

**Remarks by E. Gerald Corrigan**

**Managing Director**

**Goldman, Sachs & Co.**

**A PERSPECTIVE ON CURRENT MARKET CONDITIONS**

**March 18, 2008**

**New York, New York**

## **Introduction**

Good afternoon ladies and gentlemen: these are difficult times as we seek to better understand and ultimately contain and reverse the alarming deterioration in credit markets – a situation that has been amplified by a multi-faceted wave of contagion forces that in some respects are virtually without precedent. Needless to say, coping with the credit market situation has been made all the more difficult in the face of \$100 plus oil and a distinctly murky outlook for economic activity.

### **I. Systemic Financial Shocks in Perspective**

- As many in this audience know, I have long maintained that our collective capacity to anticipate the specific timing and triggers of systemic financial shocks is virtually nil.
  - Unfortunately, the experience of the last 6 to 8 months provides further evidence in support of that reality.
  - While financial disturbances (as distinct from financial shocks) occur with some frequency, financial shocks with systemic knock-on effects are relatively rare.
  - By my count, the last four decades have witnessed four such events as follows:
    - The LDC debt crisis of the 1980's
    - The 1987 stock market crash
    - The 1997-98 Asia, Russia, Long Term Capital episode
    - The current credit market crisis
      - Needless to say, over this long period, we also experienced a number of “near misses.”

- While financial shocks tend to have a number of broadly similar common characteristics, each is distinctive in terms of (1) its proximate and underlying causes; (2) its dynamics; (3) its contagion elements; (4) its resulting damage; and (5) its resolution.

## **II. Causes and Triggers**

- Obviously it is impossible to capture the complexities of the current situation in a few paragraphs but I do think the highlights of what happened and why it happened are reasonably clear, at least with the benefit of hindsight.
- It is painfully obvious that the proximate cause of the current problem is centered on multi-year housing bubble in the United States with particular emphasis on the emergence of multiple forms of credit excesses in the sub-prime sector of the mortgage markets.
  - The turn of events in the sub-prime mortgage sector is particularly depressing in human terms since achieving the noble goal of broadening home ownership in demographic and income distribution terms has suffered.
- While it is easy to point to the sub-prime mortgage situation as the proximate cause of the current crisis, identifying the underlying causes is more difficult. However, I believe that there are four inter-related forces that are particularly important sources of the underlying causes of the problem. Each is discussed briefly below.

First; for several years running global financial markets have been awash with liquidity. This condition reflected in part the recycling of (1) excess saving from

Asia in general and China in particular; and (2) excess cash from energy producing countries. It may also reflect the phenomenon of an extended earlier period of very low interest rates, especially in the U.S. Both of these factors are also related to the global economic and financial macro-economic imbalances that have long been recognized as a potential source of instability.

There can be no doubt that ample financial market liquidity and relatively low interest rates were an important driving force behind the pervasive “reach for yield” phenomenon of recent years and that the reach for yield phenomenon, in turn was an important factor in driving the surge in demand for and supply of highly complex structured credit products.

Second; reflecting in part the forces discussed above and the intensity of competitive factors in the financial market place, credit risk has been mis-priced for some time. The evidence of this was clear in the terms and conditions of credit extension in the sub-prime mortgage market and in the leveraged finance sector, to say nothing of the extraordinary tightness of credit spreads more generally. In these circumstances, it was widely recognized that sooner or later credit spreads and credit terms would inevitably adjust. However, it was all too easy for many, if not most, to conclude that when the correction took place it would be gradual and orderly. Obviously, that conclusion was wrong.

Third; for a variety of reasons, some structural, some technological and some behavioral, contemporary finance has become incredibly complex. We see this in the speed and complexity of capital flows, we see it in the complexity of many classes of financial instruments (some of which contain large elements of embedded leverage) and we see it in the extraordinary complexity faced by

individual financial institution in their day-to-day risk management activities and in their policies and practices as related to valuation and price verification for some classes of financial instruments. Needless to say, the complexity factor is also an issue as it pertains to the capacity of the international community of supervisors and regulators to discharge their responsibilities.

While recent experience may result in a few examples in which complex and highly structured financial practices or instruments will find their way to the graveyard, the underlying force driving complexity can not be suppressed. Thus, we are faced with the pressing need to find better ways to manage and mitigate complexity, a subject that will continue to challenge the best and the brightest among us.

