

EXECUTIVE SUMMARY

Chapter 1: Acute Risks Reduced: Actions Needed to Entrench Financial Stability

Global financial and market conditions have improved appreciably in the past six months, providing additional support to the economy and prompting a sharp rally in risk assets. These favorable conditions reflect a combination of deeper policy commitments, renewed monetary stimulus, and continued liquidity support. Together, these actions have reduced tail risks, enhanced confidence, and bolstered the economic outlook. However, as global economic conditions remain subdued, the improvement in financial conditions can only be sustained through further policy actions that address underlying stability risks and promote continued economic recovery. Continued improvement will require further balance sheet repair in the financial sector and a smooth unwinding of public and private debt overhangs. If progress in addressing these medium-term challenges falters, risks could reappear. The global financial crisis could morph into a more chronic phase, marked by a deterioration of financial conditions and recurring bouts of financial instability.

The Euro Area Crisis: Acute Risks Have Declined, Much Work Lies Ahead

In the euro area, acute near-term stability risks have been reduced significantly. Funding conditions in the markets for sovereign, bank, and corporate debt have improved. Despite this notable progress, many banks in the euro area periphery remain challenged by elevated funding costs, deteriorating asset quality, and weak profits. Credit transmission remains weak in several economies, as bank balance sheet repair is uneven, while fragmentation between the core and periphery of the euro area persists. Corporations in the periphery are directly affected by bank balance sheet weakness, cyclical headwinds, and, in many cases, their own debt overhangs.

The analysis presented in this report suggests that the debt overhang at listed companies in the euro area periphery is sizable—up to one-fifth of debt outstanding. To limit the extent of required deleveraging in the corporate sector, continued efforts to reduce fragmentation and lower funding costs, as well as ongoing restructuring plans to improve productivity, are essential. In addition, a combination of asset sales or cutbacks in dividends and investment may be needed to reduce debt burdens.

Banking Challenges: Deleveraging, Business Models, and Soundness Challenges

Banks in advanced economies have taken significant steps to restructure their balance sheets, but progress has been uneven, as systems are at different stages of repair. The process is largely completed in the United States, but it requires further efforts for some European banks. Banks in the euro area periphery, in particular, face significant challenges that are impairing their ability to support economic recovery. Balance sheet pressures are less acute for other European banks, but the process of de-risking and deleveraging is not complete. For banks in emerging market economies, the main challenge is to continue supporting growth while safeguarding against rising domestic vulnerabilities. The new market and regulatory environments are also forcing banks globally to reshape their business models to become smaller, simpler, and more focused on their home markets.

Rising Stability Risks of Accommodative Monetary Policies

The use of unconventional monetary policies in advanced economies continues to provide essential support to aggregate demand. These policies are generating a substantial rebalancing of private investor portfolios toward riskier assets, as intended. However, a prolonged period of extraordinary monetary accommodation could push portfolio

rebalancing and risk appetite to the point of creating significant adverse side effects. While the net benefits of unconventional policies remain highly favorable today, these side effects must be closely monitored and controlled. Of particular concern is the possible mispricing of credit risk, riskier positioning by weaker pension funds and insurance companies, and a rise in liquidity risk, particularly in countries where recoveries are more advanced. Corporate leverage is rising in the United States and is already about one-third of the way through a typical cycle. Other spillovers include excessive capital flows into emerging market economies, where corporations—which generally have sound finances at present—are taking on more debt and foreign exchange exposure in response to low borrowing costs. More broadly, the favorable funding environment for emerging market economies might breed complacency about growing challenges to domestic financial stability. Valuations have not yet reached stretched levels (except in a few hot spots), but sensitivity to higher global interest rates and market volatility has increased across asset classes, including in emerging market economies. A prolonged period of continued monetary accommodation will increase vulnerabilities and sensitivity to a rise in rates.

Reinvigorating the Regulatory Reform Agenda

Although much has been done to improve global and national financial sector regulations, the reform process remains incomplete. Banking sectors are still on the mend, and the pace of reform has appropriately been moderated to avoid making it harder for banks to lend to the economy while they are regaining strength. But the pace of the reform process also reflects difficulties in agreeing on the way forward on key reforms due to concerns about banks facing more structural challenges.

Delays in completing the reform agenda are not only a source of continued vulnerability, but also a source of regulatory uncertainty that may impact the willingness of banks to lend. They foster the proliferation of uncoordinated initiatives to directly constrain banking activity in different jurisdictions, given the strong political imperatives to take action. Such initiatives may be inconsistent with the efforts

to harmonize minimum global standards and may hamper, rather than complement, the effectiveness of the G20 reform agenda.

Policymakers must therefore take decisive action to restructure weak banks and encourage the buildup of the new capital and liquidity buffers as part of the implementation of Basel III rules on an internationally consistent basis. Improved financial reporting and disclosures by banks remain essential to promote better transparency and prudent and consistent valuation of risk-weighted assets. Enhanced disclosure will help improve market discipline and restore confidence in banks. Effective resolution regimes also need to be established to allow for the orderly exit of unviable banks, including effective cross-border agreements for winding down failing cross-border banks. Finally, further work is needed on the too-big-to-fail problem, over-the-counter derivatives reform, accounting convergence, and shadow banking regulation.

