

## Welcome to the first Review of Duisenberg school of finance

Dirk Schoenmaker, Dean, Duisenberg school of finance



**Welcome to the first Review of Duisenberg school of finance. This Duisenberg Review aims to inform our stakeholders – the financial industry and our students – about education and research at Duisenberg school of finance as well as our other activities, such as public lectures and conferences. The Duisenberg Review will be published on a quarterly basis.**

As the new dean of Duisenberg school of finance, I am proud to start this first Review. With my background in academia (Erasmus University Rotterdam, London School of Economics, and VU University Amsterdam) and policy (Ministry of Finance, and International Monetary Fund), my aim is to steer Duisenberg school of finance to the international forefront of academic research in finance and to contribute actively to the international policy debate on the future of the financial system. This research based strategy enables Duisenberg to offer first class education. The mission of Duisenberg school of finance is to educate the future leaders of finance.

We have started two Master of Science classes, Risk Management and Finance and Law. Next year, we will add two new MSc programmes on Corporate Finance and Banking, Financial Markets and Institutions and a new LLM programme on Finance and Law. Moreover, the Duisenberg school of finance has set up a MPhil/PhD programme of Finance with the renowned Tinbergen Institute.

Subsequently, we have established a public lectures series on topical issues, such as **Integrity and Finance** by Professor Michael Jensen, **the Risks of Massive Risk Creation Associated with Leveraged Securitization** by Professor Raghuram Rajan, **the Financial Crisis and the Future of Capitalism** by Professor Andrei Shleifer and **European Banking, beyond the crisis** by Professor Jean Dermine.

What is special about our approach? Duisenberg school of finance is a joint initiative of the universities and the financial industry. Our founding partners – top executives of financial institutions – are keen to provide a stimulating and challenging environment for attracting and training the brightest students in finance. Academic classes given by our international faculty are alternated with seminars by practitioners on current issues. The intensive twelve month MSc programmes also include a six week mandatory internship at a financial institution.

The Duisenberg Review informs you about our achievements and aspirations. In this first Duisenberg Review you can find outlines of three of our public lectures held, an article of one of our top professors, and also an interview with one of our students. We hope you will enjoy reading this Review and join our activities in the future.



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## Re-regulation, over-regulation, and missed opportunities

André Lucas

- Programme Director Duisenberg school of finance
- Professor of finance, VU University Amsterdam
- Director of graduate studies, Tinbergen Institute

### Risk Management

With the start of its MSc in Risk Management in September 2008, Duisenberg school of finance initiated a niche programme in an area that is currently proving to be a focal point for new research and policy development. The unprecedented speed with which developments have unfolded, the surprising lack of overview and transparency, and the global mutual embarrassment about the implications of perverted management incentives have put risk management high on the agenda for politicians, industry professionals, regulators and academics alike.

Given public awareness of the many issues that have gone amiss in the financial system, it comes as no surprise that the pressure on policy makers to design and implement additional rules to prevent similar events in the future is considerable. Such new rules should come on top of the regulatory frameworks of Basle II and Solvency II. This article reviews some of the ideas that have been put forward and will argue that, even if all the current proposals are implemented, too little attention is given to developing regulation for the one thing that needs it most: the financial system itself.

### Measuring risk: Basle II and Solvency II

The key issue in risk management in financial institutions concerns the identification and measurement of risk factors. Although the first capital accord Basle I of 1988 contained interesting elements in terms of distinguishing different risk factors (market risk, credit risk), as well as various degrees of risk levels (government, corporate), with their associated capital requirements, the agreement was inadequate, given the rapid development of new financial products. As early as 1996 a market risk amendment was necessary to make capital buffers both more transparent and more responsive to market risk exposures taken through off-balance derivative contracts.

The basic workhorse of the market risk measurement system was Value-at-Risk (VaR): a simple management tool to express downside risk in monetary, rather than statistical terms. VaR, despite all its defects, served to spur risk management practices significantly beyond their status of previous years. This was not primarily due to the VaR number itself, but much more to the IT, control and other management efforts needed to compute it within the context of a large and complex organisation.

