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Foundation of the Swiss National Bank

STUDY CENTER
GERZENSEE

NEWSLETTER

JANUARY 2014

EDITORIAL

This Newsletter briefly reports about the Center's activities in the recent past and the plans for the months ahead. It also contains an interview with Patrick Bolton of New York University, who taught one of the advanced doctoral courses in the summer, and informs about other developments at the Center.

Looking back to 2013, the Study Center organized numerous academic activities that brought a large number of central bank practitioners, academics, and PhD students from around the world to Gerzensee. Conference highlights included the event with the Journal of Money, Credit and Banking – featuring papers on the topic of "Financial Frictions" – as well as the traditional meetings co-organized with the Swiss Finance Institute and the Centre for Economic Policy Research. Six central bankers' courses and many doctoral course weeks completed the academic program. The Center's new "Open Course Ware" website makes the teaching material of selected courses publicly available.

Looking forward, we plan a series of courses and meetings in 2014, including the traditional conference with the Journal of Monetary Economics (JME). In the Swiss Program for Beginning Doctoral Students in Economics, we welcome two new external lecturers in the macroeconomics sequence, Fernando Alvarez and Ricardo Reis of the University of Chicago and Columbia University, respectively. They replace Robert G. King who served over many years as lecturer and co-organizer of the JME-conferences. We are very grateful for Bob's invaluable support to the Center, and we wish him all the best for the future. Continuing the expansion of the program initiated in 2013, we offer five advanced doctoral courses, including several lectures on financial stability related issues. We will organize a new central bankers' course entitled "Monetary Policy and Commodity Prices".

I would like to warmly thank everybody who contributes to the Center's activities for their appreciated support! I am also looking forward to welcoming many of this Newsletter's readers as well as "newcomers" to the Study Center in the near future.

With best wishes,

Dirk Niepelt
Director

INTERVIEW WITH PATRICK BOLTON

BANKING GOVERNANCE AND REGULATION

We would like to start this interview by talking about the problems of designing good corporate governance in financial firms.

I am currently working on a paper with Jeffrey Gordon, on rethinking governance for financial institutions. We draw a distinction between diversified and concentrated shareholders. The active shareholder in a bank is typically someone who has a large stake in the bank, a concentrated shareholder that is. However, an un-diversified concentrated shareholder does not necessarily have good incentives to run the bank in the best interest of the economy. To give an extreme example, suppose there is one large bank in the economy, and that you are a representative investor holding a diversified portfolio which includes both stock and bonds issued by that bank. So if the bank's CEO starts increasing risk, you are exposed to this risk on the equity side and on the debt side. As a result, you don't care about risk shifting because you gain on the equity side what you loose on the debt side. However, you are a passive shareholder, and only the concentrated shareholder has some decision power. As he is proportionately less exposed to the debt side, he benefits from excessive risk taking, and this is one reason why you don't want to give him too much power. In the paper, we are exploring what the implications are for director liability, for the business judgment rule, and so on.

In another paper that you wrote with Marco Becht and Ailsa Roell, you argue for different bank governance. Can you go into more details on this issue and explain why banks and other financial firms are so different from non-financial firms?

In this paper we review a number of empirical studies that have been done during the crisis. These studies show that the institutions that ended up failing are different from the others along at least two dimensions: first, the way they were compensating their executives and second, the way the governance was aligned with all the best established norms. The paper starts from the observation that the rules for non-financial firms are not adequate for banks and financial firms, as they differ in their leverage. Non-financial firms typically only lever up to 40% while financial firms are levered up to 90% to 95%. Highly levered institutions automatically have risky debt on their balance sheet, which introduces conflicts between shareholders and creditors. Empowering shareholders to the maximum extent may be counterproductive because they will act more in their interest than in the interests of creditors. The research reviewed in our paper points out that we should really think about governance of banks differently. Another study by Andrew Ellul and Vijay Yerramili shows that the more senior the chief risk officer (CRO) is – whether the CRO is a senior executive, a member of the board, or directly reporting to the board – and the more authority the risk management team receives, the less likely the bank is to end up in financial distress or to incur losses in the crisis. This is a very striking study with a very simple idea on governance that is easy to implement: there should be rules on risk management and the seniority of the CRO. The CRO should be given a very senior position in the institution and bank regulators could design governance rules to allow for that.

Are these considerations part of the Dodd-Frank Act?

Well, although Dodd-Frank does discuss governance and gives regulatory agencies some role, particularly the Federal Reserve, to put in place rules, there is nothing that has happened on this front. This is one area that has been neglected.

