

## EXECUTIVE SUMMARY

### Short-Term Risks Have Abated

Short-term risks to global financial stability have abated since the April 2016 *Global Financial Stability Report* (GFSR). Commodity prices have risen from their lows earlier in the year, and ongoing adjustments in emerging markets have supported a recovery in capital flows. Immediate concerns over a slowdown in China have eased on the back of policy measures to shore up growth.

In advanced economies, weaker growth was mitigated by the prospect of further monetary accommodation, which supported asset prices and spurred some recovery in risk appetites. The shock of Brexit—the June 2016 U.K. referendum result in favor of leaving the European Union—initially roiled markets. Markets have subsequently adjusted smoothly to concerns about downside risks to the U.K. economy and potential spillovers.

### Medium-Term Risks Have Risen

Despite lower short-term risks, medium-term risks are building. The continued slowdown in global growth has prompted financial markets to expect an extended period of low inflation and low interest rates and an even longer delay in normalizing monetary policy. The political climate is unsettled in many countries. A lack of income growth and a rise in inequality have opened the door for populist, inward-looking policies. These developments make it even harder to tackle legacy problems, further expose economies and markets to shocks, and raise the risk of a gradual slide into economic and financial stagnation. In such a state, financial institutions struggle to sustain healthy balance sheets, which weakens economic growth and financial stability.

Financial institutions in advanced economies face a number of cyclical and structural challenges and need to adapt to this new era of low growth and low interest rates, as well as to an evolving market and regulatory environment. These are significant challenges that affect large parts of the financial system, and if unaddressed could undermine financial soundness.

- Weak profitability could erode banks' buffers over time and undermine their ability to support growth. This report finds that a cyclical recovery will not resolve the problem of low profitability. Over 25 percent of banks in advanced economies (about \$11.7 trillion in assets) would remain weak and face significant structural challenges. More deep-rooted reforms and systemic management are needed, especially for European banks. Japanese banks also face significant business model challenges. These banks are expanding abroad to offset thin margins and weak domestic demand, but this exposes them to greater dollar funding risks. A disruption of dollar funding sources could force Japanese banks to curtail their offshore lending and investment.
- The solvency of many life insurance companies and pension funds is threatened by a prolonged period of low interest rates. Low interest rates add to the legacy challenges facing many insurance companies and pension funds, along with those from aging populations and low or volatile asset returns. Heightened concern over these important long-term-saving and investment institutions could encourage even greater saving, adding to financial and economic stagnation pressures.

Emerging markets are also adapting to an environment of lower global growth, lower commodity prices, and reduced global trade. The current favorable external environment, including low interest rates and the global search for investment opportunities, presents an opportunity for overly indebted firms to restructure their balance sheets. Corporate leverage in many of these markets may be peaking, since firms have slashed investment in the wake of commodity price declines and slowing demand.

The challenge for many emerging market economies is to achieve a smooth deleveraging of weakened corporate balance sheets. Approximately 11 percent of corporate debt (over \$400 billion) is held by firms with weak repayment capacity. Indebtedness declines only gradually under our baseline scenario, as high

debt levels and excess capacity make it difficult to grow out of the problem, leaving them sensitive to downside external or domestic developments. A disorderly adjustment is still possible if global risk premiums rise and earnings fall. Such a scenario would exhaust bank capital buffers in some emerging markets.

Continued rapid credit growth in China and expanding shadow banking products pose mounting risks to financial stability. The rapidly growing financial system is becoming increasingly leveraged and interconnected, and a variety of innovative investment vehicles and products are adding to the complexity. As discussed in the April 2016 GFSR, corporate debt-at-risk remains high, and underlying risks from nonloan credit exposures add to these challenges.

### More Potent and Coordinated Policies Needed to Foster Stability

Policymakers need a more potent and balanced policy mix to deliver a stronger path for growth and financial stability. Financial markets have benefited from renewed risk appetite in the wake of unprecedented central bank actions. Although monetary accommodation is still needed to support the recovery, a more comprehensive set of policies would ease mounting burdens on central banks. Some monetary policies, such as negative interest rates, are reaching the limits of their effectiveness, and the medium-term side effects of low rates are rising for banks and other financial institutions. There is an urgent need to implement fiscal and structural policies to bolster confidence and raise global growth, and deploy macroprudential policies to strengthen the foundations of the global financial system. This could help to avoid slipping into a state of financial and economic stagnation. A financial stagnation and protectionist scenario could result in a loss of world output by about 3 percent through 2021.

A number of pressing global challenges must be addressed to ensure that the global financial system can continue to support the recovery and sustain hard-won resilience. Progress on the following fronts—together with a more balanced set of macroeconomic policies outlined in the October 2016 issues of the *World Economic Outlook* and the *Fiscal Monitor*—would help promote a virtuous cycle between financial markets and the real economy. The resolution of debt overhangs in an era of low nominal growth is also likely

to require growth-friendly fiscal policies to support economic activity and create incentives for restructuring private debt, while facilitating the repair of banks' balance sheets.

Banks must adjust to this new environment of low growth and low interest rates by reducing large stocks of legacy problem loans, and rationalizing balance sheets and industry structures. This will require adjusting dated business models in order to maintain profitability, and adapting to new business realities and regulatory standards. In some cases, weak banks will have to exit and banking systems will have to shrink. This is important to ensure that the remaining banks have sufficient credit demand to foster a vibrant and healthy banking system that can grow and sustain its strengthened capital and liquidity buffers. Policymakers can help reduce uncertainty by completing the regulatory reform agenda, without significantly increasing overall capital requirements, while preserving the integrity of the capital framework.

