



## New Paradigms in Money and Finance?

Report on the 29th SUERF Colloquium held in Brussels on 11-12 May 2011 jointly organized by the Belgian Financial Forum, in association with the Brussels Finance Institute and the Centre for European Policy Studies (CEPS).

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On 11-12 May, approximately 130 participants gathered at the Dexia Congress Center, close to the historic centre of Brussels. **Catherine Lubochinsky**, SUERF President and professor at Université Paris 2 and **Frank Lierman**, Chief Economist, Dexia Bank Belgium, and newly-installed SUERF Vice President gave welcome addresses.

The first plenary session was chaired by **Jan Smets**, National Bank of Belgium and Belgian Financial Forum. **Luc Coene**, Governor of the National Bank of Belgium started his keynote speech by referring to the turmoil in May 2010 on financial markets due to the worsening of the sovereign debt crisis. As a response, the Eurosystem announced a set of measures including a programme to intervene in markets for debt instruments. Against this background, the Governor focussed on monetary policy in the euro area, and in particular on the challenges posed by the current macroeconomic outlook and how the sovereign debt turmoil has an impact on euro area monetary policy decisions. In its latest World Economic Outlook, the IMF talks about a two-speed recovery. Emerging market economies show significant growth while the advanced economies still have low growth and

excess capacity. In the euro area, the so-called “core countries” are posting nice growth numbers while the countries most affected by the sovereign and banking crises are lagging behind. Higher inflation can be observed and this has caused the ECB Governing Council to raise interest rates. But how do such increases square with the ongoing sovereign debt turmoil? The securities market programme and the re-introducing of the regime of fixed-rate full allotment for longer-term operations contribute to maintain financial stability, but these measures are temporary in nature. Fiscal consolidation is indispensable to secure sustainable public finances over the longer term. In the view of the Governor, heterogeneity across euro area countries does not greatly complicate the task of the Eurosystem. It is part of a necessary process of adjustment through which some countries have to go in order to regain competitiveness and to repair their balance sheets. Although monetary policy cannot be tailored towards the needs of specific countries or regions, national developments are to some extent taken into account. When deciding on monetary policy measures, the Governor saw no problems in raising interest rates, while at the same time continuing to provide banks with unlimited liquidity. The two types of measures are geared towards different, but complementary, goals. The Eurosystem has the will and the tools to cope with the challenges in front of us. There is a lot of work to do.

**Andrew G. Haldane**, Executive Director Financial Stability, Bank of England gave a thought-provoking keynote speech “*The short long*”. The speaker started by asking: “Is the world becoming short-sighted?” In his presentation, he tried to provide some evidence on short-termism drawing on equity market experience. The evidence suggests that short-termism is both statistically and economically significant in capital markets. It appears also to be rising. Investment choice, like other life choices, is being re-tuned to a shorter wave-length. Public policy intervention might be needed to correct for this capital market myopia. But which public policy response would be appropriate? The lightest touch approach would be to require greater disclosures by financial and non-financial firms of their long-term intentions. For financial firms, this might include metrics of portfolio churn. A more intensive approach would involve acting directly on shareholder incentives through their voting rights. For example fiduciary duties could be expanded to recognise explicitly long-term objectives. Shareholder rights could be enhanced for long-term investors, perhaps with a duration-dependent sliding scale of voting rights. Employment contracts could be conditioned on long-term performance. Government could through taxation or subsidies penalise short-duration holdings of securities, or incentivise long-duration holdings. Public policy could help keep the plums in the pudding.

**Martin Merlin**, European Commission, gave a keynote speech on “*Financial supervision in Europe after the crisis*”. In integrated financial markets, there is no such thing as national financial stability. In Europe, we had no adequate macroprudential supervision before the crisis. We had ineffective early warning mechanisms. The exchange of information between national supervisors was inefficient. Today, we have the European Systemic Risk Board, three European Financial Supervisory Authorities and harmonized rules. Actions can now be coordinated in crisis situations and disputes can be settled. A better risk-management and crisis resolution framework is being developed. The new supervisory institutions have legal personality and are up and running. We are now able to find European solutions to European problems.

