# José Manuel González-Páramo: The challenges of credit risk management – lessons learned from the crisis

Speech by Mr José Manuel González-Páramo, Member of the Executive Board of the European Central Bank, at Risk Europe 2010, Frankfurt am Main, 26 May 2010.

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Ladies and gentlemen,

It is a great pleasure for me to address again this year, for the second time in a row, the annual Risk Europe conference here in Frankfurt. I would have liked to say that this simply shows the great importance that the ECB places in the development of sound and effective risk management practices in the financial industry. However, I must admit that my eagerness to address this forum is also a result of the great challenges that we, central banks and private financial institutions alike, continue to face collectively in managing risk. These challenges seem to persist, although they have been changing face. The high levels of uncertainty manifested in unprecedented levels of asset volatility in the years 2007-2009 emanated originally from liquidity shortages in the off-balance sheet management of highly complex assets. In late 2009 and 2010 we have seen again high levels of volatility, this time associated with concerns about the large fiscal imbalances in some EU Member States.

In both phases of the crisis, financial markets have reacted to the increasing fear that some market participants may fail to honour their obligations; they have in other words experienced an increase in credit risk. Under the general concept of credit risk I would include both the risk of default of issuers of securities held in portfolios as well the counterparty risk faced in over-the-counter transactions. Today I would like to share with you some thoughts on the management of such risks in general and in central banks in particular.

## General principles in the management of credit risk

It is widely accepted (but not appropriately emphasised) that one of the causes of the deep financial crisis witnessed since mid 2007 has been the deviation from well established principles in the management of risk (in particular credit risk) by financial institutions. Common sense risk management practices such as "know your counterparties", "invest only in products you understand", "do not outsource credit risk management by relying exclusively on external credit assessments", "do not rely exclusively on quantitative models, however sophisticated" had been abandoned. It is interesting to recall at this stage the work of the original Counterparty Risk Management Policy Group[1] co-chaired by E. Gerald Corrigan and Stephen G. Thieke which already in 1999 stressed that "better knowledge of one's counterparty represents the foundation upon which the other pillars of risk management rest". Re-establishing these principles in risk management practice is essential for the resilience of the financial system.

I would like to highlight in particular the trend witnessed in recent years for many market participants to exclusively rely on external assessments for the management of their credit risk. These assessments have been often provided by only a small number of specialised institutions (rating agencies). The critique on the role of rating agencies has become a recurring theme in all analysis of the current crisis. In addition to potential conflicts of interest embedded in their business models, rating agencies have faced questions on their methodology, in particular in the area of structured finance, and the lack of transparency in their activities. The ex-post assessment of the performance of their ratings in the last two

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[1] Counterparty Risk Management Group: "Improving Counterparty Risk Management Practices", June 1999.

years has raised serious concerns. At the same time the use of credit rating in legislation, regulations, and other supervisory policies is so widespread[2] that I would agree with the Financial Stability Forum which has questioned whether it is not these policies that unintentionally give credit ratings an official seal of approval and discourage investors from performing their own due diligence. This should certainly be one of the main concerns of regulatory authorities in the immediate future.

## How central banks address credit risk

Central banks are unique as market participants because they do not face liquidity risk in their own currency. However, they are not immune to credit risk. Losses occurred because of a default of one of their counterparties or an issuer of a security they hold in their portfolio can deplete their financial buffers. Although their financial survival does not depend in any vital way on such buffers, their perceived lack of financial resources could irrevocably damage their credibility in the market and thus their ability to implement monetary policy and safeguard financial stability. Furthermore, if a recapitalisation of the central bank by the government becomes ultimately necessary, it could jeopardise the independence of the monetary authority.

In general central bank risk management is considered conservative, so that overall it could be perceived that the development of an elaborate risk management framework is not really necessary. However, the central bank becomes an above average risk taker in a crisis situation – first of all by showing inertia in its risk management framework. There is thus some fundamental transformation taking place in the risk tolerance of the central as it continues operating in a financial crisis when other market participants have long adopted a very conservative approach. At a time when all risk measures (probabilities of default of collateral issuers and counterparties, correlations, expected loss, VaR-measures) have gone up dramatically and financial institutions are cutting credit lines and are increasing margin requirements in the interbank market, the central bank becomes the lender of last resort. In such a situation its risk taking increases considerably. This suggests that the management of the central bank's risk exposures is even more important in a crisis and requires, at least then, a very carefully designed risk management framework.

## Credit assessment in the Eurosystem

The experience of the financial crisis has led the Eurosystem to solidify the already elaborate credit risk assessment framework it uses in its credit operations. Let me now give you some more information on the way the Eurosystem handles credit risk assessment in the context of its own credit operations. As you are probably aware, Article 18.1 of the Statute of the ESCB requires that all credit operations conducted by the ECB and the National Central Banks (NCBs) should be based on adequate collateral. In particular all such collateral must meet high credit standards.

The Eurosystem has defined an elaborate framework of credit assessment (the European Credit Assessment Framework – ECAF) to ensure that such standards are met. In the assessment of the credit standard of eligible assets, the Eurosystem takes into account credit assessment information from credit assessment systems belonging to different sources. Some of them are private, namely external credit assessment institutions (ECAIs), counterparties' internal ratings based (IRB) systems and third-party providers' rating tools (RTs). Others are public, namely the national central banks' in-house credit assessment systems (ICASs), Additionally, in the assessment of the credit standard, the Eurosystem

[2] Basel Committee on Banking Supervision: The Joint Forum: Stocktaking on the use of credit ratings.

takes into account institutional criteria and features guaranteeing similar protection for the instrument holder such as guarantees.