The subsequent developments were twofold: one involved extending the progress made in regulating market risk to other key areas, such as credit risk and operational risk (Basle II); the second copied the



“The way forward is not an increasingly more precise measurement of institutional risk and sophisticated modelling approach at the level of the individual institution.”

best practices developed in the banking sector to other parts of the financial system, such as insurers (Solvency II), pension funds (FTK), and (arguably) corporates (parts of IFRS). This has left the world with a rather complicated and detailed set of rules based on a number of different simple workhorse models.

A detailed set of model-based rules for capital requirements, however, comes at a cost. One aspect of this is the cost of over-simplification. In a complex and dynamic environment like the financial sector, workhorse models can only provide a crude attempt to measure the degree of risk posed by institutions at the portfolio level. It is not possible to apply a universal model to all aspects of the instability of market volatility, risk premia, hedge effectiveness and liquidity. A hands-off approach by regulators, allowing institutions to develop their own internal models to integrate these different sources of risk, is only a partial solution to the problem. Although institutions may be at an advantage in estimating their own risk exposures and the interrelations between these risks, it is impossible to carry out adequate back testing of all these models along all the possible dimensions of misspecification.

The other cost of a model-based regulatory framework is that of over-confidence. The precision of a quantitative, statistical framework for capital buffer determination may create an unjustified sense of accuracy. The lack of attention to the imprecision of parameter estimates and the range of other model uncertainties should lead to caution when interpreting simple descriptive summaries of loss distributions, such as VaR numbers. This has become painfully clear during the recent financial crisis: risk factors that have played only a minor to moderate role over recent years, may suddenly become prime sources of risk during periods of market stress.

The most important aspect of the way forward, therefore, does not appear to lie in an increasingly more precise measurement of institutional risk and sophisticated modelling approach at the level of the individual institution. A typical example of where this does not work is the regulatory attempt to quantify operational risk, a task that appears almost impossible for low-frequency/high-incidence events, due to the lack of data. Although refinements in risk measurement models are certainly needed, they are, in themselves, insufficient to address the main challenges that lie before us.

### **Beyond individual models: a systemic approach**

In short, previous regulatory developments have been targeted at regulating individual financial institutions. On the whole, they have succeeded in bringing regulatory proficiency in risk management to the next stage in its development. However, one key issue that remains unaddressed is the risk management of the system itself. Although every institution is required to be in control of its risks, it is unclear whether anyone actually is, or could be, in control of the sum of all the residual 'controlled' risks, i.e., the systemic risk. The need to answer this question has clearly emerged from the current crisis. Even though most institutions were subject to stringent regulation under Basle-type standards, this has not prevented many of them from falling into default or near-default.

The current debate on regulatory reform focuses on yet further increases in rules for individual supervision. There is no problem with this where existing prudential guidelines have not been implemented, or have not been implemented strictly enough. It is, however, inadequate as an answer to the systemic effects of the crisis. The only clearly audible complement to the call for more individual rules is the concern about the pro-cyclicality of current regulations. It is precisely in situations of stress, like the current recession, that the riskiness of asset portfolios increases. Given the risk sensitivity of capital requirements under the Basle model-based regulatory framework, this causes capital requirements to increase across the board. Clearly, if implemented ruthlessly, this may lead to a further deepening of the credit crunch. Antagonists of the pro-cyclicality in capital requirements argue that the current regulatory framework is set too much in the context of capital charges, rather than capital buffers. Capital buffers should be set in such a way

that they are allowed to shrink in situations of stress. Conversely, the buffers should accumulate during economic booms. Rather than capital buffers following the moods of the economic cycle, (and thus becoming more like capital charges), these counter-cyclical capital requirements would restore the role of capital buffers to their original purpose: that of a cushion against the bad times.

“Transnational coordination and strong leadership are thus the prerequisites for setting up a global system for systemic risk management.”