You have mentioned leverage is one of the major differences between financial firms and non-financial firms, but is one difference also the distribution of leverage in the sense of the maturity of the debt itself?

Yes, the difference in the maturity of the leverage has to do with the maturity transformation role of financial intermediaries, that they borrow short-term, whether it's through deposits or through wholesale financing, and they lend long-term. The additional dimension this brings up is that when you think about the governance of the financial institution you have to take into account the systemic implications of how the institution is managed. So you cannot just look in isolation whether the managers are running the bank in the best interest of shareholders. You have to worry about the fact that this is a bank and the bank can be subject to runs. When a bank is large and subject to runs, it can give rise to systemic risk and that has to be taken into account. That's another reason why we need to change the governance rules.

You have mentioned bank runs. During the crisis, there was a run on some money market mutual funds by the fear that they would "break the buck". Is there any reason why institutional investors are so averse to incurring losses?

We are entering a territory that has not really been that much studied and researched. We have inherited the idea from the great depression that money put into bank deposits has to be 100% safe. The 40 years following the great depression have been very stable and we have bought into the idea that the introduction of deposit insurance has been the source of this stability, although other causes may underlie this period of stability. Now, we are in a situation where we also see some of the negatives of deposit insurance and we realize that we can't for example insure everything. This certainly was the case in the Cyprus crisis where not all deposits were fully insured. It doesn't make sense to fully insure everything because of moral hazard consequences. However, the question is then how much should the regulator insure, to what extent should he insure, but we haven't really gone much in that direction.

What role did securitization play in shifting risks from banks to institutional investors?

In the last 20 to 25 years, in the US and the UK, pension funds and other institutional investors have become the main holders of securities. In the lecture course, I made a distinction between long-run investors and short-run investors to explore one important consequence of this trend. You can think of short-run investors as commercial banks originating loans and mortgages because they have the know-how, and long-run investors could be pension funds. Banks are catering to short-run investors – people who value liquidity – so they are not the best placed to hold the long-run assets they originate. There is a gain from transferring the assets to long-run investors. This is the fundamental economic justification for securitization. It has a lot of good properties: a better allocation of risk and it exposes banks less to interest rate risk. But we didn't pay enough attention to origination incentives. If you can originate a loan and sell it off why should you care about how good the loan is? The originators held less and less of the loan and rating agencies allowed for insurance schemes through CDS, thus eliminating the incentives to originate good assets. Also we thought too much in a static way. Every time a bank distributes an asset it has fresh cash available. Banks have been using the cash to originate even more assets, distributing those, thus increasing leverage even more. This dynamic effect of securitization is obviously undesirable. It accelerates lending booms and, at best, leaves

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originating banks holding the riskiest portions of originated loans when the bubble bursts.

So this is some sort of risk shifting multiplier?
Yes, that's a nice expression. We have been ignoring this dynamic component of securitization and so we still need to think exactly how we want to regulate the process of transferring assets to long-run investors.

You present risk taking (origination) and risk shifting (distribution) as two different problems. Do they require two different types of regulation?
Yes, the high leverage giving rise to risk shifting incentives, is a problem that exists even in a world with no distribution, as we saw for example in the Savings and Loans crisis. But the problem that arises once you can distribute is different from that of risk taking. And they need different answers. So, how do you regulate the transfer, the distribution part in shadow banks? This was the core of the crisis of 2007-2009. When you look at Dodd-Frank, it does very little to regulate the shadow banking sector.

Do you think that Basel III capital requirements regulation sets the right incentives for preventing future crises or for banks to act in a way that is socially optimal?
We are not there yet. It will make a big difference, but it will not save us from another crisis. I am a big advocate of contingent capital [a.k.a. convertible bonds, or cocos]. Even if you increase capital requirements you are not addressing their pro-cyclical effects. In a boom people expect the bank to be able to lend a lot and to be very profitable. So they can raise equity and increase their balance sheet. But in a recession people worry that maybe the bank over lends, or has no other lending opportunities. So stock prices go down, and as it is much harder to maintain or build up an equity capital stock, the bank has to downsize. By converting a fraction of debt into equity, contingent capital allows the bank to get cheap equity exactly when it needs it. In sum, contingent capital ensures that the bank is able to build a big equity buffer just when it needs it the most: it makes it possible for the bank to effectively "raise" a lot of equity in recessions at a pre-committed favorable price and thus to maintain its lending activities.

