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Duisenberg school of finance

Duisenberg Review

Duisenberg school of finance training of central bankers and regulators

Renewed commitment to multilateral institutions

While it is far from early to announce the end of the financial crisis, it is already clear that it has been a transformational event. Not only are there major changes taking place in the global financial sector, but the crisis has also triggered a wide-ranging debate about the performance of monetary policy and the role played by regulatory policy in maintaining the health of the banking system. At the international level, moreover, there is apparently a renewed commitment to multilateral institutions, which appeared obsolete before the crisis, and a coordinated approach to the governance and oversight of the global economy and financial markets. Given the challenges to monetary policy beyond the financial market crisis and the fundamental changes proposed in the regulation of banks, it was especially propitious timing for Duisenberg school of finance to organize a Central Bankers and Regulators course in January.

New techniques in monetary economics

Top echelon central bankers and regulators from the constituency countries of the IMF, led by De Nederlandsche Bank (the Dutch national bank), participated in a course organized by Duisenberg school of finance professors Florencio Lopez de Silanes and Joseph McCahery that dealt with the practical and analytical aspects of monetary and financial policies. The course, which was sponsored by the Ministry of Foreign Affairs, exposed participants to frontier models, new techniques in monetary economics and stimulated discussion about applied monetary problems that central bankers have tried to address from the beginning of the crisis. While there are few benefits that can be easily derived from the current crisis, the high quality presentations made by leading economists at the course received great interest both from academic economists and the central banking community in attendance.

New developments in forecasting

At the course, a number of speakers, including Markus Brunnermeier (Princeton University), Andrei Schleifer (Harvard), made regorous presentations on new developments in banking and financial stability. In addition, there was a paper presented by Jeremy Stein (Harvard) on quantitative easing and its impact on the Federal Reserve's balance sheet and mortgage spreads. Raghuram Rajan (Chicago) provided an assessment of the effectiveness of the non-conventional monetary policy measures taken by central banks during the crisis and the need for optimal interest rate policies after the bubble. In the final course presentation, Florencio Lopez de Silanes critically discussed the track record of government ownership of banks rejecting optimistic assessments of the beneficial consequences of such ownership for subsequent development in the long run.

Participants at the inaugural course were offered a range of options to address the key prudential and regulatory issues confronting regulators and policymakers. Given the success of this year's event, Duisenberg school of finance will organize the second course for Central Bankers and Regulators in January 2011.

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Positive regulatory reforms towards a financial sector out of the hands of the State

Professor Florencio Lopez de Silanes

- **Academic Advisor, Duisenberg school of finance**
- **Professor of Finance and Law, EDHEC Business School**
- **Head of a new research programme on regulation and mutual fund governance at the EDHEC Risk and Asset Management Research Centre.**

One of the main reasons behind the current financial crisis is the lack of financial transparency in financial institutions. Unlike other corporations around the world, who had to upgrade their financial transparency and conflicts of interest disclosures, financial institutions were kept aside and avoided many changes as a result of their special status as a key industry for the economy. Poor disclosure and corporate governance practices in financial institutions are thus part of the problem.

"One may wonder if this is the end of the capitalist model which has been embraced by most countries in the world. I do not think so."

Lack of good disclosure

Financial institutions, pushed by the pursuit of profitable investment opportunities, were caught holding a large portion of mortgages securities just at the time the prices of real estate started to fall. The lack of good disclosure practices for this and other potentially risky securities prevented markets from knowing the true exposure of these institutions. For the same reason, as prices of real estate fell, markets found it difficult to figure out the potential size of the hole in each bank, and thus it became uncertain which institutions would survive. In these circumstances, institutions held to their own cash to try to survive and the credit market dried up bringing its collapse.

Banks and other financial intermediaries around the world were holding similar long positions on US mortgage securities, so the crisis was quickly transmitted across developed and developing countries. The expectation of an economic downturn, as a result of the losses, was also at the root of the fall in economic activity across nations.