Whilst we may be sympathetic to the general idea of counter-cyclical capital requirements, it is hard to implement them in practice. The key problem is that we are notoriously bad at predicting turning points of economic cycles. This is important both during an upswing, when it is important to start accumulating capital in time, and during a downswing, when the capital cushion must not be eroded before the end of the trough. All in all, this requires a degree of sophistication and foresight on the part of the supervisor that appears to be unrealistic. A more straightforward route would follow along the lines of the three stages of standard risk management practices: identifying the main sources of risk, measuring them and deciding on how to deal with them effectively.

At the system level, we have so far reached only the first of these three stages, by acknowledging that market risk, credit risk, liquidity risk, operational risk and systemic risk are important. The natural next step would be to try to measure the systemic risk components. Here, as with the early stages of market risk regulation in the 1996 amendment, the interest is not so much in the quantification of the risk itself, but rather in the process needed to produce this quantification. For one thing, this would mean that an international agency would be required to gather information on linkages in the financial system. Such an overview has been lacking during the recent crisis, causing the haphazard approach of the U.S. government to allowing some financial institutions to survive, while letting Lehman Brothers fail. Having more information on possible spillovers from one financial institution to another would allow regulators worldwide to anticipate cascade effects in defaults and liquidity better. Moreover, it would truly allow supervisors to perform well-informed stress testing of the financial system. This, in turn, would provide for a set of instruments to manage risks at the system level, for example, by the timely reacting to accumulating concentrations of particular risks (e.g., mortgage risks) in the sector. ▶



The reactions could be in terms of dynamic capital requirements. This, in turn, would enable the development of a new set of instruments to manage risks at the system level. For example, regulators could pro-actively implement policies upon increasing concentrations of particular risks (e.g., mortgage risks) in the system. The actions could

take the form of dynamic capital requirements that would co-vary directly with the concentration of risks within the financial system. This stands in sharp contrast with the current framework, that reacts rather mechanically to only the dynamics of the business cycle.

Naturally, the measurement of the interrelationships within the financial sector appears to be a daunting task. It is already a complicated task getting in control of risks at institutional level, let alone managing the risks of the financial system as a whole. One of the lessons of the 2008 credit crisis, however, is that we can no longer postpone such an exercise. What is more, we cannot leave such an initiative to the private sector itself. The real incentive to design a global risk measurement system lies in the undesired externalities of system failures. Economic theory tells us that individual institutions within that system will not have enough incentives to invest sufficiently in such a measurement system. Government intervention is therefore indispensable. However, taking the underinvestment problem one step further, economic theory also warns us that individual governments also have an incentive to under-invest in a global system. Transnational coordination and strong leadership are thus the prerequisites for setting up a global system for systemic risk management.

## Duisenberg Interview

**Osne Kirzner**  
Student MSc Finance and Law programme at  
Duisenberg school of finance.

**Osne Kirzner is a typical student at Duisenberg school of finance. As he was preparing to graduate in Medicine at the University of Amsterdam he began looking for a high-quality post-graduate course. His initial thoughts were to opt for a general MBA, but Osne found exactly what he was looking for in the MSc programme in Finance and Law at Duisenberg school of finance.**

Our reporter caught up with him and asked why he had chosen a course offered by Duisenberg school of finance.

### The best of the best

'As I went into my final year at university,' Osne explained, 'I started looking at post-graduate programmes. My first thought was to find a good MBA course. I was really impressed with the high quality of universities in the Netherlands, but none of the courses really stood out. Then I came across the Master's programme in Finance and Law offered by Duisenberg school of finance. During the information evening I was amazed at the enthusiasm and the quality of the lecturers, who all come from top universities and financial companies. By taking the best brains in the business, Duisenberg school of finance has put

themselves head and shoulders above anything else I've come across. And that's precisely what I was looking for. I want to be one of the best in my profession, and feel that Duisenberg school of finance is offering the highest level of education I could hope for, from some of the foremost lecturers in their field.'

