

Forthcoming SUERF Conference*
Financing of SMEs in Europe
and
Forthcoming SUERF Annual Lecture 2008

*Putting SMEs at the Heart of
European Policies*

To be delivered by
Vice-President, Commissioner Günter Verheugen
European Commission

11/12 September 2008
Conference Room, Sénat, Palais du Luxembourg, Paris

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Small and medium size enterprises (SMEs) play a key role in the European economy: they account for 99 % of all European Enterprises and provide two-thirds of all private sector jobs. More than 100 millions of Europeans are SME-employees. Start-up firms belong almost by definition to the category. Innovation in SMEs contributes significantly to economic growth. Bank business lending is to a large extent based on credit evaluation of SMEs. Against this background, it is not surprising that the availability of SME financing has attracted political attention. The European Commission and OECD have recently published reports on financing of SMEs and their entrepreneurial activity.

* With the support of the former AFCB, Association Française des Centrales de Bilans

Programme

Thursday, 11 September, 2008

- 9.00-9.30 Registration
- 9.30-9.45 Opening and Welcome by
Catherine Lubochinsky, SUERF President; Professor of Economics, Université Paris 2
- 9.45-10.30 **Keynote Speaker: Nancy Huyghebaert**, Professor of Corporate Finance, AFI-Finance, Katholieke Universiteit Leuven⁺
Financing of SMEs: A Topic of Great Relevance for Firm Growth and Economic Policy
General Discussion
- 10.30-11.00 *Coffee break*
- 11.00-13.00 **Session 1 – Does a European Model exist for SMEs?**
Chairperson: **Laurent Clerc**, Deputy Director Financial Stability, Banque de France
- 11.10-11.30 *The SME Finance Gap: are there blind spots if any?*
Frederik A. von Dewall, Managing Director Von Dewall Advisory & Management; former Global Chief Economist of ING Group and Chairman Dutch State Commission on SME Finance⁺
- 11.30-11.50 *Financing Obstacles and Growth: An Analysis for Euro Area Non-financial Corporations*
Chiara Coluzzi, PhD Candidate, Università di Roma “Tor Vergata”, Annalisa Ferrando, European Central Bank, and Carmen Martínez-Carrascal, Banco de España
- 11.50-12.10 *Changing Patterns of Firm Ownership and Financing: Evidence from SMEs in France*
Elisabeth Kremp, Banque de France, and Thomas Philippon, New York University
- 12.10-12.30 An Empirical Examination of Firms’ Financing Conditions in Transition Countries
Ulrich Volz, Senior Economist, German Development Institute, Bonn
- 12.30-12.50 Discussion
- 12.50-13.00 General Discussion
- 13.00-14.30 *Lunch with coffee*
- 14.30-16.30 **Session 2 – SMEs and Credit Risk Analysis**
Chairperson: **Beat Bernet**, SUERF Council of Management; Director of the Swiss Institute of Banking and Finance, University of St. Gallen
- 14.40-15.00 *The Impact of Size, Sector and Location on Credit Risk in SME Loans Portfolios*
Michel Dietsch and Joël Petey, Université Robert Schumann, Strasbourg⁺
- 15.00-15.20 *SME Financing in Europe: Measures to Improve the Rating Culture Under the New Banking Rules*,
Rym Ayadi, Head of Research, Centre for European Policy Studies, Brussels
- 15.20-15.40 *Bank Organization and SME Finance: Evidence from a Survey*
Michele Benvenuti, Luca Casolaro, Silvia Del Prete, and **Paolo Emilio Mistrulli**, Banca d’Italia
- 15.40-16.10 *Coffee break*
- 16.10-16.30 Firms as Monitors of Other Firms: Mutual Guarantee Institutions and SME Finance
Francesco Columba, Senior Economist, Banca d’Italia and NBER Cambridge, Leonardo Gambacorta, and Paolo Emilio Mistrulli, Banca d’Italia
- 16.30-16.50 *Mid-Sized Firms that innovate fight at two frontiers in Schumpeterian Competition*
Gerhard Mensch, Rector, European Innovations Academy, Tutzing
- 16.50-17.10 *Financing of New Ventures – Measuring Entrepreneurial Quality in Credit Risk Analysis*
Josef Mueller, Klagenfurt University

- 17.10-17.30 Discussion
 17.30-17.40 General Discussion

SUERF Annual Lecture 2008

- 17.40-18.00 Registration and Refreshments
 18.00 Welcome by **Catherine Lubochinsky**, SUERF President; Professor of Economics, Université Paris 2
 18.00-19.00 **Putting SMEs at the Heart of European Policies**
 Vice-President **Günter Verheugen**, Commissioner for Enterprise and Industry,
 European Commission, Brussels
 Discussion
 19.00 Closing Remarks
Reception at the Galerie dorée of the Banque de France

Friday, 12 September, 2008

- 10.00-11.50 **Session 3 – Banks and Financing SMEs**
 Chairperson: **Wim W. Boonstra**, SUERF Council of Management; Chief Economist, Rabobank Nederland, Utrecht
 10.10-10.30 *Bank Lending, Financing Constraints and SME Investment*
Santiago Carbó-Valverde, University of Granada and Federal Reserve Bank of Chicago,
 Francisco Rodríguez-Fernández, University of Granada, and Gregory F. Udell, Indiana University
 10.30-10.50 *SME-Bank Financing Relationships within Regional European Areas*
Steve Mercieca, Standard Chartered Bank, London
 10.50-11.20 *Bank Loans: Do Innovative Firms Face Specific Financial Constraints?*
Frédérique Savignac, Banque de France, and Patrick Sevestre, Université Paris I-Panthéon Sorbonne
 and Banque de France
 11.20-11.40 Discussion
 11.40-11.50 General Discussion
 12.00-13.30 Lunch with coffee
 13.30-15.30 **Session 4 – SMEs and Regulatory Issues**
 Chairperson: **Morten Balling**, SUERF Council of Management; Professor of Finance Emeritus, University of Aarhus
 13.40-14.00 *Innovation and Advertising: The Role of Competition*
 Philippe Askenazy, Thomas Breda, Paris School of Economics, and **Delphine Irac**, Banque de France+
 14.00-14.20 *Financing of SMEs: An Asset Side Story*
Jan Bartholdy, and Cesario Mateus, Aarhus School of Business, University of Aarhus
 14.20-14.40 *Risk Classification of SME Loans – Impact Analysis for the Use of Different Rating Models by Banks*
Simone Westerfeld, Assistant Professor, University of St. Gallen
 14.40-15.00 Discussion
 15.00-15.10 General Discussion
 15.10-15.30 Concluding Remarks
Ernest Gnan, Secretary General of SUERF and Counsel to the Board, Oesterreichische Nationalbank
 15.30 End of the event