The performance of all credit assessment systems that are accepted by the Eurosystem is closely monitored. On an annual basis the observed default rate for the set of all eligible debtors assessed by a particular system is compared to the credit quality threshold set by the Eurosystem. This way, the results from credit assessments are comparable across systems and sources.

With regard to the ECAI source, the Eurosystem does not automatically follow the assessments provided by a rating agency. First, any such assessment must be based on a public rating. Even then, the Eurosystem reserves the right to request any clarification that it considers necessary. In particular when it comes to asset-backed securities, a number of transparency requirements are imposed. Ratings must be explained in a publicly available credit rating report, namely a detailed pre-sale or new issue report, including, inter alia, a comprehensive analysis of structural and legal aspects, a detailed collateral pool assessment, an analysis of the transaction participants, as well as an analysis of any other relevant particularities of a transaction. Moreover ECAIs must publish regular surveillance reports for asset-backed containing an update of the key transaction data (e.g. composition of the collateral pool, transaction participants, capital structure), as well as performance data.

The need for better understanding of the underlying assets in securitised transactions was emphasised by the ECB when it launched a public consultation on loan-by-loan information requirements for asset-backed securities (ABSs) in the Eurosystem collateral framework. With this initiative, the ECB strives to promote an improvement of disclosure standards in securitisation markets from current levels. Such higher standards would contribute to avoiding the inadequate assessment of risks in the underlying asset pools of ABSs by investors and the exclusive dependence on third-party assessments that was at the core of the current crisis.

Finally, I would like to emphasise one important element of our framework. Despite the fact that the Eurosystem uses ECAI ratings as one of its credit assessments it still reserves the right to determine whether an asset fulfils the requirement for high credit standards on the basis of any information it may consider relevant from a risk management perspective. Therefore it should not come as a surprise that on 3 May 2010 the ECB decided to suspend the application of the minimum credit rating threshold in the collateral eligibility requirements for the purposes of the Eurosystem's credit operations in the case of marketable debt instruments issued or guaranteed by the Greek government. This suspension was based on the positive assessment on the side of the Governing Council of the ECB, in liaison with the European Commission and the International Monetary Fund of the Greek government's economic and financial adjustment programme. The measure acknowledged therefore the strong commitment of the Greek government to fully implement the programme and was an example of the ability and will of the ECB to make an independent credit assessment.

## The connection between credit and liquidity risk

While I have emphasised so far credit risk management, I would also like to touch upon the more elusive concept of liquidity risk. The current financial crisis has been triggered by the inability of some financial institutions to fund some complex assets. It has been traditionally thought that while such a situation may put the institution at strain, it should be clearly distinguished from that of an insolvency. However, the experience of the last three years has showed that the distinction is far from simple. A prolonged period of liquidity difficulties may easily leave no other choice to the institution than an emergency sale of assets at significant losses and a subsequent depletion of its capital position. Therefore a liquidity problem, if it cannot be properly addressed – possibly by the intervention of the central bank- can easily lead to insolvency.

In recognising the importance of liquidity risk and the systemic implications of a liquidity crisis, the Basel Committee issued a consultative document on an international framework for liquidity risk management, standards and monitoring in December 2010. The document put forward two liquidity risk standards and a set of tools for ongoing monitoring of liquidity risk exposures and information exchange among supervisors. The two standards, namely (i) a global minimum “liquidity coverage ratio” which aims at capturing liquidity risk in the short term by ensuring that banks hold sufficient high quality liquid assets to withstand an acute stress lasting one month; and (ii) the longer term “net stable funding ratio” which aims at incentivising banks to fund themselves using more stable sources on a structural basis by establishing a minimum acceptable amount of stable funding based on the liquidity characteristics of the financial institution’s assets and activities over a one year time horizon.

A discussion has been triggered and various concerns were voiced on the calibration of the standards, which in the view of some could generate significant negative repercussions for the real economy, for certain markets (such as the money market and interbank market) and for the business models of some banks. Central in this discussion is the question on the set of assets considered eligible for the short-term liquidity standard. It has been claimed that the proposal is not in line with the severe stress scenario that is assumed and that it could lead to concentration risk as well as higher cost for the assets that are not included. Furthermore, the design of the longer-term standard was questioned, as it was argued that a higher level of mismatch between assets and liabilities is necessary for banks to fulfil their intermediation role in the economy.

The ECB has a particular interest on the Basel Committee proposal on liquidity risk as it relates to the implementation of monetary policy, has an impact on the money market, as well as possible consequences on the financial integration in the Euro area. Clearly the proposed liquidity standards address the major shortcomings identified by the financial crisis in the area of liquidity risk by requiring banks to increase their holdings of liquid assets and to reduce their reliance on short-term volatile funding sources. Furthermore, enhancing the liquidity risk management of banks could have a positive impact on market confidence, reducing thus the volatility in money and capital markets.

Still the calibration of the proposed liquidity standards needs to be revisited to take into account the comments received during the public consultation and their impact on the banking sector, financial markets and the overall economy. Finally, the establishment of an appropriate phase-in period that will allow banks to adjust their balance sheets without an undue impact on their operations or an increase in their reliance on central bank funding is warranted.

## Conclusions

I would like to close my remarks by the rather pessimistic conclusion that, unfortunately, it appears that periods of “irrational exuberance” can lead us to forget well established practices on how to prudently manage risks. Financial crises like the current one remind us of their importance. Also central banks have learned valuable lessons in their own risk management and have made steps in solidifying their defences, while remaining faithful to their objectives of ensuring price stability while also safeguarding financial stability.

Thank you very much for your attention.