**André Sapir**, University of Brussels and Bruegel gave a paper entitled “*The euro: a currency without a state – lessons from the crisis*”. Can a monetary union with centralised monetary policy and with decentralised fiscal policy work? The answer is that coordination of fiscal policy does not work under normal circumstances. The Stability and Growth Pact has not been effective. Will nothing short of political union be possible? According to the speaker, we must hope that there is a workable model with a more limited surrender of sovereignty. Financial stability and fiscal sustainability are interconnected. With respect to supervision, we have now – due to the crisis – seen a jump forward. The countries hit the most by the sovereign debt crisis were the countries with strongest economic growth from 1999 to 2007. Part of this growth was unsustainable. The present crisis is an “over-indebtedness” crisis. The political issue is how to share the debt burden. Tax payers both in debtor and creditor countries are involved. Such a problem is not for economists to solve. It is for the politicians to solve.

## Commission work

According to SUERF tradition, a considerable part of the colloquium work took place in three parallel commissions.

**Commission 1** – “*New paradigms in monetary theory and policy*?” - was chaired by **Morten Balling**, Aarhus School of Business and Social Sciences, Aarhus University and **Edwin de Boeck**, KBC Group.

**Philipp C. Rother**, ECB, gave a paper entitled “*Challenges for the EU fiscal framework: fiscal sustainability, government debt and monetary policy*”. A comparison of the euro area, Japan and USA shows that there are government deficits everywhere. The government gross debt in proportion to GDP is close to 80% in the euro area, 100% in the USA and over 200% in Japan. The future debt scenarios depend on the fiscal consolidation paths. If the target is to stabilise debt-to-GDP ratios at the level of 60% in 2030, the fiscal

adjustment needs are very large in Japan, Ireland, United States and Greece while Germany, Austria, Belgium and Italy are in more manageable situations. Evidence from several countries from 1994 to 2008 shows that it is possible to reduce high government debt ratios. The speaker concluded with a relatively optimistic message: the euro area countries are on a path towards consolidation. The euro area governance framework is being strengthened. There are, however, risks that reforms will not be ambitious enough to ensure sufficiently binding rules and effective enforcement.

**Andrei Sirchenko**, European University Institute, Florence presented the paper: “*Policymakers’ votes and predictability of monetary policy*”. Central banks follow different disclosure policies. The Fed and Bank of England publish voting information. ECB does not disclose voting records because it would show disagreements among nations, force Governing Council members to follow national interests etc. The paper focuses on the case of Poland, where the National Bank of Poland discloses voting information with a delay. The members of the Polish monetary policy committee often disagree. Dissenters’ votes have a strong predictive content as supplementary statistics when controlling for relevant economic and financial determinants driving the interest rate. According to the speaker, the results suggest that the publication of voting records could reduce the informational asymmetry and refine the public’s understanding of systematic policy responses and the decision-making process.

**Dramane Coulibaly**, Centre d’Études Prospectives et d’Informations Internationales (CEPII), presented the paper: “*Does inflation targeting decrease exchange rate pass-through in emerging countries?*” co-authored with Hubert Kempf. The analysis is based on empirical evidence from 27 emerging economies, 15 are inflation targeters while 12 are non-targeters. The evidence suggests that inflation targeting has helped to reduce the pass-through to various price indexes. The analysis indicates that the contribution of exchange rate shocks to price fluctuations in targeters’ countries is important, while the contribution of exchange rate shocks to price fluctuations in non-targeting countries is insignificant.

**Michael Kock**, South African Reserve Bank (SARB), presented the paper: “*The monetary policy transmission mechanism in an open emerging-market economy: the case of South Africa*”. The paper describes the channels of monetary policy transmission in the South African context. The SARB uses a number of instruments to ensure that the money market remains in a liquidity-deficit position. It is concluded that the policy rate has a significant impact on credit, aggregate demand, asset prices, output and inflation, but in a more complex way than proposed by the conventional theory on the transmission mechanism of monetary policy.

**Øistein Røisland**, Norges Bank, explained in his presentation “*The role of interest rate forecasts in Norwegian monetary policy*”. One of the reasons behind publishing the forecasts is to improve the general understanding of the Bank’s reaction pattern. In general, the interest rate forecasting has worked well. There is little doubt that the contingency of the forecasts is well understood. Interest rate forecasts are an essential part of Norges Bank’s communication policy with a view to managing market expectations.