Fourth; reflecting in part the forces described above, the current crisis has witnessed patterns of contagion the speed and reach of which are different in degree, if not kind, from that *which* we have witnessed in earlier periods of financial instability. The list is long, asset backed-commercial paper, conduits, SIVs, CDOs, quantitative funds, municipal bonds, auction rate securities, monolines, and hedge funds, to say nothing of significant write-downs and other problems at a number of financial intermediaries. To a considerable extent, the “hot spots” where contagion forces have emerged share at least two common denominators; first, the risk aversion contraction in market liquidity; and, second; various forms of leverage made it very difficult and costly to unwind positions.

— If the preceding is a reasonable approximation of the causes of the current crisis, to grasp the exact triggers that unleashed the crisis, we must look back to the events of the early to mid-summer of last year.

– In late 2006 and early 2007 there was evidence of gathering storm clouds, particularly in the sub-prime mortgage space. Having said that, I do not think it is an exaggeration to stipulate that even for the few who believed that a mortgage market correction was in the cards, virtually no one anticipated the scale of the crisis that would take hold in the July-August timeframe of last year.

– The closest I can come to identifying the wake up call as to the looming crisis is to cite the problems encountered by Bear Stearns and two of its hedge funds in late June and July and the roughly simultaneous initial downgrades of a small number of sub-prime related mortgage instruments by the rating agencies in early to mid-June.

— In those circumstances, the trigger mechanisms that unleashed the crisis seem to me to center on two more or less simultaneous developments as follows:

First; we experienced a broad-based drive to re-price credit risk which took hold across broad segments of the credit markets that were by no means limited to sub-prime mortgages.

Second, in a separate but related development, we witnessed a simultaneous drive across all classes of financial institutions to reduce risk.

— The drive to re-price credit and to reduce risk in the face of changing market conditions is hardly a new phenomenon. But, in current episode there were factors at work that made this phenomenon different in degree from earlier episodes. I would cite two such factors that quickly elevated contagion risk. They are:

First, the credit re-pricing process was hindered by the break down in the price discovery process for some classes of complex financial instruments including, but not limited to, sub-prime mortgages and their related instruments such as CDOs. And, as the markets for such instruments became illiquid, the price discovery process was further impaired. Obviously, if price discovery in the credit space is not working well, re-pricing credit suffers accordingly.

Second, risk reduction, which necessarily entails reducing position risk and/or hedging such risks, inevitably brings with it added pressures on market liquidity which, in turn, contributes to increased volatility and higher risk premiums. Ironically, such increases in volatility also increase measured risk, thus frustrating efforts to reduce risk. Indeed, I suspect that for many institutions, increases in volatility were largely offsetting efforts aimed at position reduction such that key risk metrics such as “value at risk” were little changed, or may have increased, despite meaningful reductions in position risk. This phenomenon is not new, but in the face of uncertainties about the value of some financial instruments as discussed above, it certainly did aggravate the turmoil in credit markets.

- By mid August, the crisis was clearly at hand but for a time in September and early October conditions appeared to be stabilizing only to be followed by renewed instability in the credit markets generally and knock on effects spreading to the real economy – conditions that are still very much with us as I speak today.

### **III. The Lag in Crisis Recognition**

With the benefit of hindsight, all of the above raises a troubling question; namely, why – across the public and private sectors – were so many so slow in recognizing during the first half of 2007 that we were on the cusp of a truly major financial crisis not a relatively localized correction in the housing sector and segments of the mortgage markets. Keep in mind, for example, that the Dow Jones Industrial Average closed at 14000 on July 19. In raising this question, I have to confess – much to my professional embarrassment – that I did not recognize the scale of the imminent danger until late spring or early summer and even now, I am not sure that I can satisfactorily explain the reasons for the crisis recognition lag but the following factors seem to have played a role.

First; in the almost ten years since the LTCM episode, we had experienced a number of financial, economic and geopolitical disturbances all of which sorted themselves out with relatively little damage. This experience, undoubtedly, created a false sense of security suggesting that the growing problems evidenced over the first half of 2007 would also sort themselves out with little by way of systemic damage.

Second; we tend to forget that centuries of experience tell us in unmistakable terms that bubbles almost never deflate gradually – they burst.

Third, we were not sufficiently sensitive to the extent to which tighter financial linkages and the resulting speed with which market conditions can change, would, and did, amplify contagion risk.

Finally; human nature being human nature, collective behavior produces a natural aversion to being the last one in or the first one out when markets are booming.

#### **IV. A Word about CRMPGII**

As many of you know, in 2005 I was the Chair of the industry group which produced the CRMPGII Report which was released on July 27, 2005 – almost 3 years ago. At the time, I had high hopes that the Report would help us get ahead of the curve in mitigating and managing the next – but unforeseen – financial crisis. Needless to say, those hopes have been frustrated even if it is true that the Report did, in fact, discuss many of the issues – including complex financial products – that have been at the center of the current crisis.

