ANNEX

SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the Global Financial Stability Report *on September 14, 2007.*

Assessing Global Financial Stability Risks

Directors noted that global financial stability has endured a difficult period since the publication of the April 2007 *Global Financial Stability Report* (GFSR). Overall, financial risks have risen and markets are continuing to experience bouts of turbulence. Directors agreed with staff that, while there has been some calming in certain respects, markets generally remain unsettled, and credit conditions may not normalize soon.

Against this background, Directors welcomed the GFSR as providing a clear, well-focused, and timely analysis of the recent market turbulence. They broadly concurred with the report's insights regarding the causes and consequences of the recent episode of turmoil, and felt that the report presents a balanced assessment of the primary areas of concern and the potential policy responses. Directors continued to view the staff's use of the global financial stability map as useful, allowing them to track the deterioration in risks and conditions more concretely.

Directors noted that the threat to financial stability has been most evident in the money markets that provide short-term financing. At the heart of the difficulties in these markets was a funding mismatch whereby medium-term, illiquid, hard-to-value assets, such as structured credit securities, had been financed by short-term money market securities—often asset-backed commercial paper. When these asset values were threatened by a rise in delinquencies and ratings declined, short-term funding for those holding these assets became more difficult to obtain. For some entities, especially some conduits and special investment vehicles, investors became uncomfortable holding the commercial paper that was supporting these illiquid, hard-to-value assets. For others, such as hedge funds, this forced a deleveraging process, once their prime brokers balked at providing additional funding and insisted that more collateral be posted at lower values.

Directors noted that, in the recent situation of market turbulence, various central banks had moved quickly to provide liquidity—both in the overnight market, but also at longer maturities. Despite significant injections of liquidity, market participants remain uncertain about their counterparties' condition, and are thus reluctant to onlend.

Directors agreed with staff that there are potentially a number of other reasons why funding markets had not functioned normally—including the possibility that large banks have experienced an increase in their balance sheets in the form of structured credit securities or loans associated with leveraged buyouts. In such circumstances, it remains to be seen how effective lower interest rates will be in stemming pressures in money markets, and how policymakers will balance medium-term inflation objectives against nearer-term threats to financial stability. Some Directors cautioned that care will be needed to avoid moral hazard, including by ensuring that central banks focus on addressing general disorderly markets, rather than taking on credit risk or favoring certain institutions.

Directors commended the staff for its analysis of the various issues raised by the turbulence, including the implications of the potential losses, their distribution, and their wider impact on the financial system of developments in U.S.

mortgage markets. Many Directors cautioned that the difficult conditions in the U.S. subprime mortgage market may continue, calling for continued vigilance. Directors also noted that the continued work on leveraged buyout activity has aided understanding of why major banks may be unwilling to provide liquidity to others—including the likelihood that they may be holding the excess liquidity in anticipation of leveraged loans arriving on their balance sheets.

Directors noted that, so far, the financial market turbulence has not had a large adverse effect on emerging market and low-income countries. As a whole, these countries' very favorable growth performance over the last several years has encouraged both residents and nonresidents to invest in local markets and in private sector assets. Several Directors noted, however, that the risks for emerging markets may be finely balanced, and cautioned that the turmoil in mature markets may yet spill over to emerging market countries. The deterioration in financial market confidence seen in mature markets could be expected to begin to affect some emerging market countries going forward, particularly those that have been experiencing rapid credit growth. This concern is heightened in countries where credit extension has been primarily supported by external funding, or where other vulnerabilities—such as large current account or fiscal deficits—are present. Against this background, Directors underscored the need for strengthened vigilance and surveillance in emerging markets—in addition to mature markets—to ensure credit discipline and sound development of financial markets.

On the use of synthetic rate and structured credit products by investors in emerging market countries, Directors noted that, as the growth of these instruments has been associated with a period of benign volatility, some investors are likely to see losses with the reversal of this environment. The reversal of carry-trade-style external borrowing by emerging market firms could also be detrimental to investors. Directors advised that monitoring systems for these types of exposures of domestic corporations and financial institutions be strengthened so that risks can be better managed.

Directors considered that the current episode of turbulence should not be viewed as having ended, and with this awareness, broadly endorsed the initial set of policy conclusions reached in the report. Directors recognized that the development of financial markets in recent years has resulted in many benefits and useful innovations, and underscored the importance of not rushing to judgment about the causes of the current turmoil or the implications for financial sector policies. At the same time, they noted that much remains to be done to improve transparency and disclosure, starting with the complex structured products that have proliferated across large parts of the global financial system. More information about how they are valued and the underlying assumptions—as well as how they are distributed across investors—would remove much of the uncertainty that underlies the current concerns of market participants. Directors also viewed better transparency and disclosure regarding financial institutions, and their various conduits and special investment vehicles, as particularly important. Directors also generally considered that the recent episode suggests that the "originate and distribute" business model used by many financial institutions to securitize and redistribute risks may need to be reevaluated to ensure that the supply chain has adequate incentives to evaluate the credit quality of the loans being repackaged.

