Christian Noyer: World financial crisis – public and private strategies to overcome the crisis

Speech by Mr Christian Noyer, Governor of the Bank of France, at Paris-Europlace, Dubai, 22 January 2009.

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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 and on solutions that may be found to overcome the situation. It is too early to draw definitive 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 crisis that we lay the foundations for the future financial system.

Having said that, I propose to discuss with you two main topics:

- The nature of the financial crisis
- The policies implemented to address it both from a public and a private sector perspective.

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 in the Western world. More than a year later, tensions on money markets are still with us. Recent months 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. They also have spilled over to emerging market economies, which had until the autumn 2008 remained largely unaffected.

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. These were financing short-term illiquid and complex assets 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 accounting rules, 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 and still exhibit high solvency ratios, above minimum prudential requirements. Overall, they remain profitable. This is so not least because they benefit from regular sources of income. They are universal banks; and as such much less vulnerable to funding market conditions. Sound and revolving sources of profits are a vital asset at the current juncture. In this context, French banks can 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 both from a public and a private sector perspective

Past months have seen a marked change in public policy. Having been in a first phase geared exclusively to providing liquidity to financial intermediaries, public intervention is since last Fall 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 shown gradual signs of improvements. Yet, there is still some way to go. To this end, central banks have mobilised 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. As for the Eurosystem, they have been providing liquidity at a fixed rate for unlimited amount. Enhanced international coordination between monetary authorities is ensuring that their actions are part of a consistent overall strategy. These measures are highly exceptional with indeed unprecedented monetary easing leading key policy rates to historically low levels and the adoption, in certain cases, of unorthodox monetary policy actions. 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 until year end, has been 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, significant reforms of accounting rules are now being implemented. Basically, these reforms allow banks to transfer instruments previously marked to market to portfolios where that will no longer be the case. They also provide for greater flexibility in methods used to 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? 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 and also with a view to protect taxpayers' interests. Second, the law also creates a state-owned company empowered with EUR 21 billion and entitled to subscribe to banks' subordinated debt issues or preferred shares. As you know, six banks have issued subordinated debt and the Government subscribed to these issues for EUR 10.5 billion. Such support boosted 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 the Belgo-French bank 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 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 private sector strategies to overcome the crisis cover several aspects. First, I would like to mention the initiative to create a compensation scheme with a central counterparty for credit default swaps (CDS). This initiative from the private sector is strongly encouraged by public authorities given its importance for financial stability. Regarding institutions themselves, different proposals are on the table which relate to their business model and risk profile, to governance and risk management schemes and to disclosure and communication policy.

In terms of risks profile, two main models are intensely discussed. Under the first one, universal banks that benefit from diversified sources of profits were better off during the crisis. By contrast, specialised financial institutions, especially those heavily engaged in investments activities, suffered significant losses. I have already mentioned the case of French banks. In the same vein, the interest of Deutsche Bank for Postbank in Germany stems from the same logic: to diversify sources of funding and of profitability.

Conversely, the other model under scrutiny focuses on selected core businesses precisely to reduce diversification in markets for which in-house knowledge and capacity may have proved insufficient relative to the risks involved. The move towards this more focused model is contributing to the deleveraging process that is deeply needed in some institutions. The case of Citibank which is on the verge of selling Salomon Smith Barney illustrates this trend.

As far as governance and risk management are concerned, major improvements are needed, and I think, are on their way. It is certainly true that regulation needs adjustments and that a more macro-financial angle is requested in order to avoid, for example, procyclicality.

However, the first responsibility lies with financial institutions themselves that did not develop enough scrutiny in risks analysis, were too much focused on short terms profits, did not integrate the cost of risks premium and liquidity, and in some circumstances, did not fully understand the likely financial consequences of their behaviour.

Therefore, strong improvement is needed in terms of risk management and governance at the highest level of financial institutions.

In terms of disclosure and communication policy, the crisis showed the importance of transparency. Financial institutions made a lot of efforts in this respect in recent months. They should continue to do so. Authorities will monitor progress on that matter.

Public and private strategic improvements will help overcome the financial crisis. Beyond that, there is a growing consensus around the need for a fundamental review of the foundations of financial regulation. Heads of States of the G20 have mandated changes in that matter and set principles to that purpose. 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 has been termed 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. As a contribution to this debate, I would like to make two final 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 especially in a fair value world where fluctuations result in capital gains or losses.

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. 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 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.

Let me conclude by stressing what may seem obvious. We are going through very challenging times, in some respect even unprecedented times. In this context, policy making is also about confidence building and financial education.

Thank you very much Ladies and Gentlemen.