Forthcoming SUERF and BCL Conference

Productivity in the Financial Services Sector

11/12 November 2008

Banque Centrale du Luxembourg, Luxembourg



Productivity growth reflects improvements in how financial institutions combine their inputs (mainly labour, capital and technology) to create outputs. Productivity of financial institutions has increased substantially during the last decades, largely thanks to the creative use of the information technology – not only for back office operations, but also for client relations, risk management and for product and services development.

A variety of methods exist for measuring productivity in financial services, but their comparability over time and across institutions is limited because they often rely on different sources of costs and revenues. Estimates are often influenced by regulation, taxation, technology, market conditions, client attitudes, firm strategy, and shareholder expectations.

The operational efficiency ratio (OER), also known as the cost-to-income ratio, is often considered a key factor in the evaluation of the productivity performance of financial institutions. Academics, bank researchers, rating agencies, and equity analysts try to establish a clear view on the OER in this context.

The Programme and Registration Form will be available very soon from the SUERF website www.suerf.org – and will be sent to our members also electronically.

Report on the SUERF and BWG Workshop and Special OeNB East Jour Fixe

Commodities, Energy and Finance

By Ernest Gnan, SUERF Secretary General and
Counsel to the Board, Oesterreichische Nationalbank

More than 100 participants from 16 countries participated in this workshop, which was jointly organised by SUERF and the Oesterreichische Nationalbank on 3rd March 2008 at the central bank's premises in Vienna.

In his **opening remarks**, the Governor of the OeNB, **Klaus Liebscher** appreciated the long-standing close cooperation between SUERF and the Oesterreichische Nationalbank, which hosts the SUERF General Secretariat. He appreciated SUERF's tradition of combining academic and practitioners' perspectives in a most fruitful and useful manner. Liebscher set the scene for the topic of the workshop by, identifying the drivers of the debate: first, ongoing and probably lasting shifts in the global supply and demand of energy and commodities; second, massive hikes in energy and commodity prices and their consequences for the economy; third, the search for yield and risk diversification in international portfolios and the resulting financialisation of the markets for commodities and energy. Despite the huge increase in commodities and energy prices, demand is not falling, on the contrary. Most of the additional demand will be supplied by countries in the Middle East, historically prone to political crises. In this situation of a continuing tight balance between the supply and the demand for oil, even small supply disruptions – be they of a technical or a political nature – cause disproportionate price hikes. Europe is particularly dependent on imported gas. Up to now, the macroeconomic effect of oil price shocks has been different from the 1970s, due to the absence of adverse concurrent shocks, a smaller share of oil in production, more flexible labour markets and improvements in monetary policy. In the euro area, the strong exchange rate of the euro has also dampened the price hike of oil. Higher oil prices can be seen as a wealth transfer from consumers in oil-importing countries to oil-exporting

countries. The majority of commodity and oil revenues have been recycled into global financial markets, among others, by sovereign wealth funds. This has for some time added to global demand for financial assets, dampening interest rates and credit spreads. Where petrodollars have gone into real estate investment, they may also have contributed to unsustainable asset price developments in certain real estate segments. Financial investors have re-discovered commodities as an asset class. Liebscher concluded by raising a number of questions: Should monetary policy pay more attention to energy and commodity price developments? Should one try to separate fundamental from speculative price moves? Are petrodollars making monetary policy more difficult due to their dampening effect on interest rates? Is the world economy headed for a prolonged period of low growth combined with inflationary pressures, reminiscent of the 1970s? SUERF's President, **Catherine Lubochinsky**, Professor of Economics, Université Paris 2, thanked the OeNB for its hospitality and gave an outline and a motivation for the five sessions of the workshop.

The first two sessions of the workshop dealt with the various channels of mutual influence that commodity and financial markets may exert on each other. The **first session**, chaired by Professor **Beat Bernet**, Swiss Institute of Banking and Finance, University of St. Gallen, showed the role of commodities as an element in investment portfolios as an asset class. Long-term analysis has shown that the returns on commodities futures are negatively correlated with the returns of stocks and bonds, and that they perform better in periods of unexpected inflation. This feature predestines investment in commodities futures as a means of portfolio diversification, especially in times of unexpected inflation. The two speakers of this session count among the pioneers of investment in commodities futures. **Geert Rouwen-**

horst, Professor of Finance, Deputy Director from International Center for Finance, Yale University was among the first to academically show regularities of the performance of commodities returns. He talked about the long-term properties of commodity futures as an asset class. The second speaker was **John Cavalieri**, Vice President and Real Return Product Manager of the investment firm PIMCO, which specialises in fixed income management. Being a practitioner in commodity investments, he addressed issues such as “*How much to invest in commodities*” and “*How investors actually implement their exposures*”; he advocated using commodity indexes for most efficient commodity investments.

The **second session**, chaired by **Ernest Gnan**, SUERF Secretary General and Counsel to the Board, Oesterreichische Nationalbank, looked at how using commodities for financial purposes may feed back into the markets for commodities. In particular the question was investigated whether financial activity in commodity markets drives commodities and energy prices away from fundamentals. It also addressed the question as to whether commodity markets become more complete and liquid through derivatives markets. Speakers in this session were **Alexandra Heath**, Senior Economist at the Bank for International Settlements, and **Michael Lewis**, Global Head of Commodities Research at Deutsche Bank in London.

The **third session**, chaired by **Doris Ritzberger-Gruenwald**, Head of Foreign Research of the OeNB, had a closer look at the state of play of energy markets in Europe. It investigated how well the markets for trading energy across Europe have been developed so far and to what extent liberalisation and privatisation have enhanced competition and lowered prices for consumers and businesses. A number of remaining challenges to build a true integrated energy market for Europe were identified. Many economic and political developments depend partly on them, such as productivity growth, inflation or energy security. The speakers at this session were **Juan Delgado**, Research Fellow from the Brussels-based European economic policy think-tank BRUEGEL

and **Walter Boltz**, Chairman of the Austrian Energy Regulatory Authority – E-Control.

