



BANK OF ENGLAND

News release

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Pricing for Perfection

In a speech given today to a group of market participants, Sir John Gieve - Deputy Governor for Financial Stability - said that near-term risks to financial stability remain low. This view reflected benign macroeconomic conditions in the UK and globally, the strength of major financial institutions and the continued resilience of markets.

He did caution, however, that many markets appeared to be 'priced for perfection'. Implied volatilities in equity markets, bond markets, credit markets and foreign exchange markets are low by historic standards. Risk premia are also at subdued levels. This seems to have encouraged risk taking outside the financial sector, for example, via leveraged corporate borrowing - a vulnerability previously identified by the Bank.

He suggested that while there were good reasons to believe there had been a genuine decrease in macroeconomic volatility, some of the fall in financial market volatility might be driven by the popularity of derivative strategies that amount to selling insurance against unlikely financial events. At a time when "risks in the wider environment are as great as ever, it is not clear to me that these risks are fully priced into the market".

He concluded by stressing the importance of effective market discipline in current circumstances. "Given the rapid pace of innovation in financial markets and products and the low level of risk premia, investors may need to take particular care to understand the risks they are exposed to. More than in the past, they may need to ask some searching questions about how funds are being invested and how risks are being managed." He suggested that one approach might be to put greater emphasis on stress test results as well as more conventional risk metrics.

Note to editors

The Bank has decided to change the publication months of its bi-annual Financial Stability Report to April and October from the previous June and December schedule. This change will improve alignment between the production timetables of the FSR and other Bank publications. In transitioning to this new timetable, the Bank has decided not to publish an FSR in December 2006. The next edition will be released in late April 2007.

<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2006/speech295.pdf>