The SSM at 1

Report on the 32nd SUERF Colloquium & Deutsche Bundesbank/Foundation Geld und Währung Conference

Frankfurt, 3-4 February 2016

By Jens Ulbrich, Deutsche Bundesbank, Carl-Christoph Hedrich, Commerzbank and Morten Balling, Aarhus University

On February 3-4, SUERF – The European Money and Finance Forum, Deutsche Bundesbank and Stiftung Geld und Währung jointly organized a Colloquium/Conference in Frankfurt in order to evaluate the experience with the SSM – the Single Supervisory Mechanism – during the first year of its existence.
Erich Loeper, Head of the Deutsche Bundesbank’s Banking and Financial Supervision Department, welcomed the participants. He said that by taking over the responsibility for direct supervision of the systemically important financial institutions in the Euro Area (the SIFIs), ECB had become one of the most important supervisors in the world. The creation of the SSM is the first pillar of the European Banking Union (EBU). Joint supervisory teams with members from many different countries work together in the SSM in order to provide a solid and coordinated basis for supervisory decisions. Risk-profiles of each SIFI are developed, the aim being that the performance of the institutions should be measured by a common yardstick. To create a level playing field for cross border competition among banks is a main concern. Non-SIFIs are still supervised by National supervisors, whose approaches are being harmonized, but room is left for national discretion. It takes time to develop such a comprehensive and unique European supervisory structure, and SSM is still making important experiences, but all in all SSM has – in the view of the speaker - started better than expected.

On behalf of SUERF, Urs Birchler, Professor of Banking and Finance, Zürich University and SUERF President also welcomed the participants and announced a few changes in the day’s program.

The first keynote speech “Monetary policy in the clutches of financial stability”, was given by Luc Laeven, Director-General of the General Research Directorate of the European Central Bank. He structured his lecture by posing three questions: 1) Should central banks incorporate financial stability considerations in the conduct of monetary policy? 2) Is macro-prudential policy effective in preventing the occurrence of financial instability? 3) Should bank capital be raised to support financial stability? Concerning the first question, the pre-crisis view was that central banks should focus on price stability, whereas financial stability objectives should be left to prudential authorities. After the crisis, a common view has been that central banks should incorporate financial stability considerations in the conduct of monetary policy. By leaning against the wind also by monetary policy instruments, the high costs of financial crises could be avoided. The appropriateness of leaning against the wind depends, however, on the relevance of the risk-taking channel of monetary policy. Different theoretical approaches deliver different predictions on the relationship between the monetary policy rate and bank risk taking. Portfolio allocation models predict that an exogenous decrease in the yield on safe assets will lead to greater risk taking. In models with limited liability and risk shifting, a decrease in interest rates may reduce risk taking by reducing the bank’s funding cost. The net effect of interest rates on bank risk taking is therefore an empirical question. Recent empirical studies support the presence of a risk-taking channel of monetary policy. Question 2 – the effectiveness of macro prudential regulation – is critical. Overall, the empirical literature supports the use of macro-prudential instruments in reducing the procyclicality of credit, but the extent to which they alone can effectively manage credit cycles and reduce systemic risk depends on circumstances. The cost of intervening too early and running the risk of stopping a desired boom have to be carefully weighed against the desire to prevent financial crises. In his answer to Question 3, the speaker said that higher capital requirements are desirable for two reasons: They increase the likelihood that buffers will be sufficient to absorb shocks, and they reduce the need for monetary policy to act in support of financial stability. In his view, the general direction of higher capital requirements taken by the Basel Committee seemed right. One should not forget, however, that corporate governance theory suggests that bank ownership structure influences risk taking. The keynote speech was followed by a Poster Session.
Sascha Steffen, University of Manheim & ZEW, presented a poster “Zero risk contagion- banks’ sovereign exposure and sovereign risk spillovers”. The underlying paper is co-authored by Josef A. Korte, Goethe University Frankfurt. The authors were awarded the 2016 Marjolin Prize. European banks hold large amounts of sovereign debt on their balance sheets. According to the EU Capital Requirements Directive banks are allowed to apply “zero risk weights” for EU sovereign debt. By using data on sovereign CDS spreads, the authors demonstrate larger co-movement with other European CDS spreads if banks have large exposures for which they do not hold capital. In this way, they identify a transmission channel for sovereign risk within the euro area. They show that more capital as well as less aggressive risk-weighting can mitigate this transmission channel.

Roberto Baviera, Politecnico di Milano, presented a poster “Is the comprehensive assessment really comprehensive?”. The underlying paper is co-authored by Emilio Barucci and Carlo Milani, also at Politecnico di Milano. The authors analyze an ECB database in order to evaluate the comprehensive assessment (CA) i.e. asset quality review (AQR) and stress test (ST) of banks carried out in 2014. They find that risk-adjusted capital ratios are negatively related to AQR shortfalls, but not to the stress test shortfalls. The CA is predominantly concentrated on traditional credit activity rather than on banks’ financial assets. The CA seems, however, to be characterized by double standards. Non-core countries were penalized by the AQR. Use of national discretion in capital requirements and state aid did not help mostly peripheral countries to pass the assessment. The authors regard the CA as an important step towards a level playing field in the banking sector. It is, however, too concentrated on credit activity rather than financial assets. It is appropriate that the Basel III rules focus on leverage ratios.

Jean-Edouard Colliardy, HEC Paris, presented the poster “Multinational banks and supranational supervision”. The underlying paper is co-authored by Giacomo Calzolari, University of Bologna and Gyöngyi Lóránth, University of Vienna. The authors address the risks of fragmented supervision and resolution and contagion through multinational banks (MNBs). These risks provide a strong rationale for a common supervision as the SSM. Centralized supervision solves coordination problems. Subsidiaries are better supervised. MNBs may, however, change their organizational form. The SSM has the potential of reducing losses and of redistributing losses across borders. In the long-run, supranational supervision encourages branches over subsidiaries and can discourage cross-border expansion all together.