The **fourth session**, chaired by **Peter Mooslechner**, Director for Economics and Research at the OeNB, addressed the role and management of sovereign wealth funds, and the possible challenge posed to oil exporting countries by the risk of a dual economy. Speakers were **Vasily Astrov**, Economist from the Vienna Institute for International Economic Studies and **Simon-Erik Ollus**, Economist from the Institute for Economies in Transition – BOFIT in Helsinki. They discussed the Russian Oil Fund as a tool of stabilization and sterilization and whether there are signs of a Dutch disease in the Russian non-fuel sector. **Birger Vikøren**, Director of the Financial Markets Department, Central Bank of Norway, presented the case of Norway as a resource-rich country.

The **fifth session**, chaired by **Már Gudmundsson**, Deputy Head of the Monetary and Economic Department of the Bank for International Settlements, discussed implications for monetary policy. Panel members included **Irma Rosenberg**, First Deputy Governor of the Sveriges Riksbank, **Ulrich Kohli**, Alternate Member of the Governing Board of the Swiss National Bank, and **Frank Smets**, Deputy Director General Research at the European Central Bank. They addressed several issues facing monetary policy makers when it comes to commodity and energy prices: How should monetary policy react to changes in commodity and energy prices? Should monetary policy pay more attention to core or headline inflation? How should commodity and energy prices be taken into account in measuring core inflation? Are commodity and energy prices leading indicators of economic activity and inflation developments?

Ernest Gnan, SUERF Secretary General and Counsel to the Board, Oesterreichische Nationalbank, in his **concluding remarks**, wrapped the workshop up by summarising the many interesting findings, but at the same time indicating the limitations of the analysis and perspectives chosen.



Report on the 27th SUERF Colloquium

NEW TRENDS IN ASSET MANAGEMENT: EXPLORING THE IMPLICATIONS

Jointly organized with Bayerisches Finanz Zentrum,
12-14 June 2008 in Munich

By Morten Balling, Professor of Finance Emeritus,
Aarhus School of Business and
SUERF Council of Management^{1,2}

Catherine Lubochinsky, SUERF President and Professor of Economics, University Paris 2, **Wolfgang Gerke**, President, Bayerisches Finanz Zentrum and **Heinz Laber**, Member of the Board, Hypo- und Vereinsbank AG, Munich welcomed the participants in the excellent conference venue HVB Forum. Main points in the wel-

come speeches were that the world of asset managers had changed since 2007 and that the reputation of banks more than earlier depended on their asset management abilities. In today's turbulent world, the topics to be discussed in Munich were highly relevant to investors, financial institutions, supervisors and central bankers.



¹ The text has been strongly inspired by input from the Commission chairmen *Wim Boonstra, Frank Lierman and Franco Bruni*.

² For the precise list of authors and papers in the three commissions we refer to the official Colloquium Programme on the SUERF website www.suerf.org



Juergen Pfister, SUERF Council of Management, Chief Economist and Head of Investment Research, Bayerische Landesbank, Munich chaired the plenary sessions.

Sushil Wadhvani, CEO, Wadhvani Asset Management LLP, London delivered the first keynote speech *Should Monetary Policy Respond to Asset Price Bubbles? Revisiting the Debate*. The speaker started with the arguments for a *Leaning Against the Wind* (LATW) approach to monetary policy. Countercyclical monetary policy tends to offset the impact on output and inflation of bubbles. The speaker underlined that he was not advocating that asset prices should be targets for monetary policy. His main point was that central banks can improve macroeconomic performance by reacting systematically to asset price misalignments over and above their reaction to inflation forecasts and output gaps. Interest rates should be raised modestly as asset prices rise above what are estimated to be warranted levels and lowered modestly, when asset prices fall below warranted levels.

Many central bankers and academics have argued that difficulties associated with identifying bubbles make LATW impractical. The speaker did, however, not see any significant difference between the information requirements of any form of monetary policy rule that requires a reasonably accurate aggregate demand forecast, versus a LATW rule. Alan Greenspan (1999) had advocated a “mopping-up” approach meaning that nothing is done when asset prices rise alongside credit expansion but reacting aggressively after a fall-out has occurred. The speaker argued that such a monetary policy might imply an asymmetric behaviour that could reinforce the pro-cyclicality of the financial system.

With reference to positive Swedish experiences with a LATW-approach, the speaker argued that a LATW monetary policy should be part of a broader countercyclical framework. It might be relevant also to consider capital adequacy requirements linked to excessive growth of the value of bank assets and maximum loan-value

ratios. Mr Wadhvani concluded his presentation by expressing the hope that he had persuaded the audience that there is a theoretical and empirical case for considering a LATW-tilt to the way we run monetary policy.

During the very lively discussion that followed the keynote speech, one of the participants pointed to the fact that large countries are more heterogeneous than small countries. There might be increasing property prices in some regions and declining property prices in other regions of a large country. Thus, if the wind blows in different directions in different parts of the US or EU, it is difficult to decide what *Leaning Against the Wind* implies for the FED and ECB. Another topic discussed was the frequently observed tendency of many private investors not to go against a developing bubble but rather with it. Many private investors may be aware that a bubble is evolving but they feel that they must *dance with the music*. The speaker answered that it is exactly the independence of central banks which implies that they do not have to *dance with the music*.

Axel A. Weber, President, Deutsche Bundesbank, Frankfurt gave the next keynote speech: *Financial Markets and the Central Bank*. The speaker focussed on three main issues: Monetary Policy Transmission, Financial Stability and Financial Market Integration.

There had in recent years been important changes in the monetary policy transmission mechanism in the Euro Area. The Eurosystem closely monitors the changing ways in which short-term interest rates are transmitted between financial markets. In the conduct of monetary policy, the Eurosystem takes account of asset prices. They are key variables but they are not included in the objective function. The president expressed some scepticism regarding the use of interest rate policy towards asset price movements. House prices are important but they are not closely related to interest rates. Different channels of monetary policy transmission supplement each other: the interest rate channel, the bank balance sheet

channel and the bank lending channel. Germany has a hybrid system that has gradually resulted in a closer relation between market and bank interest rates. Changes in the value of collateral have affected volatility in the credit supply. Variations in the borrowers' possibilities have had an impact on the demand for property and other assets. Securitization has, however, also made borrowers less dependent on bank loans. There is an empirical literature on this, but it is mostly tentative.

