



## The need for a new financial architecture after CORONA, an opinion\*

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*JEL-codes: F30, E52, E58, G15, G20, O10.*

*Keywords: Corona, architecture, financial system, ambiguity, financial stability.*

*Since the start of the 21st century, the architecture of the financial system has changed under the pressure of several crises. The way supervisors, central banks, regulators, and the commercial banks interact is now very different from the situation at the end of the 20th century. Many changes have been implemented as an “urgency measure” to stabilize the system, without looking at the coherence of the whole system and the occasional unintended consequences in the long run. Given that the Corona crisis will not allow us to return quickly to the architecture in line of “best practices” of last century, there should be a thorough analysis of the new “normal” and its internal coherence. Many of the existing “checks and balances” in the architecture have been eliminated for short term reasons. It is urgent to think about a financial system, adapted to the reality of today.*

### 1. Introduction

The CORONA crisis is already the third major crisis of the 21st century. The exploding dotcom bubble in 2001 was the first one, followed by the global banking crisis in 2008. These two crises started within the financial sector but had a severe impact on the real economy, which backfired again to the financial sector. The CORONA crisis is a medical crisis but will have an even more severe

impact on the real economy, and therefore potentially also on the financial sector. In each of these crises, the limits of financial stability were reached, and each time, regulators and supervisors had to invent “out of the box” approaches in order to calm down markets and return to relative stability. During the crisis, there were also discussions about fundamentally transforming the financial system, but in practice, there was only some finetuning of existing rules

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\* The article is also published in [BFW digitaal / RBF numérique 2020/5](#).

such as Basel III as an improvement of Basel II, but no spectacular changes in the formal construction of the system.

This does not mean that the financial system has not changed in practice since 2000. Indeed, the financial system has changed radically in the last 20 years, however, not based on a well-considered redesign, but because of bottlenecks that urged such changes. “TINA” (There Is No Alternative) has been the alibi for making changes under pressure without a coherent all-encompassing long-term vision. Such changes usually aim to tackle an urgent problem, without, however, addressing the root causes of the problem, and without focusing on the longer-term “unintended consequences”. The question is whether the interplay of all these emergency interventions and their cumulative effect for 20 years will not gradually become the cause of bigger problems in the future.

In this article, the philosophy of the architecture of the financial system as it existed until 2000 is briefly outlined. Afterwards it describes how that philosophy gradually changed since 2000 and deviated from its original design.

## 2. The financial architecture until 2000

At the end of the 20th century, there was a broad consensus in most developed countries about how to organize a financial system in order to support economic growth, while keeping the system stable. Major ingredients were the central bank, a competitive commercial banking sector, well organized financial markets, specific financial supervisors, a methodology for valuation of financial instruments and a methodology for building models.

### 2.1 The central bank, guardian of confidence in the currency, anchor for financial stability

The central bank is a government-controlled institution and is the only authorized issuer of primary money, say banknotes. It must have wide operational autonomy from the government to avoid that money is created as an easy solution for budget deficits. After all, that would undermine confidence in the currency and thereby jeopardize financial stability in the long run. Inspiring confidence is also why the central bank is managed by independent financial experts. At the same time, this independence obliges the government to keep some

budgetary discipline because it must finance deficits in a competitive capital market, without access to money creation. In several cases, such as the European Banking Union, direct financing of governments is even strictly prohibited by law.

The central bank also conducts autonomously the monetary policy that aims to create financial stability and confidence. The direct objectives of monetary policy can vary according to national preferences, but are usually a mix of economic growth, inflation and exchange rate monitoring in a sustainable manner. These objectives are usually enshrined in a law. That law also ensures that the central bank has the necessary instruments to influence the amount of money in circulation and the interest rates.

The central bank is also the banker of the commercial banks and as such has a far-reaching impact on the functioning of the commercial banks but does not compete with them.

The central bank has the possibility to provide commercial banks with emergency loans on their demand when they face liquidity problems. To this end, the central bank will create additional money. However, such loans are only provided to healthy banks and at a dissuasive interest rate, to promote discipline in the banking sector and to avoid distortions of competition.

