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The Acting Chair's Summing Up
The Recent Financial Turmoil—Initial Assessment,
Policy Lessons, and Implications for Fund Surveillance
Executive Board Meeting 08/31
April 4, 2008

Executive Directors welcomed the staff paper on the Recent Financial Turmoil—Initial Assessment, Policy Lessons, and Implications for Fund Surveillance, prepared in response to the IMFC's October 2007 communiqué. While recognizing that the financial crisis is still evolving, Directors underlined the importance of analyzing its causes in order to begin to draw tentative lessons that could inform both the Fund's bilateral and multilateral surveillance and the broader international discussion on the appropriate policy responses. In this regard, they welcomed the staff's close collaboration with the Financial Stability Forum, standard setters, and other international bodies. Directors broadly supported the staff's analysis and recommendations, taking note of the staff's emphasis that these represent work in progress. They offered helpful suggestions for carrying this work forward to strengthen the international financial system, which will be taken up by the staff in both its analytical studies and surveillance operations. In this regard, some Directors stressed that the Fund is not a regulatory body and should focus its work on areas related to its core mandate.

Directors agreed that multiple factors have contributed to the financial crisis, and that the five subject areas examined by the staff—risk management practices; credit rating agencies; valuation, disclosure and accounting; central bank liquidity frameworks; and supervision and crisis management—provide a useful framework for the analysis of the crisis and for drawing policy lessons.

Directors concurred that failures of risk management have been an important feature of the present crisis. These failures have been compounded by the environment of abundant liquidity and associated search for yield, by the rapid pace of financial innovation, and by an excessive reliance on credit risk ratings. Moreover, especially with regard to structured products, risk management practices have paid insufficient attention to liquidity and funding risks, the robustness of hedging strategies, and contingent and off-balance sheet liabilities, and stress testing has been inadequate. With the benefit of hindsight, Directors considered that senior management of financial institutions and supervisors had not been appropriately proactive in ensuring that these risks received appropriate attention.

Directors agreed that weaknesses in the credit ratings of structured products, combined with an over-reliance on these ratings by investors, contributed to the crisis. Directors also questioned whether the rating agencies had been sufficiently independent in their assessments, and some argued in favor of a separation of consulting and ratings services. Directors generally agreed that there is a need for credit rating agencies to develop a different rating system, and possibly a different scale, for complex structured finance products, and to provide information on the stability and limitations of these ratings. As well, regulators should also review the role that credit ratings play as part of prudential regulatory and supervisory systems.

Directors agreed that fair-value accounting gives the most comprehensive picture of a firm's financial health. However, they noted the staff's concern that it has the potential to exacerbate the crisis in an environment of thinly traded and hard-to-value instruments, and that financial reporting has generally underestimated the risk to the reporting entities. Directors felt that supervisors should encourage financial institutions to hold larger capital buffers against structured products in view of uncertainties in the valuation and risks of such products. At the same time, additional work and further guidance might be needed on how to value these products when markets are not functioning properly. Standardization of some components of structured products would also help to mitigate current gaps in the price discovery mechanism. However, Directors cautioned that changing accounting standards at the height of the crisis would risk adversely impacting investor confidence.

Directors welcomed the timely actions of the central banks in providing emergency liquidity support, as well as the central banks' willingness to adapt their liquidity facilities to changing circumstances. They noted the staff's finding that the experience of managing the crisis suggests a number of important lessons, including having in place the scope to widen the range of counterparties and eligible collateral that central banks may accept in stress situations, and the need for intensified collaboration among central banks when dealing with globally active financial institutions. Nevertheless, a number of Directors emphasized the risks of moral hazard, and the need to foster market discipline in the liquidity management practices of financial institutions.

Directors noted that the crisis has exposed shortcomings in many aspects of the regulatory and supervisory frameworks in mature market economies, and highlighted the importance of a more risk-focused approach to supervision. Crisis management and bank resolution frameworks have also been found to be lacking in some cases, which illustrates the importance of supervisors having adequate legal powers and resources and being proactive in their examinations of financial institutions. Moreover, recent developments suggest the need for supervisors to be more vigilant in applying consolidated supervision and prudential reporting, including for off-balance sheet entities and to contingent obligations. Finally, robust bank resolution and deposit insurance frameworks systems are critical for maintaining public confidence while minimizing moral hazard.

While noting that implementation of the Basel II framework would help address some of the supervisory shortcomings, Directors welcomed the planned review of that framework to take account of the lessons from the financial crisis. They emphasized that country authorities should introduce the Basel II framework carefully and only when capacity—both among supervisors and financial institutions—is adequate, since partial or incomplete implementation could increase risks.

Directors encouraged the staff to continue to work closely with national authorities, international bodies, and market participants to draw lessons from the financial crisis in its areas of expertise. This crisis provides an important opportunity to strengthen the Fund's surveillance, and for the Fund to forge a more active role in preventing and resolving financial crises. Of particular importance would be to better understand both the linkages between the financial sector and the real economy and cross-country financial linkages. Equally important, Directors stressed that the Fund should communicate its findings to the public in a proactive and timely manner. They encouraged the staff to use Article IV consultations, FSAP assessments, multilateral surveillance and other global fora, and technical assistance to deepen further its analysis and to disseminate the lessons learned—including best practices—among the membership, and to facilitate dialogue on preventive measures and crisis resolution responses with emerging market and other countries. They also encouraged the staff to provide feedback to national authorities and standard setters that could contribute to further improvements. A number of Directors, however, expressed reservations about the specific issues proposed as potential topics for a future multilateral consultation. On process, it was agreed to revise the staff paper in light of today's discussion and the findings of the report of the FSF working group and to send it to the IMFC as a background paper.