My frustrations notwithstanding, I also believe that CRMPGII did help to produce a number of very constructive changes that – believe it or not – have probably worked in the direction of preventing the current crisis from being even worse than it is. As examples, I would cite (1) improvements in counterparty risk management; (2) the outright elimination of the practice of “assigning” CDS contracts to a new counterparty without the explicit consent of the original counterparty; (3) major enhancements in the technology and processing of documentation associated with OTC derivative transactions in high risk segments of the financial markets, especially credit default swaps. Indeed, given the recent growth in the CDS market, I shudder to think about the risk implications of today’s volume levels had those enhancements in market practices not been made.

Even today, however, there are key aspects of our financial infrastructure that must remain the subject of continuing effort and focus. Let me cite two examples;

First; while efforts to manage settlement practices in the credit default swap space in circumstances of the default of a reference entity have advanced and have worked reasonably well, such efforts are still managed on a case-by-case basis rather than by a common protocol. While I do not minimize the problems associated with the adoption of a common protocol, I want to strongly encourage the industry to continue to push hard in that direction, especially in a setting in which the incidence of defaults will rise in the period ahead.

Second; in CRMPGII we also discussed the complexities associated with the execution of close out procedures to be followed by a given counterparty if a second counterparty has defaulted. I remain uneasy that this subject has not received the policy level attention it merits. I can also say that having recently looked into this issue in great detail, I can attest to how extraordinarily complex the legal, operational and policy issues associated with close out can be, particularly in a disorderly market environment.

## **V. Looking Ahead**

Since it is quite clear that the current credit crisis has not yet run its course, we must exercise caution in drawing firm conclusions as to the lessons learned and their implications for future public policy and private initiative. Given the credit driven complexities of the current crisis, the one thing we know for certain is that containing and reversing the crisis requires a broad menu of initiatives, both public and private. Importantly, and despite the almost daily flow of troubling news, that menu is taking shape even though it will take time for these initiatives to have their

desired impact. In saying that, allow me to single out a number of forces that I believe are working in the right direction.

First; the fiscal stimulus package passed by Congress and signed by the President will begin to bear fruit in the spring.

Second; monetary policy is quite accommodative and, more generally, Chairman Bernanke, President Geithner and their colleagues have, in my judgment, done a terrific job of crisis management under very difficult conditions and I am highly confident they will continue to do so.

- Having said that, we must recognize that (1) given the credit-driven nature of the crisis; (2) the dollar; (3) emerging inflationary risks; and (4) near-term risks to economic growth, there are limits as to the extent to which Fed actions, by themselves, can out-muscle the complex forces that are driving the credit crisis.

Third; some progress has been made in framing largely private and voluntary measures to cushion the foreclosure and related problems in the mortgage space amid a growing sentiment that still further initiatives may be needed.

- Congressional leaders, industry groups, prominent academic economists and others have all suggested various approaches that would broaden and accelerate the mortgage restructuring process. While I am not an expert in this field, I personally have come to the conclusions that additional measures at the federal level are in order subject to a number of conditions including the following:
  - Creditors must bear their fair share of the cost of restructurings;

- We must find a pragmatic way to insure that speculators who were borrowing to obtain multiple properties only with the aim of flipping them for quick gains do not benefit from the initiative;
- Great care and discipline must be exercised in anticipating and containing the actual and potential fiscal costs of any such initiative even if framed largely around the use of guarantees.

Fourth; last week the President's Working Group on Financial Markets issued a far reaching Report which outlines a comprehensive agenda for reform which covers virtually all major areas of weakness that have contributed to the crisis.

- Among other things, the PWG Report expressed its support for the formation of private sector group to reassess the CRMPGII guiding principles and recommendations regarding risk management.
- I have informed representatives of the PWG that I will take the lead in promptly organizing such a private sector group to undertake this task and also to help frame a fresh and systematic approach to further strengthen our financial infrastructure with particular emphasis on the market for OTC derivatives.

Finally; as we refine and implement this menu for stability, we must recognize the effort will take time. More importantly, it will also require ongoing flexibility in public policy and a high level of financial statesmanship on the part of market participants as they work

together to sort out problems in a setting in which our shared interests in the restoration of financial stability must guide our actions.

In closing, I wish I could give you a precise timetable as to the wind-down of the crisis and the return to more normal credit market conditions but my crystal ball remains somewhat clouded. What I can say is that I know that there are huge amounts of investable cash on the sidelines. I am not wise enough to know exactly when and what will trigger the shift from risk aversion to renewed risk taking but I do not rule out the possibility that when that shift occurs it may well gather momentum faster than many now anticipate.

Thank you.

\* \* \* \* \*