### 2.2 The commercial banks transform the saving of the population into loans

The provision of banking services to the public is left to a competitive sector of credit institutions, the “official” name for banks. They attract public savings through deposit accounts and transform these into loans. These credit institutions can function under different forms: cooperatives, mutual, commercial companies possibly listed on the stock exchange, or even public institutions. They compete and are all subject to similar rules. As custodians of the population's savings, they have a prime responsibility to keep these intact, even though they provide credit with these savings, which involves risks. That is the fundamental challenge for banks. They are therefore obliged to maintain enough solvency and liquidity buffers. Since such buffers affect profitability, determining their minimum mandatory size is a delicate balancing act delegated to a supervisor/regulator (see 2.4). In order to further support public confidence in banks, they enjoy additional guarantees such as the deposit

guarantee system that reimburses depositors should a bank fail.

In the European regulation (CRR art 4), credit institutions are narrowly defined as “... *an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account*”. In addition to attracting the savings of the (retail) public and thus granting credit, the banks may also develop other financial activities insofar as these do not jeopardize their main task. For such activities, banks compete with non-bank financial companies.

Demand deposits with banks are considered part of the money supply because they are available at short notice. As banks provide loans with those deposits, the banking system implicitly creates money on top of the money supplied by the central bank. This mechanism, called the money or credit multiplier, supports economic growth but is potentially risky and is carefully monitored and influenced by the central bank, which has tools to curb or encourage money creation by commercial banks.

### ***2.3 Financial markets as an alternative to banks in the context of financial intermediation.***

Not all financial operators need the (expensive) security that the banks basically offer. They will directly invest in a wide variety of financial contracts (stocks, bonds, derivatives, etc.) on the financial markets, and bear the full risk themselves. As such, markets offer an alternative way of intermediation between lenders and borrowers. Financial markets are characterized by continuous and sometimes violent price fluctuations, reflecting fluctuations in the supply and demand for the traded contracts. Financial markets allow to hedge risks, but also to speculate.

There has always been a love-hate relationship between banks and financial markets. On the one hand, banks need financial markets to hedge their risks and develop useful products for their traditional customers, on the other hand, the distinction between careful investing, hedging risks and speculation is not easy to determine, while speculation is in principle not allowed for banks as they use the public's savings. As a result, significant fluctuations can be observed in time of the extent to which banks can operate in financial markets. After the Wall Street crash in 1929, which caused many banks failures, financial markets in many countries

(including Belgium) became prohibited territory for the banks. Rules have been relaxed since the 1980s, but after the 2008 financial crisis, banking activities in markets became again somewhat more limited, but without drastic rules.

### ***2.4 One or more financial supervisors***

Specific Banking Supervisors have been set up in many countries after the crash of Wall street in 1929 and the following worldwide depression. That crisis demonstrated how important a stable banking system was for the real economy, which justified a specific regulatory and supervisory framework.

Banking supervisors mainly aim to avoid financial problems of individual banks, as they are the “custodians” of community savings. They focus on the risk behavior of banks and on the buffers in terms of capital and liquidity that banks have in the event of problems. Central to banking supervision is currently an international treaty, Basel III, which is also transposed into EU law and national law.

Since operators in the markets consciously take risks, market regulators are primarily concerned with the transparency of the market and the honesty and expertise of the financial intermediaries that operate there. For the EU, the regulatory framework is MIFID.

Until 2008 there was a tendency to get to a single financial supervisor for all aspects of the financial sector, since the whole financial sector was increasingly integrated. After the banking crisis of 2008 that tendency reversed. With the banking union in the EU, the ECB became the micro-prudential supervisor for all banks of the Eurozone. Market supervisors remained national.

