

EXECUTIVE SUMMARY

The global financial system is still in a period of significant uncertainty and remains the Achilles' heel of the economic recovery. Although the ongoing recovery is expected to continue under the baseline scenario, resulting in a gradual strengthening of balance sheets, progress toward global financial stability has experienced a setback since the April 2010 Global Financial Stability Report (GFSR). The recent turmoil in sovereign debt markets in Europe highlighted increased vulnerabilities of bank and sovereign balance sheets arising from the crisis. The financial situation has subsequently improved, owing to the forceful response by policymakers which helped to stabilize funding markets and reduce tail risk, but substantial market uncertainties persist. Global output has expanded in line with earlier projections, with growth in emerging market countries particularly strong. Mature economies are transitioning from temporary support to more self-sustaining private demand. Nevertheless, sovereign balance sheets are highly vulnerable to growth shocks, making debt sustainability less certain. In this context, policymakers must tackle the following key reforms in order to ensure a viable global financial system and safeguard the recovery: (1) deal with the legacy problems in the banking sector, including, where necessary, recapitalization; (2) strengthen the fundamentals of sovereign balance sheets; and (3) continue to clarify and specify regulatory reform, building on the substantial improvements proposed by the Basel Committee on Banking Supervision (BCBS).

The setback in progress toward financial stability was precipitated by turmoil in the sovereign debt markets in Europe, where increased vulnerabilities of sovereign and bank balance sheets became the focus of market concern. Existing sovereign debt sustainability challenges, combined with concentrated short-term debt rollovers and an undiversified investor base, left some euro area sovereigns vulnerable to funding pressures. These pressures spilled over to the banking sector, increasing the likelihood of a grim scenario of shrinking credit, slower growth, and weakening balance sheets. The forceful response at the national and supranational level to address sovereign risks and strengthen confidence in the financial system, including in particular through the provision of detailed information on bank balance sheets, helped to stabilize funding markets and mitigate risks, but conditions remain fragile.

Chapter 1 of this report presents an analysis of the challenges facing advanced countries as they deal with the juxtaposition of a slower recovery, higher debt levels and rollovers, and a still-impaired financial sector. The report starts from the premise that private and sovereign balance sheets will continue to strengthen in a gradually improving economic environment and that policy measures to address legacy problems in key banking systems are implemented alongside important stabilization policies. Nonetheless, higher downside macroeconomic risks, sovereign financing pressures, and intensifying funding strains could produce a difficult environment, requiring adept policy maneuvering.

In Europe, coordinated support programs and the announcement of ambitious fiscal reforms in countries facing the greatest funding difficulties helped contain the turmoil in the euro area after its rapid escalation in May. Nevertheless, sovereign risks remain elevated as markets continue to focus on high public debt burdens, unfavorable growth dynamics, increased rollover risks, and linkages to the banking system. Second-tier institutions and banks in countries whose sovereign spreads remain under pressure continue to have only limited access to funding markets and face rising costs. Although governments have put in place national and supranational backstops to ensure that

markets remain open, continuing forceful policy measures are needed to remain firmly on track toward building financial system resilience.

In the United States, financial stability has improved, but pockets of vulnerability remain in the banking system. Although banks have been able to raise a substantial amount of capital, and expected demands appear manageable, some raising of additional capital may be needed to reverse recent deleveraging trends and possibly to comply with U.S. regulatory reforms. Weakness in the real estate sector constitutes an additional challenge in the United States. To a large extent, the apparently modest capital needs of U.S. banks reflect the large scale of government-sponsored enterprises and other government interventions without which those needs would have been substantially higher. This highlights the extent to which risk has been transferred from private to public balance sheets, as well as the need to address the burden placed on public institutions.

In Japan, a near-term disruption in the government bond market remains unlikely. So far, the stable domestic savings base and healthy current account surplus reduce the need to attract external funding sources. Over time, the factors presently supporting the Japanese bond market—high private savings, home bias, and the lack of alternatives to yen-denominated assets—are expected to erode as the population ages and the workforce declines.