Maximilian Muhn, Humboldt University, Berlin, presented the poster "Believe me, it will be enough: Governmental guarantees and banks’ risk taking in the fair value portfolio". The underlying paper is co-authored by Ulf Mohrmann, Universität Konstanz, Martin Nienhaus, Universität Münster and Jan Riepe, Universität Tübingen. The title is inspired by ECB President Mario Draghi’s announcement on 26th July 2012: “whatever it takes” to preserve the euro. This announcement was interpreted by the market as a signal about the ECB’s willingness to put a floor under EU sovereign debt prices. The authors do, however, not focus on the consequences for the bond markets of the ECB announcement. Instead they argue that governmental guarantees in general span a safety net for banks and, as a consequence, risk taking becomes more attractive. They investigate whether the so-called “Level 3 assets” are used as a way to exploit governmental guarantees. Model-based valuations contain a high degree of managerial discretion, which might be used to engage in regulatory arbitrage.

Alessandro D. Scopelliti, University of Warwick, presented the poster “Rules and discretion(s) in prudential regulation and supervision: evidence from EU banks in the run-up to the crisis”. The underlying paper is co-authored by Angela Maddaloni, European Central Bank. The authors use an indicator of regulatory and supervisory effectiveness constructed from EU directive implementation to investigate the role of prudential regulation and supervision in the prevention of banking crises across countries. They look at the stability of credit institutions subject to different national regimes – before the crisis – within the context of the European Union. Crisis support may be capital injections, guarantees on bank liabilities, asset protection schemes and liquidity facilities. They find a higher probability of crisis support for banks in countries with more flexible regulation or supervisory discretion. There is a larger
increase in the support probability for banks subject to a laxer prudential framework if they are more financially fragile (subject to higher liquidity constraints).

Anna Damaskou, University of Luxembourg, presented the poster “Banks v. SSM: the party has just started”. The presenter referred to cases before the EU Court in which the legality of decisions by other EU institutions has been challenged. Against this background, the question arises: is the SSM prudentially constructed (institutionally) and prudentially operating (procedurally), so as to refute possible future arguments of this nature, in order to keep its decisions standing? Good governance at institutional and procedural levels is crucial for the lawfulness of SSM’s decision-making. The SSM is still at its infancy. Thus, there is still ample room for strengthening its institutional and procedural soundness. Success of the SSM will be assessed also on the basis of the legality of its decisions.

Hanno Stremmel, Otto Beisheim School of Management, presented the poster “Can financial cycle dynamics predict bank distress?” The underlying paper is co-authored by Giannoula Karamichailidou and David G. Mayes, both University of Auckland. The paper addresses the research question in the call for papers: How to construct an early-warning system for systemic risk? The authors consider the importance of financial cycle fluctuations and other potential systemic risk influences both to the real economy and also to the banking sector. They attempt to improve existing early warning systems by incorporating a financial cycle measure. Z-scores are accounting-based measures, obtained from balance sheet and income statements of listed and unlisted institutions under investigation. Their model displays a modest ability to explain banks’ individual z-score in Europe. Bank-specific and banking system variables have the expected signs and plausible magnitudes. The model offers a clear impact of the financial cycle phase but the role of macro-economic variables appears to be rather limited. The authors are, however, not very optimistic about the early warning ability for individual banks in general.

Frederik Mergaerts, Ghent University presented the poster “Business models and bank performance: a long-term perspective”. The underlying paper is co-authored by Rudi Vander Vennet, Ghent University. They find that business model characteristics are important determinants of performance, but that no specific bank type outperforms in all dimensions. Bank performance is measured by return on equity, return on assets and net interest margin. Classification of bank business models is based on factor analysis. They find that both a higher degree of retail orientation and functional diversification are associated with better performance. An implication of the study is that prudential regulation should also reflect the heterogeneity of bank business model decisions. This is in line with EBA guidelines to supervisors.

The Poster Session was followed by a Panel: Interaction of micro-/macroprudential policies and monetary policy.

Claudio Borio, Head of the Monetary and Economic Department, BIS gave the first panel presentation: “Seven don’ts and one hope: The nexus between prudential and monetary policies”. The speaker wanted to explore the nexus between prudential policy (PP) and monetary policy (MP). The presentation was structured in the form of 7 don’ts (Ds). The focus was on how to tame the financial cycle. D.1 was: Don’t oversimplify the micro/macro prudential distinction. Macroprudential policy is a philosophy/orientation of PP, not a separate policy. D.2: Don’t underestimate the role of capital as the basis for lending. The regulators should be less timid when asking for higher regulatory capital. D.3: Don’t set overly ambitious goals for macroprudential policy during busts. It is better to make sure that capital buffers are sufficiently high to start with. D.4: Don’t regard the length of the financial cycle as a reason to forget MP. It is best to think of macroprudential and MP as complementary tools. D.5: Don’t overlook the impact of the financial cycle on productivity growth. Financial booms tend to undermine productivity growth. Thus, constraining financial booms has benefits even if busts and crisis do not follow. D.6: Don’t think of a financial stability-oriented MP simply as “leaning-against-the-wind”. It is key not to deviate too much and for too long from “financial equilibrium”. D.7: Don’t presume that even MP and PP combined can tame the financial cycle. There are serious political economy obstacles. The hope is to edge closer to taming the financial cycle in the future.

Sergio Nicoletti-Altimari, ECB called his presentation “Monetary and macroprudential policies”. In
Macroprudential policy, a broad set of targeted instruments are used to tackle systemic risk in the financial sector – the aim is financial stability. Monetary policy operates primarily through the interest rate and aim at asset prices and price stability. Macroprudential policy has the potential to smooth the financial cycle and to reduce amplifications through regulation. Macroprudential measures aiming at markets for real estate comprise limits to loan/value ratios, income-based limits and restriction on maturity of loans. The use of such measures varies across EU countries. Banks, insurance companies, investment funds and pension funds hold securities with different ratings in varying proportions. Their concern for credit quality varies. The macroprudential tool kit should be developed such that financial stability perspectives are taken into consideration.