Many Directors noted concerns about the ratings agencies' conflict of interest, as they both rate and help design complex securities for issuers requesting the rating. Some Directors noted that this is a longstanding conflict, and that ratings agencies still perform a useful and fundamental role in rating credit risks that will need to be retained. It was also suggested that ratings agencies should review the quality of their methodologies. At the same time, most Directors agreed that investors, for their part, must also take responsibility for their own analysis of such products, particularly given that the risks are not confined to credit risk, but also entail market and liquidity risks.

Many Directors viewed the recent episode as a reminder to regulators and supervisors that there remain gaps in their oversight of financial institutions that would likely require further attention and examination. Directors noted that some financial institutions' risk management systems and their disclosures—even to supervisors—make it difficult to detect the off-balance sheet risks being undertaken, and that this would need to be rectified going forward. At the same time, Directors acknowledged that the experience to date does not point to a need for a substantial overhaul of regulatory frameworks. Any revisions would have to be carefully considered, and unintended consequences anticipated.

Do Market Risk Management Techniques Amplify Systemic Risks?

Directors welcomed the improvements in market risk management systems in recent years. At the same time, they welcomed the staff analysis of certain weaknesses in these systems as a timely and relevant reminder that no risk management system is perfect. In particular, Directors noted that risk management practices and models—including the popular value-at-risk (VaR) measures—have the potential to exacerbate volatility and to lead to systemic risks if followed mechanistically.

Some Directors observed that it would be difficult to avoid the trend toward greater uniformity in the approaches that firms use in risk management modeling, as the desire to attain "best practices" is encouraged by many aspects of risk management—including through supervisory guidance and capital requirements, peer pressure, and similarly-trained risk managers. Nonetheless, Directors generally acknowledged that financial institutions should aim to analyze the risks specific to their organization, by developing their own models and rigorously stress-testing their positions to assure the institutions' viability during a time of stress.

Directors noted that recent events point to the potentially negative influence of some risk management practices—such as margin requirements—that have added to "fire sales" of some assets used as collateral. However, if margin requirements are initially set more conservatively and are less risk sensitive, market dynamics would be more stable. Further, it was noted that a diversity of positions and types of trading strategies could help contain amplifying effects. Directors also believed that better disclosure of how risks are managed could allow institutions and supervisors to better anticipate the negative effects during stressful events.

The Quality of Domestic Financial Markets and Capital Inflows

Given the rapid capital inflows experienced by several emerging market countries, Directors welcomed the renewed focus on the challenges—and related policy responses—associated with surges in capital inflows. They observed that, while macroeconomic performance and growth prospects are the dominant influences on capital flows, equity market liquidity and financial openness also help attract capital inflows. Most Directors concurred with the empirical analysis that more financial openness is associated with lower capital inflow volatility. Also, improved institutional quality in the financial sector is shown to lower the volatility of capital inflows. While Directors agreed with the main results of the study, several Directors noted that its recommendation—to improve financial market infrastructure and depth—represents a medium-term challenge.

Directors recognized that large capital inflows in different country circumstances call for different policy responses. Good regulation and supervision, as well as strong risk management practices, are important for mitigating the potentially destabilizing effects of a reversal of inflows. In this context, many Directors questioned the usefulness and effectiveness of capital controls for managing capital inflows—especially given the difficulties in their sustained implementation and the associated reputational costs. Some Directors, however, recognized the usefulness of capital controls in the short term in stemming large, speculative capital inflows. It was noted that, if capital controls are used, they should preferably be market-based, have a fixed horizon, and be considered as part of a consistent set of macroeconomic and prudential measures. Several Directors also noted that concerns related to rapid and risky credit expansion are best dealt with through prudential measures, rather than by attempts to impede the inflow of capital.

Directors welcomed the analysis of Sovereign Wealth Funds (SWFs) contained in the report. Some Directors observed that some SWFs have adopted best practices in financial management. Moreover, SWFs can play a positive role in enhancing market liquidity and financial resource allocation. Several Directors suggested that SWFs warrant further study, given their macroeconomic role, potential size, and implications for global capital flows and asset prices. They called on staff to engage in further research on the objectives and characteristics of SWFs, including their asset management strategies, institutional and governance arrangements, and disclosure practices.

Finally, Directors commented on the broader question of the IMF's role as an international monetary institution in situations such as the recent market turmoil. A key aspect of this role entails working closely—and exchanging views and information—with national regulators, central banks, and other international institutions, both bilaterally and through established fora such as the Financial Stability Forum. Several Directors underscored that the IMF should be able to act in a timely and proactive fashion in sharing its perspectives with, and providing its advice to, national authorities, drawing on its unique insights gained from financial surveillance of its virtually universal membership.
To this end, continued work to broaden and deepen the IMF's financial market expertise—including with respect to emerging markets with increasingly globalized financial systems—will be important. Given the crucial need for timely and accurate information in assessing and responding to financial market turbulence, several Directors also highlighted the important contribution that the IMF can make to filling information gaps by virtue of its access to financial sector information in its surveillance activities. Overall, Directors saw a role for the IMF in facilitating appropriate responses to the current situation, and more broadly in promoting global financial stability.