Jean-Claude Trichet: Remarks on the financial turmoil

Speech by Mr Jean-Claude Trichet, President of the European Central Bank, at the British Bankers Association's Annual Reception, European Parliament, Brussels, 8 December 2008.

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Ladies and Gentlemen,

Let me begin by thanking MEP Purvis and Ms Knight for the opportunity to address such a distinguished audience and to share my remarks on the financial market turmoil. I need not emphasize to this audience just how extraordinary and challenging current times are; but I would like to emphasize that the response of central banks and governments to address these challenges have been equally extraordinary.

In my intervention today I will focus on the decisive and resolute actions taken by public authorities to support the functioning of the financial system in the wake of the very difficult developments following the intensification of the financial crisis that occurred mid-September, I will also take the opportunity of speaking before you, to stress the important role that the financial industry has to play in this respect.

Indeed, the failure of Lehman Brothers in September triggered an unprecedented deterioration in the degree of confidence in the banking sector which ran the risk of undermining its fundamental function of financial intermediation. In Europe, this was reflected in record increases in overnight interest rates, especially for US dollar funding, and a marked decline in traded volumes, in both interbank and swap markets. Some banks were even "locked out" of the money market completely. In addition, strong declines in banks' share prices and large increases in banks' CDS spreads were observed. These developments required a prompt and extensive set of actions to be coordinated across countries and public institutions.

With hindsight and drawing on my personal experience in those very intense coordination efforts, I can say that the overall response by governments and central banks was effective in preventing further deterioration in market conditions. With particular reference to the experience in the EU, in addition to the long-established cooperation among central banks, the coordinated approach for government measures to support the banking sector should be highlighted. The agreement by the Heads of State of the euro area Member States on 12 October, subsequently endorsed in the European Union summit were key events in endorsing an action plan at the highest political level. These summits were very important milestones because they demonstrated the high degree of commitment and responsibility of public authorities to act decisively and in a unified manner to preserve confidence and proper financing conditions for the economy.

I should also underline the very effective coordination which prevailed between governments and central banks in the definition of these measures.

Let me now focus on the measures taken by public authorities aimed at facilitating the funding activity of banks and their recapitalisation. I will then turn to key challenges going forward that need to be addressed to prevent the reoccurrence of such financial market turbulences in the future.

The funding conditions of banks

Since the onset of the financial turmoil, increased uncertainty, reflected particularly in counterparty risk, has led banks to hoard liquidity. This has resulted in a significant decline of trading in the interbank money markets. However, the dramatic deterioration of confidence that emerged in mid-September led public authorities to take a wide array of measures to support the funding activity of banks. Central banks intensified their actions in the interbank money market which were complemented by specific government measures to improve market functioning over longer term maturities.

First, the Eurosystem and other central banks substantially stepped up their efforts to ensure access to central bank liquidity by solvent banks. Let me recall the main measures in this respect.

On 8 and 15 October 2008, the Eurosystem took in particular the decision to adopt temporarily a fixed-rate tender procedure with full allotment in all refinancing operations, that is operations with maturities of 1 week up to 6 months. These measures increased the intermediation role of the Eurosystem and were aimed at reducing banks' funding costs which had soared as parts of the money market became dysfunctional. At the same time, longer-term operations are conducted more frequently and at more diversified maturities. These exceptional measures ensure that banks have access to refinancing at longer-term maturities, the market for which has been particularly affected by the turmoil.

Since December 2007, the ECB has participated in unprecedented joint operations with the US Fed and several other central banks to improve US dollar funding conditions by providing US dollar refinancing to its own counterparties against euros or collateral eligible for euro open market operations. In October 2008, the ECB started conducting its US dollar operations as fixed-rate tenders with full allotment and increased the range of maturities. In addition, it entered into a swap agreement with the Swiss National Bank to facilitate the distribution of Swiss franc liquidity to euro area banks.

Coupled with the sizeable enlargement of the list of assets eligible as collateral, which will remain in place until the end of 2009, these measures have substantially reduced the funding strains of banks. However, significant challenges remain as money market activity continues to be abnormally limited.

Second, governments in a concerted and coordinated manner granted guarantees on new issuances of bank debt.

The aim of this measure is to address funding problems of liquidity constrained but solvent banks. The granting of government guarantees on bank debt should facilitate the distribution of liquidity in interbank money markets, particularly by reducing globally the uncertainty on counterparty risk and by increasing the volume of tradable collateral in the private interbank market.