**Guonan Ma**, BIS, looked in his presentation “*Global imbalances and Chinese exchange rate policy*” at the interplay between the high saving rate in China, the People’s Bank of China’s exchange rate policy and global imbalances. The speaker and his co-author Robert N. McCauley characterised China as a large, fast-growing surplus economy. The government has led the impressive rise in saving. Since the USD-zone represents about half of the global economy, and since China is the biggest country in the world, international competitiveness, trade patterns and capital flows are strongly dependent on the choice by the Chinese monetary authorities between stabilisation of the renminbi’s (RMB) relation to the USD or to a basket of currencies. The evidence referred to by the speaker suggests that in recent years (except some months in 2008) the RMB has been managed to appreciate gradually over time against a trade-weighted basket of currencies. The policy which is followed by some other Asian monetary authorities as well can be described as a crawling band against a basket.

**Claudio Morana**, University of Piemonte Orientale, Italy presented the paper: “*The great recession: US dynamics and spillovers to the world economy*”. The speaker and his co-author Fabio C. Bagliano assess the mechanics of the 2008-2010 recession considering both its domestic propagation within the US and its spillovers to advanced and emerging economies. Based on very comprehensive empirical evidence from 50 countries the presenter concluded that asset price misalignments in the housing and stock markets, as well as low real interest rates, over the boom phase of the cycle, might have been driven by excessively generous liquidity in the system. Concerning the real effects of the crisis, there is stronger evidence of an asset price channel than of a liquidity channel. The trade channel seems, however, to be the key transmission mechanism of the US economic crisis to the rest of the world.

**Wim Boonstra**, Rabobank Nederland, described in his presentation “*A new global financial infrastructure*” how the USD dollar’s role as a global currency has contributed to the current situation of global balance of payments disequilibria and the US becoming the world’s biggest debtor. Calls for an alternative to the USD-dominated international financial system are becoming louder and are also coming from China. According to the speaker,



the stability of the global economy would be greatly enhanced if, instead of a national currency in the role of a global anchor currency, a supranationally managed currency unit were to be introduced. The SDR managed by IMF appears to be an ideal candidate for this role.

**Donato Masciandaro**, Bocconi University, investigated in his presentation “*Government, central bank and banking supervision reforms: does independence matter?*” whether central bank independence and monetary policy setting can jointly influence the likelihood that policy makers assign banking supervision to central banks. The underlying paper is co-authored by Lucia Dalla Pellegrina and Rosaria Pansini. A so-called GMT-index is used to measure central bank independence by aggregating scores over 15 different criteria. Other proxies are used to capture the quality of governance, the level of economic development and financial market conditions. The main conclusion is that higher central bank operational freedom is associated with a reduced degree of supervisory powers.

**Leonardo Gambacorta**, BIS asked: “*Does monetary policy affect bank risk?*” The underlying paper is co-authored by Yener Altunbas and David Marqués-Ibañez. There is strong evidence that relatively low levels of interest rates over an extended period of time contributes to an increase in bank risk-taking. The influence can work through valuation of assets, incomes and cash flows that are used as inputs in the banks’ credit evaluations. Another explanation is the banks’ “search for yield” when interest rates are low. Finally, risk-taking may also be influenced by the communication policies of a central bank if it gives the banks the perception that monetary policy will be eased if the economy turns bad. In his conclusion, the speaker said that central banks would need to consider the possible effects of monetary policy actions on bank risk.

**Tobias C. Michalak**, Ruhr University of Bochum, referred in his paper “*The nexus between monetary policy, banking market structure and bank risk taking: an empirical assessment of the risk taking channel of monetary policy*” to publications by the former speaker. Taking the “risk-taking channel” as his point of departure, the speaker investigated the nexus between low levels of short-term interest rates, monetary policy decisions, the banking market structure and the financial soundness of banks. The empirical findings support the “risk-taking channel theory”. Banks in more concentrated banking markets, along with banks operating in strict regulatory and supervisory environments, and banks subject to stronger

market discipline, are less prone to financial fragility. The speaker agreed with Leonardo Gambacorta that the risk-taking channel must be considered in the formulation of monetary policy.

**Commission 2** – “*New paradigms in banking and financial markets?*” – was chaired by **Frank Lierman**, Dexia Bank Belgium and **Freddy van den Spiegel**, BNP Paribas Fortis. All presentations were interesting and resulted in a lively discussion.

The first session was dedicated to the structural changes. **Adam Szyszka**, Poznan University, presented the paper “*Systemic changes in the financial world and the search for the new paradigm of finance*”. He showed that the neoclassical theory of finance has lost its credibility. The behavioural approach to capital markets must be integrated. It is a valuable supplement when trying to understand financial markets, but it is not yet a rigorous and completed alternative theory.