### Spoilt for choice

When asked why, from the range of courses offered by Duisenberg school of finance, he had decided to enrol on the MSc Finance and Law programme Osne hesitated. 'It was difficult to choose between the excellent programmes on offer. In the end, I felt that with my medical degree, Finance and Law would give me the perfect combination and would teach me the best skills to work between the medical and financial industry. I believe I'll have far more career opportunities than with just a medical degree on its own.'

### The advantage of a multi-discipline approach

When recently asked by two student-friends who are studying at the technical university in the Dutch city of Delft, to comment on a medical product they had developed, Osne found that his original high expectations of his choice were justified. 'By applying what I'd learnt during my medical studies and what I'm learning on the Finance and Law course at Duisenberg school of finance, I was in a far better position to look at whether there was a genuine need for the new product in the medical world and, at the same time, assess its financial viability,' he explained. But Osne is keen to point out that he hasn't

acquired these extra skills on his own. 'What's unique about studying at Duisenberg School of finance,' he points out, 'is that there are so many experts in the place. Our lecturers hold some of the top positions in the financial academic world, as well as playing a major role as consultants to leading blue chip companies.'

### Learning from the best in the industry

Osne is enthusiastic about the contact students have with their lecturers. 'Because Duisenberg school of finance is a specialist academic institution, classes are small and we have direct access to the lecturers,' he explains. 'During a dinner with one of our Programme Directors, Prof. Dr. Joe McCahery, I was able to discuss with him a whole range of ideas. His experience and expertise is truly amazing.'



"Now, more than ever before, I believe the financial world needs fresh ideas and a new approach to global issues such as risk management and in particular the key area of finance and law"

Students not only learn directly from leading minds from across the financial world, they are also supported by sponsors from the very heart of the financial sector. It is this unique combination of intellect and experience that is helping to guide and coach the minds of the top financial students.

### The new generation

Osne Kirzner sees himself and his fellow students at Duisenberg school of finance as part of the new generation of financial talent. 'Now, more than ever before, I believe the financial world needs fresh ideas and a new approach to global issues such as risk management and in particular the key area of finance and law,' he explains. 'It's clear that the old risk models are no longer adequate for the essential role they play in society. I'm excited to be part of the move to look at how we can take the best of the old, change what we need to change, get rid of elements that no

longer work and search for new models which will meet the needs of the financial industry of the future.' It is clear that Osne is grasping this opportunity with both hands: 'I love being at the centre of this period of major change. I feel that at Duisenberg school of finance I am learning how to make a difference.'

Unsure of your future? – Osne's advice: Make the most of opportunities. When asked if he has any advice for potential future students at Duisenberg school of finance or for anyone not sure about which post-graduate course to take, Osne is clear, 'Make the most of the opportunities offered to you on a course like the MSc in Finance and Law at Duisenberg school of finance. It's hard work, but the benefits are second to none. You learn so much in such a short time span and the access we as students are given to the real gurus in the industry not only means we know what people at the top are really thinking, it also give us a great network when it comes to getting a job later. If you are accepted on to one of the courses here, grab the opportunity, it might not come round a second time!'

### The bank of the future

And finally, we wondered what Osne thought the banker of the future would be like in 10 years' time. 'It is clear that the banker will have to get closer to his client and understand his ailments and requirements, in the same way a doctor knows his patient.' Osne sees many useful parallels between his two studies of Medicine and Finance and Law. 'Being a doctor is a humble profession. You do everything you can to heal and save people. That's your main purpose. You treat your patient as you would want to be treated yourself.' He has come to recognise this as one of the key areas where the financial sector has gone wrong: 'Bankers have had the tendency to look at what is good for the bank, rather than for the client. There is less contact with the customer, and the banker is further away from the day to day world of the people he serves.'

But Osne Kirzner is pragmatic and sees a light at the end of the tunnel: 'Of course, faith in bankers has taken a major knock during the financial crisis. The industry needs to regain the trust of the people it serves, for example by putting the interests of society as a whole higher up on the agenda. A medical professional keeps in touch with the needs of the patient. This is what the bankers will need to do more often in the future. This will ensure that the right specialists are available when they are needed and that they have the latest expertise needed to address the demands of an ever-changing society.'

