Press Points for Chapter 1: ***Navigating the Financial Challenges Ahead***

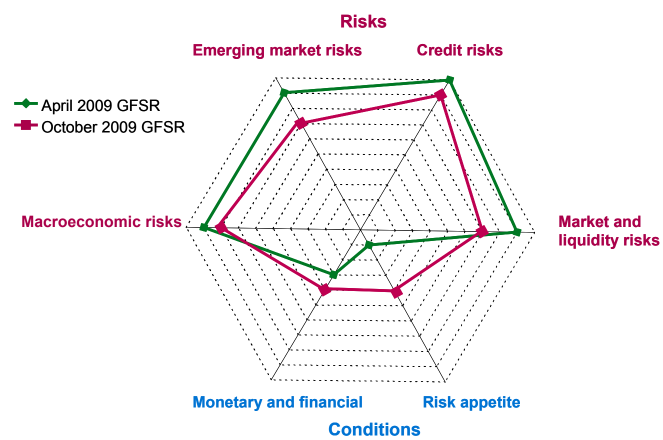
Global Financial Stability Report (GFSR), October 2009

Key messages

- **Global financial stability has improved, but risks remain elevated.**
- **Estimated global losses have improved to $3.4 trillion. However, further deterioration in banks' loans is to come—over half of their writedowns are still to be recognized.**
- **Policymakers face considerable near-term challenges. These include ensuring sufficient credit growth to support economic recovery; devising appropriate exit strategies; and managing the risks arising from heavy public borrowing.**

Global financial stability has improved following unprecedented policy actions and signs of economic recovery. Still, overall risks remain elevated and the risk of reversal remains significant (Figure 1). Our estimate of global losses arising from the crisis for 2007-10 now stands at roughly $3.4 trillion (around $600 billion lower than the last GFSR), largely due to rising securities values.

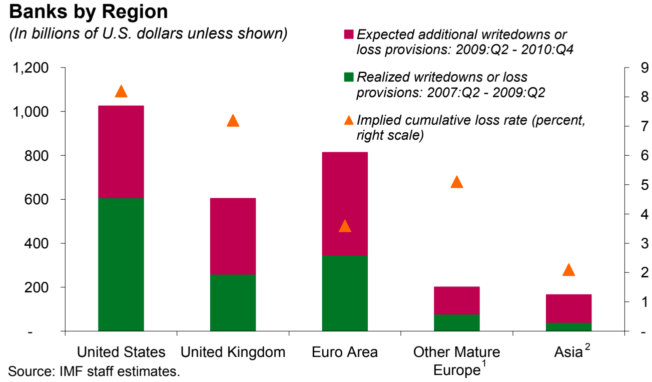
Figure 1. Global Financial Stability Map



Source: IMF staff estimates.
Note: Closer to center signifies less risk, tighter monetary and financial conditions, or reduced risk appetite.

Financial institutions continue to face three main challenges—rebuilding capital, strengthening earnings, and weaning themselves off government funding support. Securities writedowns by financials have begun to taper, but credit deterioration will continue to lead to higher loan losses over the next few years. Bank writedowns on holdings of loans and securities realized between mid-2007 and mid-2009 have amounted to $1.3 trillion. We estimate that $1.5 trillion of actual and potential writedowns through end-2010 has yet to be recognized (Figure 2). While the capital positions and outlook for banks have improved significantly since the last GFSR, earnings are not expected to fully offset forthcoming writedowns. Banks have enough capital to survive, but they remain under deleveraging pressure. With steady-state earnings likely to be lower in the post-crisis environment, stronger action is needed to bolster bank capital and earnings capacity to support lending.

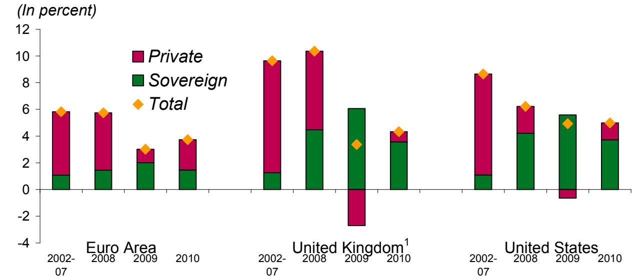
Figure 2. Realized and Expected Writedowns or Loss Provisions for Banks by Region
(In billions of U.S. dollars unless shown)



Source: IMF staff estimates.
[1]Includes Denmark, Iceland, Norway, Sweden, and Switzerland.
[2]Includes Australia, Hong Kong SAR, Japan, New Zealand, and Singapore.

Private sector credit growth has continued to contract across the major economies as weak activity and household deleveraging restrain private sector credit demand and the financing capacity of both the bank and nonbank sectors remains limited (Figure 3). However, total borrowing needs are not decelerating as rapidly, due to burgeoning public sector deficits. The likely result is constrained credit availability. Continued support by central banks may be required to help alleviate this constraint.