Social benefits

One may wonder if this is the end of the capitalist model which has been embraced by most countries in the world. I do not think so. If we go back several decades to the Great Depression, we see that capitalism survived that crisis and many positive reforms came out as a result. Financial capitalism survived that crisis and reformed itself. In the following half century, the capitalist model has indeed brought substantial growth across countries and created large social benefits. Statistics about living standards, education and other measures of economic growth show that this is indeed the case even among the poorest.

Increased regulation

A period of financial repression is more likely to be the outcome of this crisis, mainly because of the increased role of the state in the banking sector, larger credit controls and restricted international trade. It is likely that we will observe a period of increased regulation around the world. This may not necessarily be a bad thing, if regulation were thought out clearly. The new financial regulation put in place after the Great Depression is an example of positive regulatory reforms. But for the new regulatory wave to be of benefit to markets and society, it needs to be refocused precisely on the issue that failed: transparency and good governance practices.

Sound governance principles

In order to get out of the crisis quickly, France, the US and other developed and developing countries need to return to a financial sector out of the hands of the state. We have empirical evidence showing that the state's involvement in banking limited innovation and led to lower financial and economic growth rates across countries in the past 50 years. As my previous research shows, the new regulatory framework that should accompany the re-privatized banking sector should be based on sound governance principles, and most importantly, on transparency not only to regulators, but to the markets so that they can be a force against deviations.

Duisenberg school of finance proudly presents: Dr. Mia de Kuijper, launching her new book Profit Power Economics:

A New Competitive Strategy for Creating Sustainable Wealth

An interview by Judith Kohsiek with Mia de Kuijper, Dean External Relations and Executive Education at Duisenberg school of finance

What's it all about?

"The central idea is that firms should aim to focus their ownership on "power nodes", which are the parts of a business system that earn the highest rate of risk adjusted return and that allow control of the system by means of relationships rather than via ownership. Power nodes are not only the sources of contemporary profitability, they are also the competitive weapons in multi-dimensional competition as well as the "glue" in new distributed business models. Being able to recognize these power nodes informs what firms should own, how they should compete, how they should be organized, and how they can survive in markets driven by network dynamics. In this book I have highlighted the twelve principle power nodes that are seen in practice today and how they can be utilized."

What is the most important message in your book?

"The main message is that corporations have to have strategies that are appropriate for the current age. This is an age in which information is becoming cheaper and more available to everyone and where people, markets and companies are becoming more interconnected. This makes their decision-making interdependent. This interconnectivity is a new and important dynamic. Tight connectivity, as we have seen in the financial crisis, messes up the old models and the old ways of economic thinking. This interconnectivity requires new ways of looking at markets and economies. The easy availability of information exposes companies to competition from new competitors and other markets. On the other hand, it also provides companies and investors with more flexibility to own just what they want to own, and to organize themselves in ways that were not possible earlier.

"Corporations have to develop different strategies on how to compete in this new age. For financial markets and financial institutions, in particular, there is a need to adjust their risk management approaches to this new kind of interconnectivity. As Profit Power Economics shows, all these companies have great opportunities to build sustainable profitability by adjusting their strategies to take advantage of the fundamental changes that are taking place."

How does this relate to Duisenberg school of finance?

"We at Duisenberg would like to build a school that is recognized at an international level for being at the cutting edge of finance. It is our responsibility as a school to translate those new age dynamics into financial tools. We want to be at the forefront of finance and the new way of economic thinking.

"But Duisenberg is more than just a school that teaches the most modern tools and provides the latest insights. Very importantly, Duisenberg is special because it also helps students to prepare to function in the real world and to make a difference wherever they may go to work. To become effective and progress to financial leadership, they also need training in how to perform in practice. And that is the type of education that Duisenberg school of finance wants to deliver to its students: via our Leadership programme, via small group problem solving, via practitioners seminars, via our Career Resources support, and via our internships programme. It's all about making a difference.