What is needed now is a renewed political commitment at the global and national levels to complete the reform agenda. This commitment is critical to minimize regulatory uncertainty and arbitrage, and to reduce financial fragmentation. Without greater urgency toward international cooperation and comprehensive bank restructuring, weak bank balance sheets will continue to weigh on the recovery and pose ongoing risks to global stability.

Policies for Securing Financial Stability and Recovery

Further policy actions are needed to address balance sheet weaknesses in the private and public sectors, improve the flow of credit to support the recovery, and strengthen the global financial system. These actions should continue to be supported by accommodative monetary policies.

In the *euro area*, the priorities are bank balance sheet repair and steps toward a stronger financial oversight framework within the European Union.

- Bank balance sheets and business models need to be strengthened to improve investor confidence, reduce fragmentation, and improve the supply of credit for solvent small and medium-sized

enterprises. Enhanced disclosure for banks and conducting selective asset quality reviews will help restore confidence in bank balance sheets and improve market discipline.

- To anchor financial stability in the euro area and for ongoing crisis management, fast and sustained progress toward an effective Single Supervisory Mechanism (SSM) and the completion of the banking union are essential. A Single Resolution Mechanism should become operational at around the same time as the SSM becomes effective. This should be accompanied by agreement on a time-bound road map to set up a single resolution authority and common deposit guarantee scheme, with common backstops. Proposals to harmonize capital requirements, resolution, common deposit guarantee schemes, and insurance supervision frameworks at the European Union level should be implemented promptly. Modalities and governance arrangements for direct recapitalization of banks by the European Stability Mechanism should also be established.
- The developments in Cyprus underscore the urgency for completing reforms across the euro area in order to reverse financial fragmentation and further strengthen market resilience.

On a *global level*, vigilance is needed to ensure that accommodative monetary policies and an extended period of low rates do not give rise to fresh credit excesses. This is particularly important in the case of the United States. Financial supervision should be tightened to limit the extent of such excesses; and regulation will need to play a more proactive role in this cycle at both the macro- and microprudential levels. Restraining a too rapid rise in leverage and encouraging prudent underwriting standards will remain key objectives.

In *emerging market economies*, policymakers must remain alert to the risks stemming from increased cross-border capital flows and rising domestic financial vulnerabilities.

Together, these policies will consolidate the recent gains in financial stability, strengthen the global financial system, and support continued improvement in the economic outlook.

Chapter 2: Sovereign Credit Default Swaps

The debate about the usefulness of markets for sovereign credit default swaps (SCDS) intensified with the most recent bout of sovereign stress in the euro area. Chapter 2 takes a closer look at whether SCDS markets are good market indicators of sovereign credit risk and whether they provide valuable protection to hedgers; or whether they are prone to speculative excesses and lead to higher sovereign funding costs and financial instability. The chapter finds that many of the negative perceptions are unfounded. The markets for both SCDS and sovereign bonds are similar in their ability to reflect economic fundamentals and market factors. SCDS markets tend to convey new information more rapidly than do the markets for government bonds during periods of stress, although not during other times; but SCDS markets do not appear to be more prone to high volatility than other financial markets. While overshooting was detected in some euro area SCDS markets during the latest bout of stress, there is little evidence that “excessive” increases in a country’s SCDS spreads generally lead to higher sovereign funding costs. The question of whether SCDS markets are more likely to be contagious than other markets is difficult to answer because sovereigns and financial institutions are now more interconnected, and hence the risks embedded in SCDS cannot be readily isolated from the risk of the financial system.

The chapter’s results do not support the need for a ban on “naked” SCDS protection buying, which went into effect in the European Union in November 2012. The policy initiatives underlying the over-the-counter derivatives reforms—mandating better disclosure, encouraging central clearing, and requiring the posting of appropriate collateral—should help to allay concerns about spillovers and contagion that may arise in these derivatives markets.

Chapter 3: Do Central Bank Policies since the Crisis Carry Risks to Financial Stability?

Chapter 3 returns to the issue of unconventional monetary policy and its potential side effects with further in-depth analysis. The chapter investigates the policies as pursued by four central banks (the

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Federal Reserve, Bank of England, European Central Bank, and Bank of Japan), which include a prolonged period of low real policy interest rates and a host of unconventional measures including asset purchases. The policies, termed “MP-plus” in the chapter, appear to have lessened banking sector vulnerabilities and contributed to financial stability in the short term—in line with the intentions of the central banks. So far, central bank intervention in specific asset markets has not adversely affected market liquidity. MP-plus policies have improved some indicators of bank soundness, although the evidence suggests some reluctance by banks to clean up their balance sheets. Although potential risks raised

by MP-plus in the banking system so far appear relatively benign, policymakers should be alert to the possibility that risks may be shifting to other parts of the financial system—shadow banks, pension funds, and insurance companies—due in part to increasing regulatory pressures on banks. Policymakers should use targeted micro- and macroprudential policies to mitigate emerging pockets of vulnerability (identified in Chapter 1) that are likely to increase the longer that MP-plus policies are in use. Implementing macroprudential policies in a measured manner, as needed, would allow central banks to continue to use MP-plus to support price stability and growth while protecting financial stability.