

## 10 Years after the start of the financial crisis: Contours of a new normal

Report on a conference jointly organized by Belgian Financial Forum and SUERF  
National Bank of Belgium, Brussels, 14 September 2018

---

### Conference Report

---

By Frank Lierman, Member of the Council of Management of SUERF, Chairman of the Editorial Board of the *Revue bancaire et financière*/Bank- en Financieuzen

**Jean Hilgers**, President of the BFF and Executive Director of the National Bank of Belgium (NBB), and **Jakob De Haan**, President of SUERF and Head of Research of the Nederlandsche Bank, expressed a warm welcome to more than 300 participants attending this high level conference in the auditorium of the National Bank of Belgium.

**Jan Smets**, Governor of the NBB, presented his keynote speech on “The Future of Central Banking”. The main message was that price stability, financial stability and promoting the smooth functioning of the payments system will also in the future govern most of central banks’ actions. It is the task of central banks, to foster trust in each of these domains. This trust is not something which falls from heaven. It needs to be built and maintained on a daily basis. While technical know-how of experts is of course essential, on its own it is not enough. The stability of money is a common good and deserves a quasi-constitutional status. It is a deep and precious fundament, which must be safeguarded under all circumstances, as a prerequisite for welfare, as well as freedom and fairness. Therefore, it has to rest on a strong societal underpinning and needs to be shielded from the volatility or even arbitrariness resulting from short-termism. Thus, it is justified to allocate this goal to institutions which have this stability as their primary task and which are accountable for achieving it. That is precisely the mission of central banks, also in the future.

The theme of the first panel was “Scars and scratches: how damaging is the fall-out from the crisis for the real economy and the natural rate of interest”. The panel was chaired by **Freddy Van den Spiegel**, Professor at the

Vrije Universiteit Brussel and Chairman of the Coordination Committee of the BFF.

**William De Vijlder**, Group Chief Economist of BNP Paribas, focused on the uncomfortable new normal. The global financial crisis of 2008 had a profound impact on the evolution of the global economy in subsequent years, but the repercussions of other developments should also be taken into account: the sovereign debt crisis in the eurozone, the structural decline of potential GDP growth, the changed behaviour of inflation, the slowdown of Chinese growth, etc. With this in mind, a mixed picture emerges: in most countries per capita real GDP is higher than before the crisis, but this has required a huge stimulus effort, in particular on the monetary front. Public sector debt has not declined, despite the growth environment and sharply falling interest rates. The build-up of corporate debt in foreign currency in several emerging markets has increased their sensitivity to spillovers from US policy tightening or a stronger dollar. Conditions have not been met to restore monetary policy leeway to a sufficient degree and countercyclical fiscal policy will likely be constrained as well because of high public sector debt rather than because of the level of structural budget deficits. In addition to the structural reforms and the efforts to avoid the build-up of imbalances, thinking about how to address the next downturn should be high on the agenda.

**David Turner**, Head of the Macroeconomic Analysis Division of the OECD, underlined that care is needed in assessing the cost of the global financial crisis. Using pre-crisis extrapolations of GDP is likely to exaggerate the output cost as such trends were unsustainable.

Evaluating the loss in comparison with pre-crisis trends in potential output, suggests that the medium loss among OECD countries experiencing a bank crisis was still more than 6%. This is almost entirely attributable to lower productivity, rather than lower employment. Much of the lower post-crisis productivity is in turn accounted for by lower growth in capital per worker, whereas declining total factor productivity growth pre-dated the financial crisis.

According to **Cinzia Alcidi**, Senior Research Fellow and Head of the Economic Policy Unit of CEPS, the crisis year 2007 and even 2008 is not the right benchmark because the GDP was inflated due to the bubble in housing and credit. Overcapacity has been built up in the former years. Looking at the construction sector in Spain and Ireland it represented some 21% of GDP while the average for the euro area was only 11%. Why nobody intervened to stop that overcapacity? Well, everybody was gaining: consumers were happy with the increase of the real estate prices, which increased the value of their property, the taxes of the governments moved up, employers had more orders and welcomed higher profits, and employment was attractive. Looking at the financial cycle of 12 European countries, we observe peaks for Greece, Spain and Ireland in 2008. Was it a pure price phenomenon or was there an underlying misallocation of resources during the booming period? It is clear that it was difficult during the crisis to move to an optimal allocation of the resources. Meanwhile, the financial cycle reached a bottom in 2017 and a new growing phase started which could justify some optimism. We observe a new credit growth, increasing housing prices, a better economic environment. But is this a fundamental trend seeing that the debt accumulation is still there? There is a slowing growth trend of that debt, but not yet a real deleveraging. This implies a huge challenge for the coming years.