"Actually, it appears that our students are very well-versed in the modern world of abundant information and connectivity. They are functioning in this world every day. They are using the newest available tools, a multitude of sources of information, new forms of communications, and powerful, fast computers. They are often at the forefront of the new reality of consumer and financial markets. They are among the kind of people who are creating the new age dynamics that Profit Power talks about."

"In Profit Power Economics I presented one of the most effective modern power nodes: a "hub." A hub is a place in which everything that is related and relevant comes together and in so doing reinforces itself. Duisenberg wants to have a modern power node and wants to be a hub. By using the dynamic of being a hub of financial excellence, the school will get ahead. By being at the cutting edge of teaching finance and professional effectiveness, we can attract great students, which in turn will attract great professors, attract great employers for our students, and great sponsors. This in turn will attract great students and so on. That way we get the best of all worlds.

"Finally, by becoming a hub for financial excellence, the school may contribute to one of the larger goals of our founding fathers and the city of Amsterdam: of strenghtening Amsterdam as a hub as well."

We would like to thank ING for facilitating the public lecture on 9 February 2010 in the ING house and Koos Timmermans (Chief Risk Officer at ING) for his valuable contribution to this lecture.

Putting it into Practice; the DSF way

A different story

It's no secret. Many people today, for various reasons, do not actually end up applying much of what they studied and learned during their education to their everyday work. However, if Duisenberg school of finance alumni are any indication, its graduates will have a different story to tell.

Raj Ravindranath: "I believe the coursework really prepared me for what I could expect in the industry."

In a candid interview in an ING conference room with alumnus Rajgopal (Raj) Ravindranath, dr. Antoine van der Ploeg, Senior Trading Quantitative Analyst at ING and Lonneke Korenromp, Student Counsel and Career Services Manager at Duisenberg school of finance, we gain proof for how the school practically prepares students to effectively apply on-the-job what they've learned.

Packed with information

Raj Ravindranath studied Risk Management at Duisenberg school of finance and obtained his Master of Science degree in September 2009. According to Raj, the Risk Management programme was intensive and "packed with lots of information". In the rigorous programme, Raj says he gained "a real overview of risk management, learned the latest techniques, and also improved his quantitative and programming skills."
To get a taste of work in the financial industry, Raj decided to first perform an internship with ING in risk management. "I learned of the many ING internship opportunities from a morning company presentation hosted at Duisenberg school of finance. Upon completion of the 2-month internship I had a couple of options to pursue. Together with Lonneke, I carefully weighed my career options before deciding on my current position."

Raj now works with ING on the insurance side of its operations. In both the internship and, now, in his current position, he uses the same programming software as he did in his courses at Duisenberg school of finance. "I regularly apply the same, or similar, risk management techniques and models on-the-job, that I've learned in the classroom. I believe the coursework really prepared me for what I could expect in the industry."

Confidence

Raj is not the only one with this story, though. In a different ING internship at ING Corporate Market Risk Management (CMRM), supervised by Antoine van der Ploeg, fellow student Andrzej Blacha was equally able to take the latest techniques he learned in the classroom and directly applied it to risk modelling in his internship. Van der Ploeg: "ING CMRM is shifting to a new Historical Value-At-Risk model, so Andrzej was involved in improved scenario generation to further enhance the reliability of the risk figures. This is an advanced-level project, one which could also be carried out by full-time employees. Of course, Andrzej needed guidance, given the complexity of the assignment, yet I felt confident to have Andrzej work on it, knowing his background."

Standing out from the crowd

As a regular industry guest lecturer at Duisenberg school of finance Antoine van der Ploeg has become rather familiar with the kind of intensive quantitative training Duisenberg school of finance students receive. Now, having supervised and worked together with a couple of students at ING, he also knows what the results of the schools method of operation are in practice.

