Christian Noyer: Some thoughts on the financial crisis

Speech by Mr Christian Noyer, Governor of the Bank of France, at Paris-Europlace, Tokyo, 18 November 2008.

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Ladies and Gentlemen,

It is a great pleasure for me to be here and share some thoughts on the financial crisis.

It is too early to draw all the lessons from recent events in financial markets. It is however vital to start reflecting on the experience of the last few months. Even more in periods of tension than in normal times, action and reflection should reinforce one another. It is at the very moment of managing the current crisis that we lay the foundations for the future financial system.

Having said that, I propose to reflect with you on four topics:

- The nature of the financial crisis
- The policies implemented to address it
- The macroeconomic outlook
- The outlook for financial regulation

The nature of the crisis

The crisis first emerged as a liquidity crisis. The first symptoms appeared at the beginning of August 2007 when serious disruptions surfaced on the inter-bank market. More than a year later, tensions on money markets are still with us. Recent weeks have witnessed abnormal levels of spreads, a shortening of maturities, and the contraction, or even closure, of some market segments. Through spill-over, these tensions are also affecting non-financial corporations and, more broadly the financing of the economy.

The crisis also emerged as a crisis of securitisation. Securitisation is an old and successful technique used to refinance a range of loans. What was new about it is that it got used extensively in highly unstable financial structures, which were financing short-term assets that were illiquid, complex, and whose value proved to be uncertain and contingent upon models. The instability of such structures was largely masked. Indeed, cheap money allowed easy refinancing of poor quality debt and of assets with uncertain value. Also, favourable ratings and credit enhancements artificially boosted the quality of loans underlying structured products. The rise in defaults on such loans, first on subprime mortgages, triggered a chain of reactions whose consequences are still unfolding now. Credit protections proved illusory. Liquidity dried up much more quickly than it had appeared. Rating agencies massively, suddenly and sharply downgraded products which until then were deemed of the highest quality.

The demise of the "new" securitisation chain highlights two fundamental realities. The first one is that far from being spread across the whole system, credit risk was implicitly or explicitly concentrated in the hands of specific institutions, foremost among which were the major investment banks. Hence the successive waves of depreciations of structured products, imposed by the accounting rules in place, with these depreciations in turn fuelling doubts about counterparty risks and solvency, liquidity constraints and further falls in asset prices. The second reality is that recent financial innovation served mainly to increase leverage in the system. Signs of this are many. Banks' balance sheets became overstretched. Off-balance sheet vehicles without any equity proliferated. Monoline insurers guaranteed volumes of structured products way beyond what their equity position could bear. As you know, leverage works both ways. It amplifies gains as well as losses. Amplified gains took the form of the US property boom. Amplified losses are with us now. The whole deleveraging process still underway has meant, since its start, that financial institutions unable to raise capital had to suffer very considerable depreciations on some products, which in some instance wiped out their net worth, bringing them to failure.

Against this background, what about French banks? Of course, they are not immune to the crisis. Direct or indirect exposures to toxic assets implied that they too had to record write-downs; sometimes substantial ones. The liquidity shortage is also hurting and the prolonged market disruptions have raised their refinancing costs. That said, our banks are sound and robust. Indeed bearing in mind the following. First, French banks exhibit high solvency ratios. Indeed well above minimum prudential requirements and above ratios of many competitors. Second, overall, they remain profitable. It is so not least because they benefit from regular sources of income. They are universal banks; and as such much less susceptible to funding market conditions. Sound and revolving sources of profits are a vital asset at the current juncture. Fourth, French banks can “manoeuvre” and play an active role in the ongoing restructuring of the international financial sector. All in all, beyond sometimes serious tensions and incidents, French banks are now reaping the benefits of the major advances in productivity and innovation they have made over the last two decades.

Public policy during the crisis

Recent weeks have seen a marked change in public policy. Having previously been geared exclusively to providing liquidity to financial intermediaries, public intervention is now also aiming to support banks’ financing and own funds. This is a significant shift.

Needless to say, restoring liquidity remains a pressing priority. Inter-bank markets have recently shown modest signs of improvements. Yet, there is still some way to go. To this end, central banks have mobilized considerable ammunition. A process underway for over a year has culminated in the central banks having adjusted their operational frameworks in various areas. The maturity and currency of their facilities have been expanded. The range of eligible counterparties has been broadened. The tender procedures have been modified with a view to ensure unlimited amounts of central bank money. The list of collateral for refinancing has been widened. Enhanced international coordination between the monetary authorities is ensuring that their actions are part of a consistent overall strategy. These measures are highly exceptional. As such, they should greatly contribute to restoring confidence and a smooth functioning of money markets.

Governments have moved aggressively to support banks' solvency and resilience. Since the Paris Declaration by euro area member-countries, Europe, under the leadership of France, is acting according to what I consider a sound and consistent action plan. I won’t enter into the details. Just bear in mind the three following elements. First, authorities are extending guarantees to banks’ refinancing so that they can, in turn, properly finance the economy. Second, very significant reforms of accounting rules are now being implemented. Basically, these reforms allow banks to transfer instruments previously marked to market value to portfolios where that will no longer be the case. They also provide for greater flexibility in marking to market value assets whose market has shut down. Third, and lastly, governments have confirmed their willingness, when warranted, to step in and support banks’ capital.