The Eurosystem contributed to this endeavour by proposing a set of recommendations on the appropriate framework for the granting of government guarantees. These included recommendations on overarching objectives as well as on parameters of the pricing system. From our perspective, such a framework should aim at: solving the funding problems of solvent but liquidity constrained banks; preserving the level-playing field among financial institutions, avoiding market distortions; and ensuring consistency with the management of liquidity by the Eurosystem and with its operational framework, so as not to impair the implementation of the single monetary policy.

Banks have recently begun to make use of this funding opportunity. The current outstanding volume of government guaranteed unsecured bank bonds in Europe amounts to €24 billion, of which €15 billion have so far been issued by the UK banks. More banks have already indicated their intentions to issue similar bonds this year. The issuances have been considerably oversubscribed and spreads of these government guaranteed bonds are lower than for secured bonds from the same country with a comparable maturity. Thus this initiative is effectively representing a viable and less costly source of funding.

The recapitalisation of banks

Government measures in this context should mainly be designed to strengthen the capital position of fundamentally sound banks, with the aim of improving the functioning and stability of the banking system and fostering an adequate flow of credit to the economy.

Member States have committed to providing banks with additional capital resources, by acquiring equity in the form of ordinary shares, preferred shares or other hybrid instruments such as subordinated debt.

Also in regard to these measures, the Eurosystem has contributed with a set of recommendations on the main features and pricing of different forms of capitalisation instruments. These recommendations are without prejudice to guidance from the European Commission aimed at avoiding distortions in competition in accordance with State aid rules of the Treaty.

In this context, the Eurosystem considers that any recapitalisation should take into consideration the specific market situation of each institution, distinguishing in particular between fundamentally sound and distressed banks. Furthermore, it is important to ensure that the temporary nature of government measures is preserved and that capital raising by private investors is not discouraged.

The level of commitment of public authorities in restoring confidence and the flow of credit to the economy is very high. This is also reflected in the figures: EUR 1,800 billion in government guarantees and EUR 280 billion in recapitalisation schemes have been agreed thus far.

Overall, I believe that the actions taken by central banks and national governments provide an exceptional response to address the challenges stemming from the recent significant deterioration in market confidence and provide a new environment aiming at reactivating the intermediation role of banks. At the same time, success ultimately depends on the banking sector making appropriate and prudent use of these measures and contributing to restoring normal market conditions. In this context, reactivating the interbank market and ensuring the proper financing of the economy is of paramount importance. Taking advantage of speaking before such a distinguished audience, I call on banks to live up to their responsibility in this regard.

Key challenges to be addressed

Let me now shortly focus on some key challenges that need to be addressed in order to prevent that such a crisis occurs again in the future.

At the current juncture, priority has been given to comprehensively formulate policy responses to address the challenges raised by the financial market turbulence and to effectively and timely implement the agreed measures. As you are aware a number of reforms have been put forward at the European and international level notably by the ECOFIN Council and the Financial Stability Forum (FSF), and have recently been reflected in the declaration of the G20 summit. I will mention three issues, which I believe are especially important in a longer-term perspective: first, mitigating procyclicality; second, correcting incentives towards short-termism and third, enhancing transparency by improving the availability of data important from a financial stability perspective.

First, there is a need to mitigate procyclical effects stemming from the current regulatory framework. A number of potential sources need to be investigated, including capital requirements, valuation and leverage, banks' compensation schemes and provisioning regimes. In this context, I welcome the work to be carried out under the auspices of the FSF.

Second, markets have excessively rewarded short-term profits at the expense of lower long-term performance or plain losses. The excessive focus on the short-term has resulted in a significant underestimation of low probability but high risks and in the increase of risk-taking behaviour. In this context, there is a need to create an incentive framework that adequately assesses and rewards performance over the medium to longer term.

Third, the availability of aggregate information regarding the main risks to the financial system needs to be significantly enhanced. Information should be available concerning institutions, instruments and markets that are currently unregulated but whose risks raise financial stability concerns given their potential systemic impact. In this context, one example is the need for increased transparency in the OTC derivatives markets. In particular, I welcome the initiative to establish a central counterparty clearing for the CDS market.

Conclusion

To conclude, national governments and central banks have taken decisive and concerted measures to address the challenges posed by the current conditions in the financial markets. In addition we have put forward reforms aimed at avoiding the reoccurrence of a similar crisis in the future. However, measures taken by public authorities can only go so far.

The banking sector needs to also do its part by committing to reactivating the interbank market, resuming their intermediation role and implementing the necessary reforms aimed at strengthening the resilience of the financial system in the long term. The Governing Council of the ECB looks forward to witnessing your action in this regard and will continue to support your efforts.

Thank you for your attention.