When asked whether there are additional characteristics separating Duisenberg students from others, Van der Ploeg remarked that he found the majority of students to be more motivated and engaging than students he encountered at other universities during guest lectures. Without wanting to draw too many generalised conclusions, Van der Ploeg did observe this key difference noting that it was clear the Duisenberg students are genuinely interested in what is being offered in their Master's programmes. They demonstrated their interest with well thought out questions during lectures and in informal discussions after the lectures.

Van der Ploeg found the school's training on financial regulation, which every student attends as part of the Duisenberg Leadership Programme, to be helpful for students, since he himself never received such training in his Master's and PhD programmes. With the Dutch Central Bank's tighter regulatory rules affecting ING banking operations, resulting in additional requirements such as hedge and liquidity testing and use of exotic derivatives in modelling, a course on regulatory finance is quite beneficial.

Antoine van der Ploeg: "Risk modelling is of course, by its very nature, very technical, so being able to effectively communicate or present related concepts is crucial."

There is always room for improvement

As expected, Duisenberg school of finance's excellent technical and analytical preparation of students was a common theme in this discussion, but there was room for improvement as well. For instance the students' training on the soft skills like interpersonal communication and presentation skills, which according to Raj could be given more attention in the Master's programmes. Van der Ploeg: "Risk modelling is of course, by its very nature, very technical, so being able to effectively communicate or present related concepts is crucial."

Lonneke highlights that, as off 2009, personal and professional communication skills are part of the Duisenberg Leadership Programme. Components are professional communication skills by Krauthammer International, courses in McKinsey's Pyramid Principle in communication and Marketing Yourself workshops. In addition, the Career Resource Center creates opportunities for students to put their newly developed skills in practice, like company meetings and mock interviews, as well as various other formal and informal networking events with professionals. Thus, Duisenberg students can expect to improve their soft skills and be prepared for both technical and social challenges in the workplace.

Success speaks for itself

Duisenberg school of finance is proud that its graduates can be expected to tell a different story – how their investment in post-graduate education wasn't for nothing. The programmes do realistically achieve what they set out to do, as reflected by the experience of alumni like Raj Ravindranath and confirmed by the financial sector.

The aim of Duisenberg school of finance is to offer Master programmes that accurately reflect and respond to career demands in a tough, contemporary financial market - not only contentwise, but also in preparing bright people to be able to launch their careers in a recovering economy, where interpersonal and leadership qualities make a great difference. If there's anything that underlines Duisenberg school of finance's success in readily preparing students for work, consider this: of the three students that had internships with ING in 2009, every one of them was offered a position!

Lonneke Korenromp: "Duisenberg students can expect to improve their soft skills and be prepared for both technical and social challenges in the workplace."

Whether a current or prospective student, a recruiter, or industry professional, you can contact Lonneke Korenromp through CRC@dsf.nl or 0031 20 525 8588 for more information on DSF programmes, and career and networking events, including when they will happen and how you may be able to get involved.

Agenda

Central Bankers attend DSF course on regulation

11 Maart 2010
Conference
Bank Crisis Resolution - 'Living Wills'

9-11 June
Leadership & Governance

April
Career Sessions
For more information
Contact Career Resource Center
crc@dsf.nl

Career Sessions event

For more information about Duisenberg school of finance events, please visit our website www.dsf.nl

Duisenberg school of finance introduces new master programme

Programme Information

MSc in Asset Management

The MSc in Asset Management is a niche programme designed to equip future asset managers with a fundamental, yet critical, understanding of existing markets, market developments, and investment opportunities and their risks. Since the past decades witnessed an increasing attention for non-standard asset classes as part of financial portfolios, the MSc in Asset Management programme will instil students with a profound insight into alternative investments, as well as fixed income investments and portfolio allocation with a strong foundation in econometrics. The faculty will particularly explore market regulation, trading on markets, pricing, investment opportunities and pitfalls, and common risk measures and portfolio management techniques. Some attention will be given to hedge funds and understanding how to hedge appropriate exposures to risk when allocating portfolios. Students will emerge from the MSc in Asset Management programme with varied career possibilities, both in strategic and tactical asset allocation.

