International Monetary Fund
Global Financial Stability Report
October 2010

Press Points for Chapter 1: ***Economic Uncertainty, Sovereign Risk, and Financial Fragilities***

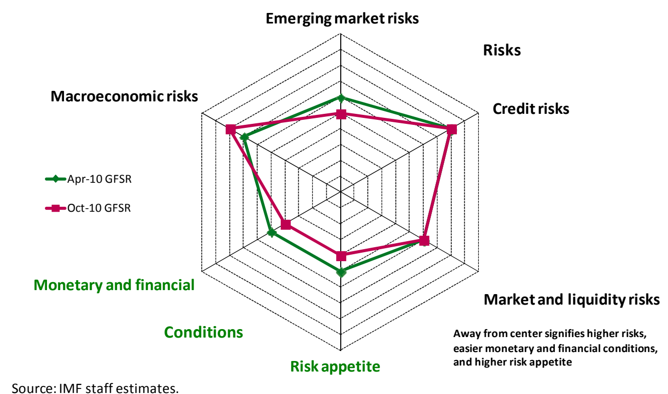
The financial sector remains the Achilles' heel of the economic recovery

- ***Our baseline scenario is for a gradual improvement in financial stability as the ongoing economic recovery continues but substantial downside risks remain.***
- ***Without further bolstering of balance sheets, banking systems remain susceptible to funding shocks that could intensify deleveraging pressures and place a further drag on public finances and the recovery.***
- ***Sovereign risks remain elevated as markets continue to focus on high public debt burdens, unfavorable growth dynamics, and linkages to the banking system.***
- ***Policy actions need to be intensified to contain risks in advanced and emerging economies, tackle the legacy challenges of the crisis for the banking system, and put in place a new regulatory and institutional landscape to ensure financial stability.***

Overall progress toward global financial stability has suffered a setback since the April 2010 GFSR as illustrated in our assessment of risks and conditions (Figure 1). The turmoil in sovereign debt markets in Europe highlighted increased vulnerabilities of bank and sovereign balance sheets and has served as a stark reminder of the close linkages between the two, as well as the potential for cross-border spillovers (Figure 2). Implicit and explicit guarantees for the banking system have heightened concerns about risk transfer between banks and the sovereign.

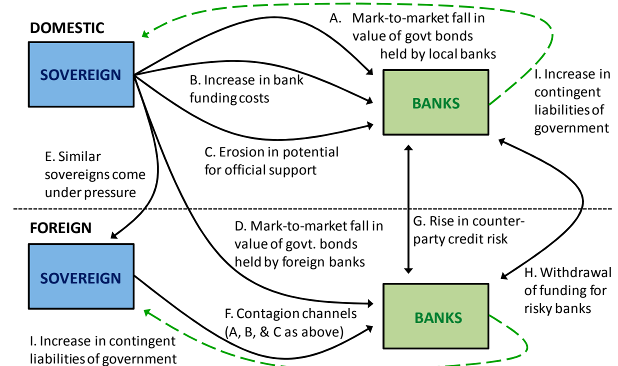
Coordinated support programs and the announcement of fiscal reforms in countries facing the greatest funding difficulties have helped contain the turmoil. The forceful response by European policymakers helped to stabilize funding markets and reduce tail risks. Nevertheless, sovereign risks remain elevated as markets continue to focus on high public debt burdens, unfavorable growth dynamics, and increased rollover risks and linkages to the banking system (Figure 3). Governments' efforts to credibly address fiscal sustainability concerns are made more

Figure 1. Global Financial Stability Map



Source: IMF staff estimates.

Figure 2. Spillovers from the Sovereign to Banks and Banks to Sovereigns

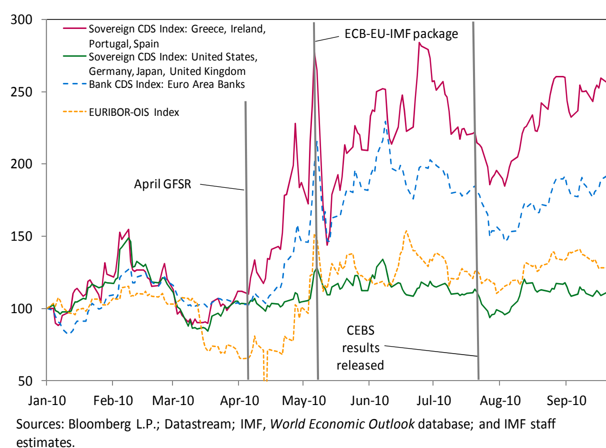


difficult by significant uncertainty about growth prospects. Medium-term debt sustainability concerns can lead to funding difficulties in the short term in the case of large public debt rollovers and difficult market conditions.