What about France’s actions? The Government and Parliament very quickly put meat on the bones of the European principles. A new bill has been passed, which provides for two things. First, it sets up a EUR 320 billion funding vehicle to guarantee banks’ medium-term refinancing (i.e. up to five years). This vehicle is strictly supervised by the French Government and the Banque de France. The guarantee is granted for a fee, so that the beneficiaries pay costs corresponding to normal market conditions. Second, the law also creates a state-owned company empowered with EUR 40 billion and entitled to subscribe to banks' subordinated debt issues or preferred shares. As you know, six banks have expressed that they will issue subordinated debt and the Government announced that it will subscribe to these issues for EUR 10.5 billion. It is expected that such support will boost their capital position and as a result ensure these banks to keep up their lending to the economy.

Did the French banks really need such a boost to their solvency and capital? Setting aside DEXIA, the answer is not really. DEXIA was very specific: because of its large exposure to US monoline risks, public recapitalisation was absolutely necessary. By contrast, all the other French banks, without exception, have sufficient own funds, be it in terms of prudential requirements or in comparison with their peers from other developed countries. Public recapitalisation is not aimed at making up for faults or weaknesses. Rather, it is to anticipate potential problems. Circumstances are indeed exceptional; even the soundest and most profitable banks cannot take it for granted that they will be able to tap markets to meet their funding and capital needs. As long as such uncertainty pervades and markets continue to fail, it is the public authorities' duty to protect the credit system and safeguard the financing of the economy.

The macroeconomic outlook

It is fair to say that the public opinion is worried about the economic consequences of the financial crisis. I understand these concerns. Yet, I do not totally share them. Let me explain.

When attempting to understand the situation we are facing, it is tempting to look at the past and draw lessons by mere analogy. Indeed, some sort of an intellectual vogue is flourishing, which contends that, in light of past experiences, any banking crisis is bound to have severe adverse economic consequences. You have those, the optimists, who predict a Swedish-type of crisis. And you have those, the pessimists, who allude to Japan's "lost decade".

If referring to the past is of any use, it is precisely to learn from past errors. As a result, any comparison is bound to be misleading. Not only is today's economic situation critically different. It is also addressed very differently. Let me insist on one key difference, which has to do with policy reactions to the crisis. They have been extraordinarily rapid, massive and vigorous. We have learnt from past crises, especially from the long adjustment Japan has been through after the burst of the asset price bubble in the late 80s. Let me also mention that macroeconomic policy instruments are available and could be used should output decline dramatically.

The outlook for financial regulation

A major consequence of the crisis already apparent is the growing consensus around the need for a fundamental review of the foundations of financial regulation. The crisis has also rekindled concerns about the structure of supervision.

As you know, at the French President's instigation, huge efforts are made to think about what is termed now a "new Bretton Woods". Beyond these ambitious words, I do believe it to be useful to take a fresh look at the existing financial regulation. This must be done without haste, but no stone should be left unturned. Improved regulation appears to be necessary in several domains, from rating agencies to risk management, the organisation of financial markets and even the question of compensation. As a contribution to this debate, I would like to make two sets of remarks. One has to do with the fluctuations of financial systems. The other concerns financial supervision.

Financial systems that operate in the context of a developed market economy are, by nature, subject to cyclical forces. Some are a consequence of the business cycle. Credit activity is an obvious example, as credit demand is heavily influenced by economic activity. Others are from within financial systems. For instance, financial institutions' equity position moves in line with asset prices specially in a fair value world where fluctuations result in capital gains or losses. This effect tends to be exacerbated when financial intermediaries actively manage their balance sheets to target a preferred degree of leverage.

The challenge for the authorities is to assess whether and to what extent regulations reinforce these dynamics and impact the entire financial system. With these questions in mind, work is being undertaken to examine the impact of prudential standards. It is also on this basis that the accounting adjustments that I mentioned earlier have been made. We will have to set up supervisory systems that are more suited to economic developments. The need to develop a "macro-prudential" policy is now under debate. The general principle is straightforward: it consists in ensuring that supervision manages to limit risks for the stability not only of a particular institution, but also of the entire financial system. Its implementation, however, is complex. For the moment, we are only at a preliminary stage, contemplating which tools a macro-prudential policy could be based on, and how these tools could be used.

As regards supervision, this crisis has shown three things. First, it has highlighted the merits of having the banking supervisor close to the central bank. The point is not to claim there is an optimal supervisory structure that fits any country's circumstances. Rather, it is to note that a system such as the one we have in France has proved very useful in allowing for an in-depth knowledge of the banking sector and the various financial institutions. It also allowed for very swift and timely exchanges of information, and, as a result, allowed us at the central bank to quickly pass sensitive judgments, not least on the usefulness of injecting liquidity. Second, the crisis also revealed that, as far as supervisory infrastructure is concerned, simple, robust and pragmatic plans have shown their efficiency. Thirdly, the crisis stressed the need for supervisory structures to adapt to their environment. This is very true for Europe. I guess it is also true for other countries and regions. Let me just say that, while adjusting our institutions and tools to changes in financial systems, we should be pragmatic and completely in tune with reality rather than based on a theoretical scheme or vision.

Let me conclude by stressing one point. We are going through very challenging times, in some respect even unprecedented times. Economic and financial forces are at play and recent events are the consequences of such forces. That said, we should not completely disregard the importance of what Robert Shiller terms "attention cascade". For him, a cascade is the situation in which economic events and problems become the subject of more and more talks and stories, until they become the dominant public thinking. We, as policy makers, have a very critical role to play to try and ensure that such qualitative "attention cascades" remain aligned with facts and reality. Today, policy making is also about confidence building and financial education.

Thank you very much Ladies and Gentlemen.