Figure 3. Growth of Nonfinancial Sector Debt: History and Projected Borrowing Needs
(In percent)

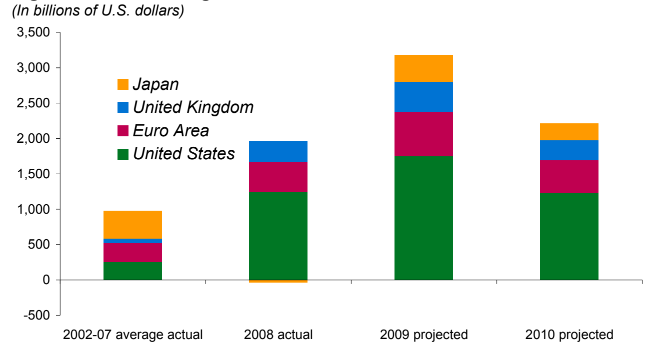


Source: IMF staff estimates.
Note: Data for 2002-07 represent average annual totals while 2009 and 2010 are projected borrowing needs. Total growth is broken down into private and sovereign contributions.
[1]There was no reliable fit for corporate credit demand in the United Kingdom, so the U.S. model was used as a proxy.

Tail risks in emerging markets have declined as a result of strong policy measures. Asia and Latin America have benefited most from the stabilization of core markets and a recovery in portfolio inflows. However, refinancing and default risks in the corporate sector remain relatively high, with corporates facing a foreign-currency debt refinancing burden of $400 billion in the next two years. The situation is most acute in emerging Europe, where corporate revenues are declining sharply as a result of the recession and several large defaults have already occurred, but is also a concern for smaller, leveraged corporations in Asia and Latin America. Countries heavily dependent on external financing and cross-border funding are most vulnerable.

The transfer of risk from the private sector to public balance sheets raises concerns that longer-term interest rates may face upward pressure unless governments credibly commit to medium-term fiscal sustainability and anchor expectations. While net sovereign issuance is expected to decline in 2010–12 relative to the projections for 2009, it is likely to remain well above the 2002–07 average, as fiscal deficits remain high (Figure 4). Historical panel data analysis indicates that a persistent 1 percentage point increase in the fiscal deficit relative to GDP leads to a 10 to 60 basis point increase in long-term interest rates.

Figure 4. Net Sovereign Debt Issuance in Mature Markets
(In billions of U.S. dollars)



Source: IMF staff estimates.
Note: Numbers are converted to U.S. dollars at current exchange rates. Net issuance includes bonds and bills.

While systemic risks have declined, the policy challenges are significant. Policymakers need to (i) ensure sufficient credit growth to support the nascent economic recovery; (ii) devise appropriate exit strategies; (iii) manage risks associated with sovereign balance sheet pressures; and (iv) maintain a balance between regulation and market forces in reducing future systemic risks. Moving toward the medium-term, policymakers should seek to restore market discipline, address risks posed by systemic institutions, institute a macroprudential policy approach, and strengthen the oversight of cross-border financial institutions.

Press Points for Chapter 2:
Restarting Securitization Markets: Policy Proposals and Pitfalls

Global Financial Stability Report (GFSR), October 2009

Prepared by John Kiff, Jodi Scarlata, Andreas Jobst, and Michael Kisser

Key points

- Sound securitization provides important benefits—to allocate credit more efficiently, transfer credit risk away from banking sector to more diversified investors, and more finely tailor risks and returns to potential end investors.

- Failure to restart securitization would come at the cost of prolonged bank funding pressures and a diminution of credit, and a continuing need for central banks and governments to take up the slack.

- The new model of sound securitization should leave behind the "high octane" markets of the past and establish markets that reliably fulfill lender funding needs without increasing product complexity and ramped up leverage.

- The variety of proposals to restart sustainable securitization—increased capital requirements, tighter accounting standards for off-balance sheet entities, retention requirements, and enhanced disclosure requirements—all move in the right direction.

- However, if all are implemented in combination, the interaction of these proposals could make restarting securitization too costly. Impact studies should be conducted before such proposals go into effect to ensure that, in combination, they foster—not suffocate—sound securitization.

The soaring securitizations seen during 2005-07 resulted from misaligned incentives from a variety of sources—issuers and credit rating agencies interacted to overrate securities, regulatory and accounting arbitrage motivated inappropriate investment structures and products, and short-term-focused performance-based compensation boosted issuance. Many investors also failed to apply proper due diligence to their securitization positions, often because the information required to do so was not freely available. When all these weaknesses came to the fore—seen, in part, in mounting defaults by borrowers and a breakdown in pricing—securitized product prices and issuance plummeted and much of the market effectively shut down in 2008 and 2009.

This chapter examines the rise and fall of private-label securitization markets and evaluates the various initiatives aimed at restarting them on a sustainable basis. These proposals aim to correct misaligned incentives and opportunities for regulatory arbitrage, which have encumbered the efficient distribution of risk, weakened market discipline, and induced slippage in both underwriting and monitoring standards. Proposals under discussion include increased regulatory capital charges, tighter accounting standards for moving assets off-balance sheet, increasing retention requirements for originators, and enhanced disclosure requirements.