**Hans Groeneveld**, Rabobank Nederland, explained in the paper “*The co-operative banking model: Performance and opportunities*” why cooperative banks have been less affected by the credit crisis than have other types of banks. Corporate governance with member ownership and influence is crucial. The winners emerging from the most recent crisis will be the banks that are able to offer good products and services at fair prices with highly efficient operations in the long run, that put the customers first and that are well-capitalised with moderate risk profiles. Cooperatives contribute to diversity in banking and to the stability of national financial systems. Cooperative banking is not a panacea for post-crisis banking but should be viewed as a viable enduring and parallel alternative to shareholder value banks.

The second session was dominated by two papers on liquidity, which is to be considered as a crucial building block for strengthening the buffers.

**Matthias Schaller**, University of St. Gallen presented a paper “*Liquidity dynamics of bank defaults*”, co-authored by Stefan Morkoetter and Simone Westerfeld. A dataset of some 11,000 failed and non-failed US banks from 2001 to mid 2010 was used. Diverging capital and income structures have been detected. Defaulted banks drift away from the traditional business model by abandoning term transformation. Higher liquidity and lower degree of term transformation have a negative impact on the income structures, driving up the default risk. Liquidity is cost intensive and negatively affects income levels. Term transformation is a stabilizing income source for banks. Bond holders force low risk strategies.

**Emil Slazak**, Warsaw School of Economics focused in the paper “*The revisited concept of liquidity in the theory of bank intermediation*” on the role of liquidity. Before the crisis, liquidity was considered a “forgotten risk”. Funding liquidity was less important than liquidity.

Asymmetric information influences the banks' liquidity in unpredictable ways. The weakness of traditional theory of funding liquidity focusing on internal liquidity has been exposed by the fragility of CDO market stability.

**Giovanni Calice**, University of Southampton, had given his paper the provocative title "*Are there benefits to being naked?*" co-authored by Jing Chen and Julian Williams. The inclusion of naked CDS positions (a party pays an income stream to a seller of protection to swap away default risk on an underlying defaultable security without actually holding this reference instrument) in broad highly diversified fund of funds portfolios provides a partial hedge against capital risk in respect to equity, commodity and foreign exchange instruments. But the leverage of short positions produces effects beyond the original design of the CDS contract. The presence of variable collateral and clearing house margins reduces the incentive problem inherent in such highly leveraged transactions with normally zero upfront costs.

Two of the papers presented in session 3 described the CEE banking sector after the financial crisis.

**Dubravko Mihajlek**, BIS, presented the paper "*Properly pricing country risk: a model for pricing long-term fundamental risk applied to CEE countries*", co-authored by Debora Revoltella and Fabio Mucci. The recent crisis has shown that CDS spreads might lead to some underpricing or overpricing of fundamentals in the case of excessively low or high risk aversion. The developed model extracts the volatile, short-term market sentiment component from the sovereign CS spread in order to improve its reliability in periods of market distress. This measure of country risk sheds some light on the observed stability of cross-border bank flows to CEE banks during the crisis. Major international banks have a long-term horizon in the funding of their CEE subsidiaries.

**Malgorzata Pawlowska**, National Bank of Poland, presented the paper "*Competition on the Polish banking market (before the financial crisis and during the crisis) – empirical results*". Commercial banks operated in an environment of monopolistic competition. The level of competition before the crisis was similar to the one in the euro zone countries. Competition increased strongly between 1999 and 2004 caused by Poland's accession to the EU. A slight decrease of competition is seen during the crisis. Liberalisation increases banking crises. A strong institutional environment and adequate regulation reduces them. Coordinating regulation and competition policy is necessary.

**Peter Reedtz**, Asset Allocation Institutet, Copenhagen gave the presentation "*Conflicts of interest in investment advice to private individuals – a call for greater transparency and better alignment of interest*". A paradigm shift in remuneration for the provision of investment

advice is needed. Implementing impartial investment advice will inevitably lead to lower earnings for banks and other advisors in the short term, but in the long term it will be amply offset by the benefits of a more balanced and ethical business model.

In the 4th session the presenters took a new look at risk management and credit business.

**Frank de Jonghe**, Deloitte and University of Antwerp, developed in the paper "*Perfect models, fallible humans?*" a view from the trenches on the risk models. Theoretical models are in practice operated by fallible humans. An alternative was presented. Risk models do have scenarios for different outcomes and probabilities for each scenario. Mostly absent are expert judgement of probabilities and a presumed knowledge of cause and effect. We have to embrace them but keep it mathematically consistent. Tools to do this include linear programming.