As far as what his own future holds in store, Osne is confident that the unique combination of his medical degree from the University of Amsterdam and his MSc in Finance and Law from Duisenberg school of finance will ensure he is able to find a position to enable him to influence financial thinking within the medical industry.

**We wish him and his fellow students well!**

## Agenda



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End of June 2009

**Start internships students**

September 2009

**Opening Academic Year  
Duisenberg school of finance**

18 September 2009

**Graduation Class 2008/2009  
Duisenberg school of finance**



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[www.duisenbergschoolof-finance.com](http://www.duisenbergschoolof-finance.com)

## Andrei Shleifer

### The Financial Crisis and the Future of Capitalism

**Public lecture held on 10 February 2009**

#### The upside

Andrei Shleifer, a professor of economics at Harvard University, reminds us of the economic growth the world economy experienced after the introduction of free markets. The transition from socialism to capitalism in Eastern Europe all contributed to the acceleration in the rate at which global capitalism was being embraced. Living standards rose, infant mortality dropped, levels of education and democracy increased globally and the absolute number of people living in extreme poverty declined, at a time when the world population was exploding. Professor Shleifer argues that the free market policies introduced over the last 25 years were the main cause of these improvements.

#### The downside

On the other hand, housing bubbles bursting and increased bank leverage have resulted in the massive failure of the financial system which has cumulated in the current recession. This shows that not all policies introduced between 1980 and 2008 have played out well. Financial innovation, such as securitisation and recommendations by rating agencies enabled CDOs to spread into the balance sheet of banks, insurance companies and pension funds, which in turn increased their exposure to the overheated US housing market. Also extreme leverage and integration introduced into the financial system enabled

the accumulation of skyrocketing profits in the industry at the beginning of this decennium, whilst at the same time making the system extremely vulnerable to the drop in housing prices, when it came.

#### The way forward

Bank rescues are undertaken not only to save the institutions involved, but also to encourage them to open up lending to the economy again. A combination of cash injections, putting bad assets in bad banks and repurchasing bad assets from banks may be successful. However subtle interventions are likely to fail. Yet Professor Shleifer, stresses that the current failure in the financial system is not the end of capitalism. In order to be effective, the regulatory system should be based on the following elements: private ownership of banks; complete disclosure to the public (not just to the regulators) - including derivatives and off-balance sheet liabilities; mark-to-market accounting; improvements in clearance; improved provisions to handle bankruptcy of financial institutions; and no restrictions on financial innovation. And, above all, the rules need to be enforced.

#### Don't throw out the baby with the bathwater!

Finally, Professor Shleifer reminds us of the advantages liberalisation of our (capital) markets has brought to us over the last two decades and warns us not to forget the benefits of our current system.

## Duisenberg school of finance offers the following programmes, starting September 2009:



- MSc in Risk Management
- MSc in Corporate Finance & Banking
- MSc in Financial Markets & Investments
- MSc in Finance and Law
- LL.M in Finance and Law
- MPhil and PhD programme in Finance

For more information about the Programmes of  
Duisenberg school of finance, please visit our website:  
[www.duisenbergschooloffinance.com](http://www.duisenbergschooloffinance.com)

## Michael C. Jensen & Steve Zaffron

### Introducing a New Integrity Model



#### Public lecture held on 14 October 2008

Michael Jensen, a professor at the Harvard Business School, provides us with a clear pathway of specific actions towards integrity that would increase the performance of individuals, groups, organisations, and societies. The integrity model introduced in his public lecture assumes a causal link between integrity (without any normative aspects) and performance/value creation.

#### My word is my bond

In addition, he presents integrity as a necessary precondition for a workable model. For an individual this means 'honour your word'. Whilst we may acknowledge that it is not always easy, or indeed possible to keep all of one's promises, we can retain integrity by striving to keep our word, or alternatively, as soon as it becomes clear that this is not possible, informing the people to whom promises have been made and resolving the problems caused by a broken promise. Not only will always keeping your word increase your performance, it will also create solid working relationships, by providing a means of earning the trust of others. However, integrity is not for the short-term and it will be impossible to carry out a cost-benefit analysis, without damaging the foundation on which you are building your long-term relationships – that of trust.