The banking system continues to build on the ongoing economic recovery. Our estimate of total crisis-related bank writedowns and loan provisions between 2007 and 2010 has now fallen from $2.3 trillion in the April 2010 *GFSR* to $2.2 trillion (Figure 4). In addition, banks have made further progress in realizing those writedowns, with more than three quarters already reported. The average Tier 1 capital ratio in the global banking system rose to over 10 percent at end-2009. In our baseline scenario, a gradual further strengthening of balance sheets is expected, with the further recovery of the economy.

Figure 3. Mature Market Credit Default Swap Spreads

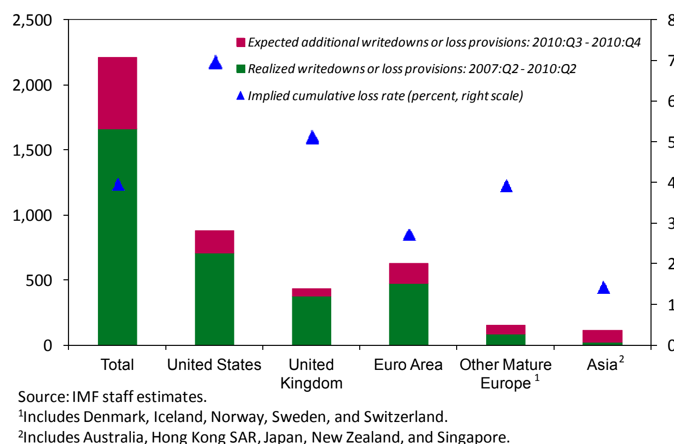
(1/1/2010=100)



Sources: Bloomberg L.P.; Datastream; IMF, *World Economic Outlook* database; and IMF staff estimates.

Figure 4. Bank Writedowns or Loss Provisions by Region

(In billions of U.S. dollars)



Source: IMF staff estimates.

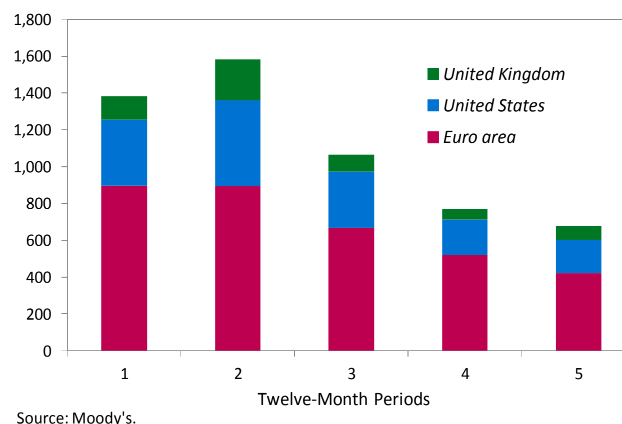
[1]Includes Denmark, Iceland, Norway, Sweden, and Switzerland.

[2]Includes Australia, Hong Kong SAR, Japan, New Zealand, and Singapore.

Yet structural weaknesses in bank balance sheets remain, leaving them vulnerable to a confidence shock. These include a high degree of reliance on wholesale funding, little progress on lengthening the maturity of funding, and continued usage by some banks of central bank liquidity support (Figure 5). To reduce the vulnerability to potential future shocks, and to break the sensitivity and interconnectedness between sovereign and bank balance sheets, additional recapitalization and higher quality capital are still required in a number of countries. If left unaddressed, these weaknesses could intensify deleveraging pressures and place a further drag on the economic recovery.

Figure 5. Bank Debt Maturity Profile

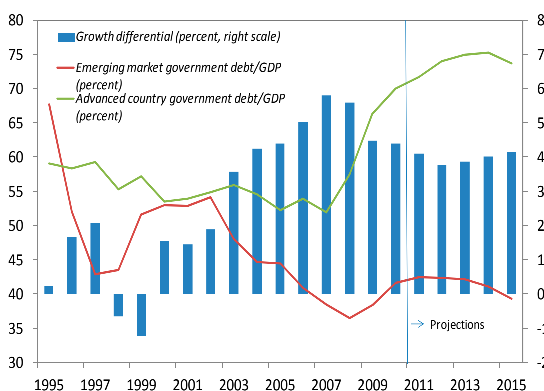
(In billions of U.S. dollars, 12-month period from July 1, 2010)



Source: Moody's.