**Robert Krainer**, University of Wisconsin – Madison presented the paper "*On the role of a stock market in the European bank loan market: A study of France, Germany and the euro area*". A traditional demand-oriented model is compared to a non-traditional capital budgeting model of bank lending based on movements in the cost of equity capital. Stock markets play a key role in the lending decisions of banks, even in Europe, which has a bank-oriented financial system.

**Sergio Mayordomo**, Comision Nacional del Mercado de Valores, presented the paper "*An empirical analysis of the dynamic dependencies in the European corporate credit markets*". Credit spread returns are largely driven by innovations but also by changes in the expected loss, the risk premium and the liquidity terms. The relative importance of each component changes over time. The CDS market is more influenced by risk premium-related factors. Bond and ASP intra market dependence decreased during the crisis, but inter market it remains stable. Expected loss, risk premium and liquidity factors do not enable us to understand fully the correlation between credit spread returns.

**Commission 3** – "*New paradigms in financial regulation and supervision?*" – was chaired by **David T. Llewellyn**, Loughborough University, and **Rym Ayadi**, CEPS.

**Susanna Walter**, University of St. Gallen, presented the paper "*An alternative way of calculating pragmatic risk-based premiums*", (co-authored by Matthias Schaller). The authors introduce a Merton-based calculation of deposit insurance premiums. Covered deposits are applied as the factor of size when determining deposit insurance premiums. As measures of respectively bank capitalisation and bank liquidity, the authors use the tier 1-ratio and the cash ratio as defined in the Basel II and Basel III frameworks. These are combined into a multiple indicator model. They model the evolution of default probabilities over time. Evidence suggests that the moral-

hazard-limiting method would have been able to prevent some fund distress in the US. The model also supports the view that the current tier 1-ratio as of Basel III is too low.

**Sigbjørn Atle Berg**, Norges Bank gave a presentation “*Systemic surcharges and measures of systemic importance*”. The purpose of a systemic surcharge on top of the standard capital adequacy requirement should be to mitigate the risk-taking incentives that are implicit in the large banks’ importance to the economy. He reviewed proposed measures of systemic importance from the research community and discussed their merits relative to how a regulator would ideally wish to calibrate surcharges on systemically important banks.

**Robert E. Krainer**, University of Wisconsin-Madison presented the paper “*Towards a program for financial stability*”. The paper contains a review of some of Milton Friedman’s monetary policy prescriptions from 1959 in light of the financial and economic crisis of 2007-2009. The author argues that Friedman’s proposal for 100 percent reserves or narrow banking merits serious consideration in current policy discussions.

**Bernd Schwaab**, ECB gave a presentation “*Systemic risk diagnostics*” based on an ECB Working Paper co-authored by Siem Jan Koopman and André Lucas. The authors propose a novel empirical framework to assess financial system risk. They estimate a broad financial sector failure rate that takes into account a large cross section of banks and financial non-banks. They further estimate the probability of simultaneous failure of a large number of financial sector firms. The analysis makes it possible to develop an early warning signal to use in financial stability policies.

**Alexandros P. Vardoulakis**, Banque de France, presented the paper “*Minsky’s financial instability hypothesis and the leverage cycle*”. The paper is co-authored by Sudipto Bhattacharya, Charles A.E. Goodhart and Dimitrios P. Tsomocos. In periods of prosperity, financial institutions increase their leverage and shift their portfolios towards projects that were previously considered risky. This results from institutions rationally updating their expectations and becoming more optimistic about the future prospects of the economy. Default is inevitably harsher when a bad shock occurs after periods of good news. Competition among financial institutions for better relative performance exacerbates the boom-bust cycle.

**Stefan Kerbl**, Oesterreichische Nationalbank, presented the paper “*Regulatory medicine against financial market instability: what helps and what hurts?*” The author builds an agent-based stock market model in order to evaluate the effect of different regulatory measures. He examines the effects of respectively a ban on short selling, a mandatory risk limit, a Tobin Tax, and any arbitrary combination of these measures. Only a mandatory risk

limit is beneficial from every perspective. Measures may block each other and a well chosen combination can mitigate unforeseen side effects.

