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INTERNATIONAL FINANCIAL STABILITY:

Major new report assesses the risks and outlines key policy measures

Financial stability is more important today than ever before. The increasing complexity and scale of international finance has raised the potential impact of instability on the real economy. With the financial turmoil of recent months, new questions are being asked about the stability and regulation of the global financial system.

According to the ninth *Geneva Report on the World Economy*, published today, in many respects, financial markets are better regulated and more stable now than 20 years ago. But new institutions and new market phenomena also pose risks to financial stability. The report analyses these risks, concludes that they are manageable and outlines measures that would make the system work better and underpin stability.

The team of authors includes: **Roger W. Ferguson, Jr.**, Swiss Re Head of Financial Services, Chairman of Swiss Re America Holding Corporation and former Federal Reserve Vice-Chairman; London Business School professor and CEPR President **Richard Portes**; **Philipp Hartmann** of the European Central Bank; and **Fabio Panetta** of the Banca d'Italia. In the report the authors emphasize the following policy implications of their analysis:

- Regulators and market participants should pay particular attention to tail risk
- New regulations could require originators to retain equity pieces of their structured finance products.
- Regulators need aggregate information on structured finance instrument holdings and on the concentration of risk to assist in the regulatory process.
- Industry bodies should promote product standardisation and accurate pricing in the structured finance market.
- Credit market transactions that do not definitively transfer risk should not be treated by regulators or risk managers as if they do.
- Regulators should insist that prime brokers and investors know better the positions and strategies of the hedge funds with which they transact.
- Ratings firms should provide a range for the risk of each instrument rather than a point estimate or should develop a distinct rating scale for structured finance products.

Richard Portes outlines the threats to international financial stability:

'Today the global financial system shows signs of stress, after a decade of quiescence. This is financial turmoil, but not a systemic financial crisis: there has

been no failure of a large complex financial institution nor a widespread decline of asset prices.'

'Risk is being repriced, funding vehicles are being unwound, some large institutions have suffered sizeable losses on credit instruments, and liquidity is restricted in some markets.'

'In many respects, financial markets are better regulated and more stable today than 20 years ago. For example, the volume of derivatives outstanding and the scale of hedge fund activity are at levels unimaginable then, yet the frequency of derivatives disasters and large hedge fund failures is no greater.'

'Still, the risks are there: global imbalances, the carry trade, asset price bubbles, the rise in household indebtedness, financial consolidation and the rise of systemically important financial institutions with extensive cross-border reach, and a proliferation of new and often opaque financial instruments (associated with the banks' shift from 'buy and hold' to 'originate to distribute').'

The new Geneva Report analyses these risks in detail and finds that they are manageable. Financial innovation should not be reversed, even if that were possible. But there are measures that would make the system work better and underpin stability.

ENDS

'International Financial Stability', *Geneva Reports on the World Economy 9*, CEPR/ICMB 2007

**Press Briefing at CEPR, London - 10:00am GMT Monday 12 November.
Contact Anil Shamdasani at CEPR for further details.**

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