It is natural that – in periods of stress – financial stability issues are high on the central bank's agenda. The experience shows that risk factors cannot be considered to follow normal distributions. Non-linearity is a challenge for monetary authorities. We must remember that the quality of risk transfers is only as good as its weakest element. Central banks try to identify risks that have not yet materialized. They are not passive. In the 2007 crisis, the FED stepped in as lender of last resort. Additional liquidity was needed because private banks' willingness to lend declined and the money market more or less dried up. Also the Eurosystem stood this test reasonably well. It promptly injected liquidity and re-established confidence in the market. It is unfair to criticise the Eurosystem for flooding the money market. The system has followed a cautious and stepwise approach. But, even though central banks can ease stress, this has to be done on a short-term basis. Central banks cannot engage in long-term commitments. Some regulatory changes are needed but a large-scale regulatory approach should be avoided.

Financial market integration has in particular been strong in markets that are close to monetary policy. In the Euro-area, retail markets are still segregated. There have only been a few cross-border consolidations in banking. The ongoing integration of stock markets is documented in the observed lower home-country bias in institutional security portfolios.

One of the issues raised during the discussion after Axel Weber's keynote speech was the extent of the credit risk being absorbed by the central bank in connection with the broadening of the types of collateral accepted. The speaker underlined in his answer that the ECB takes a lot of precautions when it accepts collateral. Sub-prime assets are not accepted, and the ECB uses a hair-cut to eligible assets. In response to questions concerning bad risks in bank balances, the president made a strong statement: *Some banks have made mistakes in their investment and loan policy and they should pay for those mistakes.*

In his concluding remarks, the President said that the FED and the ECB had increased the REPO-facilities in similar ways and that the framework applied by ECB had been adopted by several other central banks.

The focus of **COMMISSION I** was **Evolving interaction of asset management with the economy.**

The Commission was chaired by **Már Gudmundsson**, Deputy Head, Monetary and Economic Department, BIS, Basle and **Wim W. Boonstra**, Chief Economist, Rabobank Nederland, Utrecht. The work in the Commission was divided into six sessions.

Session 1 dealt with Asset prices, *liquidity and financial stability*. There was a thorough discussion of housing markets, both in the US and in Europe. It led to the conclusion that in several European markets there is a danger of a significant decline in real housing prices. For the US, some expected a prolonged period of economic underperformance, although other views were expressed. The problems of leveraged investors were another important topic. A paper illustrated that, especially for fully leveraged investors, a relatively small shock may lead to forced liquidations which could add to market turbulence.

Session 2 dealt with *Reserve management and foreign exchange*. Sovereign wealth funds (SWFs) are growing fast but compared to global private sector wealth they are still small. It remains an open question whether or not it makes sense for a country to establish a SWF. Only for commodity exporting countries or countries with very high savings rates and a fiscal surplus does it really appear to make sense. One paper used the concept *Opportunity cost of holding ample reserves*. It was discussed whether central banks should manage huge reserves or funds. There was a danger of conflicting interests between reserve fund management and monetary policy. A paper dealt with emerging market currencies.

Session 3 dealt with *Evolving asset composition*. Papers were presented on topics such as financial cycles in OECD countries, securities and insurance related to climate changes and the impact of derivatives markets on asset management and the economy. It was discussed whether new market participants (hedge funds) or asset classes (derivatives) have added to the efficiency of financial systems and the real economy. The conclusion seemed to be that they actually appear to fill part of the gap that traditional products and participants recently face in explaining the fostering of economic development.

Sessions 4 to 6 dealt with *Asset pricing, investors, and capital flows and convergence*. One particularly well written paper linked credit risk premia observed in the market to the observed equity premium. The author – **Tobias Berg** – develops a new framework for estimating the equity premium. The location factor was another important topic in these sessions. One paper focussed on cross-border private equity deals. Return differentials between countries, their cultural and geographical proximity as well as their business environments are important determinants of cross-border private equity investments. Globalization and its impact on the financial services industry were discussed. Especially when products are commoditized, they get footloose and find the lowest cost location. However, in high value added services, local factors remain dominant. In Eastern Europe, cross-border capital flows have in recent years been strongly affected by the ongoing economic and monetary convergence process.

The title of **COMMISSION II** was **Changing approaches to asset allocation**. The Commission was chaired by **Morten Balling**, Professor of Finance Emeritus, Aarhus School of Business, University of Aarhus and **Frank Lierman**, Chief Economist, Dexia Bank Belgium, Brussels.



Session 1 dealt with *Mutual funds*. One speaker compared the performance of respectively sustainable and responsible funds with other funds. Most of the empirical studies surveyed showed no sign that sustainable and responsible funds compromise returns in the long run. A paper dealt with diversification objectives and portfolio behaviour of international equity funds. It showed that investors tend to prefer funds that are less correlated with the US market and funds that invest in a diversified portfolio of securities from different regions in the world.

Securitization was another topic. Using Spanish data, the authors documented that, overall, liquidity needs are the main and exclusive driver of securitization carried out by Spanish banks. The last paper in the session focussed on exchange traded funds. The very strong growth in the market was documented.

Session 2 was a panel discussion among practitioners. One of the speakers explained the implications of using ‘principal protected strategies’ in asset allocation. The particular feature of funds managed in this way is that they deliver risk-free deposits in downward orientated markets, but in upwards markets give results slightly higher than a price index and slightly lower than a return index. A speaker introduced *outcome related products*. Portfolio decisions by pension funds must be adapted to the time profile of their liabilities. They need to know what risk they can afford to take. The next speaker explained the implications of treating real estate as securitized assets while the last speaker applied product life concepts and innovation analysis to support asset allocation decisions.

