Looking Beyond the Current Credit Crisis

Remarks by

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It is a great honour and privilege for me to have been invited to this meeting to share with you some thoughts on the current turbulences in financial markets. It is also a particular pleasure to meet again the members of ECON and renew the friendly and constructive exchanges which I so much enjoyed in my earlier activities.

What can I offer you? Surely not advice on how to manage the current crisis. Crisis management is in the able and expert hands of my former central banking colleagues who have been acting with speed, determination and imagination in a situation which imposes upon the Eurosystem navigation in very turbulent, and at the same time almost completely uncharted, waters. We are lucky to have in such a situation as President of the ECB a son of Brittany who by his origins has surely a comparative advantage for a navigation of this kind.

I am confident that we will get out of our predicament – not speedily, nor without pain, but we will. At that time – not yet today – we shall have to answer a number of challenging questions. Time is not yet ripe to give these answers. Shooting from the hip is not to be recommended in matters of such complexity -

even if one might be tempted already now to identify targets which would seem to deserve to be shot at. But, please, let us resist this temptation.

On the other hand, we are already beginning to see several groups of interconnected questions or queries that in due course *will* have to be answered. In what follows I shall try to list some of them.

By way of introduction to that list, I take the liberty of reading out to you a quotation from the Final Report of the Committee of Wise Men on the Regulation of European Securities markets (15 February 2001) which I had the privilege to chair. Under the heading "Managing the prudential implications" we wrote this:

"While the Committee strongly believes that large, deep, liquid and innovative financial markets will result in substantial efficiency gains and will therefore bring individual benefits to European citizens, it also believes that greater efficiency does not necessarily go hand in hand with enhanced stability.

Increased integration of securities markets entails more interconnection between financial intermediaries on a cross-border basis, increasing their exposure to common shocks. It is not within the remit of this Committee to evaluate such risks, and even less to make recommendations on how to deal with them. However, given the growing interlinkages between all segments of the securities markets and the full range of financial intermediaries, the Committee believes that there is urgent need to strengthen cooperation at the European level between financial market regulators and the institutions in charge of micro and macro prudential supervision. The ECOFIN Council should ask the Economic and Finance Committee to report on the development of this cooperation".

Given that ECOFIN excluded prudential matters from our mandate, this was about as far as my Committee could go in expressing our concern about the potential emergence of financial fragility (and the daunting task of managing it) in a financially globalised world.

Looking back over the time elapsed since the publication of this recommendation, I am happy to report that there *has been* progress in its implementation. Just three examples. First, the four-level regulatory approach (which we recommended just for the securities markets) has been extended to the whole of the financial industry – notably to banks, where the regulatory focus is predominantly on prudential matters. Second, the Level 3 committees now meet on a regular basis – these are the so-called 3L3 meetings of the European Financial Regulators. As a result market regulators *do* have an opportunity to meet regulators with prudential concern in their mind. Third, there have been well organised stress-testing exercises, which I am sure, have significantly improved the channels of communication and decision making systems within the Eurosystem. The question as to whether progress on these lines has been sufficient, or if not, what should be done about it, will have to be at the core of the discussions that will have to take place once we have the active crisis management phase behind us.

Now let me turn to the list of my queries, which are overlapping and surely not complete. I regrouped my remarks under six headings.

Responsibility of the "originate-and-distribute" business model

Until this crisis most market participants and a number of weighty officials argued (1) that the model (just as securitisation in general) increased the efficiency of our system, and (2) that it had a stabilising effect on our global system, by diminishing the concentration of risk on the banking sector, and distributing these risks more widely.

I have always found convincing the first argument. As to the second, while I did not deny that it might also be valid, I always nourished some suspicion about it, because its validity hinged on three crucial assumptions: that the purchasers of these highly complex instruments (more about this complexity in my next remark) knew what they were acquiring, that they were willing and capable of assessing their risk-resistance capability in times of stress, and that in case of financial stress they would not succumb to the temptation of herd behaviour. It now appears that, to various degrees, these three assumptions have not been met.