**Maria Nieto**, Banco de España, presented the paper “*Creating an EU level supervisor for cross-border banking groups: Issues raised by the US experience with dual banking*” co-authored by Larry D. Wall and David Mayes. The paper explores the idea of an EU level supervisor that could supervise all systematically important cross-border banking groups without requiring an opt-in by the bank’s home country. They look at the US experience with a dual bank chartering system and a mix of state and federal supervision in order to identify important issues and demonstrate some of the consequences of some possible solutions.

**Alexander Popov**, ECB gave the presentation “*Multinational banking and the cross-border transmission of supervision and regulation: Evidence from before and during the 2007-2008 crisis*”. The underlying paper is co-authored by Steven Ongena and Gregory F. Udell. The paper provides empirical evidence on how home-country regulation and supervision affects bank risk-taking in host-country markets. The authors find strong evidence that laxer regulation restrictions in the home country are associated with higher loan rejection rates by banks in host-country markets, but that the resulting loans are mostly to small, unaudited, non-exporting, and innovative firms. The findings imply that loose home-country regulation and supervision is associated with important negative externalities for the host-country in terms of more risk-taking by cross-border banks.

**Rüdiger Ahrend**, OECD, presented the paper “*Does prudential regulation harm competition in the banking sector?*” The paper is co-authored by Jens Arnold. The authors pose the question as to whether there exists a trade-off between competition and stability objectives. The message that emerges from their analysis is that stronger prudential regulation has generally not stood in the way of competition in the past. On the contrary, in some areas strong supervision has helped to create a level playing field across all competitors. In the field of entry and ownership requirements, however, there appears to be some interference with competition. The paper gives some guidance for building more efficient regulatory systems that can achieve a desired degree of stability at a higher level of competition.

**Rym Ayadi**, CEPS gave the presentation “*Basel and Incentives: Is RWA Appropriate?*”. The author notes that empirical studies show that fixed capital requirements lead to ambiguous results and can lead to more risk taking by banks although in principle the incentive to take more risk can be countered by properly designed risk-sensitive capital requirements. More generally, regulation creates incentives for regulatory arbitrage, and regulation does not always achieve what it is trying

to achieve because it creates incentives for regulated firms to try to circumvent the regulation. The implication is that the regulator and supervisor will always be behind the curve. When Basel III has been implemented, regulatory arbitrage will have changed again. The paper notes that Basel III will have the effect of lowering banks' ROE.

**Marc Quintyn**, IMF Institute, based his presentation on the paper "*Economic crisis: Did financial supervision matter?*" The paper is co-authored by Donato Masciandaro and Rosaria Vega Pansini. The paper gives a systematic analysis of the impact of two key features of the supervisory architecture – consolidation and quality of governance – and comes to the conclusion that both were negatively correlated with economic resilience. Also the central bank involvement in supervision did not seem to matter. After having pointed out the limitations of the governance arrangements and using a new distinction between macro and micro prudential surveillance, the authors suggest that supervision be assigned to two separate institutions (macro vs. Micro) rather than a single integrated agency so that checks and balances, as a complement to governance, rather than consolidation, can assist in reducing the possibility of failure.

**Cristina Danciulescu**, Trondheim Business School, gave the presentation "*Pitfalls and solutions in current risk management methodology*". Basel II allows financial institutions to determine their VaR estimates using their own internal risk models. For both banks and regulators it is a challenge to determine whether or not VaR forecasts represent accurate measures of a financial institution's actual level of risk exposure. In the paper it is shown through Monte Carlo simulations that use of VaR models can be misleading.

**Benjamin Born**, University of Bonn, gave a presentation "*Macprudential policy and central bank communication*" based on an ECB Working Paper, co-authored by Michael Ehrmann and Marcel Fratzscher. The paper shows that central bank communications about financial stability has important repercussion for financial sector stock prices. Financial Stability reports create news in the sense that the views expressed move stock markets in the expected direction. They also reduce noise as market volatility tends to decline in response to publication of the reports. The findings suggest that financial stability communication by central banks is indeed perceived by markets to contain relevant information.

