major central banks, as has been done successfully in the past.

The ongoing adjustment of financial markets is likely to last for some time. This could prove to be challenging and further test the shock-absorption capacity of components of the financial system. Policy-makers and market participants have already taken significant measures, and several additional initiatives are under way, to address the identified weaknesses in the financial system, enhance risk management practices, restore confidence and strengthen the resilience of the financial system.

V. Concluding remarks

The policy challenges that the ECB and other central banks are facing this year and beyond require the close monitoring of all developments, as well as comprehensive analysis and determined action to prevent certain risks from materialising and to effectively manage others. Fundamentally, however, the performance of our economies and the resilience of our financial system depend on market participants' decisions, actions and risk management. The close cooperation of policy-makers and market participants is an essential ingredient for achieving sustainable economic growth and preserving price stability. To this end, the Global Association of Risk Professionals has an important role to play, as the expertise and experience of its members will contribute to further improvements in the field of risk management. Once again, I should like to thank you, also on behalf of all my colleagues at the Bank, for awarding the Risk Manager of the Year Award to the ECB.

Thank you very much for your attention.