Executive Directors welcomed the insights of the Global Financial Stability Report (GFSR) and broadly endorsed its main messages. Directors noted that, since the October 2009 GFSR, risks have eased as the recovery has gained traction, but global financial stability is not yet restored. They were of the view that vulnerabilities now increasingly emanate from concerns over the sustainability of sovereigns’ balance sheets. Such longer-run solvency concerns could translate into short-term strains in funding markets and intensify funding challenges facing banks in advanced economies. Changes in the global risk profile also reflect a greater differentiation of conditions across countries. Nevertheless, most countries face common policy challenges to further reduce risks, including containing sovereign vulnerabilities and their spillovers; addressing remaining areas of financial sector weakness; and sustaining financial regulatory reforms. Timely international cooperation will remain crucial to ensure effective policy implementation.

Directors noted that the crisis has led to a deteriorating outlook for debt burdens. They agreed with the emphasis in the GFSR on the interlinkages between fiscal and financial sector risks, which could lead to financial instability if government financing pressures become acute. The skillful management of sovereign risks—including development of credible fiscal consolidation plans, prudent debt management, and structural reforms—is essential for averting an adverse feedback to banking systems and an extension of the crisis.

Directors welcomed the improvements in the advanced economy banking systems, noting that estimated bank writedowns have declined, capital raising has continued, and recent positive earnings have allowed some banks to replenish their capital. However, they expressed concern that in some countries segments of the banking system remain poorly capitalized and face significant downside risks. Directors considered that slow progress on stabilizing funding and addressing weak banks could delay policy exits from extraordinary support measures.

Directors agreed that credit supply is likely to remain constrained as banks continue to repair balance sheets and sovereign borrowing needs rise. Policy measures to address capacity constraints, along with the management of fiscal risks, should help to relieve pressures on the supply of and demand for credit.

Directors noted that, while emerging markets appear to have withstood the crisis well, vulnerabilities may be developing that require the attention of policymakers. Capital flows, particularly portfolio flows, to some emerging market economies have been quite rapid and could lead to excessive credit growth and asset price bubbles. Directors generally agreed that there is no strong evidence of system-wide bubbles at present, but cautioned that, in the current environment of low interest rates, excessive asset valuations could form over the medium term.

As regards surges of capital inflows, Directors agreed that, as discussed in Chapter 4, macroeconomic and prudential measures should constitute the main policy response. The use of capital controls can in some cases complement conventional policies, but can only provide temporary relief.

Directors stressed the need to press ahead with financial sector reforms to make the global financial system more resilient. Such reforms will entail more and better quality capital and improvements in liquidity management and buffers. Greater attention should also be paid to addressing the complex issues related to too-important-to-fail institutions and systemic financial risks. Given their complexity, Directors called for a careful further consideration of the reform proposals.
Moreover, the reforms discussed in the report should be seen together with other initiatives under way, such as governance of financial institutions, supervision, and macroprudential frameworks.

Directors noted that Chapter 2 provides in-depth analysis and practical advice for addressing systemic risks, and welcomed a possible methodology to devise systemic-risk-based capital surcharges. However, a number of critical issues, including intensive data requirements, merit further examination before this approach could be considered. In addition, such surcharges should be evaluated relative to other methods or regulations and weighed against the benefit of lowering systemic risk. Moreover, should capital surcharges be implemented, this should take place gradually, so as to ensure the availability of adequate credit to support the recovery.

Directors welcomed the analysis on financial regulatory architecture. It would be important to strike the right balance between protecting the stability of the financial system and ensuring its innovativeness and efficiency, in particular with regard to too-important-to-fail institutions. Directors were generally of the view that, regardless of how regulatory functions are allocated, regulators’ toolkits will likely need to be augmented to mitigate systemic risks.

As regards improvements in the financial infrastructure, Directors agreed that a critical mass of over-the-counter derivatives should be moved on to central counterparties to reduce systemic risks as described in Chapter 3. However, central counterparties should be prudently risk-managed and regulated because they concentrate credit and operational risk. A gradual phasing-in of central clearing is advisable to minimize potential shocks to dealer balance sheets from the need to post more collateral. Furthermore, recognizing that some contracts will not be centrally cleared, some Directors considered that the recording of all over-the-counter derivative transactions in regulated and supervised central trade repositories should be mandated, and the data recorded there should be made available to the appropriate authorities.