The following keynote speech was given by Isabel Schnabel, University of Bonn and German Council of Economic Experts. The title was “Should banking supervision and monetary policy be separated?” With the establishment of the SSM more than a year ago, the ECB had become responsible for both monetary policy and banking supervision in the euro area. One could therefore ask: Has the ECB become too powerful? Could another structure be superior? Sharing of information in a unified structure on the supervised financial institutions can bring advantages. Coordination of macro- and micro-prudential actions may be easier. However, when there are conflicts between price stability and financial stability objectives, the ECB faces a difficult weighing problem. This may in particular be the case, when the ECB uses the risk-taking channel of monetary policy. If supervisors make mistakes, it might damage the ECB’s reputation. The speaker referred to a recent study of central banks in 34 OECD countries. The central banks had been asked about their involvement in supervision of banks at the national level. The empirical analysis showed that cooperation between supervisors and central banks had a positive impact on the results of crisis management, but that the transfer of tasks to a single authority was less important. The speaker concluded that an important policy implication of the study was that the SSM ought to be established as an independent institution separated from the ECB. The SSM-institution should also include non-euro EU member states. She said that she was concerned about the current situation.

The dinner speech at the evening of February 3 was given by Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank. The title was: “A success story? Reflecting on one year of European banking supervision”. The speaker started by quoting Henry Ford, who once said: “Coming together is a beginning, keeping together is progress, working together is success”. European supervisors came together in November 2014, when the SSM became operational. The ECB assumed responsibility for supervising the most significant banks (the SIFIs) in the euro area. By this step, the ECB became the first supranational supervisor in the world and one of the biggest. Since the establishment, the experience with keeping together has been quite positive. Banks in the euro area are now supervised according to a set of harmonized standards. At the same time, the SSM has to meet the challenge of implementing supervisory practices that are proportionate to the specific characteristics of individual institutions. Institutions that are not SIFIs, continue to be directly supervised by the national competent authorities. The ECB and the national supervisors are currently in the process of developing joint standards for the supervision of these smaller banks. However, supervising the non-SIFIs is, and should be, a matter for national supervisors. That conforms to the principle of subsidiarity and represents the most effective and efficient solution. Since the ECB is responsible for European banking supervision, it follows that the Governing Council is accountable not just for monetary policy issues but also for matters of banking supervision. In order to minimize potential conflicts between monetary policy objectives and supervisory objectives, a governance structure has been put in place to limit the Governing Council’s involvement in supervisory decisions. The European Banking Union (EBU) is scheduled to rely on three pillars: The Single Supervisory Mechanism (SSM), the Single Resolution Mechanism (SSR), and a common European deposit guarantee scheme. The SSR has been operational since January 1, 2016. In the view of the speaker, it would be premature at the present time to establish pillar no. 3, a single European deposit guarantee scheme. It would necessitate wide-ranging changes to both national and European legislation, which do not have sufficient political support. There is no justification for pan-
European risk sharing without fundamental adjustments of the current framework. Significant progress has been made in the regulatory space in recent years. Basel III with stricter capital requirements and new liquidity rules is the most important measure. The speaker’s regulatory priority was to finalize the Basel III reform package in 2016, i.e. the review of the trading book and banks’ internal models for credit risk as well as calibration and design of the leverage ratio. The speaker underlined that nevertheless all these regulatory projects would not target on imposing further burdens on the banks. In his concluding remarks, Mr. Dombret came back to the Henry Ford quotation: Working together – as regulators and supervisors, at the national, the European and the global level – would be a huge step towards successfully safeguarding financial stability.

On February 4 in the morning, Mario Draghi, President of the ECB gave the 2016 Marjolin Lecture “How central banks meet the challenge of low inflation”. The president distinguished between two types of monetary policy challenges: Challenges that are common to all central banks in advanced economies, and challenges that are special to the monetary authorities in the euro area. All central banks are faced with the question: can the price stability mandate be delivered? This leads to the question whether inflation is currently more rooted in global factors than in domestic ones. Or, whether more structural factors hold inflation down, e.g. demographic forces in ageing societies. President Draghi took these arguments in turn, acknowledging that inflation has been affected significantly by oil and commodity price developments. This does not imply, however, that monetary policy can step back or treat these factors with benign neglect. If low inflation is increasingly being caused by structural factors in the global economy that cannot be addressed through domestic monetary stimulus, it would constitute a very fundamental criticism of central banks’ mandates. It seems, however, unlikely that demography can explain why inflation is low today across advanced economies that have very different demographic profiles. Other structural shifts are the long-term cycle in commodity prices, technological change and globalization. There is, however, no reason why any of these structural changes should make the current price stability objectives unobtainable. Central banks do typically refrain from reacting to supply shocks that have opposing effects on output and inflation, so as not to overreact and reinforce the effect on growth, in either direction. However, since there is always a backward-looking component in inflation developments, the longer inflation stays too low, the greater the risk that inflation does not return automatically to target. Low inflation can feed into inflation expectations and create second-round effects. Risks of acting too late may outweigh risks of acting too early. Lessons of monetary history in the US as well as in Japan underline the importance of full commitment from policymakers. If we have the will to meet our objective, we have the instruments. The lower bound for policy rates is not at zero. Furthermore, the ECB has demonstrated the suitability of non-standard measures. If all central banks act to deliver their mandates, then global disinflationary forces can eventually be tamed. Some observers have expressed concerns about the impact of expansionary monetary policies on accumulation of excessive foreign currency debt or asset bubbles abroad, especially in emerging markets. The president’s contra-argument was that it would not help emerging markets if advanced economy central banks failed on their mandates. Countries have the option to improve their financial regulation and supervision to make their financial systems more resilient to external shocks. They can also apply fiscal policy and macro-prudential measures. The institutional structure in the Euro area implies special challenges. ECB conducts monetary policy in a segmented banking and capital market, and without a single area-wide fiscal authority as a counterpart. Segmentation of markets leads to lower sharing of risks. It means that the bank lending transmission channel and the balance sheet channel are more likely to be disrupted in the event of major shocks. It means also that financial fragmentation takes place.
along national lines. The ECB must design its instruments to compensate for this. Examples are the measures to substitute for the drying up of the interbank market, the intervention in sovereign debt markets and the credit-easing package. The creation of the European Banking Union (EBU) is, however, an important step to remove fragmentation risks more permanently. The two pillars - the SSM and SRM - are now in place. The third pillar – a European common deposit insurance scheme– is, however, still missing. The ECB welcomes the Commission’s proposal for such a scheme and expects it to contribute to both risk sharing and risk reduction and to ensure a more homogenous transmission of monetary policy. Under the existing institutional structure, ECB has to implement its asset purchases in multiple markets. It implies that the measures have an impact on credit allocation across regions and types of borrowers. ECB designs its monetary policy instruments in a way that minimizes distortions. The allocative effects can also be reduced by further integrating the markets, in which the ECB intervenes. To that end, a robust fiscal framework, which is enforced credibly would reduce the risk inherent in individual government bonds in the euro area.

