Press points for Chapter 1: *Assessing Global Financial Risks*

Global Financial Stability Report (GFSR), April 2007

Key points

- **Global financial stability remains underpinned by favorable economic prospects.**

- **However, credit and financial market risks have increased since the previous GFSR in September 2006 that warrant attention.**
- **The deterioration in the U.S. subprime market has been more rapid than expected at this point in the cycle, and while the fallout has been limited, it could yet spread to other market segments.**
- **The recent wave of leveraged private equity buyouts shows signs of weakening of credit discipline, while the more highly indebted acquired firms are more vulnerable to economic shocks.**

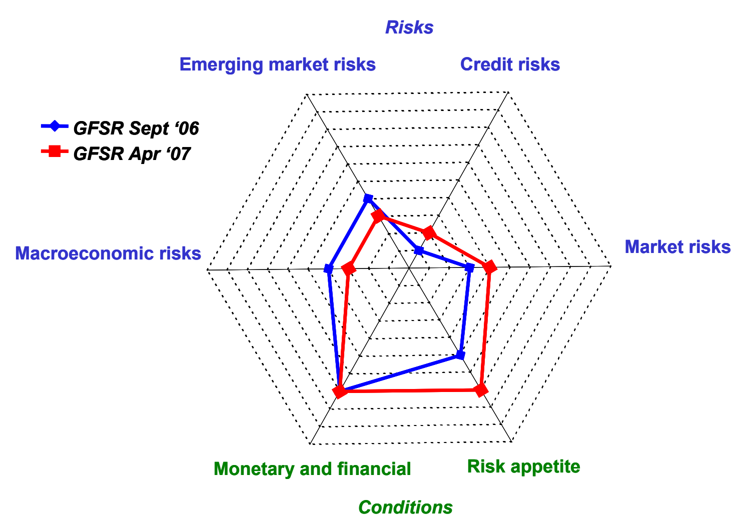
- **Although emerging market fundamentals continue to improve overall, rapid capital flows into some emerging market countries could pose challenges for financial stability.**

- **Investors may not be giving sufficient weight to downside risks leaving markets vulnerable to the possibility of a "volatility shock" being amplified by the increased linkages across financial products and markets.**

Global economic conditions have been supportive of a benign financial environment, but underlying risks and conditions have shifted somewhat since the publication of the last GFSR in September 2006, and have the potential to weaken financial stability.

Global Financial Stability Map

(Closer to center signifies less risk or tighter conditions)



Credit and financial market risks have increased in certain areas:

➢ **The subprime segment of the U.S. mortgage market has deteriorated more rapidly than had been expected at this point in a housing downturn.** Although the impact of a cooling housing market has been primarily confined to subprime mortgages and securities issued on them, the growth in the subprime segment and its increased linkages to various types of securities mean that shocks could create dislocations in broader asset markets. In particular, (i) looser credit standards may have extended beyond the subprime sector, as higher-rated mortgage collateral, notably portions of the "Alt-A" market, the next riskiest mortgage segment, may have been subjected to the same underwriting weaknesses observed in the subprime sector; (ii) prices in the wider market for structured products backed by subprime mortgages have reacted to the signs of deterioration; and (iii) other consumer credit markets, including credit card and subprime auto loans asset-backed securities (ABS) could experience losses.

- **A massive increase in private equity buyouts has been spurred by strong corporate performance, capital structures that have been perceived as having too little debt, a desire to reduce the scrutiny associated with being a public company, and a large influx of capital into private equity funds** . So far, target firms are mostly those with high cash flows and low leverage. However, there are signs that credit risks have risen as valuations of target companies are rising along with leverage, while credit discipline is eroding reflected in the continued weakening of loan covenants.. The leveraged buyout (LBO)-acquired firms that have become heavily indebted may be more vulnerable to economic shocks. A collapse in one or more high-profile deals could leave banks with exposure during the syndication stage and could trigger a wider reappraisal of risks across a broader range of credit products.

- **Financial market investors may be giving insufficient weight to downside risks**, assuming that low risk premia and low volatility are a more permanent feature of the financial market landscape. The growth of carry trades is another sign that market participants do not view the cyclical factors—including ample liquidity, low leverage and high risk appetite—contributing to the low volatility environment as likely to reverse in the near-term. A "volatility shock" could be amplified by leveraged positions and uncertainties about concentrations of risk exposures stemming from the rapid growth in innovative, complex products.

Risks associated with capital inflows to emerging markets and the global macroeconomic outlook remain, but have receded somewhat:

- **Capital inflows to some emerging markets have risen rapidly, in part reflecting improved economic fundamentals,** but also the search for yield given low interest rates in mature markets. The shift to private sector flows, especially bank-based flows into emerging Europe and portfolio flows into other regions suggests foreign investors are taking on more risk. This can pose challenges for the authorities of some recipient countries with large current account deficits, especially if capital flows were to reverse.

- **Risks associated with changes in global growth, which are still tilted to the downside, have also declined since last September.** While the downside risk from a possible disorderly unwinding of global imbalances has receded somewhat, it remains a concern. Staff work suggests that flows into U.S. bond markets that have helped finance the U.S. current account deficit have become more responsive to interest rate differentials, suggesting the impact of a decline in interest rate spreads on such flows could be significant.

None of the individual areas of risk is a direct threat to financial stability, but an adverse effect on one of them could lead to a reappraisal of risks in the others. In the United States, financial supervisors need to identify the potential for spillovers from the cooling of the housing market and continue ensuring that mortgage underwriting standards are maintained. Policy makers in mature markets need to continue scrutinizing the growth in private equity buyouts and encourage financial intermediaries' appreciation of the associated risks and maintaining lending standards. Finally, the risks associated with market participants' increased risk taking are best addressed through policies aimed at assuring that participants adequately understand the risks they are taking so that the likelihood of abrupt reversals in behavior is reduced.