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 March 26, 2008.*

Executive Directors noted that global financial stability has deteriorated markedly since the issuance of the October 2007 *Global Financial Stability Report* (GFSR). They agreed with staff that what began as a fairly contained deterioration in portions of the U.S. subprime market has spilled over rapidly into severe dislocations in broader credit and funding markets that now pose risks to the macroeconomic outlook in the United States and globally. Directors considered that the immediate priorities for policymakers are to reduce uncertainty, mitigate risks to the global financial system, and restore confidence.

Directors welcomed the GFSR as providing a timely and in-depth assessment of the deepening crisis. They found particularly useful the report's focus on the origins and evolution of the crisis, the sources of the current vulnerabilities, and macro-financial linkages. They also welcomed the wealth of data presented to underpin the conclusions, as well as the clear recommendations for both the public and private sectors, which draw a useful distinction between short-term remedial actions and more fundamental medium-term reforms. Directors underscored that, in carrying forward these recommendations, careful attention should be paid to sequencing and prioritization, to country circumstances, and to adequate coordination among the relevant international and national agencies. They emphasized the role of the IMF in contributing to these efforts, working alongside national and international institutions and bodies, including regulatory and supervisory agencies, central banks, and private sector organizations as appropriate.

Directors generally supported the report's finding that markets and investors, the official sector, and monetary authorities collectively failed to appreciate the extent of leverage taken on by a wide range of financial institutions, and the associated risks of a disorderly unwinding. Private sector risk management, disclosure, financial sector supervision, and regulation all lagged behind the rapid innovation and shifts in business models, leaving scope for excessive risk-taking, weak underwriting, and maturity mismatches. In the recent period, these systemic concerns were exacerbated by a deterioration of credit quality, inadequate incentive structure, a drop in the valuations of structured credit products, and a lack of market liquidity accompanying a broad deleveraging in the financial system.

Against this background, Directors broadly concurred with the assessment presented in the global financial stability map, which shows that macroeconomic and credit risks have increased substantially. They agreed that the significant economic slowing in the United States, along with declines in real estate prices, is now a key driver that threatens to broaden the deterioration in the household mortgage market and to spread to consumer credit, as well as to corporate high-yield debt markets. Corporate debt markets appear particularly vulnerable, as the past period of unprecedented low-tier debt issuance with weak covenants and increased leverage can boost default rates in the period ahead.

Directors shared the staff's view that systemically important financial institutions and markets are facing severe strains. Continuing uncertainty over the size and spread of losses has elevated systemic risks, notwithstanding the reported subprime-related losses to date. Potential losses arising from a broader deterioration in credit could be sizable, although some Directors argued that the effects of credit shocks could be smaller than estimated. Nonetheless, Directors generally considered that available estimates provide a valuable indicator of the sources of strains to bank capital and interbank funding markets. Directors therefore underscored the importance of ensuring that these large financial institutions continue to move quickly to repair their balance sheets by raising equity and medium-term funding, in order to boost confidence and to avoid further undermining the credit channel.

Directors noted that emerging markets and developing countries have been relatively resilient to global turmoil, reflecting policy improvements, high levels of official reserves, and terms of trade gains. That resilience could yet be tested by rising costs and tightening external funding conditions affecting the corporate and banking sectors or by a reversal of the recent commodity price boom. Directors recognized that a protracted weakening of growth in the advanced economies or a broadening of the problems in financial markets—such as a generalized increase in risk aversion—could also have an adverse impact on emerging markets, although these effects will vary depending on country circumstances. Particularly vulnerable are some emerging European countries that have experienced rapid credit growth financed externally by international bank and bond borrowings and those with high current account deficits.

Directors welcomed the staff's work on the macro-financial linkages and the feedback between the ongoing credit crisis and its impact on the real economy. Given the high risks of a global credit crunch, they considered that the potential economic impact of the present turmoil could be more pronounced than in previous credit cycles. Some Directors saw the Financial Sector Assessment Program (FSAP) exercise as a useful vehicle for enhancing the IMF's assessment of such linkages. Several Directors, while recognizing that many central banks regularly produce financial stability reports, saw merit in reflecting upon the scope for special financial stability reports issued by national authorities if they are seen as helpful in dispelling misperceptions, and filling any information gaps that add to stability risks. Directors also supported the IMF's work on developing new applications for stress tests and other risk assessment models to help identify and address vulnerabilities in individual countries as well as in a multilateral context.

