Press Points for Chapter 1: ***Assessing Risks to Global Financial Stability***

Global Financial Stability Report (GFSR), September 2007

Key points

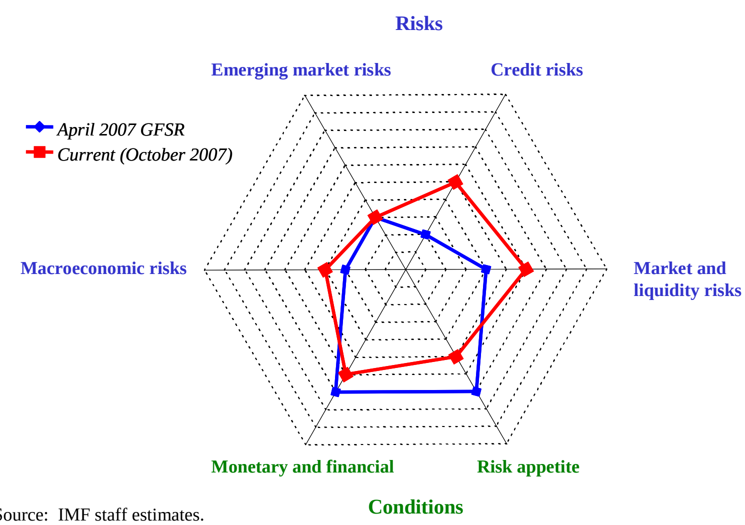
- **The global financial system is enduring an important test. Markets have recognized the extent that credit discipline has deteriorated in recent years. This has caused a re-pricing of credit risk and a retrenchment from risky assets, that combined with increased complexity and illiquidity, has led to disruptions in core funding markets. This has prompted extraordinary liquidity injections by central banks.**

- **Systemically important financial institutions began this episode with adequate capital to manage the likely level of credit losses. The event also hit during a period of robust global growth, but if financial conditions remain difficult, the global expansion will likely slow further.**

- **The adjustment process will take time, and it is too early to make definitive policy conclusions. We identify five areas that will require increased attention. The first is the important role of uncertainty and the need for accurate and timely information to properly price risk and assess creditworthiness. Second, there is a need to understand how securitization contributed to the current situation, and how the incentive structure may have weakened credit discipline through the supply chain. Third, there is a need to examine the risk analysis of credit derivatives and the role of ratings agencies. Fourth, the management of liquidity risk requires more consideration. Finally, the perimeter of risk consolidation for banks must be set wider than the usual accounting or legal perimeters, to reflect contingent liabilities and reputational risk.**

Following an extended period of favorable financial conditions, international markets have entered a difficult period. The current episode of turbulence represents the first significant test of innovative financial instruments used to distribute credit risks broadly. The absence of markets for some structured credit products, and concerns about potential losses have led to disruptions in money markets and funding difficulties for a number of financial institutions. This disruption has required extraordinary liquidity injections by a number of central banks.

Figure 1.1. Global Financial Stability Map



Source: IMF staff estimates.
Note: Closer to center signifies less risk or tighter conditions.

Stability risks have increased significantly, led by credit and market risks. The April GFSR highlighted rising credit risk, in U.S. mortgage-related instruments and across a range of other credit markets. These *credit risks* have materialized and intensified, with ratings agencies downgrading significant amounts of mortgage-related securities. These risks have been exacerbated by signs of weakening credit discipline in the leveraged buyout (LBO) sector. Potential losses appear to be manageable and banks are well capitalized to weather more severe stress, but there is still considerable uncertainty regarding the magnitude and distribution of losses, the ability of banks to absorb the pressures on their balance sheets, and their possible broader financial stability implications.

The latest episode highlights the interrelatedness of key risks. At the center of the turmoil is a funding mismatch whereby medium-term, illiquid, hard-to-value assets were being funded by very short-term money market securities. The fragility of this strategy, combined with the complexity and the market illiquidity of structured products, translated into a disruption in underlying funding markets. Thus, financial conditions have been adversely affected, with potential economic consequences.

Emerging market risks appear balanced. Lower sovereign risks and improving balance sheets supported by strong fundamentals are balanced against rising risks in some economies experiencing rapid credit growth, particularly where banks are using capital markets to finance credit growth. Emerging markets are also vulnerable to a rise in volatility, as some private sector borrowers in certain emerging markets are adopting relatively risky strategies to raise financing.

The chapter includes a discussion of other issues, including an annex exploring some aspects of sovereign wealth funds (SWFs). SWFs are becoming an important investor group and questions have been raised about the impact of their cross-border asset allocations. The Annex attempts to clarify some of the discussion surrounding their structures and goals by providing a taxonomy of sovereign wealth funds and their asset allocation frameworks.