Overall, emerging markets have proven very resilient to sovereign and banking strains in advanced economies, and most have continued to enjoy access to international capital markets. Cross-border spillover effects were mostly confined to regions with significant economic and financial links to the euro area. With the current slowdown in growth in advanced countries, emerging markets, in general, have become increasingly attractive to investors because of their relatively sound fundamentals and stronger growth potential. This shift in global asset allocation is likely to increase as long as this relative difference persists. However, a potential buildup of macro-financial risks stemming from strong capital inflows—including from excess demand in local markets and possible increased volatility—remains a concern for countries on the receiving end of this ongoing asset reallocation.

Policies to Address Risks

Policymakers in many advanced countries will need to confront the interactions created by slow growth, rising sovereign indebtedness, and still-fragile financial institutions. In addition, the foundations underpinning the new financial regulatory regime need to be put into place.

Address legacy problems in the banking system. Confidence in the financial sector has not been fully restored. On the bright side, bank regulatory capital ratios have improved and global writedowns and loan provisions have declined. Our estimate of crisis-related bank writedowns between 2007 and 2010 has fallen slightly from \$2.3 trillion in the April 2010 GFSR to \$2.2 trillion now, driven mainly by a fall in securities losses. In addition, banks have made further progress in recognizing those writedowns, with more than three-quarters of them already reported, leaving a residual amount of approximately \$550 billion. There has been less progress, though, in dealing with the imminent bank funding pressures: nearly \$4 trillion of bank debt will need to be rolled over in the next 24 months. As a consequence, exits from extraordinary financial system support, including the removal of government guarantees of bank debt, will have to be carefully sequenced and planned. Resolving and/or restructuring weaker financial institutions—through closure, recapitalization, or merger—remains a priority so that funding markets can return to normal and the industry to better health. National and supranational backstops should be available to provide support where needed.

Strengthen the fundamentals of sovereign balance sheets. In the short term, adequate supranational support should be available to sovereign balance sheets in those countries facing immediate strains. In the medium run, sovereign balance sheets need to follow a credible path to ensure fiscal sustainability (see the October 2010 *World Economic Outlook* and the November 2010 *Fiscal Monitor*). Sovereign refinancing risks should be addressed by debt management policies that lengthen the average maturity structures as market conditions permit. Managing and reducing public contingent liabilities using price-based mechanisms should also be part of the plan.

Clarify and specify regulatory reforms. Much of the proposed financial reform agenda remains unfinished. International rule-making bodies have made progress to identify the most egregious failings of the global financial system in the run-up to the crisis, but their member countries have yet to agree on many of the details of the reforms. Dealing with too-important-to-fail entities, strengthening supervisory incentives and resources, and developing the macro-prudential framework are still under discussion. Further progress will require a willingness to suppress domestic interests in favor of a more stable and better functioning global financial system. The sooner reforms can be clarified, the sooner financial institutions can formulate their strategic priorities and business models. In the absence of such progress, regulatory inadequacies will continue for some time, increasing the chances of renewed financial instability.

As part of these ongoing efforts, we welcome the recent proposals of the BCBS, which represent a substantial improvement in the quality and quantity of capital in comparison with the pre-crisis situation. In particular, common equity will represent a higher proportion of capital and thus allow for greater loss absorption. Also, the amount of intangible and qualified assets that can be included in capital will be limited (to 15 percent). These include deferred tax assets, mortgage servicing rights, significant investments in common shares of financial institutions, and other intangible assets. Phase-in arrangements have been developed to allow banks to move to these higher standards mainly through retention of earnings. As the global financial system stabilizes and the world economic recovery is firmly entrenched, phasing out intangibles completely and scaling back the transition period should be considered. This will raise banking sector resilience to absorb any future shocks that may lie ahead. Furthermore, it is essential to make progress with the overall reform agenda. Putting in place sound micro-prudential regulation is not sufficient. Appropriate regulation needs to be developed with a macro-prudential approach to dampen procyclicality and to limit the systemic effects of financial institutions, some of which are not banks.