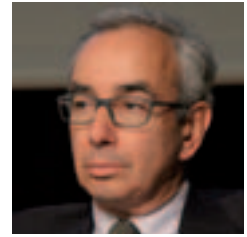
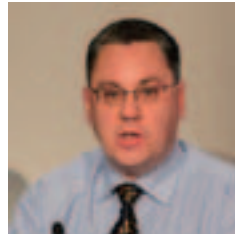
## SUERF Marjolin Lecture 2011

**Athanasios Orphanides**, Governor of the Central Bank of Cyprus, delivered the 2011 SUERF Marjolin Lecture. The title of the lecture was: "*New paradigms in central banking*". The Governor started by saying that the business of central banks is to ensure price stability, financial stability and economic stability. This has been the case for 200 years, but the understanding of the elements and the focus has changed. The Federal Reserve System was founded in 1913 to overcome a financial crisis (to ensure financial stability). After 1945, maintaining economic stability was the main task. There were several lessons to draw from the most recent crisis.

The importance of central bank independence and credibility has been underlined. The massive increases in liquidity in the autumn of 2008 could have caused increased inflation expectations but this did not happen due to the credibility of central banks. There seems to be a broad consensus about a forward looking orientation in monetary policy strategy. There is, however, a debate on how to pursue a systematic policy. How ambitious should monetary policy be? Do central banks know enough? Output gap estimates are often misleading. This illustrates why central banks should not rely on an activist approach.

The term "unconventional monetary policy" has been used often recently. The ECB has phased out some unconventional measures. The problem is, however, that the understanding of "unconventional" changes through time. There is a recognised need to strengthen macroprudential supervision, but can greater central bank involvement in regulation and supervision pertaining to credit and finance contribute to better management of overall economic stability? Not unless central banks have the appropriate tools. Any way, regulation and supervision should be closer to the central banks. Sound fiscal policy is a prerequisite for economic stability.

In several European states governments tolerated structural deficits and public debt levels that posed risks when the crisis hit. Inadequate adherence to sound long-term fiscal planning has left a limited fiscal space. The Stability and Growth Pact should have encouraged a sound fiscal policy, but it did not work. Doubts about some governments' ability to fulfil their debt obligations have led to the crisis. Ten year yields on government bonds – all denominated in euro – show how financial markets evaluate the sovereign risks. A strengthening of economic governance in the euro area must in the future prevent irresponsible fiscal behaviour and make it difficult to postpone necessary fiscal consolidation when it is needed. Today, lack of clarity about euro area governance and crisis resolution has an adverse impact on the euro area.



## The closing plenary session

The closing plenary session was chaired by **Peter Praet**, National Bank of Belgium.

**Rudi Vander Venet**, University of Ghent and BFI gave a keynote speech: “*Bank business models, performance and governance*”. Banks are involved in liquidity provision, maturity transformation and risk management. The speaker illustrated the functioning of banks by means of a stylised (average) bank balance sheet and income statement. The dynamics before, during and after the crisis involved increasing leverage, quest for profits, rising risk, return to bank basics, deleveraging and compliance with tougher equity requirements. Banks with different business models performed differently during the crisis. Loan and deposit ratios and dependence on money market funds were important. Non-retail banks were hit hardest by the crisis. Profit efficiency is important for competitiveness. Banks can use scenario analysis when they intend to restructure their business models.

**John Hollows**, KBC, described the rescue package received from the Belgian Federal and Flemish Regional government: EUR 7 billion worth of core capital perpetual securities and a state guarantee on EUR 18.1 billion worth of CDO-linked instruments. The restructuring programme agreed with the European Commission implies a divestment of banking and insurance via complementary channels in Belgium, banking in Russia and Serbia, international corporate banking for international customers, structured derivatives, and private banking outside the home markets. The “new KBC” building on the existing bancassurance model and growth options in CEE, will be a more focused regional European player with a reduced risk profile. This will allow KBC to fund sustainable organic growth, reimburse the state capital within a reasonable time and deliver an attractive return. The objective of the new risk approach is to help the group deliver sustainable and valuable growth by making the business accountable for, driven by, and expert in, risk and capital adjusted performance. The business plan 2010-2013 is focused on a leverage of earnings power, on a decrease of risk weighted assets by 25 % and on a reimbursement of state aid whilst maintaining sound solvency and steady organic growth.

**Lars Machenil**, BNP Paribas Fortis underlined the key role the finance function plays in enabling all stakeholders to continue to exercise their function efficiently in the rapidly changing operating environment. Two practical cases were developed: divestment process and the new solvency and liquidity framework. The exit from core business or geographies within 18 months was linked to a refocus on the core mission: being a universal bank in Belgium and Luxembourg, having a European footprint through a reinforced commercial banking networks and hosting several competence centres servicing the group. Of course all must comply with applicable laws, rules and regulation. Valuation and cut-off dates were handled carefully. For the new regulatory framework, finance sits in the driver’s seat because it is implied in accounting, risk models, reporting, control, rigour, capital aspects. Under Basel III there is a need to move from transfer price as the metric to manage performance towards a basket of criteria.