In particular, the chapter evaluates initiatives put forward in both the United States and Europe to introduce a minimum 5 percent retention requirement for originators to have more "skin in the game," ensuring that someone takes responsibility for diligent underwriting and monitoring. The chapter demonstrates that flexible implementation is required to achieve a broad-based alignment of incentives, because as default probabilities change, as well as economic conditions and loan qualities, originators of securitized products have varying incentives to screen loans.

Policy proposals

Several policy proposals arise from the chapter, some of which encompass activities already under consideration and which also build on earlier GFSR proposals.

- Policies should reduce incentives for "rate shopping" and for ratings-related arbitrage of regulatory requirements, including by having ratings agencies disclose their methodologies and publish their rating performance data, and reducing regulatory reliance on ratings.

- Retention requirements should be tailored to the type of financial product, its underlying risks, and forward-looking economic conditions—barring this, policymakers should choose a second-best retention scheme that covers most outcomes.

- Financial statement disclosure and transparency should be enhanced, especially as regards off-balance sheet exposures. However, disclosures should concentrate on materially relevant information and not overburden securitizers or investors with irrelevant data.

- Securitizer compensation should be revised toward a longer-term horizon and recent changes to accounting standards for securitizations move us closer to this goal.

- Securitized products should be simplified and standardized in order improve liquidity, ensuring prices better reflect actual transactions.

A fundamental message of this chapter is that, although individually all of these measures are aimed in the right direction, before they are implemented, their interaction needs to be carefully evaluated. Impact studies should be conducted to ensure that, in combination, they promote sustainable securitization.

Press Points for Chapter 3: ***Market Interventions During the Financial Crisis: How Effective and How to Disengage?***

Global Financial Stability Report (GFSR), October 2009

Prepared by Effie Psalida, Wouter Elsenburg, Andreas Jobst, Kazuhiro Masaki and Sylwia Nowak

Key points

- **While it is too early for a comprehensive assessment of the long-term effectiveness of crisis interventions, the empirical analysis in this chapter indicates that crisis intervention announcements have been effective in calming distressed financial markets.**

- **As measured by their short-term goal of calming markets, announcements of liquidity support were most effective during the early phases of the crisis, while bank recapitalization and asset purchases by the authorities were most effective in later stages.**

- **As regards long-term effectiveness, our initial conclusions are that the market prices of some financial instruments have started to stabilize and that debt issuance is picking up in response to the public sector's unprecedented crisis measures.**

- **Disengagement from crisis interventions should be guided by the return of lasting confidence in the health of financial institutions and markets. Clear communication about unwinding—not only when to start, but how the entire process is designed is important for retaining market stability and managing expectations.**

This chapter assesses the extent to which interventions announced and undertaken by the authorities of major advanced economies during the current financial crisis have been effective in calming distressed markets and restoring financial stability. Together with a preliminary examination of the longer-term impact of these interventions on their intended target markets, the chapter also discusses disengagement from these crisis interventions by touching upon issues of timing, sequencing, and market distortions.

The chapter addresses three main questions:

How effective were the announcements of crisis interventions in calming markets?

Receding stress in the banking sector and some return to self-sufficiency in the most impaired debt markets are promising signs that the most sweeping public sector interventions in the financial sector since the Great Depression have helped rein in concerns about systemic risk. Policy responses to the crisis were rapid and, to some extent, effective in calming financial markets and restoring market functioning.

The analysis was based on an event study of policy announcement in 13 advanced economies over a two-year period (June 2007 to June 2009). The conclusions of this event study are that in an environment of high market uncertainty and counterparty risks, such as that in the early phase of the crisis when concerns were primarily about funding liquidity, liquidity support was most effective in calming financial markets.

As the crisis evolved from one of liquidity to one of solvency, announcements of bank recapitalization and asset purchases by the authorities were most effective as these measures helped alleviate credit risk.

What is the longer-term effectiveness of crisis interventions?

Although it is too early for a comprehensive assessment of long-term effectiveness, there are several aspects one can usefully evaluate in the interim. The chapter examined longer-term effectiveness by looking at volumes of issuance and general price movements of the financial instruments that the authorities have attempted to influence. While tying the specific policy interventions to longer-term effectiveness is very difficult due to intervening events and other confounding factors, the initial conclusions are that some market prices are stabilizing and debt issuance is picking up.

When and how should the public sector disengage from crisis measures?

In general, disengagement of crisis interventions in the financial system by central banks and governments should be guided by the return of lasting confidence in the health of financial institutions and markets. Since economic and financial conditions differ across countries, there is not a common template for when and in what order the public sector should unwind the facilities put in place during the crisis.

That said, some general principles do apply.

1. The strategy for the timing and the manner of unwinding crisis measures should include managing market expectations and having a clear communication on both when to start and on how to execute the unwinding strategies.

2. It is important to plan on averting arbitrage opportunities either across sectors or across national borders. For example, it is preferable, where possible, for countries to coordinate the unwinding of government guarantees on bank debt issuance.

3. For government financial sector measures, priority should be given to exiting from support programs that have a significant distortionary impact on financial markets and involve large contingent liabilities for the government. Still, the timing and modalities of these decisions would need to be balanced against the condition of financial markets and, specifically, how illiquid or fragile they may still be.