Another way is also to require building up capital through the upturn and so increase the capital requirement there.
Exactly, this also has other good countercyclical properties. Now Basel III allows for a countercyclical equity buffer and the way this works is that you might have, let's say 11% equity capital requirements in boom times and then you can bring it down to 9% in recessions. That's how it works. If you think about it, that is the wrong way around because you are allowing banks to reduce their capital buffer when they are most vulnerable. But you would like the bank to have a lot of capital in bad times. And that's what contingent capital allows you to do.

Relating to that, the Swiss economy may be experiencing a lending boom. At the same time the SNB fears that there is a housing bubble and it activated the countercyclical capital requirement where basically now the bank's capital requirement is higher. Would you argue that this is a good idea?
Very good idea! The context is a little bit different, Switzerland already has convertible bonds; however they are not enough to stop the boom. What you would like to do is to raise interest rates. But you can't because Switzerland is under very specific policy constraints. If raising interest rates is impossible then raising capital requirements is the only thing you are left with.

So you would argue that the countercyclical requirement is an instrument that should belong to any central bank's toolkit?
In this context yes, absolutely. I would go even further than that. Looking at the Spanish experience, Spain had a pro-cyclical loan-loss provisioning rule. So you had to provision more on expected losses in boom times than in recessions. And the idea was to in a way put in place a countercyclical policy. It didn't work for Spain, but it was a pretty good rule. I think doubling the loan provisioning in booms, or doubling the capital requirements would not have stopped the Spanish boom. My guess is the SNB is going to increase the capital requirements and it is going to have minimal effects on the housing boom. And so I think what you need here is to go beyond financial regulation and monetary policy and you need to look at fiscal policy: you have to directly put in a tax to discourage home purchases.

Monetary authority could also be in charge of financial market and banking regulation.
Well that's the trend. The European Central Bank, the Bank of England, and FED are moving there and I think it is inevitable. We have learnt from the crisis that we cannot confine monetary policy to inflation targeting, because monetary policy is also about maintaining the health of the financial system. The lender of last resort function is part of the definition of central banking, that's why central banks were created in the first place. But the literature on inflation targeting has sort of forgotten about it and we realize with the crisis that this is an integral part of monetary policy.

Professor Bolton, thank you very much for this interview.

Cyril Monnet and Nicole Aregger conducted this interview.

ACADEMIC CONFERENCES

RESEARCH DAY AND SWISS DOCTORAL WORKSHOP IN FINANCE

June 10 - 11, 2013, jointly with Swiss Finance Institute

Selected Sessions:
Corporate Finance
Liquidity and Liquidity Risk
Financial Markets
Quantitative and Behavioral Advances in Asset Pricing
Selected Topics on Financial Institutions and Lending

EUROPEAN SUMMER SYMPOSIUM IN ECONOMIC THEORY

July 1 – 12, 2013, jointly with CEPR

Focus Sessions:
Information Frictions in Financial Markets
New Developments in Business Cycle Theory
Behavioral Mechanism Design

EUROPEAN SUMMER SYMPOSIUM IN FINANCIAL MARKETS

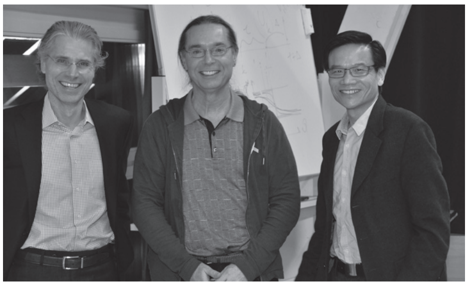
July 15 – 26, 2013, jointly with CEPR

Focus Sessions:
Information & Organisational Structure
Shareholder Activism
New Perspectives on the Term Structure
High Frequency Trading

OTHER EVENTS

Graduation Ceremony for the participants of the Swiss Program for Beginning Doctoral Students in Economics 2012 on April 19, 2013

Gerzensee Alumni Conference on November 14 – 15, 2013
Selected Sessions:
Social Planning with Spillovers: The Persistent Effect of Short-term Peer Groups
Economic Complexity in an O-ring Economy: Theory and Evidence
Over-Investment in a New Monetarist Model with Complementary Media of Exchanges
The Chicken and the Egg: Financial Innovation and the Demand for Risk-Free Assets
A Theory of Trade Liberalization, Innovations and the Impact on Industry Level
Financial Intermediation in a Global Environment
Competitive Market Segmentation
Will China Escape the Middle-income Trap? A Politico-Economic Theory of
Growth and State Capitalism