#### Personal benefits

Michael Jensen states that as long as we regard integrity as a virtue, we create an unworkable situation in our lives and in our organisations. Moreover, we are biased towards our own actions and deceive ourselves about what it is that we have promised and what we ultimately deliver. In doing so, we ignore the role integrity can play in increasing our production and will therefore fail to achieve our full potential in life. More importantly, according to Professor Jensen, it is personally beneficial to always honour one's word and not to attempt to carry out a cost-benefit analysis on something which should simply be at the core of all we do.

#### How to be a successful leader

Michael Jensen is an internationally renowned economist, but here he has presented a clear and workable model for what it takes to be a successful leader in any walk of life. Being a person of integrity will make your life more meaningful and valuable, but at the same time it means that you will no longer have the choice of when, and when not to honour your word. To be opportunistic regarding the trust you have created in giving your word results in self-disintegration and will restrict your potential. Being aware of the possibilities in our lives enables us to make a difference when the time comes. This framework for integrity offers the guidance needed to achieve this goal.

## Raghuram Rajan

### The Risks of Massive Risk Creation Associated with Leveraged Securitization

**Public Lecture held on 3 December 2008**

Raghuram Rajan is a professor at the Booth School of Business at the University of Chicago. As former Chief Economist at the International Monetary Fund Professor Rajan was one of the first financial economists to point out the problems, which were to emerge as a result of the recent financial developments. Already in 2005 he published a paper (**Has financial development made the world riskier?**) presenting an analysis of the risks facing the financial industry.

#### Why did no-one listen?

According to Professor Rajan, the incentive structure within the financial industry amounted to an unstable system, one which ignored any risks with a low probability, which had the potential to generate severe adverse consequences and create possible problems further down the line. In addition, he expressed his concerns regarding whether banks would be able to provide liquidity to financial markets if tail risks materialised, and financial losses had to be allocated in order to minimise the consequences for the real economy. Unfortunately, we can now conclude that his concerns were justified.

#### Where do we go from here?

Policy makers will, according to Professor Rajan, inevitably react by implementing regulations that focuses on the underlying problems of the subprime crisis. Such measures, however logical they may seem, will not in fact prevent any future crisis. Periodic disasters are simply inevitable in the long run. This is why it is important to strengthen the infrastructure to deal with potential disasters.

As it is the private sector which makes the profit on the way up, it is these institutions that should pay for the clean up during a crisis, preferably upfront. Otherwise the taxpayer ends up paying the bill.

#### Protectionism is not the answer

With the massive drop in asset values, (house prices and the equity market), the US middle class has faced a wipe out of their wealth. They had no option but to stand by and watch as the value of their houses, stocks and pension funds plummeted. This inevitably results in a less favourable attitude towards a market-driven economy in the United States, (as was the case in certain European countries when hyperinflation soared after the Great Depression). While Professor Rajan acknowledges this is not necessarily a bad thing, such an attitude tends to go hand-in-hand with more protectionist policies like trade barriers and saving 'national champions' from bankruptcy. If the US were to implement such policies, other countries may well react with similar measures, ultimately leading to the current recession turning into the Great Depression of this century.



The emerging market economies are even more vulnerable to such influences, as they do not have the benefit of a long positive experience with either markets or free enterprises. However, it is in the interest of these emerging countries to make the effort to benefit from financial access and the markets in general. In spite of the obvious benefits to be gained from active involvement in (financial) markets, trade and capital flows, Professor Rajan is concerned that support for open market is limited in emerging economies.

#### A voice to be listened to

In light of Professor Rajan's foresight in predicting the current financial crisis and his careful analysis in December 2008, analysts and policy makers alike could do well to follow his work in the future. His view of what is needed may well provide valuable insights into our future, which, in turn may help us to delay the onset of the next crisis, and give us the time to set up the 'sprinklers' needed to respond adequately.

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