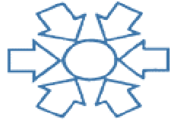

FedFin Client Report

Thursday, October 12, 2017

IMF Highlights Problem GSIBs, GSII Worries, Underlying Fears about Central-Bank Unwinds

Client Report: **SIFI22**

Executive Summary

In this report, we assess the IMF's in-depth assessment of global financial stability which for the first time names those GSIBs it fears could pose a threat by 2019. That the Fund chose to single out so many banks for so much specific scrutiny is surprising given longstanding official consensus that it is best to keep problem-bank names carefully guarded. The IMF is keenly aware of the risk here, but likely decided to name names because this report raises many structural fears about financial stability and is surprisingly pessimistic about cross-border resolutions. Although generally positive about the resilience of other GSIBs and GSIIs, the IMF's stability fears arise from heighted migration of credit, liquidity, and market risk outside the regulated financial sector.

Departing considerably from the Federal Reserve's public confidence in its ability to unwind its balance sheet, the Fund here also raises significant worries about the impact of Fed action in concert with other central-bank efforts to reduce huge portfolios given these and other structural challenges across global financial markets. Macroprudential remedies are suggested, but the data presented by the Fund lead us to conclude that there is growing stress in the capitalization channel. As we noted in a prior assessment of a new FRB-SF staff report on the link between economic inequality and financial crashes, the capitalization channel transmits risk from the household sector due to high, leveraged indebtedness and from the corporate sector due to significant capital distributions. The IMF report does not link all the factors it identifies as growing risks to economic inequality, but its data on indebtedness and capital distributions suggest significant risk pressure in the capitalization channel also evident in the sharp inequality increases described in recent FedFin reports.

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Analysis

GSIBs

One third of these institutions are deemed to be at significant medium-term risk, with the overall resilience of GSIBs a critical concern due to their holdings of $47 trillion in assets (about one-third of all global banking assets). At-risk GSIBs are: Citigroup, Société Générale, UniCredit Group, Deutsche Bank, Barclays, Standard Chartered, Sumitomo Mitsui Financial Group, Mizuho Financial Group, and Mitsubishi UFJ Financial Group. Despite the findings below, the Fund does not make it clear what national or global authorities are to do about these GSIBs other than watch and worry.

Findings include:

- Reduced GSIB intermediation capacity may undermine market liquidity under stress. Reduced balance-sheet capacity also poses market concentration and risk concerns, with both issues warranting further study.
- There is a pronounced shift to global subsidiarization, which makes banks more liquid and resolvable but could also lower ROEs due to the need for additional capital and reduce resilience due to trapped capital and liquidity.
- Significant challenges remain to ensure cross-border GSIB resolution.

GSIIs and Large Insurers

Key findings here are that:

- Post-crisis balance-sheet adjustments have been slow to fix pre-crisis problems (e.g., variable-rate annuities) and now also reflect additional credit and market risk despite risk-sensitive capital regulation, with the U.S. of particular concern due to the use of unregulated subsidiaries to house higher-credit risk positions.
- Japanese GSIIs and U.S. insurers are taking the most market risk.
- The sector is also taking on greater liquidity risk, with the U.K. the greatest worry here.
- Dutch, German, and Nordic life insurers will have negative spreads absent interest-rate rises.

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- Supervisors should accelerate efforts to set global insurance capital standards.
- More work is also necessary to establish robust stress-test protocols.

Macroprudential Regulation

The IMF report is as noted very pessimistic about changes to the capitalization channel and how likely these make financial-crisis risk. Recommendations here (which surprisingly do not suggest use of counter-cyclical capital buffers) are that:

- DTI and LTV limits should be imposed in economies with high household-debt levels (which are found to be principally the result of mortgage credit). Unspecified mortgage-loan contract constraints are also suggested despite IMF fears that too much control over mortgage credit could adversely affect financial inclusion; and
- non-financial corporate leverage should be vigilantly monitored. Sectoral capital requirements or higher risk weights for foreign currencies should also be considered.

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