Overall, policymakers cannot relax their efforts to reduce refinancing risks, strengthen balance sheets, and reform regulatory frameworks. As apparent on several occasions over the past three years, conditions in the global financial system now have the potential of jumping from benign to crisis mode very rapidly. Against this backdrop, policymakers should not squander opportunities to strengthen and recapitalize banking systems, address too-important-to-fail entities, reduce contingent liabilities, and place sovereigns on a credible fiscal path. With the situation still fragile, some of the public support that has been given to banks in recent years will have to be continued. Planned exit strategies from unconventional monetary and financial policies may need to be delayed until the situation is more robust. At the same time, it is important to ensure that the need for extraordinary support is temporary, as it is no substitute for repairing and reforming financial sectors, and realigning their incentives to build stronger balance sheets and reduce excessive risk taking.

For emerging markets, the policy challenges are different, with most of the financial system risks on the upside. Many will need to cope with the effects of relative success, where maintaining stability will depend on their ability to deal with surges in portfolio inflows. Traditional macroeconomic policies may need to be supplemented in some cases by macro-prudential measures as they may not be fully adequate to meet the macro-financial challenges arising from particular domestic circumstances, such as inflation pressures or asset bubbles. Policies to address high and volatile capital flows are well known (see Chapter 4 of the April 2010 GFSR and IMF Staff Position Note 10/04). Moreover, emerging markets should continue to pursue policies aimed at fostering the development of local financial systems, so that they have the capacity to absorb and safely and efficiently intermediate higher volumes of capital flows.

Chapter 2: Systemic Liquidity Risk

A defining characteristic of the crisis was the depth and duration of the systemic liquidity disruption to key funding markets—that is, the simultaneous and protracted inability of financial institutions to roll over or obtain new short-term funding across both markets and borders. Chapter 2 examines this episode and shows how banks became more vulnerable to a funding problem as a result of several factors: new suppliers of wholesale funds that were less-

stable providers; greater use of secured lending markets (repurchase agreements) based on cyclically high valuations of collateral (in particular for structured credit products) and insufficient margining processes; growing use of cross-border, short-term funding of longer-term assets in foreign currency; weaknesses in the infrastructure of associated markets; and a lack of information about counterparty risks. Importantly, many were unaware about the extent of interactions between banks and nonbank institutions in the use of short-term funding markets. Hence when central banks had to step in to stabilize markets, they had to extend liquidity to nonbanks, accept a larger diversity of collateral as protection for their lending, set up cross-border foreign currency swap lines, and engage in other actions, all of which raised moral hazard issues that remain unaddressed.

Making progress to mitigate systemic liquidity risk is difficult and not easily measured, as funding markets consist of a diverse set of institutions that interact in multiple markets, each with different infrastructure characteristics. Chapter 2 examines this issue, both for institutions and markets. Current proposals focus on micro-prudential measures aimed at improving liquidity buffers and lowering asset/liability mismatches in individual banks—the BCBS proposals being most prominent. While helpful, addressing systemic liquidity risks by raising buffers at one institution does not fully protect against a system-wide liquidity shortage. In these circumstances, central banks will likely need to step in as a liquidity provider of last resort to support markets and institutions. To avoid overuse of central bank facilities and to minimize moral hazard, the liquidity risk framework should focus on ensuring that banks and others considered important to liquidity and maturity transformation are contributing in some form to systemic risk insurance in good times. To do this effectively, a good measure of systemic liquidity risk will have to be developed. However, there are significant data gaps to be addressed in order to appropriately measure and monitor systemic liquidity risks.