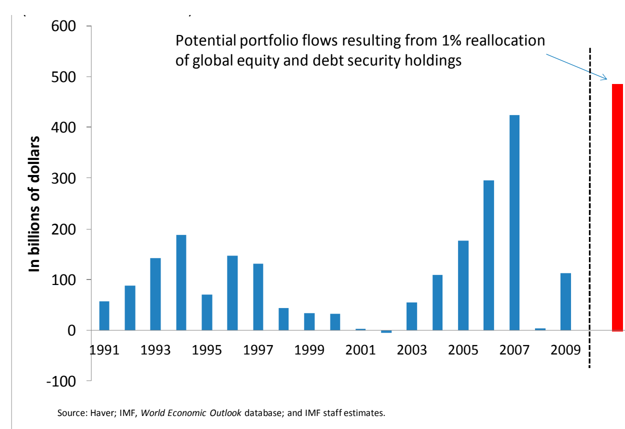
The crisis in advanced countries has shifted perceptions of risk-reward in favor of emerging markets assets, and has contributed to a reallocation of investment portfolios towards these assets. Emerging markets have become relatively more attractive compared with advanced economies because of their better fiscal fundamentals, stronger growth outlooks and higher yields (Figure 6). There is a scope for additional sizable asset reallocation to emerging markets, which could be overwhelming in some cases. The reallocation of a small proportion of financial assets of advanced countries could have very large effects on emerging market countries. A one percentage point shift of global equity and debt securities held by the world's largest real money investors would result in additional portfolio flows of $485 billion (Figure 7).

Figure 6. Government Debt and Growth Differential
(In percent)



Sources: IMF, *World Economic Outlook* database (gross government debt, median of individual country ratios); and IMF staff estimates.

Figure 7. Portfolio Flows to Emerging Markets and Developing Countries
(In billions of U.S. dollars)



Source: Haver; IMF, *World Economic Outlook* database; and IMF staff estimates.

The intertwining of sovereign and banking risk, means that policymakers need to act on several fronts to ensure a sound global financial system and to safeguard the recovery:

- ***Sovereign balance sheets need to be strengthened.*** Such plans will, of course, need to take into account country-specific circumstances, and be accompanied where necessary by growth enhancing structural reforms.
- ***Legacy problems in the banking system need to be addressed and capital buffers strengthened.*** In some countries, both inside and outside of Europe, weaker nonviable financial institutions still need to be fully resolved and forced to withdraw from unprofitable activities in order to achieve a reduction in excess capacity.
- ***Exits from extraordinary policy support need to be carefully considered.*** Central banks and governments should remain open to providing financial support, if and when needed, and make their exit strategies contingent on adequate progress on the economic and financial stability front.
- ***Further regulatory reform and clarity on measures is needed to prevent future crises.*** We welcome the Basel Committee's announcements, which entail substantial progress towards more robust bank capital and liquidity standards. But more needs to be done. It is essential to establish a broad reform agenda for the financial sector, that goes beyond the

banking industry, and that addresses systemic risks generated by individual firms and collective behavior.

- ***Many emerging market policy makers need to focus on coping with the potential side effects of the relatively favorable outlook for their countries.*** Policy measures should also focus on the continued development of local capital markets and the reinforcement of regulation and supervisory frameworks to enhance the absorptive capacity of local financial systems to safely and efficiently intermediate structurally higher capital flows.

Press Points for Chapter Two:

Systemic Liquidity Risk: Improving the Resilience of Institutions and Markets

Prepared by Jeanne Gobat, Alexandre Chailloux, Simon Gray, Andy Jobst, Kazuhiro Masaki, Hiroko Oura and Mark Stone.

Global Financial Stability Report (GFSR), October 2010

Key points

- Financial institutions and regulators failed to account for rising liquidity risks during the global crisis that were caused by increased reliance on short-term wholesale funding.
- Collateral valuation practices in the repurchase markets need to be improved. Greater use of central counterparties for repurchase transactions should also be encouraged.
- The recent proposals by the Basel Committee on Banking Supervision will help enhance liquidity cushions and lower banks' exposures to maturity mismatch risk.
- The liquidity guidelines should, in some form, include non-bank financial institutions that contribute to maturity transformation.
- Cross-border, cross-currency dimension of funding risks should be accounted for in the new liquidity regulations.

The inability of multiple financial institutions to roll over or obtain new short-term funding was one of the defining hallmarks of the crisis. Banks and non-banks financial institutions, in particular in advanced countries, increased their reliance on short-term markets for funding, exposing them to significant risks when these markets dried up. Secured lending through repurchase operations grew immensely, greasing the funding markets. Perhaps insufficiently recognized was that the wholesale providers of funds had changed—instead of banks playing a central role in intermediating unsecured funds where needed, others, such as money market mutual funds, were growing suppliers of funds while traditional more stable depositors were not. Underestimated were also the risks associated with the greater use of low quality securities as collateral for secured funding. Moreover, the crisis demonstrated that regulators, and banks themselves, had underestimated the risks emanating from the reliance on cross-border funding. This chapter outlines a comprehensive approach for dealing with systemic liquidity risk.