**Eva Ortega**, Head of Modelling Unit at Banco de España, considered the natural rate as a real interest rate, which is the equilibrium real return on capital in line with trend growth, demographics, risk aversion. We have to look beyond the business. The long run horizon is crucial to fix the real rate. Linking natural rate gaps to business cycle and inflation stabilises output gap and inflation. The determinants of the decline of the real

interest rate are mainly linked to demography. Lower fertility rates imply lower labour input, declining capital demand, higher capital per worker, lower marginal product of capital. Higher life expectancy implies an increase of capital supply from saving anticipation of a longer retirement period. Rising proportion of old age implies more dissavers and thus declining capital supply. A turn to higher natural interest rate could come from lower risk aversion, technology driven boost in productivity or growth promoting structural reforms, pensions reforms affecting dependency ratio and saving decisions. Structural reforms can help support productivity growth and investment. Product market reforms stimulate competition and give incentives to innovate and invest in human and physical capital. Institutional reforms could lead towards more efficient public administration. Training and education can reduce the skill mismatches and stimulate a higher diffusion of technology and growth of more innovative and productive firms. Completing the Banking union can lead to more efficient allocation of financial resources and attenuate the flight to safety. Demographic trends can be affected by an increase in retirement ages, changes in the pension system replacement rates and public policies that encourage labour force participation and human capital accumulation.

The second panel focused on “The financial sector and prudential policies in the new normal”. **Jo Swyngedouw**, Head of Prudential Policy and Financial Stability, NBB, was in the chair.

**Mathias Dewatripont**, Professor of Economics at Université Libre de Bruxelles, developed a vision on bank resolution and bail-in. Banks are special due to the fragility linked to maturity transformation and the inability of most bank creditors and depositors to exercise usual discipline on their borrower. The implications are the necessity to address financial instability and moral hazard. This leads to a key general rule: concentrate the pain on investors, whose funds are stuck in the bank. The crisis was fed by under-regulation, which was significantly worsened after the fall of Lehman. There has been a double response: no more Lehmans, which implied significant rise of retail deposit insurance and massive bail-outs and re-regulation with more and better capital, liquidity ratios, recovery and

resolution planning, macro-prudential regulation. Debate continues on excessively low Basel III capital ratios versus difficulty of finding the money and risks to real economy lending. What to think about the “bail-in rather than bailout” trend in a European landscape plagued by overcapacity and a challenging environment? We do have a paradox: Basel III stresses the quality of capital and micro/macro-prudential distinction while the bailout fatigue has now led to bail-in fashion with a desire to vastly enlarge set of bank claimholders meant to be held responsible, and this even under systemic stress. Politicians feel that Basel III does not require enough capital to protect taxpayers. The Bank Recovery and Resolution Directive insists on 8% bail-in even under systemic stress, as of January 1, 2016, for access to the common resolution fund or even national public money. Beyond secured liabilities, it exempts very short-term interbank debt. It gives priority to natural persons and SMEs over other unsecured claims. As of today, no hard targets yet for bail-inable securities are decided. The aversion to bailouts is understandable due to taxpayer money and moral hazard. But remember the costliest bank failure for taxpayers in the last 10 years was Lehman, despite lack of bail-out, while TARP of 428 billion USD bailout has been fully repaid. Remember also that orderly resolution will not prevent depositors from running if they can and feel their money is at risk. In order to avoid bank runs there is a need of 8% junior long-term liabilities for all banks. Let’s have an example: if total liabilities are 100 compose of secured and very short term liabilities (25), and retail deposits (40), bail-inable senior liabilities (30), junior liabilities (1,5) and capital (3,5). Losses for senior liabilities before a bailout can be considered:  $(8-3,5-1,5)/30 = 3/30 = 10\%$ . To avoid runs, it is appropriate to increase junior liabilities to 4,5. Including senior claims in MREL does not protect other senior unsecured claimholders. There are useful national solutions: Germany makes senior bank bonds junior, retroactively; Italy makes depositors senior to bonds and derivatives retroactively; France acts similar to Germany, but not retroactively and more granular. In the EU toolkit are now non-preferred seniors. Today there is the unwillingness to renegotiate the 8% rule. But requiring 8% of long-term junior claims to re-assure senior claimholders would imply a big shock to an already challenged banking sector. So the route chosen in 2017 is precautionary recap plus compensation for retail