Session 3 dealt with *Portfolio information, return and performance*. In one paper, the authors examine very long time-series covering the period 1926-2005 and the predictive power of financial ratios in predicting stock returns. They find that cyclical components of financial ratios dominate the predictive power at short horizons, while the stochastic trend components of financial ratios dominate the predictive power at long horizons. The next speaker presented his views on risk relevant to institutional investors. He distinguished between liability risk, asset allocation risk and active risk, and explained the importance to asset allocation procedures of alpha measures and alternative definitions of beta. Risk aversion tends to vary through time and that has implications for asset allocation. The following paper on vice versus virtue investing inspired a very active discussion. The two authors had carried out an impressive empirical study of the relative performance of portfolios of respectively stocks in companies complying with ethical criteria or principles of social responsibility respectively stocks in different kinds of vice activities. They find that publicly traded companies involved in alcohol, gambling, tobacco, sex and nuclear industries are able to generate abnormal returns. *There is a premium on sin*.

Session 4 dealt with *Investment advice, policy and strategy*. In the first paper, the authors analyze the market reaction to analysts’ reports between 2002 and 2004 for the

German market. They find that earnings forecast revisions and target price forecast previsions contain valuable information. Recommendation revisions do provide little independent information. During the discussion one of the participants expressed strong doubts about the ability of financial analysts to evaluate the quality of company managers. The answer was that the authors had to assume that investors believed what analysts are saying. An interesting paper dealt with the feasibility of insurers' investment policies. By application of the Capital Asset Pricing Model as benchmark, the two authors demonstrate that it may not be possible to satisfy the demands of both beneficiaries and current contributors and sponsors. The last paper in the session focussed on integrated active asset management. The authors argue that research, portfolio selection and revision and trading should be integrated.

The headline of session 5 was *Trends in asset management and the exchange environment*. The first presenter had analyzed household financial assets by means of Italian empirical evidence. She pointed out that many households do not diversify their portfolios in an efficient manner and that many seem to ignore housing and human capital. The next paper dealt with sovereign asset and liability management. The presenter argued that an integrated risk management framework based on a total balance sheet or portfolio perspective would be the most appropriate. The last paper in the session evaluated recent trends and the future potential of asset management in Central Europe. Asset accumulation has been high in Central Europe and the bond and equity markets in many of the countries have out-performed most markets in Western Europe. The author expected strong growth in the future also and by implication also strong growth in asset management business.

The papers in session 6 concerned *Pension funds*. In the first, the authors look at stock market performance and pension fund investment policy. They find that the investment policies of Dutch pension funds are partially driven by the cyclical performance of the stock market. Rebalancing tends to be asymmetric. The pension funds buy equities when they become cheaper, but they do not sell equities when they become more expensive. The success of British premium bonds was the topic of the next presentation. The fact that premium bond gains are tax-free is one explanation. Classical risk preferences do not seem to play a major role in the investment decisions by British bond buyers. The last paper in the session dealt with disposition bias and overconfidence in institutional

trades. The authors document a propensity to cut losses rather than a reluctance to hold on to losing stocks for the fund managers. There are, however, differences among the behaviour of respectively the Euro countries, UK and the US.

The title of COMMISSION III was **Is there an optimal regulation for asset management?** The Commission was chaired by **Franco Bruni**, Professor of International Monetary Economics, Università Commerciale Luigi Bocconi, Milan and **Wolfgang Gerke**, President, Bayerisches Finanz Zentrum, Munich.



In session 1, three papers were presented that all dealt with regulation and supervision of financial firms and institutions involved in asset management in a global world. The concept of optimal regulation has to do with balancing the competitiveness of the funds industry with the protection of investors, searching for international standards for cross border consistency, looking for good principles as opposed to detailed rules, setting up a regulatory process showing both transparency and accountability. Conflicts of interest were examined, giving rise to the problem of soft commissions, of commissions hidden in distribution costs and to the problem of corporate governance of asset management firms. Rules are also needed for restructuring and pooling funds, for informing the clients on complex products and for the valuation of funds' assets.

Session 2 dealt with *Pensions*. The papers examined the effect of internationally accepted accounting principles on pension funding and the case for regulation of pension insurance, asset management and the problem of adverse selection. The papers in session 3 were all about *European regulation*. In the EU, mutual recognition and harmonization must proceed on the regulatory front, but the biggest effort must be placed on effective implementation of common rules and on common standards of supervision. Harmonization of regulation and supervision

often clashes with unavoidable differences in national basic legal principles, legal systems and procedures, both civil and criminal. Some of the papers discussed the roles and powers of regulatory and supervisory authorities at the national, European and global levels, some were focussed on the intersection of product regulations, such as UCITS, and service regulations, such as MiFID. This directive was explained and discussed with particular care and, overall, the opinion in Commission 3 emerged that MiFID is potentially very beneficial especially to the extent that it will enhance competition in the provision of asset management services. It is important to secure a sound risk management of UCITS. Circumvention of investment restrictions must be avoided. As to the structure of regulatory authorities, the so called “twin peaks” structure was largely favoured: a function-based supervision with one authority devoted to financial stability and one to conduct of business, correctness and transparency. One paper pointed out that cross-border alliances formed by stock exchanges located in different member states contributed significantly to market integration.

Session 4 dealt with *European countries’ studies*. Empirical evidence was presented on the Italian market to show how the regulation of the asset allocation of funds does not succeed in controlling their degree of risk, as the risk of each category of assets changes over time. It might be that instead of constraining asset categories and their degree of leverage, the regulator could impose a continuous rebalancing of the fund, to keep an appropriate risk indicator within prescribed limits. In the session, a paper on fairness opinions and capital markets using evidence from Germany, Switzerland and Austria was presented.

The sessions 5 and 6 both dealt with financial stability issues. A paper on hedge funds argued that their regulation must not be focussed on consumer protection but on systemic stability and that direct regulation is not appropriate for hedge funds. Market regulation, centred on transparency, is preferable. Most participants agreed that there is no evidence that hedge funds have been among the originators of the current sub-prime turbulence. The mechanism of contagion and the financial accelerator that can produce a disaster from a relatively limited shock, was described and discussed, together with the alternative ways by which the lender of last resort can step in to limit the damages. A paper argued that emergency liquidity assistance, aimed at stopping the problems of an individual bank, can, under certain conditions, turn out to be preferable to Bagehot-type open

market operations which aim at weakening the liquidity constraints of the entire, anonymous money market. A paper offered a comprehensive and clear overview of the challenges and lessons that security regulators should take from the sub-prime crisis. It gave a very clear explanation of the issues of transparency, accounting rules and rating agencies.