The following Panel: ”The SSM after the Comprehensive Assessment. Has the CA served its purpose? Have legacy assets been dealt with effectively?” was moderated by Daniel Schäfer, Handelsblatt.

**Felix Hufeld**, President of the German Federal Financial Supervisory Authority, BaFin, said that the Comprehensive Assessment for the BaFin had involved a lot of work, analysis of many thousands credit files and evaluation of bank assets amounting to more than EUR 75 billion. It was the first time that such an exercise had been conducted on a harmonized basis in Europe. He considered it to be a very solid starting point and a good basis for evaluating the quality of banks’ balance sheets. It ought to be repeated. The CA had elevated the procedures followed by the BaFin. The choice between supervision and regulation is a difficult balancing act. Together with other national supervisors and people at the ECB, we are on a joint learning curve. The next stress-test should focus on the banks’ low profitability.

**Martin Blessing**, CEO, Commerzbank, Agreed with Mr. Hufeld that the CA had been a huge task. But, it went better than he had expected. The people working for SSM were high-quality people. Sufficient bank capital is good to have for absorbing possible losses. However, supervisors do not know, what optimal bank balance sheets should look like. Investors are exposed to regulatory uncertainty. This has implications for the ability of banks to raise more equity capital. How can a bank manager give promises about the future return to shareholders, if it is uncertain how much dividend he is allowed to pay?
Klaas Knot, President, De Nederlandsche Bank, said that the CA should be seen in the context of improving bank balance sheets. It was essential that higher bank capital should enable banks to lend more. Some of the consequences of the CA were still to come. However, nobody can tell the exact point, where banks are sufficiently capitalized. There will always be a debate on banks’ dividend policy. Should future cash flows be paid out to the shareholders or should they be used for consolidation of bank capital. In the following debate among the panel members, Klaas Knot welcomed the increasing use of bail-ins. He said: “Let us bring capitalism back to the financial sector”. The fiscal space for bail-outs is exhausted. As answer to a question from the moderator concerning sovereign debt risks, Mr. Knot said that such risks should be adequately priced. Bonds are never risk-free.

The panel was followed by an interview: Mark Schieritz, Die Zeit, interviewed Claudia Buch, Deputy President, Deutsche Bundesbank. The theme was: “Completing the Banking Union/Capital Markets Union – where do we stand?” The Deputy President was asked, if she was happy with the SSM. She answered that important progress had been made with the new institutional structure. Bail-ins were being designed to bring capitalism back to the banking sector. The hierarchy of claims should, however, be further clarified. Banks should be made safer. We are still not ready for a centralized deposit insurance system in Europe. Mutualization of debt at the European level is a difficult political issue. We cannot create something completely risk-free. Somebody will always have to carry the risk. Risks should be acknowledged in regulation and in the capital requirements. The capital markets union will give greater possibilities for private cross-border risk-sharing.

Ignazio Angeloni, Supervisory Board Member, ECB gave the keynote speech: “Macroprudential policies to contain systemic risks”. He referred to some recent research projects carried out on the initiative of the Systemic Risk Board. Macroprudential and microprudential instruments aim at financial stability, while monetary policy instruments aim at price stability. Possible conflicts between the objectives require an appropriate coordination system. The SSM supervisory board can launch microprudential initiatives. A coordination forum has been established to oversee the use of macroprudential instruments. Systemically important financial institutions will in the future have to build up general systemic risk buffers. The supervisory methodology developed by the BCBS will be implemented by the responsible supervisors.

The title of the concluding panel was: “Banks’ business models: trends towards specialization or outsourcing to the shadow banking system? Do we need a “shadow banking union?”

Svein Andresen, Secretary General, Financial Stability Board introduced his contribution to the panel by illustrating the substantial costs of the recent global financial crisis. Public debt increased in the countries hit by the crisis. The crisis caused a large output loss. In advanced economies, unemployment is still well above pre-crisis levels. Most globally systemic important banks have reduced trading and interbank lending and increased non-trading securities holdings. They have also increased retail deposits and reduced short-term wholesale and long-term funding. Total bank lending has decreased in recent years, while lending by non-bank financial intermediaries has increased. The monitoring universe of non-bank financial intermediation comprise lending by insurance companies, pension funds and other financial intermediaries. The FSB has been coordinating and contributing to the development of policies to strengthen oversight and regulation of shadow banking aiming at mitigation of financial stability risks posed by shadow banking entities.

Ludger Schuknecht, Chief Economist, German Ministry of Finance, listed four drivers of change in the financial sector: 1) Deleveraging of banks’ balance sheets, 2) the low interest rate environment, 3) the regulatory environment and 4) Digitalization. Financing outside the banking system takes place through corporate bond issuance, lending by investment funds and money market funds, securitization, private placements and crowd funding. The increasing importance of non-bank financing calls for supervisory attention to developing mismatches and run risks, volatility risks, regulatory arbitrage and the lack of resolution regimes. A “Shadow Banking Union” is not needed. We should concentrate on implementing the European Banking Union. A global approach is, however, needed. And we should not forget that solvency of governments is the anchor of the system.
Sound public finances ensure the presence of safe assets in bond markets and a backstop when financial shocks occur.

Enrico Perotti, Professor, University of Amsterdam, called his contribution to the panel: “Emerging risks and shadow banking”. Shadow banking can be defined as credit intermediation by non-banks. It can also be defined as credit based on liquidity and maturity transformation based on uninsured market instruments. Bank funding is cheap because banks offer liquidity on demand. This construction makes banking unstable and requires regulation. How can shadow banks match this? They can by obtaining liquidity guarantees from banks. Shadow banks can obtain direct funding with secured financial credit. To control risks associated with shadow banking, we need to keep track of this construction. We must make sure shadow banks do not expand in illiquid assets by feeding on liquidity guarantees by banks.