Policy proposals:

A number of policy proposals arise from the chapter, including the following:

- Policymakers should strengthen collateral valuation and margin practices in the secured funding markets. Important would be to have more realistic assumptions about how long it might take to sell the collateral, more frequent adjustments to collateral to avoid the problem of abrupt shortfalls in cash. Supervisors should also encourage markets to value collateral through a full credit cycle so to discourage excessive funding when values are high. Moreover, financial supervisors should periodically validate the models banks use to price collateral used to secure funding.

- Market regulators should advocate greater use of central counterparties to lower operational and counterparty risk associated with repo transactions. Central counterparties serving repo markets should be subject to minimum regulatory requirements to ensure safety and soundness. Central bank emergency liquidity should be made available to well-run central counterparties in times of systemic liquidity crisis.

- Over time, money market mutual funds should have to choose to either become mutual funds whose net asset value fluctuates, or be regulated as banks. Ensuring that investments in such funds are regularly valued at market prices would enhance investors' awareness that they bear investment risks and that their funds are different from a bank deposit in that the principal is not guaranteed and not backed by a public deposit insurance scheme.

- The agreement reached to implement the quantitative liquidity requirements as proposed by the Basel Committee on Banking Supervision in September 2010 is a significant step towards lowering liquidity risk. The rules will encourage banks to hold higher liquidity buffers and reduce the mismatch between the cash flows of their assets and payment obligations of their liabilities.

- Policymakers should also consider extending the Basel quantitative rules, in some form, to other financial institutions that, as the crisis demonstrated, can contribute to maturity transformation and a buildup of systemic risk. This would help mitigate the buildup of liquidity risks in the less-regulated "shadow banking" system.

- Policymakers should consider ensuring that foreign exchange swap facilities of central banks are readily available in the future in times of stress. This should be complemented by placing greater emphasis on the cross-border, cross-currency dimension in the new liquidity regulations.

- Finally, closer international coordination is called for to improve the collection of financial information on relevant funding markets and institutions to allow for an adequate assessment of buildup of liquidity risks in the financial system.

Press Points for Chapter Three:
The Uses and Abuses of Sovereign Credit Ratings

Global Financial Stability Report (GFSR), October 2010

Prepared by John Kiff, Allison Holland, Michael Kisser, Sylwia Nowak, Samer Saab, Liliana Schumacher, Han van der Hoorn, and Ann-Margret Westin

Key Points

- Sovereign credit ratings have inadvertently contributed to financial instability. This is because ratings are embedded in various rules, regulations and triggers, so that downgrades can lead to destabilizing knock-on and spillover effects in financial markets.
- The reliance on ratings in financial rules and regulations should be reduced, while being wary of unintended consequences.
- Rating agencies should also be discouraged from delaying rating changes, which create potential procyclical cliff effects.
- Rating agencies should pay more attention to sovereign debt composition and contingent liabilities, and sovereigns could do more to provide such information.

Credit ratings play a significant "certification" role in fixed-income markets, and are embedded in various rules, regulations and triggers, so that downgrades can lead to destabilizing knock-on and spillover effects as investors rush to buy or sell securities as credit ratings change. This was seen in the wake of the sharp downgrades of structured finance products during the recent financial crisis.

More recently, the downgrades accompanying weakened sovereign balance sheets have again drawn attention to the credit rating agencies and their rating methodologies. The problem lies not entirely with the ratings themselves. In general, ratings are fairly accurate in foretelling when a sovereign is likely to default, though more attention to sovereign debt composition and contingent liabilities could help improve their rating decisions.

Concerns have been expressed about the conflicts of interest inherent in the issuer-pay business models of the major rating agencies that allow issuers to shop for high ratings. However, an investor-pay model can also give rise to conflicts of interest. For example, investors might pressure rating agencies to put-off downgrades to delay forced sales of securities.

Policy proposals:

A number of policy proposals arise from the chapter, including the following:

- Policymakers should work towards the elimination of rules and regulations that hardwire buy or sell decisions to ratings. They should continue their efforts to reduce their own reliance on credit ratings, and wherever possible remove or replace references to ratings in laws and regulations, and in central bank collateral policies. They should discourage the mechanistic use of ratings in private contracts, including investment manager internal limits and investment policies. However, they should recognize that smaller and less sophisticated investors and institutions will continue to use ratings.

- It is important that the authorities continue efforts to push rating agencies to improve their procedures, including transparency, governance, and the mitigation of conflict of interest. In particular, those agencies whose ratings are used in the Basel II standardized approach should have to meet similar validation standards as those required for banks that use their own internal ratings.

- Rating agencies should be discouraged from over-smoothing the downgrades that their analysis would imply since that merely delays what is likely to be inevitable, and create potential cliff effects.

- In addition, sovereigns could do more to provide relevant and timely data to enable market participants to conduct their own independent credit analysis. This should include disclosure of contingent liabilities. In that regard, the IMF has been encouraging countries to prepare and make publicly available a fiscal risk statement.