Jean-Paul Redouin: What happened to liquidity? A central banker's perspective

Opening address by Mr Jean-Paul Redouin, Deputy Governor of the Banque of France, at the Association des Marchés de Taux en Euros, Paris, 10 April 2008.

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Ladies and gentlemen,

It is a great pleasure and honour for me to be here with you. There are many reasons for me to join you tonight: the subject, for sure; but also the opportunity to meet the main players of the fixed income community.

I would like first to thank the AMTE for the invitation to discuss how a central banker views the recent financial turmoil and addresses the liquidity question. Allow me to speak wearing my two different hats – that of a central banker and that of a supervisor – since present circumstances have shown that these responsibilities can be very complementary and, dare I say, efficient.

I will discuss three points: What are the issues at stake? What happened to liquidity? And what is the role of central banks in this context? In addressing these questions, my answers will remain cautious and focused on some specific aspects. There are two reasons for this: first, the events are not yet over. Second, the Banque de France has published one month ago a full special issue of its *Financial Stability Review* focused on liquidity and showing that despite an in-depth analysis of 200 pages, answers are not so easy to find.

A. What are the issues at stake?

When referring to liquidity, three components are at stake:

- Asset liquidity: the facility with which assets can be turned into cash quickly without incurring any loss of value;
- Market liquidity: the ability to buy or sell on a market a large volume of assets without influencing their price or their volatility;
- Monetary liquidity: the quantity of liquid assets needed for an economy to develop properly and to avoid two opposite dangers, an asset bubble or a credit crunch.

Liquidity viewed from a central bank

Three key areas form the nexus of how central banks implement their monetary policy:

  - Assessing the proper quantity of money consistent with maximum sustainable growth;
  - Influencing market rates, by steering short-term interest rates;
  - Monitoring the proper running of financial counterparties.

In fact, a liquid and well-functioning money market is crucial for central banks to implement their monetary policy efficiently and achieve their main goal: ensuring price stability. In this respect, allow me to dispel one ambiguity that I see in many comments: the liquidity injections have not been aimed at bailing out specific institutions. They have been designed to help the money market as a whole, in a period of stress, to function properly and to ensure an adequate allocation of funding resources.

Some more remarks about liquidity

One year ago, studies focused on the issue of excess liquidity. The main questions were: why is liquidity so abundant? What disequilibrium could this cause on financial markets, particularly in pushing spreads far below their long-term average level? These questions remain at the heart of our concerns today, but the focus is now on market and asset liquidity.

The main discovery is that liquidity is not given. It can suddenly disappear, and for several months. The US ABCP market is a striking example of the sudden disruption of market mechanisms that were deemed to be robust. Another discovery is that these sudden liquidity dry-ups can affect even the core of the financial system, such as the interbank market.

How can we explain such a dramatic change? What are the underlying factors behind this liquidity dry-up?

B. What happened to liquidity?

What happened to assets?

One of the main triggers of the crisis was the sharp and sudden decrease in the *value of collateral*. By contagion an aggravating factor has appeared: bad assets have driven huge categories of assets out of circulation, even the good ones. That is why, over the last few months, we have observed illiquidity spreading from one market to another and from one country to another.

Three basic comments to illustrate that:

First, the proliferation of off-balance sheet structures involved in *maturity transformation* was another factor impinging on assets. Those structures with no capital buffer found themselves unable to hold long-term illiquid assets when investors decided not to roll over their short-term paper.

Second observation: the liquidity provision channels of securitised and structured assets are, by their very nature, fragile: they rely on innovative instruments that lack deep, "battle-tested" secondary markets. Their opacity and complex nature have been strong impediments to the maturing of an efficient secondary market and to the existence of observable market prices.

Thirdly, in having recourse to high leverage financial instruments originators have increased the probability of market illiquidity and, at the same time, have given investors a misleading sense of liquidity.

What happened to the money market?

The money market today faces a real dislocation. This can be viewed from different standpoints. First, a dislocation in *maturities*: over the shortest horizons (less than one week), liquidity is abundant. It's also possible to find liquidity for horizons exceeding one or two years. But a severe liquidity dry-up is occurring between these two maturities (1 month, 3 months, 6 months), with the only entity providing liquidity at those medium-term horizons being the central bank *[ECB has recently introduced a new 6-month operation]*. It is quite striking to note that some financial institutions, such as mutual funds, are ready to lend for one or two years, but more reluctant, to lend for shorter terms. To be honest, we still lack convincing explanations of this phenomenon.

Dislocation also appears between players: some lend only over the very short term, others concentrate on longer period.

In addition, industrial companies are currently finding funds more easily and, for long-term financing, at sometime lower cost than their banks – a rather paradoxical situation.

Lastly, the dislocation has also been a *geographical* one: the circulation of liquidity across borders between euro area banks came to a halt. For instance, German banks used to lend substantially to French banks, while now they hoard liquidity and French banks have to resort more to the central bank to finance their short liquidity positions. In a certain sense, borders have been reintroduced into the euro area money market!

The result is a disrupted yield curve.