Christian Thimann, Head of Strategy, AXA, called his contribution to the panel: “Views on insurance, regulation and the macro environment”. Insurance companies are large investors in European financial markets. They carry out a very diversified business and have balance sheets that are very different from banks’ balance sheets. They are experts in risk management. In insurance companies, asset-liability management is at the core of balance sheet structure and management. Their asset allocation is strongly influenced by regulation. Government bonds and private bonds represent almost two thirds of total investments. In recent years, it has been a great challenge for insurance companies to adapt to low interest rates.

Urs Birchler, President of SUERF concluded the conference by thanking Deutsche Bundesbank for use of the premises and for close cooperation in organizing the event. He thanked Foundation Geld und Währung for financial support, and he thanked the chairpersons and the speakers for their important contributions. He gave special thanks to Jens Ulbrich, Deutsche Bundesbank for his role as anchorperson in the organization.
SUERF/CEPII/PSE Conference

Rethinking Capital Controls and Capital Flows

16 September 2016
Amphithéâtre SCOR, 4, avenue Kleber
5016 Paris

Thursday, 15 September 2016
Conference Dinner
Dinner Speech by Benoît Cœuré, Member of the Executive Board of the European Central Bank

Friday, 16 September 2016
Session I: Capital flows and capital controls
Session II: Capital controls and volatility
Policy Panel: Capital flows and the international dimension of monetary policy

Confirmed Speakers:
Lorenzo Bini-Smaghi, Société Générale
Olivier Blanchard, Peterson Institute for International Economics
Kristin J. Forbes, MIT Sloan School of Management
Marcio Gomes Pinto Garcia, Pontificia Universidade Católica do Rio De Janeiro
Ilan Godfajn, Itau, Unibanco
Anton Korinek, Johns Hopkins University and NBER
Fabrizio Perri, Federal Reserve Bank of Minneapolis
Alessandro Rebucci, Johns Hopkins Carey Business School
Hélène Rey, LSE
Natacha Valla, CEPII, EIB and SUERF
Frank E. Warnock, Darden Business School-University of Virginia

www.suerf.org/paris2016
Motivation - Europe’s Economic and Monetary Union (EMU) has been a driving force of the global economy and financial markets since the project was first launched on 1 January 1999. The crisis revealed the structural fault lines of the initial project and although significant progress has been made to strengthen the institutional setup, further work lies ahead. Bringing together leading policymakers, technical experts and practitioners, the first SUERF conference held in the United States offers a unique opportunity to gain an in-depth understanding of EMU and the key factors to watch for both economic and market trends. The conference will address the following key questions: What is required for European finance to become fit for growth? Does the ECB have enough ammunition to get inflation back to target? Is helicopter money the next unorthodox policy tool? Can the Single Market deliver a new growth spurt for Europe? How will Europe tackle the changing political landscape?

Confirmed Speakers:
Edmond Alphandery, Chairman of the Centre for European Policy Studies (CEPS)
Lorenzo Bini-Smaghi, Chairman of Société Générale
Marco Buti, Director-General, Economic and Financial Affairs, European Commission
Willem Buiter, Chief Economist at Citibank
Richard Clarida, Professor of Economics, International and Public Affairs, Columbia University
Joachim Fels, Global Economic Advisor, PIMCO
Werner Hoyer, President of the European Investment Bank (EIB)
Patrick McMahon, CEO, MKP Capital Management
Edmund Phelps, Professor of Political Economy, Columbia University
Peter Praet, ECB Executive Board
Klaus Regling, Managing Director of European Stability Mechanism (ESM)
Jan Svejnar, Professor of Global Political Economy at Columbia University
Nicolas Véron, Senior Fellow at Bruegel, Visiting fellow at Peterson Institute of Economics

www.suerf.org/ny2016
SUERF/EIB Conference

**Financing Productivity Growth in Europe**

Thursday, 17 November 2016
98-100, Boulevard Konrad Adenauer
L-2950 Luxembourg

**Motivation** - The SUERF/EIB Conference will focus on the legacy of the financial crisis on corporate financing and the resulting challenge for the recovery and European competitiveness. The conference addresses high-level policy makers, academics and the business community. The EIB is preparing a background publication to guide the discussions of the conference, including own work and contribution from leading academics. The 2016 EIB investment and investment finance report will be presented during the conference. The conference consists of three panel sessions. The evening before the conference there is a welcome dinner for participants with a keynote speech.

- **Session I**: Investment in Europe: A matter of supply and demand
- **Session II**: Efficiency of European financial sector in allocating finance
- **Session III**: Making European non-financial corporations more resilient: Lessons from the financial- and sovereign debt crises

**Confirmed Speakers:**
- Marco Buti, Director-General, Economic and Financial Affairs, European Commission
- Werner Hoyer, President, European Investment Bank
- Sebnem Kalemli-Özcan, Neil Moskowitz Endowed Professor of Economics, University of Maryland
- Cathrine Mann, Chief Economist, OECD
- Gianmarco Ottaviano, Professor of Economics, LSE
- Debora Revoltella, Director, Economics Department, European Investment Bank and SUERF
- Thomas Wieser, President, Europa, Economic and Financial Committee

[www.suerf.org/luxembourg2016](http://www.suerf.org/luxembourg2016)

SUERF/Belgian Financial Forum Conference

**FinTech and the Future of Retail Banking**

Friday, 9 December 2016
Auditorium National Bank of Belgium
Rue Montagne aux Herbes Potagères 61
1000 Brussels, Belgium

**Motivation** - SUERF and the Belgian Financial Forum (BFF) will hold a joint one-day conference in Brussels on 9 December 2016 as part of the BFF’s 80th anniversary celebrations. The conference will feature a keynote session by Jan Smets, Governor of the National Bank of Belgium, and will cover the following areas:

- **Session I**: The threats and opportunities of FinTech: Is FinTech an enabler and or a disruptor?
- **Session II**: Testimonies of FinTech firms and new Financial Institutions
- **Session III**: Economic and legal vision on FinTech
- **Session IV**: Vision of leading banks, insurance companies and asset management companies

[www.suerf.org/fintech2016](http://www.suerf.org/fintech2016)
Mortgages and a housing market crash – lessons from a crisis

The causes and consequences of the financial crisis that began in the United States in 2008 and led to what is now called the Great Recession have been analysed from various perspectives in recent years. Atif Mian and Amir Sufi, professors at Princeton University and the University of Chicago, respectively, have published several studies with other authors on the factors behind the crisis, what happened during the crisis and how the aftermath was handled. Their research is also compiled in House of Debt – a stormy account of debt build-up and the events that inevitably led to a collapse.