CONFERENCE WITH THE JOURNAL OF MONEY, CREDIT AND BANKING

October 18 – 19, 2013, jointly with the Journal of Money, Credit and Banking, the Swiss National Bank, and the University of Bern

Financial Frictions

Competitive Search in OTC Markets
Authors: Pierre Olivier Weill, UCLA, Ben Lester, Federal Reserve Bank of Philadelphia, Guillaume Rocheteau, University of California, Irvine, and Tai-Wei Hu, Northwestern University
Discussant: Julien Hugonnier, Swiss Finance Institute and EPFL

The Over-the-Counter Theory of the Fed Funds Market: A Primer
Authors: Ricardo Lagos, New York University, and Gara Afonso, Federal Reserve Bank of New York
Discussant: Norman Schürhoff, University of Lausanne

More on Middlemen
Authors: Randall Wright, Wisconsin School of Business, Ed Nosal, Federal Reserve Bank of Chicago, and Yuet-Yee Wong, Binghamton University
Discussant: Luigi Paciello, Einaudi Institute for Economics and Finance

Monetary Policy and Asset Prices: A Mechanism Design Approach
Authors: Guillaume Rocheteau, University of California, Irvine, and Tai-Wei Hu, Northwestern University
Discussant: Jean-Charles Rochet, Swiss Finance Institute

Financial Deepening, the Demand for Money, and the Welfare Cost of Inflation
Authors: Aleksander Berentsen, University of Basel and Federal Reserve Bank of St. Louis, Samuel Huber, University of Basel, and Alessandro Marchesiani, University of Minho
Discussant: Fabrizio Mattesini, University of Rome, Tor Vergata

Financial Frictions, Investment Delay and Asset Market Interventions
Authors: Shouyong Shi and Christine Tewfik, University of Toronto
Discussant: Christian Hellwig, Toulouse School of Economics

Central Bank Purchases of Private Assets
Author: Stephen Williamson, Washington University in St. Louis
Discussant: Ed Nosal, Federal Reserve Bank of Chicago

COURSES

CENTRAL BANKERS COURSES 2013

Advanced Topics in Empirical Finance, jointly with Swiss Finance Institute
External lecturers: Casper de Vries, Thierry Foucault, Michael Rockinger
Monetary Policy, Exchange Rates and Capital Flows
External lecturers: Philippe Bacchetta, Giancarlo Corsetti, Philipp Harms
Banking Regulation and Supervision
External lecturers: Philippe Bacchetta, Jean-Charles Rochet, Anthony Saunders
Monetary and Fiscal Policy, jointly with Joint Vienna Institute
External lecturers: Philippe Bacchetta, Behzad Diba
Advanced Topics in Monetary Economics
External lecturers: Lawrence Christiano, Carl Walsh
Instruments of Financial Markets, jointly with Swiss Finance Institute
External lecturers: Philippe Bacchetta, Amit Goyal, Michel Habib, Erwan Morellec, Michael Rockinger

SWISS PROGRAM FOR BEGINNING DOCTORAL STUDENTS IN ECONOMICS 2013

Microeconomics
Lecturers: Piero Gottardi, John Moore, Klaus Schmidt, Jörgen Weibull
Macroeconomics
Lecturers: Jordi Galí, Robert King, Sérgio Rebelo
Econometrics
Lecturers: Bo Honoré, Mark Watson

ADVANCED COURSES IN ECONOMICS FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2013

Financial Crises and Regulatory Responses
Lecturer: Patrick Bolton
Time Series Econometrics
Lecturer: James Hamilton
International Finance
Lecturer: Gita Gopinath
Financial Stability, jointly with Swiss Finance Institute
Lecturers: Jean-Charles Rochet, Xavier Vives

LAW AND ECONOMICS COURSES FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2013

Introduction to Law, Economics and Business
Lecturer: Robert Cooter
Law & Economics of Bankruptcy
Lecturer: Jesse Fried

AGENDA

CONFERENCES 2014

Research Day and Swiss Doctoral Workshop in Finance, jointly with Swiss Finance Institute
European Summer Symposium in Economic Theory, ESSET, jointly with CEPR
European Summer Symposium in Financial markets, ESSFM, jointly with CEPR
Conference with the Journal of Monetary Economics, jointly with the Swiss National Bank