The role of banks as liquidity providers and managers

In a traditional financial intermediation framework, banks provide liquidity to the whole economy through balance sheet intermediation by creating a duration mismatch between their assets and liabilities. This transformation exists because banks are supposed to be better at pooling, selecting and monitoring loans and borrowers than their depositors, and are therefore able to reduce the information asymmetry on credit markets. In so doing, banks intermediations ease the credit constraints affecting non-financial agents.

Over the past few decades, the financial system has developed a more efficient approach of liquidity management. Thanks to financial innovation, banks have moved from an “originate to hold” model to an “originate to distribute” model, and rely more on financial markets for their funding. This has allowed the easing of credit constraints in the economy, as growth in lending could be partially disconnected from growth in bank deposits. But financial institutions were probably overconfident in their asset-liability management techniques, which became increasingly sophisticated. In times of stress, it appears more difficult than anticipated for financial institutions to adjust their ALM quickly. Hence, there is probably a limit to the optimisation of asset-liability management, and this is a lesson for the future.

C. The liquidity toolkit of the central banks?

Some prerequisites

The recent movement of re-intermediation is showing that banks are and will likely remain a major liquidity provider for the whole economy.

They are able to do so because of their direct access to central bank money. This access is only available to banks, because they comply with specific requirements, unlike mutual funds and non-regulated entities such as hedge funds. Banks satisfy minimum requirements on capital, liquidity and information disclosure about their exposures and positions. These binding constraints are counterweights to their maturity transformation capacity and their ALM optimization policy. Recent Fed actions have shown that extended access to central bank money is possible only in exchange for more extensive supervision to ensure the integrity of the financial system.

Central bank action can be assessed at two levels.

First: short-term actions

While not intended to address the underlying causes of the crisis, which lay well beyond their scope, central banks’ liquidity-providing operations have been effective in relieving pressures in interbank funding markets. To achieve this, central banks’ operating frameworks have had to adapt and undergo substantial changes, with a trend of converging towards the most flexible frameworks, such as that of the Eurosystem. The trend is towards more flexibility in terms of the potential frequency and maturity of operations, and the broadening of the range of counterparties and collateral in order to accommodate the change in the composition of the financial sector’s balance sheet. Overall, the structural flexibility of its framework has allowed the Eurosystem to weather the current turmoil by showing considerable resilience.

Only minor changes have been necessary, notably to address the dry-up of the interbank money market at intermediate maturities, i.e. an increase in the amount of the 3-month operation and the introduction of a new 6-month operation.

For the Federal Reserve, the changes have been much more substantial, as for instance they had to broaden access to central bank money to non-banks for the first time since the Great Depression. In so doing, they went a step further, taking fully into account the challenge of providing liquidity in a disintermediated world.

Second: ways ahead. To restore confidence requires some initiative. Let me address some priorities.

Re-visit the ratios

The present crisis has demonstrated that a liquidity squeeze can very rapidly turn into a solvency problem. Therefore, beside a solid capital base an efficient bank liquidity management is the first line of defence against market turmoil. This crisis has speed up the need to revise liquidity and capital requirements for banks, in order to base them on a more comprehensive vision of what influences liquidity, in line with the Basel 2 approach.

Before the crisis, the world was seen as "awash" with liquidity. Priority was given to the solvency framework and its implementation. Liquidity regulation was regarded as less important. There is a need now to give them equal priority and to take more into account the features of the "securitised" world.

Beyond quantitative regulations, banks also need to enhance their internal risk management systems and to conduct more comprehensive stress tests. If we do not want these events to happen again, banks need to implement a new generation of stress tests, taking into account systemic concerns. This means drawing-up and running tests, including contingent claims, off-balance sheet exposures and above all the interdependencies between institutions and the drying up of some markets.

Valuation issues

The crisis has also shed light on structural failures regarding the valuation of assets and the need for greater transparency in the valuation process. I am convinced that the use of market prices when there is no market is not a good solution and leads to a lot of discrepancies in banks' practices, which is confusing for market participants. We should request standard setters to revisit valuation rules for illiquid products, as current rules produce too much volatility and do not allow sufficient flexibility between the trading and the holding of these assets.

Re-create a market with simpler products: "back to basics"

One way out of this freeze, could be to start by re-creating a market with simpler products. The resilience of the equity markets or other markets such as the ABCP market in France are good example: products are more standardised, liquidity is ensured by institutional mechanisms (order books, market-making arrangements) and transparency is warranted. After all, banks tend to become "market makers of last resort" for the securitised products they had sold. By taking them back on their balance sheets, banks behave somewhat as a market maker. Of course, this will be facilitated if products are simpler and more standardised. Such a "back to basics" trend can be a first step of a virtuous circle.

Conclusion

The financial market liquidity squeeze that started last year is a very serious challenge for central banks and the financial community. I am convinced … that *there are ways out* but to help replenish liquidity, it will require:

- Time
- Close co-operation between banks, non-banks and regulators;
- Basic but hard choices. Yes, liquidity has a price. Yes, complexity carries a cost. Yes, there should be limits to over-reliance on optimisation tools and sophisticated ALM techniques.

Central banks will always be there… But we should avoid put them in the middle of the market, as it could squeeze it. Let central banks do their job, which is:

- to set and supervise rules in a level playing field manner;
- to drive short-term interest rates;
- to behave as liquidity providers and not permanent lenders of last resort.