The key message of the book is based on the following idea: Most of the wealth of the US households is in housing. If a household has a large mortgage relative to the value of the house, even a small decline in housing prices will markedly erode the household’s net wealth. For example, if a household has a mortgage of EUR 80,000 and the value of the house is EUR 100,000, net wealth is EUR 20,000. If housing prices decline 10%, the value of the house falls to EUR 90,000. As the amount of debt does not change, the net wealth is now EUR 10,000. Hence, a decline of 10% in housing prices reduced the household’s wealth by half.

If a household’s wealth suddenly decreases, the household’s consumption opportunities shrink. The household may also want to save more: maybe the housing wealth was meant for a ‘rainy day’ and the household begins to build up a new buffer to replace the one that was lost. The end result is a sharp pull-back in household spending.

The same logic applies to any asset item, but from the perspective of the aggregate effects the distribution of debt matters: if a decline in asset values concerns especially indebted households with high propensity to consume, it will cause a larger decrease in consumer demand. This is why a crash in housing prices, in particular, can be very detrimental for the overall economy.

In principle, there should be corrective mechanisms in the economy which prevent weaker spending due to a collapse of asset values from leading to large-scale unemployment. One such mechanism is a decline in interest rates: when indebted households save more, interest rates fall, which increases lending and investments by firms and spending by those that are less-indebted. Certainly, various rigidities can prevent this from happening. One such rigidity is the zero lower bound, i.e. that nominal interest rates cannot drop far below zero. That nominal wages tend not to adjust downwards is another key rigidity. Nor is it always easy for workers to switch sectors.

In the US, before the financial crisis, there were large regional differences in the level of household debt. When housing prices crashed, spending declined particularly in regions where households were heavily indebted. Unemployment increased, especially in local services. As the crisis advanced, job losses increased also in the sectors producing goods to be shipped outside of the local economy. These job losses increased also in regions which did not experience the housing bust. This development is consistent with the theory according to which spending first weakens in regions where household net wealth collapses, and through various rigidities the negative demand shock spreads to other parts of the economy.

Why were households overly indebted in some regions but not in others? Mian and Sufi begin their investigation of this issue by stating the following: “As we will argue, debt not only amplifies the crash. But it also fuels the bubble that makes the crash inevitable.”

1 The author thanks Esa Jokivuolle for useful discussions. Originally published in Finnish in the Bank of Finland blog, April 2016.
Mortgage lending expanded in 2002–2005, especially in regions where mortgage-application denial rates had traditionally been high. In this period, the denial rates declined from 43% to 30% in regions with high denial rates. This was the case despite the fact that the number of applications soared and a larger fraction than before was classified as subprime.

The fall in the denial rate could have resulted from the expected improvement in subprime borrowers’ economic circumstances. That is, they could have been borrowing against higher future earnings. But in the period 2002–2005, credit was expanding in low credit-score areas that were experiencing declining income growth. This suggests that the decline in the denial rates was not driven by improved earnings prospects.

Another possible explanation is that banks were willing to lend because of expectations of future house price appreciation. If house prices continued to rise, households could cope with their debt burden even with stagnant incomes. The third possibility is that mortgages were granted to households for which owner-housing had previously been unaffordable. This boosted the demand for housing and fuelled housing prices.

It is not easy to distinguish between the latter two explanations because household debt growth occurred at the same time as housing-price increases. So, what was the direction of causality? Here, Mian and Sufi make use of an index depicting housing supply elasticities in US cities. When housing demand increases, the price level rises more readily in areas where housing supply is inelastic. Indeed, when credit was expanding in 2001–2006, housing prices rose 40% in elastic cities and 100% in inelastic cities. If higher housing prices caused the debt build-up, debt accumulation should have been more extensive in inelastic cities. This was not the case, however. Instead, lending expanded in elastic and inelastic cities alike and especially in zip code areas with a large portion of subprime households. For this reason, Mian and Sufi conclude that the rise in housing prices was caused by the lending boom, not vice versa.

But why did subprime customers get loans more easily than before? The answer has its origins in the 1970s, when local banks started to sell off their mortgages to government-sponsored enterprises which would pool the mortgages and sell financial claims against the pool. In the 1990s, this securitisation of mortgages spread into the private markets, and the private-label securitization grew sharply in 2002–2006, particularly in zip code areas with large portions of subprime customers. Securitisation reduced local banks’ incentives to screen customers, and they expanded lending to new customers until they began to default almost immediately after the loan originated. When defaults turned up, the house of cards started to collapse.

The book describes this whole chain of events convincingly and analyses the cause–effect relationships in a plausible manner. When the authors shift to an assessment of policy responses to the crisis in the United States the text becomes more speculative and begins to show signs of annoyance. According to the authors, the reaction to the crisis was a horrendous mistake because the focus was on bailing out the banks rather than the over-indebted households. The situation was aggravated by the fact that there was no understanding of how the crisis spreads, e.g. due to labour market rigidities, to the whole economy.

Mian and Sufi seem to consider the choices made in the management of the crisis as incomprehensible. They argue that the US economy would have recovered much faster if the focus had been on saving homeowners instead of banks. Here the authors do not offer any actual counterfactual analysis but instead focus on how the crisis evolved gradually, along with the build-up of debt and subsequent rise in housing prices.