Moreover it also appeared that for reasons of legal uncertainty or for reputational reasons many banks have, in fact, *not* got rid of their risk – see the massive reintegration of these assets in banks' balance sheets - or when they *did* get rid of their risk, it became close to impossible to know who were the "final" lenders. You may argue back and forth whether this knowledge is indispensable for market participants (I believe that it is), but there is not the slightest doubt that the "evaporation" of the final lenders raises a major challenge for those in charge of crisis management. As I have said repeatedly in other meetings, gone are the good old times, when in August 1982, at the outbreak of the Mexican crisis it took us only a couple of hours to identify (on the basis of the BIS statistics), the 40 to 50 major banks which were the final lenders to Mexico. This was a crucial information which enabled the IMF to handle the crisis.

The operation of the model implied a decisive loosening of the link between debtor and creditor. The traditional information asymmetry has surely increased. Finally, it is arguable that the bank which initiated the granting of the credit but knew already at that time that it had no intention of carrying the risk until maturity had less incentive to look at the creditworthiness of the debtor than it would have been otherwise. All this leads to several broad questions: with our recent experience, what is the "balance" of pros and cons for this business model? Is it possible to preserve its efficiency-raising qualities, without having to put up with its defaults? And what would be the role of public policy *versus* codes of conduct or plain self-regulation?

The mind boggling complexity of financial instruments

As I have just mentioned, the questioning of the validity of this (by now) contested business model is closely connected with the stream of innovations which has been producing financial instruments and transactions of increasing complexity. This has substantially increased the opacity of our transactions-based financial system. Given the lack of standardisation, purchasers have to face up to the daunting challenge of trying to understand on a case-by-case basis the risks implied by each specific instrument or transaction. This is beyond the means of an average citizen – and not only of a poor subprime borrower. But it also puts under stress wholesale, or institutional investors. Such investors do possess the human resources capable of understanding complex instruments, but I know of cases when these inhouse experts were unable to carry the message to the top management.

Our regulators, who were not unaware of these problems, came up with the idea of turning to the rating agencies for help. Experience has led many of us to question the wisdom of this decision. Granting a quasi-monopoly status to these agencies raises all the traditional queries about the possible abuse of a monopolistic position. Moreover, there are potential conflicts of interest. Finally, granting, say, a AAA status to a highly complex product has turned out to be plainly misleading, and induced market participants – by relying exclusively on the rating decision – not to do their homework.

All this raises a host of questions. Enhanced consumer protection for retail investors and borrowers? Standardisation and the use of regulated exchanges for knowledgeable market participants? More fundamentally, what are the possibilities of, and the limits to, enhancing the transparency of these complex products? And, as mentioned earlier, what role for public policy *versus* code of conduct or plain self-regulation?

Banks' failure to manage their risks

One of the major revelations of the current crisis has been the blatant failure of some very large and hitherto highly respectable banks, to properly manage their risks. This observation does not apply, thanks God, to the banking systems as a whole, but the cases are sufficiently striking to warrant closer inspection – if only, because of the mere size of the banks in question, they may usher in unwelcome effects on the "real" economy.

What has caused the failure of the risk management systems? Deficiencies in their design or the dysfunction of the internal communication systems? Have there been elements in our regulatory systems which might have provided a perverse incentive to disregard risks? Have the remuneration systems – at the various levels of the hierarchy, but crucially for the top management – played any role in blunting risk awareness?

The need to enhance our crisis prevention capability

Let me now turn to the role of the authorities in crisis *prevention*. My starting point is to assume that – while reasonable efforts will have to be made to increase the transparency of our global financial system (much of what I have been saying so far is about such efforts) – we should resist the temptation of believing that it would be possible to turn the clock back, by engineering somehow generalised de-securitisation, putting a brake on financial innovation or – even worse – trying to opt out of financial globalisation. These would be pipedreams, and moreover dangerous ones.