**Lieve Mostrey**, Euroclear, described the role of Euroclear within the trading – clearing – settlement infrastructure. In 2010, Euroclear processed transactions at a level of EUR 526 trillion. So it is not an exaggeration to say that Euroclear is a systemically important institution. It is the task of the institution to minimise 1) credit risk, 2) counterparty risk, 3) market risk, 4) liquidity risk and 5) operational risk. The financial crisis has tested the robustness of the clearing and settlement infrastructure. There have in fact not been any losses. The composition of the cleared securities has changed. Central banks have accepted new types of securities as collateral. The role of non-government securities has increased and this has caused an increased attention to risk. Infrastructure institutions like Euroclear must, however, be managed as if failure is not an option.

**Jean Pisani-Ferry** from the European thinktank Bruegel began by giving an overview of the new European financial supervisory structure. The European System of Financial Supervision (ESFS) now comprises of a European Systemic Risk Board (ESRB), a European Banking Authority, a European Insurance and Occupational Pensions Authority, a European Securities and Markets Authority, a Joint Committee of the European Supervisory Authorities and the Competent and Supervisory Authorities in the Member States. The aim of this impressive new structure is to improve crisis



prevention and crisis resolution. The powers of the authorities are being strengthened considerably but there is of course a risk of confusing policies. However, great efforts have been made in the formulation of new rules concerning the division of tasks between the ECB, the Commission and the new institutions. Bank rescue plans, liquidity support, policies concerning sovereign debt and crisis resolution have to be coordinated. Ultimately, solving fiscal problems is the member states' responsibility.

Peter Praet opened the discussion by asking the practitioners in the panel about their views on the regulatory reforms in Europe. Most of them expressed their understanding of the need for reforms and supported clear, fair and strong regulation. An interesting point of view was that the new regulation would give chief risk officers in the banks a stronger hand in bank management.

## 2011 SUERF Marjolin Prize



Late in the afternoon, **Catherine Lubochinsky**, President of SUERF announced that the 2011 SUERF Marjolin Prize - for the best paper presented at the colloquium and written by an author below the age of 40 - had been awarded to **Stefan Kerbl**, an

Economist at the the Oesterreichische Nationalbank, for his paper "*Regulatory medicine against financial market instability: What helps and what hurts?*"

The SUERF President concluded the colloquium by thanking Dexia Bank Belgium for hosting the event, the sponsors for their support, the organisers, the speakers and authors and the participants.

## SUERF/Deutsche Bundesbank/IMFS Conference



### *The ESRB at 1*

Hotel Pullman Berlin Schweizerhof  
Berlin, 8-9 November 2011

#### Accepted Speakers to Date:

**Jens Weidmann**, Deutsche Bundesbank  
**Philipp Hildebrand**, Schweizerische Nationalbank  
**Stephen Cecchetti**, Bank for International Settlements  
**Martin Hellwig**, Max Planck Institute  
**Claudia M. Buch**, University of Tübingen  
**Laurent Clerc**, Banque de France  
**Jorge Shan-Lau**, International Monetary Fund

SUERF Members will be sent the completed programme and registration information electronically.

All information will also be available on the conference microsite at: [www.suerf.org/ESRBat1](http://www.suerf.org/ESRBat1)

## SUERF/ICFR Conference

### *New Risks and Fragilities*

London, 1<sup>st</sup> Quarter, 2012

SUERF and the International Centre for Financial Regulation (ICFR) are pleased to announce that they will hold a one day conference in London during the first quarter of 2012. SUERF Members will receive further information in the next SUERF Newsletter as well as electronically. All information about the event will also be available on the conference microsite at: [www.suerf.org/icfrlondon](http://www.suerf.org/icfrlondon)

## SUERF/Norges Bank Conference

Oslo, 2<sup>nd</sup> Quarter, 2012

SUERF and Norges Bank are pleased to announce that they will hold a joint conference in Oslo during the second quarter of 2012. SUERF Members will receive further information in the next SUERF Newsletter as well as electronically. All information about the event will also be available on the conference microsite at: [www.suerf.org/oslo2012](http://www.suerf.org/oslo2012)