- In the euro area, excessive nonperforming loans and structural drags on profitability require urgent and comprehensive action. Reducing nonperforming loans and addressing capital deficiencies at weak banks is a priority. Reforms that speed up asset recovery and facilitate smoother insolvency procedures would bring large benefits. For the euro area as a whole, the net capital impact from the sale of nonperforming loans would swing from a loss of about €80 billion to a gain of about €60 billion with such reforms. Enhancing operational efficiency through rationalizing branch networks, together with an improved funding mix and cost, could improve banks' overall expenses by about \$40 billion.
- In Japan, intensified supervision is needed to ensure that banks maintain adequate profitability and healthy funding profiles to meet the demands of changing global regulatory standards.
- Regulatory uncertainty needs to be reduced and procyclical outcomes avoided. The Basel III capital adequacy framework was a key plank of the postcrisis reform agenda and has led to enhanced resilience of banking systems following its phased-in implementation. The Regulatory Consistency Assessment Program, launched to monitor consistent implementation across countries, revealed excessive risk weight variability across banks using internal models. Addressing this material variabil-

ity to ensure the credibility of the risk-weighted framework and comparability of its outcomes is an integral part of the reform agenda. It is better to obtain agreement on a robust risk-weighted capital framework, even if the agreement takes more time, than to see the framework diluted or withdrawn to meet the challenging constraints of no further significant increase in overall capital requirements and the end-2016 deadline. Implementation may also have to be phased in over a longer period to avoid potentially procyclical consequences under the current circumstances.

- Shoring up life insurers and pension funds remains critical. Sustained low growth and low interest rates raise significant challenges for long-term investment and savings institutions such as life insurers and pension funds. Regulators and supervisors should act promptly to sustain the strength of insurance and pension fund balance sheets, including identifying medium-term insolvency risks and funding gaps, while enhancing the reform agenda to strengthen standards for internal models and capital frameworks and improve transparency.

Emerging market economies should take advantage of supportive external conditions to proactively monitor and address corporate vulnerabilities, particularly those arising from excess leverage and foreign exchange exposures. Actions are needed on three fronts: (1) managing the impact of corporate distress, through swift and transparent recognition of nonperforming loans and strengthening insolvency frameworks; (2) boosting oversight and response capacity through reforms to macroprudential and supervisory frameworks; and (3) ensuring continued access to international financial services, including through strengthened regulatory and supervisory regimes that help lower risk perceptions, including those supporting correspondent banking activity.

The Chinese authorities' latest reform efforts have led to more balanced growth and a greater role for market forces, improving the resilience of the Chinese economy and financial system. Nonetheless, China's corporate debt overhang and other growing financial sector vulnerabilities must be addressed promptly through a comprehensive approach to facilitate deleveraging and upgrade the supervisory framework. Curbing excessive credit growth, including in the form of riskier shadow credit products, and ensuring

sound interbank funding structures would reduce the potential for system stress and spillovers.

Global institutions have a role to play in promoting inclusive growth and encouraging an open dialogue on globalization. Most countries would reap macroeconomic growth benefits from greater access by firms and individuals to banking services. Closing gender gaps in account usage and promoting diversity in the depositor base can have broader economic benefits while creating opportunities for the disadvantaged.

### **Monetary Policy Impact Changing, but Not Weakened by Growth in Nonbank Financing**

A notable change in global financial markets in the past decade has been the rise of nonbank financial intermediaries such as asset managers, insurance companies, and pension funds. Although concerns have been voiced about a decline in the effectiveness of monetary policy given the growing role of nonbank financing, these fears appear to be unfounded. Indeed, Chapter 2 finds that, on average, monetary policy transmission seems to be stronger in economies with larger nonbank financial sectors. Nonbanks tend to contract their balance sheets even more than banks when monetary policy tightens—a behavior partly explained by the effect of monetary policy on risk taking.

Low interest rates have probably created the conditions for more risk taking by both bank and nonbank financial intermediaries. However, the conjunction of weak bank balance sheets and stronger bank regulation could mean that nonbanks now play a more important role in the transmission of monetary policy because the risk-taking channel of monetary policy has gained importance and asset managers have assumed a greater role in financial intermediation. As a result, the effects of monetary policy changes on the real economy may become more rapid and marked. This suggests the need for greater vigilance by prudential and regulatory authorities and for central banks to continuously recalibrate the dosage and timing of monetary policy actions as their impact and the speed of their transmission change—particularly in an environment characterized by new challenges to financial stability.

Given the growth of the nonbank financial sector, the information contained in the balance sheets of nonbanks is potentially at least as useful as traditional measures of monetary aggregates. In this context, improving data collection on nonbanks is essential.

### **Further Corporate Governance Reform in Emerging Market Economies Would Help Enhance Resilience to Shocks**

Has institutional progress in emerging market economies—including corporate governance and investor protection—kept pace with their international financial integration in building their resilience to external shocks? Chapter 3 finds that corporate governance and investor protection have generally improved in emerging market economies over the past two decades. These improvements are visible both at the firm level and at the country level. Even so, there are important differences across emerging market economies, and there is room for further improvement.

The analysis shows that stronger corporate governance and investor protection frameworks enhance the resili-

ence of emerging market economies to global financial shocks—an issue of particular importance in the new phase the global financial system is entering. For example, equity price declines in the wake of Brexit were relatively larger in emerging market economies with lower corporate governance standards. Corporate governance improvements enhance stock market efficiency and foster deeper and more liquid capital markets, allowing them to absorb shocks better. Emerging market economies with better corporate governance generally also have more resilient corporate balance sheets.

Policies to further bolster the rights of outside investors, especially minority shareholders; bring disclosure requirements fully in line with international best practice; and promote greater board independence are likely to yield financial stability benefits.