

## SUMMING UP BY THE ACTING CHAIR

*The Acting Chair made the following remarks at the conclusion of the Executive Board's discussion of the Global Financial Stability Report on September 20, 2010.*

Executive Directors broadly agreed with the main messages and key policy recommendations of the *Global Financial Stability Report* (GFSR). They observed that further progress in financial system repair and reform is critical to ensure that the economic recovery remains on track. Directors noted that, although recent improvements in financial markets are encouraging, progress toward global financial stability has suffered a setback since the April 2010 GFSR. The market turmoil that occurred in late spring highlighted increased vulnerabilities of bank and sovereign balance sheets that could reignite a negative feedback loop to the real economy. In this context, Directors stressed that the outlook for financial stability remains uncertain, with risks skewed to the downside.

Directors concurred that the forceful response by policymakers has helped to stabilize and reopen bank funding markets and reduce tail risks. In particular, the results of European bank stress tests and additional transparency provided by the disclosure of sovereign exposures has contributed to rebuilding market confidence, although market access for some banks has not been fully restored. Directors recognized that the close linkages between sovereigns and the banking sector highlight the importance of addressing legacy problems in banks and bolstering sovereign balance sheets in crisis-hit countries over the medium term.

Directors agreed that economic fundamentals in emerging market economies have remained strong, showing resilience to banking strains in advanced economies. Cross-border spillover effects have been mostly confined to regions with significant economic and financial links to the euro area. Directors noted, however, that policymakers in many emerging market economies face significant policy challenges from a potential buildup of risks stemming from continued

strong capital inflows. A number of Directors recommended further analysis of these issues and a continued assessment of appropriate policies.

Directors welcomed recent policy initiatives to strengthen the financial sector, particularly the European Financial Stability Facility and the agreement on capital requirements that was recently reached in Basel. They noted, however, that further policy actions are needed to address the legacy of the crisis in the banking system and provide greater clarity on the new financial regulatory landscape. Directors stressed that, to protect against potential downside risks, banks need to be better capitalized, have access to stable funding, and be able to earn self-sustaining margins. They highlighted the importance of reducing, over the medium term, the risks to financial stability from rising sovereign debt burdens and contingent liabilities, and stressed that advanced economy sovereigns need to bolster their balance sheets through a reduction of debt levels.

Directors concurred that the breakdown of funding markets during the financial crisis demonstrated the importance of addressing systemic liquidity risk as highlighted in Chapter 2. They noted the importance of addressing both institutions' own liquidity risk management processes and risks in funding markets more generally. Directors generally agreed with the proposed two-pronged approach of increasing the resilience of financial institutions against liquidity shocks, while buttressing market infrastructure. In this context, they were generally of the view that the quantitative liquidity proposals announced by the Basel Committee on Banking Supervision—requiring higher liquidity buffers and lower maturity mismatches in banks—are a first step toward achieving this goal. Directors also agreed that a number of other issues merit further examination, including strengthen-

ing collateral valuation and margin setting policies in the repo market, as well as greater use of central counterparties for clearing and collateral management. Improving the financial information available to market participants should also help the market better differentiate counterparty risk and improve the functioning of the interbank market. At the same time, consideration could be given to extending the liquidity guidelines, in some form, to nonbank financial institutions to help mitigate the potential buildup of liquidity risks outside the banking system.

Directors welcomed the analysis in Chapter 3 of the role of credit rating agencies and whether the information provided by these agencies has negative implications for financial stability. They endorsed the overarching recommendation to reduce legal, regulatory, and private contract reliance on ratings where possible. Directors supported the policy advice that rating agencies be encouraged to improve transparency, reduce conflicts of interest, and discontinue policies that attempt to over-smooth rating changes, as such policies could potentially lead to procyclical rating cliff effects.