On Thursday and Friday evening, the participants were invited to respectively a reception of the State of Bavaria at the Residenz Palace and to a dinner at the Casino, HVB Forum. On the First occasion, **Emilia Müller**, Bavarian Minister for Economic Affairs, Infrastructure, Transport and Technology gave a speech in which she described the Bavarian Government’s policy initiatives regarding the financial sector in Southern Germany.



On the Second occasion **Dominik Kremer**, Head of North Europe, Pioneer Investments, Munich delivered a dinner speech in which he outlined some important trends in the asset management industry: The amounts managed by the industry are growing rapidly, the funds are more actively managed, the spectrum of assets is widening and the risk management of portfolios become more and more sophisticated. Due to ageing and declining fertility, the ratio in EU between retired citizens and employed citizens will change from approximately 1:4 to 1:2 in the next ten or twenty years. Average retirement periods will increase from currently 17 years to 22 years. The implied level of public pensions will not be sustainable. People will need additional retirement income. Because people have become more risk averse, many are today *un-invested* in risk assets. This challenge must be met by the asset management industry. Investment products must be developed that can provide old people with a sufficient retirement income. Distribution channels must be adapted to this strongly growing market. The market will put pressure on banks to re-think their business model. Persons working in the asset management industry must understand that their future will be dynamic.

Saturday morning started with a **Concluding Panel Discussion** chaired by **David T. Llewellyn**, Professor of Economics and Banking, Loughborough University.



The Commission chairmen **Wim W. Boonstra**, **Frank Lierman** and **Franco Bruni** summarized the discussion that had taken place in their respective commissions. Three distinguished speakers had been invited to give their views on the topics discussed during the Colloquium.

Andrew W. Mullineux, Professor of Global Finance, Birmingham Business School commented on the central bank's role when a bubble is developing. He supported the view that central banks should be ready *not to dance with the music* when the expansion gets stronger. Risk-related interest rates could be considered as a kind of insurance premium to be paid by the banks. The speaker found that the ECB had not disclosed much about the size of the *haircut* that is applied on eligible assets accepted as collateral. May be minimum reserve requirements should be re-imposed as an instrument to reduce pro-cyclicality.

Robert Raymond, Honorary Director at Banque de France and of the European Monetary Institute, Paris focussed on the interplay between regulation and risk. Asset managers want to have a well functioning regulatory framework. It provides a level playing field. Regulation implies costs. Reporting and control require resources. Uniform rules are desirable in view of the competition among regulatory systems. Mark-to-Market valuation is intellectually the best but it does not apply to non-listed companies and listed companies that are not traded daily. Potential conflicts of interest must be handled carefully. It should be made transparent who bears the risk and the principles of valuation applied should be explained to the investors.

William R. White, Economic Adviser and Head of the Monetary and Economic Department, Bank for International Settlements, Basel first observed that the Sub-prime Crisis did not disappear as someone hoped. It had

spread globally and had produced market turmoil. In Commission I and II, the causes of the turmoil had been discussed, in Commission III the discussion had focused on the question: What to do about it? Experience shows that financial crises come from time to time and to some extent they look the same. We are all subject to psychological factors. Pro-cyclicality reflects human failure. People tend to overlook the risk, they suffer from *Disaster myopia*. We need a new paradigm. There should be focus on systemic exposures – macro-prudential as well as micro-prudential monitoring. There should be closer cooperation between supervisors and central banks. The discussion after the presentations focussed on the understanding of herd behaviour, asymmetric information, lack of understanding of advanced financial products and the difficulties in intervening when everything seems to go fine.

The **Marjolin Lecture** 2008 was given by the Nobel Prize Winner **Robert C. Merton**, John and Natty McArthur University Professor at the Harvard Business School, Boston. The title was: *Observations on Future Trends in Asset Management: Challenges and Opportunities*.

The speaker started by referring to the enormous changes in the financial system that had changed life for producers, users and overseers of financial services. Development of derivatives has affected risk allocation and made separation of risks possible. Risk is today a separate dimension of management decisions. There seems to be a conflict between two fundamental dictums in international economics and financial theory: *Exploit your comparative advantage and diversify your portfolio*. The core of asset management activity is to reconcile them.

Barbell strategies imply decomposition of the investment process. Very efficient, low-cost sector exposures (Beta) can be acquired through index funds, ETSs and derivatives. The implication for institutions is that they will increasingly move into alternatives, whether captive or outsourced. Greater transparency of strategies and sources of value-added should reveal costs related to alpha and beta strategies. Institutions will have a much greater need for *portfolio assembler* functions to put components



together. Investors will need integrated risk measures for alternative and traditional asset classes. The speaker explained the stages of a production process by means of a diagram in

which passive well-diversified portfolios are combined with active asset class allocation and aggregate excess-return portfolios (*Alpha Engines*). In the next stage, the resulting efficient portfolio of risky assets is combined with a portfolio of riskless assets to produce an optimal portfolio of assets. Investors should always ask where extra returns are coming from. What kind of risk do I accept to be exposed to in order to obtain extra return? Hedge funds do provide a risk-transfer service that they are paid for. The increasing un-sustainability of public pension systems implies that people must increase their savings for retirement. Unfortunately, they are not qualified for investing in the appropriate portfolios themselves. They need intermediaries.

The speaker then turned to Sovereign Wealth Funds. Although the execution of sovereign wealth funds, reserves and debt management can be decentralized, the objective function from which the optimal policies for each are derived should reflect an integrated generalized Asset/Liability Management perspective on overall country risk exposures. He used a Government Economic-Risk Balance Sheet with data from China in order to illustrate the point. He recommended that foreign currency reserves should be managed by the central bank and that risk-return considerations should be decided by the Government. Modern financial technology permits the separation of risk-exposure selection and management from physical investment choices, capital expenditure plans, ownership and governance of assets. Risk exposures can be radically changed without effecting capital, trade or income flows or the balance sheet. Thus, risk is a separate dimension of management decisions. In the last part of his lecture, Professor Merton explained the enormous potential in using swap-contracts among countries in order to preserve comparative advantages and obtaining efficient risk diversification. He listed the advantages of using the instrument: It minimizes moral hazard of expropriation or repudiation. Locals still perform industrial governance so that the political risk of “selling the crown jewels of the country” is avoided. There is no principal amount exposed to credit risk. Policy is non-invasive and reversible etc.