How can such disasters be prevented in future? If the root cause of the crisis was the large run-up in household debt, the obvious remedy would seem to be in restricting debt build-up. Mian and Sufi mention that the tax system favours debt at the expense of equity and that owner-housing is favoured over other assets, but they only briefly discuss potential tax-related measures. Nor do they go deeply into the ways of limiting household credit growth, e.g. by implementing maximum loan-to-value or debt-to-income ratios. Instead, they discuss how the entire financial system could be renovated so as to enable more efficient risk-sharing. Investments in businesses, homes and education involve risks that, if realised, may be unreasonable from the perspective of a single person. Debt contracts are too inflexible for sharing these risks: the lender gets a fixed return, which is independent of the success or failure of the investment project, except for the unlikely situation that the borrower cannot repay the debt.

It is easy to agree in principle that more efficient risk-sharing could potentially be beneficial for everyone. On the other hand, securitisation was also meant to mitigate individual banks’ housing loan risks. As Mian and Sufi’s book powerfully demonstrates, securitisation – in the end – also had other very negative effects.
Thrown in at the deep end

The governor of the Austrian central bank (OeNB), Ewald Nowotny, has argued that the welfare-economic framework has generated a very large body of literature on banking regulation, however, he also suggested that its applicability needs to consider that “policy makers have to develop regulation under substantial uncertainty about the correct model of the economy, the significance of market failure, the future development of banking, and the impact of regulation on bank behaviour and the economy”. In this regard, the book at hand serves as a beautiful case study of the latter.

Anniversary

In the introductory remarks to EBA’s first annual report (2011), Andrea Enria wrote that the EBA “started out in a pretty rough and difficult market environment with a number of key challenges to be faced immediately. It was not easy to focus on building a new organisation while having at the same time to deal with major challenges to the stability of the banking sector”. Recall that less than half a year after the EBA was established the sovereign debt crisis in the euro area unfolded. Throughout its five year existence, the EBA has had to deal not only with its primary task – “(harmonising) prudential rules for financial institutions throughout the EU, helping create a level playing field and providing high protection to depositors, investors and consumers” (mission statement, EBA website) – but the fallout from the financial and the sovereign debt crisis. This clearly made additional tasks such as promoting the convergence of supervisory practices more difficult and lead to an emphasis on risk and vulnerability assessment, including the EU-wide stress tests (another EBA task).

As the title of the book and the editor in his introduction suggest, “the objective (of the book) is to provide an overview of the tools deployed since the crisis for the assessment of large and complex institutions (in Europe)” (p. 2). The book thereby follows four main considerations behind these initiatives in a thorough bottom-up fashion; sometimes more, sometimes less explicitly.
themes: data and the harmonisation of supervisory reporting, stress testing, benchmarking exercises, and transparency. Within each chapter the author(s) provide their take on the respective tool / task rather independently.

Supervisory data
One of the undisputable achievements of the EBA is the harmonisation of European supervisory data. As Meri Rimmanen explains in Chapter 2 “The EBA was given several mandates in the CRR and CRD to develop harmonised reporting (standards) to specify uniform formats, frequencies, dates of reporting, definitions and IT solutions.” (p. 34) The legal mandate and subsequently EBA's approach followed closely the European requirements, and not only harmonised but substantially expanded supervisory reporting. As a complement to the previous chapter's bird's eye view on supervisory reporting, Remi Boutant provides as a rather technical case study to the harmonisation of the definition of Non-Performing Exposures in Chapter 3. Noteworthy, in particular, is his argument regarding EBA's push of that particular subject, which is deeply rooted in the post-financial crisis state of the banking system / assets. Read jointly, the two chapters epitomise Mr. Nowotny's call for empirically driven, responsive banking regulation.

The next two chapters, the former of which includes a guest author from the European Systemic Risk Board (ESRB), actually sit in between the data and latter benchmarking chapters. Chapter 4 tackles content – the definition of consistent and effective risk indicators, Chapter 5 process – from individual banks’ reporting data to risk dashboards and data visualisation tools. Even the most objective viewer would label these endeavours less glamorous than some of the subsequent chapters, but the authors provide both detailed technical account of their work and reference to its wider purpose: timely, comparable, granular but nevertheless accurate data for supervisors, as Gaetano Chionsini and Luis Garcia write, “to create risk profiles, analyse banks' liquidity and, ultimately, assess whether banks comply with legal requirements.” (p. 180)

Stress tests
The next three chapters tackle the EU-wide stress tests, which the EBA is mandated to initiate and coordinate. While it is true that work on EU-wide stress tests started already under the auspices of CEBS, the Committee of European Banking Supervisors and EBA's predecessor, they turned out to be as much triumph as tragedy for the institution. While EBA has received much undue criticism for the success of past exercises (or better lack thereof, in particular the 2011 edition) and not enough credit but for temporary financial press headlines, it is nevertheless disappointing to read in Chapter 6 – the overview chapter – that “crucially, the EBA has no legal powers regarding checking the results for individual banks in the stress test, which is the responsibility of relevant supervisors”. (p. 195) While this might be formally true, the actual role of EBA was much more important than implied. Personally I attribute the defensive tone of the chapter as much to the testing times the EBA started out in and more recent developments – namely the creation of the Single Supervisory Mechanism for the euro area – which took over many of the operational tasks, particularly during quality assurance, in 2014 (and most likely going forward).

This criticism, however, should not distract from EBA's achievements in establishing stress testing standards for Europe. Chapter 7 by Javier De Diego and Benjamin Friedrich summarises the main parts of EBA's methodological note (2016 edition) and, more importantly, provides a rare view of the deliberations that lead to some of the methodological choices. In a similar fashion, Jérôme Henry from the European Central Bank – the institution which on behalf of the ESRB provides the adverse scenarios for the EU-wide stress tests – does the same for stress test scenario design.

Benchmarking
The third section of the book focuses on benchmarking exercises; large-scale comparative analyses of banks’ internal models and / or risk profiles. Chapter 9 and 10 feature work the EBA conducted in line with the Basel Committee on Banking Supervision (BCBS) on credit and market risk, respectively, Chapter 11 meanwhile has a focus on EBA’s own initiative regarding funding liquidity risk. All three chapters are unified on the one hand by a real need to readdress the risks as highlighted by the financial crisis and the (perceived or real) limits of current banking regulation / supervision in addressing these risks. On the other hand, all three sections provide (i) a balanced discussion of merits and costs of current regulation /supervision, (ii) strength and weaknesses of
the benchmarking exercises themselves, (iii) ample empirical evidence that supports these arguments, and (iv) an outlook of where regulation / supervision could / should be heading. To quote Federico Cabañas and Lars Overby, authors of Chapter 10, “Just like with any other tool, one must be aware of (benchmarking exercises) shortcomings, but given the advantages they bring it is already clear that benchmarking exercises for market risk models should, and will, play an increasingly important role in the supervision of the internal models.” A view that is echoed – with regard to the respective risks and tools covered – across the other two chapters of the section as well.