### ***2.5 An increasing role of market prices and models for the valuation of financial instruments.***

Valuation of financial instruments is a critical issue, especially for banks. On the one hand, there are the contractual arrangements, such as the annual interest rate and the expiration date of assets and liabilities, but on the other hand, the real value of a contract will change depending on the circumstances. The real value of a receivable from a client will decrease when the risk increases that the client will not meet his/her obligations. The discussion about using “amortized costs” or “fair value” accounting and reporting is going on since many years. The methodology used

has far-reaching effects on the level and volatility of the results and capital of banks. Inspired by the theory of efficient markets, fair value is increasingly the standard in financial reporting such as the IFRS rules. As such, it brings the volatility of financial markets into the bank accounts and adds complexity and risk to bank management. In order to mitigate that volatility, banks can use the “amortized cost” methodology for their traditional activity (deposits and loans) but must use fair value for their financial market operations. That hybrid system can lead to some “creative accounting”.

### 3. The financial architecture in 2020

Since the start of the 21st century, we have been confronted with two major financial crises already mentioned. The 2008 crisis caused extensive damage to the entire economy. Moreover, the available instruments of the central bank and supervisors proved insufficient to successfully combat the crisis. New, original interventions were deemed necessary, but without revisiting the overall architecture of the system. The CORONA crisis is once again leading to changes in the behavior of central banks, markets, supervisors and commercial banks.

#### 3.1 The central bank and its role in maintaining financial stability

Since the crisis of 2001, but certainly that of 2008, the priority of the central banks has shifted from “sustainable stability” to “short-term survival”. This is quite an understandable priority in times of crisis, but the consequences of such interventions, especially if they apply for a longer period, must be thoroughly analyzed.

Central banks found that even massive money creation and interest rates at 0% were not enough to create adequate economic growth and inflation. The discussion about the cause of this is still ongoing. Is this a result of unbalanced globalization, of the non-functioning of commercial banks, of an excessive tendency to save, of the flawed functioning of the EU, or a decline in productivity growth? Each of these causes would require a different approach, but in the absence of consensus, experimental tools such as “quantitative easing” led to an explosion in the size of the balance sheets of the major central banks. The CORONA crisis will once again lead to further growth of central banks’ balance sheets, and their impact on financial markets. No one knows the long-term

consequences of this process, but they could well be a potential threat to financial stability.

Central banks also seem to have rearranged their objectives without changing the formal framework. Since the ECB pledged “to do whatever it takes” to save the euro, it provides massive liquidity to banks that may not all be viable, it massively buys government bonds to cushion the financing burden for weak countries and it eventually will engage in lending to the private sector as a direct competitor of commercial banks. All these practices are helpful for stability in the short run but are in contradiction with the principles described in §2.1, which are still officially the guiding principles. In addition, the massive intervention on financial markets for political reasons has a direct impact on the pricing mechanism, which raises the question if market prices are still an acceptable proxy for “fair value”.

There is a growing belief that central banks will continue to use “non-conventional measures” in the future. In addition, there is a growing debate that monetary policy in the future will have to be coordinated with general economic policy, including taxation. But to what extent will central banks still be independent from governments in that case? If one is indeed considering implementing a coordinated approach of monetary and general economic policy, would it not be more efficient to bring central banks back under the direct influence of governments in some way?

#### 3.2 The role of commercial banks

The basic functions of commercial banks, to attract savings and to grant credit, have been supplanted for decades in so-called “universal banks” by more ambitious projects in the financial markets. Attracting savings and thus granting credit may no longer be the prime goal but can become a means to bind clients to which all kinds of products from the financial markets can subsequently be sold. The duality of the bank as a “safe haven” that assumes all risks, and the bank that gives financial advice but leaves the risk of the investments to the investor, can easily lead to confusion for the public.

Moreover, with a few exceptions, the European banks have never recovered from the crisis of 2008. Worse, the pursued monetary policy of 0% interest, which was also intended to provide banks with oxygen, has put their profit margin under pressure, so that potential shareholders turn away from the banking

sector en masse. A price-to-book ratio of stock prices of just 0.4, together with a “return on equity” of just 5.8%, adequately outlines the problem: banks are considered uninteresting by the equity investors.