Programme Highlights

- Syllabus designed by distinguished professors from top universities together with leading practitioners
- World-Class Faculty with relevant experience
- Asset Management Consulting Project
- Several challenging elective courses to choose from
- Facilitation of exclusive internships with a leading bank, financial institution or corporation
- One-on-one career guidance and job placement assistance

Student Requirements

- Bachelor's degree in finance, business, econometrics or related discipline
- Professional experience preferred, but not mandatory
- A competitive GMAT/GRE score
- High English language proficiency test (TOEFL/IELTS) score
- Well rounded candidate with strong motivation, ambition and interpersonal skills

Programme at a glance

- Format: Full-time
- Length: 12 months
- Intake: August
- Classes: 5 Blocks of 8 weeks each
- Fee: € 26,000

Programme Director

- Prof.dr. Bas J.M. Werker

Career track examples

- Portfolio Manager
- Strategic Asset Allocation Consultant
- Financial Market Analyst
- Risk Manager
- Market Trader

Jeremy Stein (Harvard University)

Repairing the Financial System: Short-Run Stabilization and Long-Run Reform

Duisenberg school of finance public lecture held on 14 January 2010

Professor Stein discussed the major policy initiatives of the US government that have been initiated in 2009, in order to tackle the financial crisis. Being special advisor to president Obama on the matter, he himself has been one of the architects of the policy. His talk focused upon the Term Asset-backed Securities Loan Facility, the stress tests and the public-private investment partnerships. Stein concluded his lecture with some long-run recommendations for reform.

Haircuts

The Term Asset-backed Securities Loan Facility, abbreviated as TALF, has been initiated to replace private lending against asset-backed securities, which basically evaporated during the crisis. TALF tried to partially replace this gap by providing Fed loans to holders of newly-issued asset-backed securities. As Stein points out, the TALF appeared to be a successful policy, since there was a rebound in the issuance of corporate bonds and asset-backed securities. The short-term lesson we learned is that the assed-backed securities market is fragile. For the long-term this raises the question if we want to regulate the securitization market itself, by for example setting minimum haircuts.

The success of the stress test

The stress tests, one of the most successful policies of the Obama administration so far, tested the banks' ability to withstand adverse economic scenarios. The test gave every bank a number, which indicated the need for capital. If capital was needed according to the test, it could be collected through the private market or by making use of the capital assistance programme (CAP). CAP acted as a backstop for those banks that could not raise the money in the private market. The stress tests appeared to be a clear success, since the overarching goal of infusion of new private capital was met beyond all expectations. There are several hypothesises that try to explain the success of the tests. The first hypothesis states that the credibility of the tests reassured the markets that the potential losses were not worse and that most banks were in better shape than expected. The second hypothesis is that the tests indicated that the government would not be nationalizing large chunks of the sector, which led to an upward stock price spiral. The last hypothesis addresses the executive compensation restrictions. It argues that banks were eager to avoid taking government capital and were even willing to raise private equity if it was dilutive. As Professor Stein indicates, an important lesson we learned from the stress tests is the use of an exact number of capital that had to be raised instead of a capital ratio. While the capital ratio allows raising more capital or reducing the assets, the stress tests only allowed raising more capital. It would have been very undesirable if multiple banks would have dumped their assets at the same time. Furthermore giving the bank no option partly eliminates the signalling problem that comes with raising equity.

