

Press Points for Chapter 2: *Assessing the Systemic Implications of Financial Linkages*
Global Financial Stability Report (GFSR), April 2009

Key points

- The ongoing crisis has shown how financial innovations have enabled risk transfers that were not fully recognized by financial regulators or by institutions themselves, complicating the assessment of a “too-connected-to-fail” problem. It is thus essential to improve our understanding and monitoring of direct and indirect systemic linkages.
- The interconnectedness in the financial system is not constrained to interbank exposures as has become clear from the spillovers to the whole financial system brought about by financial institutions’ difficulties in rolling over their liabilities.
- The chapter illustrates several complementary approaches that can provide concrete measures of the too-connected-to-fail problem, thereby contributing to discussions about how to approach systemic-focused surveillance and regulation.
- Information on systemic linkages could help address questions such as which institutions are “systemically important”—an issue that the G-20 has asked the IMF with the Financial Stability Board to examine in the next few months—when to limit an institution’s exposures, and the desirability of interconnectedness-based capital surcharges.
- The chapter also reports changes in payments clearing efforts to dampen the effects of institutions’ interlinkages. Specifically, efforts to mitigate over-the-counter counterparty credit risk through recent proposals for credit default swap central clearing party.

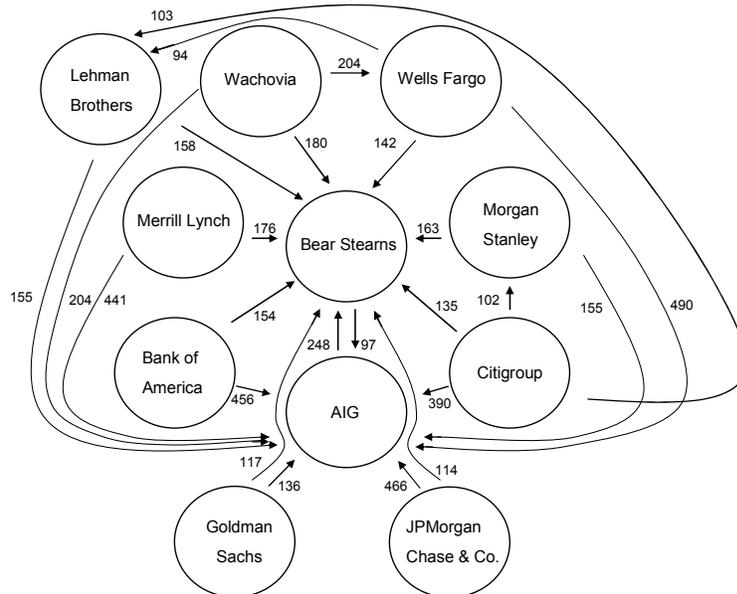
While the rise in the complexity and globalization of financial services has contributed to stronger economic growth, this has also increased the potential for disruptions to spread swiftly across markets and across borders. The crisis has shown how difficult it is to assess counterparty risk and to detect potentially systemic interlinkages across financial institutions in relation to a “too-connected-to-fail” problem.

This chapter presents an approach which relies primarily on institutional data to assess “network externalities”—how interconnections can cause unexpected problems. This analysis, which can track the reverberation of a credit event or liquidity squeeze throughout the financial system, can provide important measures of financial institutions’ resilience to the domino effects triggered by credit and liquidity distress.

Because detailed information at an institution level is hard to obtain, the chapter also illustrates methodologies that draw from market data to capture direct and indirect systemic linkages. Figure 1 shows the percentage increase in the conditional credit risk (CoRisk)—

measured by the increase in credit default swap (CDS) spreads of a “recipient” institution that would result when the “source” institutions (at the base of the arrow) is at the 95th percentile of its own CDS spreads distribution. This measures market’s perception of the increase in the “tail risk” induced by one institution toward others, as of March 2008, before Bear Stearns was merged into JPMorgan.

Figure 1. A Diagrammatic Depiction of Co-Risk Feedbacks



Sources: Bloomberg, L.P.; Primark Datastream; and IMF staff estimates.
Note: This diagram presents the conditional co-risk estimates between pairs of selected financial institutions. Only co-risk estimates above or equal to 90 percent are depicted.

Finally, the chapter presents a methodology with high predictive power that exploits historical default data for the United States to assess direct and indirect systemic linkages bank-system wide.

Each approach by itself has limitations, but together they provide an important set of surveillance tools for regulators and supervisors. In addition, the tools can form the basis for policies to address the too-connected-to fail problem, one of the most pervasive ways in which systemic risk manifests itself. More specifically, the chapter helps to inform policy makers in three areas:

- assessing direct and indirect spillovers under extreme (tail) events;
- identifying information gaps to improve the precision of this analysis;
- and providing concrete metrics to assist in the re-examination of the perimeter of regulation and what constitutes a systemically-important institution or sector.

Policy makers should give greater consideration to the hypothetical tail scenarios analyzed with these methodologies, lest they risk underestimating the probability of a tail event a

phenomenon that has been dubbed “disaster myopia.” Similarly, the global dimension of the current crisis underscores the need to assess these exposures from a cross-border perspective, which would require further coordination and data sharing by national regulators. For example, the BIS is well suited to extend its data collection exercises to aid in this exercise. The IMF could also play a role by analyzing such data in the context of its bilateral and multilateral surveillance roles.