subordinated claimholders or even national bankruptcy, which is not the first best. The challenge remains: when bailout is out and bail-in is not in, denial is the only option left.

**Isabelle Vaillant**, Director Regulation, European Banking Authority, tried to answer the question: Have we reached a new normal in prudential policies? The new financial regulatory framework is too complex. It is not so evident to find the right balance between simplicity and complexity. To build safeguards we need to reject complexity, which is however the result of risk sensitivity and proportionality. There is always the choice between materiality thresholds per risk category and one-size fits all rules. Regulators have to assess how different groups of banks might be affected by forthcoming regulation and how they might adapt to incorporate these new rules into their business models. Proportionality implies that some business models are also often correlated with size and complexity. They must also understand at a macro level the various business models as they determine the type of risks the institutions are exposed to and possible threats to financial stability, while there is the need to preserve the single market deepening. At the micro level regulators must specify the rules in accordance to the business models’ risks, assess performance and riskiness in relation to its peers. Anyhow, the differences between countries do have a serious impact on the business models. EBA uses a categorisation of the credit institutions to discover the impacts of new regulation to specify some priorities and to scrutinize the solvency and the resolvability. 57,5% of the credit institutions are co-operative banks, followed by savings banks (13%) and local universal banks (10,2%). Total assets are concentrated in cross-border universal banks (39,3%) and local universal banks (20,2%), which also reflects more generally their larger average size.

**Rudi Vander Vennet**, Head of Department of Financial Economics, Universiteit Gent, focussed on the business models of banks. Banks are operating in a new regulatory and economic environment, which implies that they have to modify their business models. These actions are up to now very slowly and modestly. The pressure is mounting due to the weak profitability. ROE is lower than the cost of equity (COE) for many banks. In the 2018 EBA questionnaire on bank risk assessment, banks

think that the COE is 8 to 10%, they expect to have a long term ROE of more than 10%. They consider that they are able to achieve viability (ROE>COE). Profitability is stressed due to new regulation and challenging interest rate conditions, structural tendencies (shift towards market-based financing) and competitive issues (consolidation, competition from new entrants, fin-tech). Banks have to react via a risk-based pricing by applying adequate margins in their lending portfolios covering not only credit risk but also interest risk and liquidity risk. The negative deposit margin (compared to the interbank rate) must be compensated by increasing lending margins (compared to swap rate) Operational efficiency is crucial. Too many banks still have a too high cost to income ratio. Simply cutting staff or branches will not be the trick. A fundamental redesign of bank intermediation is needed. Diversification of sources of revenues, both functionally (non-traditional financial activities) as well as geographically is unavoidable. A revision of the asset composition and of the asset quality is also recommended. The cyclical recovery may lower loan impairments and provisions but lots of cleaning-up is still necessary for many banks in the periphery. Banks will have to focus on what their comparative advantages are in terms of non-interest income, and adapt their business model accordingly. This should lead to a more diverse banking landscape. A new equilibrium between banks, non-banks and financial markets must be found. In terms of bank sector restructuring, it can be noticed that the pace of entry as well as M&A remains slow. The question is whether these forces will lead to more diversity instead of simply increasing the size of banks.