By means of a risk-return diagram illustrating the performance of world equity and bond markets from 1972 to 2001 and a CAPM line, he concluded with a very rough estimate of the potential gain to emerging market countries of moving by means of swap contract closer to the CAPM line. These countries would have been much bet-

ter off both in terms of higher return on assets and lower risk if they had used swap-contracts with the rest of the world. Responsible managers of financial institutions, academics, overseers, central bankers and politicians must try to understand the wonderful opportunities that come out of this. We can use these innovations to improve the world.

The very lively discussion following the Marjolin Lecture concerned the counterparty issue in the proposed swap-contracts, portfolio home-bias, the need to make decisions on incomplete data etc. Professor Merton’s final remark was: *I am an engineer by education, and I want to be a problem solver*. The applause from the audience lasted a long time.



According to the tradition at SUERF Colloquia, the Marjolin Lecturer awarded the **Robert Marjolin Prize** to the author of the best contribution to the Colloquium given by an author below the age of 40. In Munich, the award was given to **Tobias Berg**, for the paper: *Linking Credit Risk Premia to the Equity Premium*. Tobias Berg is currently a PhD student at the Department of Financial Management and Capital Markets, Technische Universität München. His research interests include risk management and asset pricing with a particular focus on risk premia on equity and credit markets. He worked as a risk management consultant and is a professional risk manager (certified by PRMIA). He received a diploma in business mathematics from the University of Marburg in 2004.

Ernest Gnan, Secretary General of SUERF and Counsel to the Board, Oesterreichische Nationalbank concluded the Colloquium by thanking the presenters, the sponsors and the co-organizers for their support in arranging the Munich Colloquium.

News from the Council of Management

It is with a very real sense of great regret that we have to announce the retirement from the Council of one of its longest standing members – **Alois Bischofberger**. Alois joined the Council in 1997 and has been an active member for over ten years.

SUERF has benefited greatly from his active support and the standing he has brought to the Council through his very successful career in international banking. He has worked at Citibank and JP Morgan in New York. He joined the Economics department of Credit Suisse in 1973 and has remained with the bank since then having been Head of the International Economics Department, Chief Economist of the bank in Zurich, Economic Adviser to the Executive Board of the Credit Suisse Group, and finally as Chief Economist. During this long period as an economist at one of the world's leading banks he has developed a major and well-deserved international reputation for his clear and incisive analysis of economic issues and how they relate to the world of banking and finance. He has an unrivalled experience of the changing nature of banking and its challenges and this has served SUERF well over the years.



During his long career, he has also been Treasurer of the University of Zurich's Foundation for Academic Research, a member of the International Conference of Commercial Banking Economists, the Conference Board's Council of Economists, and the Society of Zurich Economists.

He has been a member of the Council of Management of SUERF during a period of substantial change and, without doubt, he has been a major figure in guiding its evolution. Successive Presidencies have always been able to call upon him for wise counsel and this has been greatly valued.

He, and his bank, has supported SUERF in many ways including a valuable profile in Switzerland. In addition, and with the support of Credit Suisse, he has organised SUERF events in Switzerland including two successful local seminars on banking issues both of which were very well attended.

In addition to his professional contributions to the work and profile of SUERF, he has also been valued by his colleagues as a friend and he will be missed.

David T. Llewellyn

Member of the SUERF Council of Management

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For complete addresses of the Council Members and Curricula vitae see: www.suerf.org

Financial Crises

Franklin Allen and **Douglas Gale** (eds)- The International Library of Critical Writings in Economics Series no 218, Cheltenham: Edward Elgar Publishing, ISBN 978-1-84376-424-3. GBP 150.

International financial markets are currently in a state of turmoil. What started out as a potential problem in a particular segment of a particular financial market in a particular country, by now has spread to large parts of the world, adversely affecting not only financial but also real outcomes. Practitioners, policy makers and academics are increasingly focussing their attention to this episode of financial turmoil. Whereas academia has the luxury to learn from the current crisis by amending research agenda's (implying a stream of undoubtedly fruitful research products that will, unfortunately, only become available in the future), policy makers and practitioners have to make decisions in real time, using the information that is currently available to them. That information set includes research products, and the current volume in the International Library of Critical Writings in Economics Series of Edward Elgar Publishing consists of an impressive collection of the seminal contributions to the academic literature on financial crises of the past 3 decades. The list is impressive both in length (22 articles, dating from 1979 to 2006) and in its impact on the literature. Space constraints preclude a full listing, but contributors include C. Calomiris, J. Bryant, D. Diamond, P. Dybvig, C. Kahn, G. Kaminsky, P. Krugman, S. Morris, C. Reinhart and H.S. Shin.

Franklin Allen and Douglas Gale, themselves important contributors to the research field of financial crises, have done a commendable job in selecting papers and structuring them in a way that ensures that the volume exceeding 600 pages remains accessible to the reader. This is important for a book that consists of papers published earlier and that therefore primarily serves as a reference work. It is divided into 5 parts, allowing one – if so desired – to concentrate on the key contributions in a particular area related to financial crises. The first 2 parts are largely empirical and therefore relatively accessible, the remaining 3 parts provide the reader with the theoretical underpinnings of much of the currently existing literature on banking and currency crises.

The first part looks at financial crises from a historical perspective. This part is especially insightful, maybe disconcerting to some, as it makes clear that the crisis the financial world is currently confronted with is hardly unique, a point recently emphasised by Reinhart and Rogoff (2008).³ The comparison of stylised facts derived from previous banking, currency and twin crises - some of the data go back as far as the late 19th century - provides a very useful perspective. Examples include indicators of depth and duration of various types of crises, recovery times and the extent of the economic damage inflicted by the crises (measured in various ways). In addition to identifying correlations, other papers in this part offer causality by attempts to explain historical crises. More empirical and causal analyses are offered in the second part of the book. There one finds detailed estimates of the real economic costs of crises as well as analyses of their international interdependence and the interdependence between banking and currency crises.