Directors agreed that the immediate policy challenge is to restore counterparty confidence and reduce systemic threats and spillovers, and saw steps that focus on reducing uncertainty and strengthening confidence in mature market financial systems as the first priority. Areas for action relate to the disclosure of exposure and valuation methods, bank balance sheet repair (including raising capital), risk management, internal governance, contingency plans and early remedial actions, and strengthened supervision and regulation. Directors stressed that supervisors must be proactive in addressing weaknesses, acting promptly to require remedial action and to intervene. While recognizing that financial regulation needs to catch up with innovation, some Directors emphasized that actions to strengthen regulation should not stifle the creativity and dynamism of financial markets. A range of views was expressed on these issues, and Directors noted that specific measures would need to be geared to individual country circumstances.

Directors welcomed the detailed examination in Chapter 2 of the central role of complex structured finance products in the current crisis. It was recognized that a sound understanding of the issues surrounding the valuation and accounting of these products is important for comprehending the depth and extent of the present financial market instability. Directors generally agreed that the move toward fair value accounting for many types of financial instruments would continue, despite the apparent difficulties in implementing such valuations during the current crisis, since fair value accounting gives the most comprehensive picture of a firm's financial health. However, it was recognized that investment decision rules based on fair value accounting outcomes could lead to self-fulfilling forced sales and falling prices when valuations fell below important thresholds (either self-imposed by financial institutions or by regulation). It was also recognized that supervisors would need to play a larger role in judging the reliability of various valuation methods, especially for illiquid or hard-to-value securities, and that, in the future, accounting standard setters would need to consider how accounting practices affect financial stability. It was suggested that the rating agencies should review the quality of their methodologies. Some Directors saw merit in a differentiated rating scale for structured finance products, in order to help signal that these instruments are more susceptible to shocks and have distinct risk profiles.

Directors noted that the analysis in Chapter 2 of the business funding model of structured financial products appropriately highlights the incentives that led to the heavy use of short-term wholesale funding to support longer-term illiquid, structured financial instruments. Directors acknowledged that many of the risk management systems at major financial institutions had not been able to gauge the risk of this new business model appropriately, in part because risks were not consolidated at a high enough level. Most Directors agreed with staff that a rigorous implementation of Basel II would provide less incentive to transfer risks off balance sheets, but others noted that, even with the improvements in Basel II, further work would be needed to see where adjustments to the capital adequacy framework could be beneficial. Directors generally considered that consolidation criteria and disclosures need to be re-examined, as many institutions have been able to avoid transparent revelation of their risks to investors and counterparties.

The widespread illiquidity during this episode of financial turmoil has been surprising to many observers, requiring unprecedented intervention by major central banks. Directors welcomed the staff analysis of the interactions between market liquidity—the ability to buy and sell an asset with a small associated price change—and funding liquidity—the ability of a solvent institution to make its agreed upon payments in a timely fashion.

Directors generally welcomed the prompt and innovative actions of central banks to inject liquidity into the banking system to keep interbank markets functioning smoothly. They noted that most central banks had been flexible in their dealings with market participants, developing new operational procedures and, in some cases, new facilities, to help to alleviate the effects of the interbank illiquidity on the real economies. Directors recognized that, as challenges in maintaining adequate liquidity and normal market functioning will continue, central banks will need to remain vigilant to new problems as they arise. Some Directors pointed to potential moral hazard effects of excessive central bank activism. Some Directors indicated that, if central banks are prepared to accept a broader range of collateral, they would also need to pay greater attention to the credit risks that they are assuming.

Directors generally agreed that the recent episode of financial turmoil has highlighted the need for central banks to consider more carefully their roles regarding financial stability and monetary policy implementation—noting that these roles are becoming more intertwined. Several Directors saw merit in major central banks moving toward closer convergence of liquidity support practices as regards collateral policies and the different maturities for intervention that could be used during periods of stress. Some Directors emphasized that retaining flexibility for independent approaches would be important, in view of country-specific differences in interbank markets and in central bank operating procedures.

Directors noted that, while the authorities in individual countries are clearly moving to stem the effects of disorderly financial market conditions, the IMF should, in coordination with other multilateral bodies such as the Financial Stability Forum (FSF), as well as national agencies, play a larger role in international fora to influence policy. Directors agreed that the IMF is uniquely placed for adding such a multilateral perspective to policy responses to the current crisis, including through the *World Economic Outlook* and the GFSR; for providing a forum for ongoing discussion and exchange of views, especially with regard to possible contingency actions; and for promoting consistency of national policies and assessing their spillovers in an increasingly integrated global economy. The IMF's broad membership and expertise in dealing with financial crises make it a natural focal point for cross-country discussions. In this vein, several Directors looked forward to the consideration of the lessons from the financial crisis, including the implications for bilateral and multilateral surveillance, and of possible avenues for the IMF to be more pro-active and outspoken in its surveillance, while always remaining mindful of prudent communication. Several other suggestions were offered going forward, notably, to increase the frequency and comprehensiveness of the IMF's financial market updates and to further enhance its work on macro-financial linkages and on monitoring and early warning.