**Christine Van Rijsselghem**, Chief Risk Officer, KBC Group, presented the KBC experience in setting up new governance and risk culture. The bank received two state aids of some 7 billion EUR and one CDO guarantee in 2008 and 2009. In 2010, the EC approved the new strategic plan and divestments started. No more than 28 subsidiaries have been sold. Already in 2011 started the repayment of the state aid. In 2014, the divestment programme was completed and in 2015 all state aid was repaid. All in all, KBC paid 13 billion EUR, taking into account the huge penalty rate. Meanwhile, the risk profile was reduced substantially: the risk weighted assets came down from nearly 160 billion EUR in 2008

to less than 80 billion EUR in 2013. At the same time risk management has been strengthened. In 2010, a risk harbour strategy was implemented with independent CROs, local risk teams and group risk. In 2016, the mission became “We want risk to be in the hearts and minds of everyone, for KBC to create sustainable growth and to deserve its customers’ trust.” In 2017 the risk plan 2020 was launched with five keywords: agile, digi and data savvy, smart, simple and highly connected. The PEARL programme for corporate culture had also five key words: performance, empowerment, accountability, responsiveness, local embeddedness. This implies among other things: speaking up, open feedback; learning from mistakes, taking accountability, remuneration, diversity. It is clear that culture is what people do, when nobody is looking. Responsible behaviour is a condition for good risk culture. Risk awareness is a part of the DNA of KBC, embedded in the corporate culture. The prudential framework had a positive impact on KBC’s governance and risk management: segregation of duties and responsibilities between board of directors, risk and compliance committee and executive committee; internal controls with three lines of defence: business, risk and compliance and internal audit; risk management with very clear responsibilities for the group, countries, local entities. But there are still challenges. As an integrated bank-insurance group KBC suffers from the walls between insurance and banking regulators and from different attention points for different regulators and supervisors. Over-regulation must be avoided. Call for simple, clear and stable regulatory and supervisory requirements taking into account the customer’s view.

Panel 3 was chaired by **Peter Vanden Houte**, Chief Economist ING Belgium, and focused on “Monetary policy beyond normalisation: objectives and instruments”.

**Maria Demertzis**, Deputy Director at Bruegel, started her presentation by stressing the specific governance structure of the eurozone. She underlined the necessity to highlight the so-called “unknown unknowns” concerning globalisation, migration, technology and productivity. Then she focused on the link between monetary policy and financial stability by responding to the question concerning the targeting of financial

imbalances. Knowing that the interest rate affects the regulator's entire possibilities frontier, both, credit supply and bank soundness, are affected by monetary policy, and therefore the entire environment in which the regulator operates responds to monetary conditions. The question of the impact of increasing the inflation target was put forward. Does aiming for higher inflation avoid period of disinflation more effectively? The answer is yes. Is the objective of price stability better served by such a higher target? Probably not. Can this transition be managed? Yes. In Canada the target is reviewed every 5 years. In the UK the target is fixed every year and was lastly revised in 2003. In Japan the target was changed in 2012 and 2013. The US adopted a formal target in 2012. In 2003 the eurozone 2-pillar strategy was modified and the definition of price stability was clarified. We do need targets for a longer period than the usual two years. Looking to the experiences in many countries it is clear that working with an "inflation band" in combination with an "inflation level" gives the central banks the possibility to influence expectations and to reduce the uncertainty.

**Natacha Valla**, Deputy Director - General Monetary Policy, European Central Bank, commented first the operational framework in the last ten years before developing the outlook for the future operational framework. Before the crisis, the ECB implemented its monetary policy in a corridor system framework. Money market rates were steered to the middle of the corridor by estimating the banking system's liquidity needs from reserve requirements and autonomous factors such as banknotes, and then satisfying these liquidity needs exactly. Since mid-2014, the non-standard monetary policy measures have significantly expanded the Eurosystem's consolidated balance sheet and injected vast amounts of reserves above and beyond the liquidity needs into the banking system. The banking system is now in a position where it deposits the excess liquidity in the deposit facility. As a consequence, money market rates – the rates at which banks borrow and lend central bank reserves among each other – have been pushed to the level of the deposit facility rate. In effect, this means that the Eurosystem is operating in a floor system today. Looking to the future, the outstanding TLTROs, the continuing reinvestments of the APP portfolio for an extended period of time and the fixed-rate full allotment