CENTRAL BANKERS COURSES 2014

Inflation Forecasting and Monetary Policy, jointly with Swiss National Bank
External lecturers: Gianluca Benigno, Angelo Ranaldo, SNB-staff
Monetary Policy, Exchange Rates and Capital Flows
External lecturers: Philippe Bacchetta, Giancarlo Corsetti, Philipp Harms
Advanced Topics in Macroeconometrics
External lecturers: David DeJong, Harald Uhlig
Financial Stability, jointly with Swiss National Bank
External lecturers: Philippe Bacchetta, Martín Gonzalez-Eiras, Michael Rockinger,
Ernst-Ludwig von Thadden, SNB-staff
Monetary Policy and Commodity Prices
External lecturers: Lucas Bretschger, Jeffrey Frankel, Philipp Harms, Michael Rockinger, Central Bank of Norway-staff
Advanced Topics in Monetary Economics
External lecturers: Lawrence Christiano, Carl Walsh
Instruments of Financial Markets, jointly with Swiss Finance Institute
External lecturers: Philippe Bacchetta, Amit Goyal, Michel Habib, Erwan Morellec, Michael Rockinger

SWISS PROGRAM FOR BEGINNING DOCTORAL STUDENTS IN ECONOMICS 2014

Microeconomics
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Macroeconomics
Lecturers: Fernando Alvarez, Jordi Galí, Sérgio Rebelo, Ricardo Reis
Econometrics
Lecturers: Bo Honoré, Mark Watson

ADVANCED COURSES IN ECONOMICS FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2014

International Finance
Lecturer: Pierre-Olivier Gourinchas
Panel Data Econometrics
Lecturer: Badi H. Baltagi
Networks
Lecturer: Matthew Jackson
Financial Stability
Lecturer: Xavier Vives
Financial Fragility, jointly with Swiss Finance Institute
Lecturer: Itay Goldstein

LAW AND ECONOMICS COURSES FOR DOCTORAL STUDENTS AND FACULTY MEMBERS 2014

Introduction to Empirical Legal Studies
Lecturer: William Eisenberg
Corporate Crime, Liability & Financial Misdealings
Lecturer: Jennifer Arlen

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PUBLICATIONS

Journal of Monetary Economics 59 (S), December 2012. Special issue with the papers presented at the conference entitled "Directions for Macroeconomics: What did we Learn from the Economic Crises" held at the Study Center in October 2010

Swiss Journal of Economics and Statistics 149 (2), June 2013. Special issue with the papers presented at the conference entitled "Debt Brake - 10 Years on" held at the Study Center in November 2012

DISSERTATION

Toni Beutler
"Essays on Financial Markets and Macroeconomics"
ISBN 978-3-9523361-4-4

WORKING PAPERS

2013

13.01
Raphael A. Auer
"Product Heterogeneity, Cross-Country Taste Differences, and the Consumption Home Bias"

13.02
Nils Herger
"On Discrete Location Choice Models"

13.03
Raphael A. Auer
"What Drives Target2 Balances? Evidence from a Panel Analysis"

13.04
Sylvia Kaufmann and Christian Schuhmacher
"Bayesian Estimation of Sparse Dynamic Factor Models with Order-Independent Identification"

13.05
Harris Dellas and Dirk Niepelt
"Credibility for Sale"

13.06
Pınar Yesin
"Foreign Currency Loans and Systemic Risk in Europe"

13.07
Irineu de Carvalho Filho
"Risk-off Episodes and Swiss Franc Appreciation: the Role of Capital Flows"

13.08
Nils Herger
"Market Entries and Exits and the Nonlinear Behaviour of the Exchange Rate Pass-Through into Import Prices"

2014

14.01
Philipp Harms, Jaewon Jung, and Oliver Lorz
"Offshoring and Sequential Production Chains: A General-Equilibrium Analysis"

STAFF NEWS

Among the teaching assistants, Oliver Baltisperger and Andreas Wälchli, who is about to obtain his doctoral degree from the University of Lausanne, left the Study Center. Simon Beyeler and Christian Myohl, both University of Bern, started as assistants with the objective to write their doctoral theses. Manfred Roth celebrated his 10th anniversary as IT-supporter at the Study Center.

VISITORS' PROGRAM

Martín Gonzalez-Eiras, University of Copenhagen, visited the Study Center at the end of April to collaborate with Dirk Niepelt.

Borghan Narajabad, Rice University, USA, visited in May; Jonathan Chiu, Bank of Canada, Ottawa, came in August while Erwan Quintin, Wisconsin University, USA, stayed at the Study Center in December. All of them worked together with Cyril Monnet.

ABOUT

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STUDY CENTER
GERZENSEE

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