The largest part of the book, part 3, is devoted to the analysis of banking crises. Here the reader finds by now 'classic' models in this field, focussing on the modelling of bank runs, usually under some form of sequential-service constraint (ie depositors arrive at the bank sequentially). In addition, one can find models in which bank runs are triggered by real shocks to the economy, and general equilibrium frameworks for studying normative aspects of crises. Interactions between banks and markets are explicitly modelled, allowing for a study of the behaviour and regulation of financial systems, including their welfare properties. Obviously, the degree of completeness of markets one assumes is of pivotal importance for the outcomes of these analyses. Banking crises often follow collapses in asset prices after what appears to have been a 'bubble'. This part of the volume thus continues with models that emphasize the link between bubbles and crises. The provision of liquidity plays an important role in this respect. Despite this, the role of money is ignored

³ Carmen Reinhart and Kenneth Rogoff (2008), *This time is different: A panoramic view of eight centuries of financial crises*, NBER Working Paper no 13882, Cambridge (MA).

in most models of banking crises, as these typically assume real-deposit contracts. However, some studies, included in the 3rd part of the volume, give a role to money and find that injections of money can have a role in preventing or mitigating the adverse effects of crises.

Part 4 is devoted to models of currency crises. Classic papers belonging to both the first generation currency crisis models (where fundamentals are the drivers of crises) and second generation models (expectation-driven) are represented here. The second generation models share with the banking crisis literature the issue of multiplicity of equilibria, so that the selection of equilibria becomes crucial. The editors had the insight to include in the volume (seminal) papers that apply the global games approach to the relevant parts of the crisis literature, notably to models that assume that banking panics are sunspot phenomena. The value added of this approach is that it leads to uniqueness of equilibrium which in turn allows comparative static policy analysis, thereby greatly enhancing the practical usefulness of this strand of the literature. The fourth part of the book ends with a model that combines banking and currency crises, by itself an important contribution as the literature on the two topics has, by and large, developed independently, despite empirical studies pointing to a close connection between these two types of crises.

The final part of the book refers to the process by which a shock in one part of the financial system spreads to other parts through a series of linkages. There are many kinds of interlinkages in the financial system, and thus many channels of financial contagion. The papers included in this volume that deal with financial contagion concentrate on liquidity shocks that are correlated between banks, and on contagion due to information that is correlated between markets. It must be noted that this part of the book is relatively short on contributions, and leaves the

interested reader with no other choice than consulting other works. This to some extent reduces the value of the text as a source of reference.

As said, the book does not contain new research, it aims to bring together the most important pieces of academic research in the field of financial crises published in the last 3 decades. Although relatively short on studies of financial contagion, the book serves as a valuable reference. It is rich in bringing together the fruits of various methodologies, ie micro and macro-economic studies, empirical and theoretical approaches. But, as the editors themselves admit ‘...despite the size and scope of the literature, much work remains to be done before these important phenomena are fully understood.’ (p. xxv). Seen from this perspective, and taking the current financial turmoil into account, the most recent developments in the field of dynamic stochastic general equilibrium models, that explicitly model frictions in the financial sector, are a step in the right direction. A radically different paradigm, stressing the inherent cyclicity and perhaps instability of the financial system, might also provide useful insights.⁴ But this does not detract from the quality of this book, for which the editors are to be commended. I recommend this book to scholars, who will find here many of the intellectual ancestors of future papers. For policy makers and market participants the book should be required reading, as it will provide them with an overview of what the mainstream academic literature currently has to say about financial crises. Taking note of this literature will undoubtedly lead to better informed decision-making.

**By Jan Marc Berk
De Nederlandsche Bank
The usual disclaimer applies**

⁴ See for example R. Bellofiore and P. Ferri (eds), (2001), *Financial Keynesianism and Market Instability: The Economic Legacy of Hyman Minsky, volume I*, Edward Elgar Publishing.

SUERF Publications

New SUERF Studies

2008/2 Commodities, Energy and Finance, edited by **Ernest Gnan** and **Már Gudmundsson**. 144 pp, ISBN-13: 978-3-902109-42-2. A joint publication with the Austrian Society for Banking Research, containing the following contributions:

- Introduction, main findings, and some conclusions by **Ernest Gnan** and **Már Gudmundsson**.
- Opening Remarks by Governor **Klaus Liebscher**
- Financial Investors and Commodity Markets by **Dietrich Domanski** and **Alexandra Heath**
- European Energy Markets: Moving in a Common Direction? By **Juan Delgado**
- Energy Markets in Europe: The State of Play and Future Prospects by **Walter Boltz**
- Norges Bank's Experiences with the Organisation of the Government Pension Fund – Global by **Birger Vikøren**
- The Russian Non-Fuel Sector: Signs of Dutch Disease? Evidence from EU-25 Import Competition by **Stephan Barisitz** and **Simon-Erik Ollus**
- Energy Prices, Inflation, and Monetary Policy by **Ulrich Kohli**
- Monetary Policy and Commodity and Energy Prices by **Irma Rosenberg**
- How Should Monetary Policy Take Commodity and Energy Prices into Account? By **Frank Smets**

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Future Events

The Council of Management has decided on the following forthcoming events in 2008 and 2009. **Other events may follow during the year** and will become available on the website and in the Newsletters in due course. You are therefore invited to visit the website regularly – www.suerf.org – to receive the most updated information.

The Council of Management is always pleased to consider suggestions for joint events from members.

11/12 September 2008 Paris, France	SUERF Conference <i>Financing SMEs in Europe</i> and SUERF Annual Lecture <i>Putting SMEs at the Heart of European Policies</i> by Commissioner Günther Verheugen – see the Programme in this Newsletter!
11/12 November 2008 Luxembourg	SUERF Conference <i>Productivity in the Financial Services Sector</i> , jointly organized with the Banque Centrale du Luxembourg
23 January 2009 Vienna, Austria	SUERF Seminar and Special OeNB East Jour Fixe, <i>Russian Financial System</i>
3 / 4 September 2009 Utrecht, The Netherlands	28th SUERF Colloquium <i>Request for Stability</i> (working title) – Call for Papers to follow shortly.

**For more details and latest news on SUERF Events
and for Registration Forms and Membership Forms, please visit**

www.suerf.org