Although mitigating systemic liquidity risk at the level of institutions is certainly part of the answer, funding markets also need attention. Policies to make secured funding markets, such as repurchase (“repo”) markets, function more effectively can help lower systemic risks and prevent liquidity constraints from turning into solvency concerns. Specifically, better collateral valuation rules, margining policies, and the use of central counterparties could all help to lower vulnerabilities. Preventing investor runs from money market mutual funds is also a necessary policy goal. The chapter recommends that stable net asset values (NAV) not be used for investments in such funds, in order to ensure that fund investors better understand that the value of their investments will fluctuate with market conditions. This would need to be initiated carefully and in a period of stable funding conditions to ensure that such a change does not cause the run it was meant to prevent. Other remedies, such as those suggested for banks (higher buffers and less maturity transformation), can also be used to deal with liquidity risks in these funds. In those cases where flexible NAVs are not instituted, it is crucial that such funds be subject to the same requirements as deposit-taking institutions.

Chapter 3: Credit Ratings

The recent escalation of sovereign credit risk and the ratings downgrades of structured credit instruments over the last couple of years have highlighted the financial stability implications of credit rating agencies. Does the information content provided by ratings have negative implications for financial stability, or is it the way they are used? Chapter 3 sheds light on this issue, using sovereign debt ratings as its focus.

The use of ratings is mandated in a number of regulatory environments—most notably in capital requirements for banks in the standardized approach of Basel II. Many private sector entities—pension funds, insurance companies, and mutual funds—use ratings or ratings-based indices to make investment decisions. Central banks also use ratings in their collateral policies. Shifts in asset allocations based on ratings downgrades, for instance below an investment-grade rating, can be destabilizing, causing forced sales and so-called “cliff effects” in the pricing of such securities. The chapter finds that, indeed, ratings matter for the pricing of sovereign debt and that such cliff effects are most prominent when ratings fall below the investment grade barrier. In fact, even before an actual downgrade,

early warnings via a negative “outlook” or “watch” recommendation convey even more information in advance of a downgrade and have a greater impact on market prices.

As to accuracy, sovereign ratings are found to have generally performed well. Sovereigns that have defaulted since 1975 were rated below investment-grade in the year prior to their default, suggesting that the ordinal ranking that agencies profess to use is meaningful. That said, recent changes in types of risks taken on by sovereigns (such as contingent liabilities from the banking sector) imply that better publicly available sovereign risk information would be helpful to rating agencies and investors.

The credit rating agencies have attempted to produce stable “through-the-cycle” ratings to satisfy clients who find it costly to frequently alter trading decisions that are based on ratings. The chapter shows that a typical smoothing technique used by at least one rating agency is deemed likely to contribute to procyclicality in ratings compared to a method that accurately reflects current information at a “point in time.” This is because a “through-the-cycle” approach waits to detect whether the degradation is more permanent than temporary and larger than one notch. However, this often means that the lagged timing of the downgrade accentuates the already negative movement in credit quality.

Overall the chapter suggests the following policies to lessen some of the adverse side effects that ratings and rating agencies may have on financial stability.

- First, regulators should remove references to ratings in their regulation where they are likely to cause cliff effects, encouraging investors to rely more on their own due diligence. Similarly, central banks should also establish their own credit analysis units if they take collateral with embedded credit risks.
- Second, to the extent that ratings continue to be used in the standardized approach of Basel II, credit rating agencies should be overseen with the same rigor as banks that use the internal-ratings approach—credit metrics reported, ratings models backtested, and ex post accuracy tests performed.
- Third, regulators should restrict “rating shopping” and conflicts of interest arising from the “issuer pay” business model by requiring the provision of more information to investors. A user-pay-based business model is difficult to maintain because of the inability to restrict access to ratings and their public good characteristic of aggregating difficult-to-obtain private information. Hence, mitigating conflicts of interest in the issuer-pay design through disclosure of any preliminary ratings obtained and how the ratings are paid for is preferred.