In addition, the Corona crisis has caused the government to push banks to provide loans on a massive scale to companies, which they might not otherwise provide given the risks. The alibi is that banks should “give something back to society” as a “fine” for their “reckless” behavior that led to the 2008 crisis. From a moralistic point of view, this could make sense, but it is economically dangerous given the already difficult situation of the banking sector.

The fundamental question that arises is whether it is feasible in these circumstances to organize the banks primarily as commercial companies, owned by private shareholders, and in a competitive market. Or is it time to think again of a financial sector in which more cooperative and public banks are active, such as in Belgium until the 1990s?

### *3.3 The role of the financial markets*

Despite the intentions of MIFID and the regulators, major parts of the financial markets seem to be increasingly vulnerable. Complex products are back. HFT and other algorithmic trading is driving markets. ETFs and giant asset managers dominate the market and negative interest rates take their toll on investors desperate for some return.

It seems unlikely that under these circumstances market prices still reflect a rational consensus about value.

Nevertheless, banks are more than ever interconnected with and dependent on financial markets. Any major shock of financial markets will lead to severe problems for the banks.

### *3.4 The role of the supervisor*

In many countries in the 1930s it was decided to create a narrow regulatory framework for banks, and supervision by an independent “technocratic” regulator, who would only focus the health of individual banks (micro-prudential supervision). This was in response to the speculative behavior of the banks before, and the social problem facing a banking sector in difficulty. Just as the central bank

should only concern itself with monetary stability, the prudential supervisor should only deal with the health of the individual banks. Sometimes conflicts can arise between these different authorities, but that is simply the consequence of the architecture created.

Today, in Europe, the ECB is not only a monetary authority, but also a banking supervisor, so that any conflicts between the two roles do not surface transparently. Moreover, the ECB, together with the European Commission as legislator, is now rushing to relax banking rules to encourage banks to provide more credit. In any case, that seems to be in contradiction with its responsibility as a banking supervisor. It is increasingly becoming a challenge for the ECB to navigate between the sometimes-conflicting objectives of its different functions.

### *3.5 Financial models and valuation of financial products*

The remaining popularity of fair value is surprising: the 2001 dotcom crisis illustrated that pricing in financial markets is not always economically rational, as investors may collectively behave in an irrational way. For example, the warning for “irrational exuberance” by the then Fed chairman Greenspan in 1997 could not calm the financial markets as the stock prices continued to rise sharply for another 3 years, until the crash of 2001.

The 2008 financial crisis illustrated that complex quantitative risk management models are not infallible. Certain dimensions of risk are not or insufficiently captured by models, because risk is constantly transforming, while models are built on the experiences of the past. But more than ever, financial regulations such as Basel III are dominated by the quantitative approach to risk corrected with subjective limits if the models result in unacceptable valuations to the supervisors.

This strange combination of fair value, risk management based on complex models and regulation, also based on models but with subjective quantitative limits leads to continuous discussions and some confusion.

Both crises, 2001 and 2008, have not led to a review of the fundamental valuation rules embedded in regulations. Rather, they have led to even more complexity in modeling, or even more references to market prices.

#### 4. Conclusion

In this opinion paper, many ambiguities are identified within the actual architecture of our financial system, as it has developed over the last 20 years. Without proposing ready-made solutions, the purpose of this article is to indicate the need to have a global reflection about a coherent architecture of the financial system adapted to today's reality, given the current internal contradictions in the system that have grown in the meantime and where responsibilities, assignments and expectations are no longer always compatible. Reality is slipping away from the theoretical consensus. This exercise is urgent, knowing that any architecture has only a limited life cycle. Or as Minsky puts it in the closing

sentence of his phenomenal book “stabilizing an unstable economy”: “There is no possibility that we can ever set things right once and for all; instability, put to rest by one set of reforms will, after time, emerge in a new guise”.

And with this conclusion we could see a parallel between the challenge of a financial architecture as an instrument to maintain financial stability and the challenge of the medical sector trying to keep people healthy, and fighting hostile viruses that always succeed in mutating after some time, threatening once again health and the economy. Both must adapt continuously to the new realities and both should be forward looking. Just buying more face masks will not provide a sustainable solution. ■

#### About the author

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