Transparency
The final two chapters of the book come with a substantial change in tone, partially attributable to the authors’ background. In both Chapter 12 on transparency and market discipline and the afterword on the post-crisis regulatory regime, renowned academics from EBA’s Banking Stakeholder Group write or at least contribute to the book. In the chapter on transparency the authors first discuss standard arguments related to transparency and market discipline. To the liking of this reviewer, the argument is overambitious in its quest for balance: “(transparency) might induce suboptimal behaviour in banks, as well as ex post market externalities that lead to excessive and inefficient reaction to public news. It may also reduce traders’ incentives to gather information, thereby decreasing the information content of market prices.” (p. 351) Moreover, the discussion of Basel disclosure requirements dominates EBA’s contribution to Europe’s push for more transparency of its banks. Taking a broader view, however, the chapter brings the book full circle by giving particularly the work presented in the first section on data and the harmonisation of supervisory reporting greater meaning.

Rooted in welfare economic arguments, David T. Llewellyn of Loughborough University manages both, to close the book with the economic arguments for the work of the first five years and an outlook regarding future regulatory / supervisory developments. To conclude myself, let me return to the swimming pool metaphor. EBA was wet before it walked. As an account of its first strokes the book thereby serves as an important testimony of the supervisory reaction to the financial crisis in Europe. Beyond the readership that is interested in the book’s subjects at face value, I would therefore recommend it to anyone interested in the institutional aspects of supervision / regulation or even more broadly, the political reaction to the financial crisis in Europe. If one is both willing to read between the lines, across the chapters, and forgiving regarding a language that is peculiar to bureaucratic European institutions, one uncovers a rewarding narrative of how Europe’s new supervisory toolkit got established over EBA’s first five years of existence against the backdrop of a crisis that triggered the institution’s creation in the first place. Moreover and contrary to more feted personal accounts of the crisis, this book is written by the experts who put in the groundwork. It will thereby take the willing reader well beyond the content of individual chapters and reveal how banking supervision / regulation in Europe works in practice.
This year’s SUERF General Assembly was held during the 32nd SUERF Colloquium and Deutsche Bundesbank/Foundation Geld und Währung Conference in Frankfurt on 4 February 2016. Urs W. Birchler opened the meeting and welcomed those attending the General Assembly. He also extended thanks to Robert N. McCauley (BIS), who had served on the Council of Management and had recently stood down, for his services to SUERF.

In the subsequent elections Christian Upper, Head of Emerging Markets, Monetary and Economic Department (Bank for International Settlements) was elected to the Council of Management. The mandates of Alain Duchâteau, Deputy Director General, Department of Economics and International Relations (Banque de France), Ernest Gnan, Counsel to the Board, Head of Economic Analysis Division (OeNB), Ryszard Kokoszczynski, Member of the Board (National Bank of Poland), David T. Llewellyn, Professor of Money and Banking (Loughborough University), and Natacha Valla, Deputy Director, International Macroeconomics and Finance (CEPII), were extended for a further three years (from 1.1.2016-31.12.2019).

Since the last General Assembly held in Milan in June 2014, there had been conferences in Madrid, Vienna, Helsinki, Zurich and London with a Research Prize Workshop in Vienna. Event planning for 2016-2017 is currently underway for conferences in Paris, Luxembourg, Brussels, London and Vienna, with the 33rd SUERF Colloquium to be held in Helsinki in the third quarter of 2017.

Frank Lierman gave a detailed report on the Associations’ publication activities. A brief outline for the upcoming SUERF Conference Proceedings (SCPs) and SUERF Policy Notes (SPNs) was presented, too.

Dragana Popovic reported on behalf of SUERF’s Honorary Treasurer, Donato Masciandaro, that SUERF’s financial position remains sound, thanks to the support of the Association’s membership, in particular Corporate Members and Central Bank Members. Finally, thanks were given to the organizations with which SUERF had organized events in 2014-2015 as well as to partners, who have already committed to organize joint events with SUERF in 2016-2017.

Dragana Popovic, Executive Secretary

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New SUERF Members

A warm welcome to all new SUERF Members!

**CORPORATE MEMBERS**

Institute of International Finance (IIF)

**PERSONAL MEMBERS**

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Faculty of Business, Economics and Social Sciences
University of Hohenheim, Germany

Prof. Marina Brogi
Faculty of Economics, Management Department
Sapienza University of Rome, Italy

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SUERF Publications

The following SUERF publications are currently in preparation: “Banking Reform” and “The SSM at 1”.

Recently published:

SUERF Occasional Papers, No 1
The state as an intermediary to foster long-term investments: the case of the targeted European savings account, by Hans-Peter Burghof and Carola Müller.

SUERF Conference Proceedings 2016/1
Cash on Trial, edited by Christian Beer, Ernest Gnan and Urs W. Birchler.

SUERF Policy Notes, No 5
Some seeming paradoxes or interesting points of Russia’s economy and banking sector, by Stephan Barisitz.

SUERF Policy Notes, No 4
Gender Diversity and Monetary Policy, by Donato Masiandaro, Paola Profeta and Davide Romelli.

We invite SUERF Members to submit ideas for relevant and emerging topics for future SUERF Policy Notes.

Save the date – 2016 SUERF Events

16 September 2016
Paris
SUERF/CEPII/PSE Conference
Rethinking Capital Controls and Capital Flows

5-6 October 2016
New York
SUERF/Société Générale/Columbia University/EIB Conference
Global Implications of Europe’s Redesign

17 November 2016
Luxembourg
SUERF/EIB Conference
Financing Productivity Growth in Europe

9 December 2016
Brussels
SUERF/Belgian Financial Forum Conference
FinTech and the Future of Retail Banking

SUERF Council of Management

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