The upshot of all this is that, while I wholeheartedly recommend to support all initiatives in favour of greater transparency and risk-aware management practices, I still suspect that we shall have to live with a transaction-based, or "market centric" system which will remain to a large extent opaque. But whatever remains of opacity will continue to make crisis *management* an inherently difficult exercise. The identification of a systemic risk requires information on which institutions (and to what extent) are in trouble, and familiarity with the potential channels of transmission of an initial "shock". To put it mildly, opacity is not of great help in this respect. Hence the need to enhance our crisis *prevention* capability.

Three remarks on crisis prevention

First, central banks, which willy-nilly are in the first line of crisis management have to be in a position that would enable them to detect at the very early stages signs of fragility in specific financial institutions and, primarily, in banks. To some extent, since they operate in the money markets and oversee the payment and settlement systems, they can see the first signs of trouble by the signals given by the markets or by the disfunction of the payment and settlements systems. But this may be too late. They should receive privileged information on what is happening inside banks – which leads me to my second point.

The natural suppliers of such information are – or rather should be – bank supervisors. And here we have a problem, which I had the privilege of observing already during my prehistoric BIS years. Quite rightly, the prime duty of a bank supervisor is to observe the compliance of a bank with regulations, and (as it will happen under Basel II for large banks) with their own risk-management rules. But we live in a world of extraordinarily fast "structural" changes, which put in question all time the adequacy of the regulations or of the banks' risk management rules. If the supervisors are not in charge of trying to detect such developments and – most important – their systemic implications, who is going to do that and carry the message to the concerned central bank?

My third point is that the growing predominance of markets, and the proliferation of complex new financial products, undermine the justification of the view that prudential considerations should not be part of the mandate of market supervisors. They should be, but I realise that this is more easily said than done. There is scope here for an enhanced "horizontal" cooperation between market and banking supervisors.

Managing global liquidity

The crisis in the US subprime mortgage market has been the trigger for the development of much wider crisis manifestations in the credit and debt markets on both sides of the Atlantic.

A short reminder. By the spring of last year large segments of these markets displayed converging signs of an extraordinary appetite for risk taking – which is the dominant feature of financial euphoria. By the end of 2006 credit derivatives contracts reached the staggering amount of $34,500 billion, which implied *doubling* in one year. Mergers and acquisitions were booming. Leveraged buy-outs were flourishing. Bank profits were soaring. Market volatility was very low. And, most important, spreads between yields on treasury bills and yields on high risk debt sank to ridiculous levels. This could not go on – financial manias always come to an end.

We cannot avoid asking ourselves the question: what were the driving forces behind this financial euphoria? Some would say: the traditional ones, such as animal spirit, creativity, inventiveness or simply greed. That was very likely the case. But let me stick my neck out by submitting to you that a very powerful factor was also at work: *excess liquidity.* I am aware that there is no consensus about the definition, and even less about the measurement of excess liquidity (or for that matter of liquidity itself), but I am unaware of any possible indicator which during last spring would have signalled the opposite, i.e. tight liquidity conditions, despite the earlier changes in the stance of monetary policies. On the contrary, all market participants I was meeting at that time insisted that the financial world was "awash" with liquidity. The main point I want to make at this juncture (as I did already well before the current crisis) is that *abundant liquidity created a favourable breeding ground for reckless risk taking.*

Looking ahead, if we want to avoid the repetition of such a situation, we would be well advised to look into the availability of policy instruments that would allow our authorities to control market liquidity. Restraining monetary policy – by trying to put a brake on the excessive growth of various monetary aggregates – would seem to be the main available instrument. But the link between market liquidity and such policy action is far from being simple. For one thing, the liquidity creating effect of the persistently large US current account deficit is pretty obvious. For another, the explosive growth of the financial "superstructure" has endowed financial markets with a powerful "endogenous" liquidity creation ability over which central banks do not have smooth control. My concluding recommendation is that these problems deserve close scrutiny.

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