policy will ensure that the liquidity supply remains in excess of the banking system's need for some time to come. But at some point in the future, the Governing Council will re-assess the liquidity conditions and, taking into account the maturing TLTROs, may choose to recalibrate the reinvestment policy. Such choices will affect the amount of excess liquidity and could eventually lead to a return to balanced liquidity conditions. The question is, is the ECB moving back to the corridor system or will the ECB continue with the floor system? Several structural changes compared to the pre-crisis times may have added additional liquidity needs for the banking system. For instance, regulatory requirements such as the LCR could lead to additional, systematic demand for central bank reserves. The emergence of additional liquidity needs would mean the "neutral" liquidity supply – at which money market rates lift off the deposit facility floor of the corridor – may be higher than it used to. This analysis leads to a number of options for the future operational framework and the size of the ECB's balance sheet:

- If additional liquidity needs are reasonably stable and forecastable, they could be satisfied within the pre-crisis framework by allotting additional liquidity.
- Other objectives, such as the provision of safe assets through the central bank, may have additional implications for the balance sheet.

**Andrew Filardo**, Head of Monetary Policy, Bank of International Settlements, developed the thesis that questions regarding monetary policy are still the same but the answers have changed. Before the great financial crisis (GFC) there was a trend towards a narrowing of the monetary policy. Transparency and credibility were achievable goals. The post GFC period has brought us the conviction that inflation is not anymore a sufficient indicator for financial stability. The financial cycle and the evolution of the real economy cannot be ignored, reflecting the behaviour towards risk. Of course inflation is still important but the imbalances of the financial sector are shown via among others housing and credit prices. The focus on macro-prudential policy is comprehensive. Tools such as loan to value, debt to income, capital buffers have become common. But do we trust these tools? They are the first in line to tackle some exaggerations, afterwards the monetary policy intervenes. Leverage is still a crucial factor which is not

neutral for interest rates. The goal is to lean against the wind via discretionary use of interest rates, hoping that it will have an impact on the crisis.

The starting point of **Anders Vredin**, Head of the General Secretariat, Sveriges Riksbank, was that what has in recent years become viewed as an outcome of unconventional monetary policy- very low policy rates and large central bank balance sheets – is in fact now generally expected to be the new normal. The reasons are: real interest rates have declined globally, financial innovations, increased capital mobility and general globalisation, but also new financial imperfections, new risks and increased risk-taking are important. One factor behind the development is the existence of various frictions in financial markets. Those frictions are not important at the first glance because a short run interest rate is the only important instrument for monetary policy, the central bank's asset holdings have no significant effects and financial stability should not be an objective for monetary policy. But on the other hand, they are important due to the fact that asset purchases and sales may be both complement to, and a substitute for, changes in a short term policy rate, while financial stability should be an objective for monetary policy, in addition to price and real stability. So monetary policy cannot remain independent if financial stability becomes an additional objective for monetary policy.

The conference was closed by **Poul M. Thomsen**, Director of the European Department of the International Monetary Fund, with a keynote speech on “A financial

Union for the Euro Area”. The basic premise is that scarce political capital must be used well. Finance is a key area where meaningful progress is possible. Much of the work can be done within the confines of the current political consensus. Experts must develop compromises to take forward the banking and capital markets union projects. In banking, the task is to further strengthen supervision and resolution. The remaining national fragmentation must be removed from the single rulebook. This will maximize the effectiveness of the new framework in controlling excessive risk-taking and will ensure robust risk-sharing when banks fail. It will reduce also the need for individual countries to protect themselves with ring-fencing measures that also act as barriers to cross-border flows. There can be a virtuous circle between less fragmentation and more trust. In nonbank finance it is necessary to ensure robust oversight of the securities and derivatives markets. Here the mandate is to ensure truth, transparency and disclosure. The question can be asked if there is a case for a “super-ESMA” with pan-European regulatory powers. But one must also guard against overreach, and allow intermediaries to fail, so that market discipline can flourish. The current preference for subsidiarization and other defensive measures at the national level will recede over time as fragmentation is reduced. Eventually, this will allow a return to a banking model centered on cross-border branching. While this might sound like a case of “back to the future”, prudence will be embedded in a way that bears no semblance to the bad old days of forbearance and arbitrage that took Europe to crisis a decade ago.

Conference presentations are available at:

[www.suerf.org/brussels2018](http://www.suerf.org/brussels2018)