ANNEX

SUMMING UP BY THE ACTING CHAIR

The following remarks by the Acting Chair were made at the conclusion of the Executive Board's discussion of the Global Financial Stability Report *on September 14, 2009.*

Executive Directors agreed that systemic risks have been substantially reduced since the April 2009 *Global Financial Stability Report* (GFSR), following unprecedented, concerted policy actions and recent signs of economic recovery. The immediate outlook for the financial system has improved, and extreme tail risks have abated. Financial markets have rebounded; emerging market risks have eased; banks have raised capital; and wholesale funding markets have reopened. Nevertheless, loan losses continue to rise and credit channels remain impaired and are often heavily reliant on official support. Moreover, the risk of a reintensification of adverse feedback between the real and financial sectors remains significant as long as banking systems remain under strain and market dysfunction places a drag on recovery. Repair of financial sector balance sheets remains an urgent priority.

Directors noted that in the United States and Europe, the two areas most affected by the crisis, difficult challenges still lie ahead. While the GFSR's estimates of securities-related bank losses have declined with tighter credit spreads, global banks could see sizable further writedowns over the next 18 months. U.S. banks are more than halfway through the anticipated loss cycle, while loss recognition in Europe is estimated to be less advanced, reflecting differences in the economic cycle and a higher proportion of loans in assets. Directors welcomed the cooperative approach that staff initiated with central banks and bank supervisors, particularly in Europe, to improve the quality of data on which to base estimates of bank losses. At the same time, they pointed to remaining weaknesses in data and methodology, underscoring the need to further enhance transparency and to interpret and communicate the loss estimates carefully. Some Directors felt that the estimates would be better presented in the form of a range rather than as point estimates. Directors also noted the potential risks arising from the sizable refinancing requirements for bank debt over the next two years, and the possibility that corporate default rates could be higher than projected.

Directors acknowledged the recent improvements in the capital position of the banking system. Nonetheless, stronger earnings are not expected to offset fully prospective writedowns; banks' balance sheets remain under deleveraging pressure; and banks will need to raise capital over and above regulatory requirements in order to provide credit in support of the recovery. Directors also noted staff's projections that after absorbing record sovereign issuance, the financial system's capacity could be strained to meet even anemic private sector demand, possibly leading to a "financing gap" for mature market credit. Some Directors questioned the size of both the projected capital needs and this "financing gap." Nevertheless, despite the uncertainties, Directors saw these projections as underscoring the need for continued official support in the period ahead, and sustained further efforts to revive credit and revitalize financial intermediation.

In emerging markets, Directors noted that tail risks have declined as a result of strong policy measures, high reserve cushions, and swap arrangements with major central banks. The increase in IMF resources, the revamping of its lending framework, the provision of

IMF credit to the hardest-hit countries, and the Special Drawing Rights allocation have further enhanced confidence and helped decrease macroeconomic risks. Asia and Latin America have benefited most from the stabilization of core financial markets and a recovery in portfolio inflows. Despite a substantial easing in financial stresses, vulnerabilities in emerging Europe remain high, although risks differ substantially among the countries in the region. An orderly adjustment of bank, corporate, and household balance sheets should continue to be fostered.

Turning to policy implications, Directors agreed that the near-term focus should be on further improvements in the levels and quality of bank capital and liquidity buffers and cleansing troubled assets from bank balance sheets, while maintaining financial and fiscal policy interventions. At the same time, authorities should start developing credible plans for withdrawing these interventions. This will involve the articulation and communication of clear plans on how policy interventions in the financial sector will be withdrawn and of credible strategies to ensure medium-term sustainability of the public finances. Directors stressed that proper timing and phasing of implementation will be critical to avoid jeopardizing economic recovery and future financial sector resilience. At the same time, several Directors also saw a need to assess carefully the risks of a belated withdrawal of government support.

For the medium term, Directors agreed that policies should (i) provide clarity over the path of regulatory reform to reduce threats to financial stability and excessive risk-taking and restore market discipline; (ii) make progress on developing macro-prudential policy frameworks to address procyclicality, along with strengthened supervision at the micro level; and (iii) define systemically important financial institutions with the objective of identifying systemic risks, and mitigating them through enhanced supervisory requirements and, possibly, through surcharges. Some Directors considered that capital surcharges may not be the best instrument, pointing to the difficulty of assessing the contribution to systemic risk, and the potential to raise the cost of credit. Directors urged to build on the current reform momentum to step up implementation.

Directors stressed that, in continuing policy interventions and planning for their withdrawal, as well as in designing regulatory reforms, international coordination will be vital to ensure a consistent approach and help avoid regulatory arbitrage, competitive distortions, and financial protectionism. The IMF will continue to have a critical role to play in fostering coordination in collaboration with other international bodies. It is particularly well placed to identify vulnerabilities, assess implementation of agreed policies, and provide timely advice and capacity-building.

Turning to the GFSR's analytical chapters, most Directors agreed that the revival of securitization would play an important role in the normalization of financial intermediation. Restarting securitization on a sounder footing will, however, critically require improving accounting, disclosure, and transparency requirements throughout the intermediation chain, and reducing investors' excessive reliance on credit rating agencies. Proposals regarding higher capital charges, risk retention by issuers, sound remuneration policies, greater disclosure, and more consistent accounting treatment of off-balance-sheet entities are aimed in the right direction, although the interactions between these proposals warrant careful examination for unintended outcomes. Directors also stressed the importance of sufficient product simplification and standardization to improve transparency and risk assessments. A number of Directors highlighted the advantages of covered bonds as a reliable, cost-efficient funding instrument. However, it was noted that covered bonds are not a substitute for securitization because they do not involve the transfer of assets out of bank balance sheets.

Directors welcomed the presentation in Chapter 3 of various means of determining the extent to which certain crisis measures have been effective. Some Directors noted that the event studies do not capture the full effects and the cumulative impact of policies. Overall, the early signs on the long-term effects of interventions appear to be promising, if still inconclusive. Directors supported the view that disengagement from crisis measures should be guided by the return of confidence in the health of financial institutions and markets. While there is no single optimal exit strategy, given that economic and financial conditions differ across countries, the principles laid out by the staff were generally seen as providing useful guidance on how to unwind crisis interventions.