The not so successful public-private investment partnerships

The public-private investment partnerships (PPIP) have been designed to buy legacy (aka toxic) mortgage loans and securities. Despite the positive reaction of the stock-market (it went up 7% to 8% on the announcement) about the policy, the programme was not that successful. The PPIP can roughly be split up in two parts, the legacy loans programme and the legacy securities programme. In the legacy loans programme there have been no transactions thus far, due to the reluctance of banks to sell assets involving book losses and thereby taking a hit to capital. The legacy securities programme is proceeding, albeit at a smaller scale than initially envisioned. It appeared that the market was able to raise capital, without removing the toxic assets from their balance sheets. Nevertheless as Stein indicates, during a crisis you try different things. Some work, some do not.

The macro-oriented approach: 5 practical implications

A general lesson that we have learned from the crisis is that we should apply a more macro-prudential approach to capital regulation, instead of the traditional micro-prudential approach of regulating banks. The problem with the micro-prudential approach is that if bank distress is not idiosyncratic, one bank's adjustment to negative shocks may impose externalities on other banks. Therefore in the macro-oriented approach, capital requirements should reflect the large negative externalities associated with rapid deleveraging. Stein discussed five practical implications of the macro-oriented approach. First of all, time varying capital requirements implying that a buffer is build up in good times that can be drawn down in bad times. Second, the quality of capital is important, meaning more common equity instead of preferred equity. Third, there is a need for contingent capital schemes, which allow another way to recapitalize in bad times. Fourth, liquidity should be regulated. Instead of only looking at the mix of debt and equity also the composition of debt should be carefully analyzed. The last point referred to the need for regulation in the shadow banking system, since many assets were held in common both by banks and non-banks.

Malcolm Baker (Harvard Business School)

Behavioral Corporate Finance

Duisenberg school of finance public lecture held on 22 October 2009

Professor Malcolm Baker about the psychological underpinnings of finance

Recent crises have put Eugene Fama's Efficient Markets Hypothesis to the test. In some ways, these events are better explained with quotes from Keynes, such as 'the market can stay irrational longer than you can stay solvent,' than with the more mathematical utility theory developed by Milton Friedman and Paul Samuelson. Unlike Fama and Friedman, 'behaviorists' posit that asset prices often do not reflect rational fundamental values. There are two key ingredients to this logic. One is that individual investors make mistakes. The other is that a few rational and sophisticated investors are not well capitalized enough to stop these biases from affecting capital market prices.

Malcolm Baker chose four examples to illustrate the connections from psychology to financial decision making.

1. Categorization

Categorization is the tendency to divide a complicated and continuous world into a small number of distinct categories. This is practical, but can cause distortions, like forecasting temperature: using his Harvard MBA class room as a laboratory, Baker showed that forecasts of temperature right around the boundary of March and April lay much further apart than similarly close dates within a month. Applying this to finance: investors tend to categorize stocks by sector, region, size, and price-earnings ratios - thus distorting values around category boundaries.

2. Anchoring

Anchoring happens when individuals are unduly influenced by the phrasing of a question or by a salient number. Professor Baker asked to estimate the number of employees at Procter & Gamble: the group that was asked for an answer in millions came up with an estimate five times higher than the group that was asked for an answer in thousands. Also capital markets are full of distorting anchors, like historical high and low prices, consensus analyst estimates, round numbers, etc.

3. Inertia

Inertia is the tendency to simply accept default choices over ones that require an active decision. Take participation in retirement plans: when employees had to opt in, participation rates were low. When they had to opt out, participation rates were dramatically higher.

4. Extrapolation

The assumption that past trends will continue and the tendency to attribute past performance to skill rather than chance has implications for return chasing investment in mutual funds, and was undoubtedly a part of real estate speculation in the past decade, where past returns presumed to be related to future investment opportunities.

From Behavioral Finance to Behavioral Corporate Finance

While Friedman and Fama were developing the ideas of rational asset pricing, Merton Miller and Franco Modigliani were doing the same for corporate finance. Professor Baker explained how the ideas from behavioral economics and finance have changed how we think about corporate decision making. In particular, he focused on the idea that investor biases and inefficient capital market prices could change how firms chose to raise capital, pay dividends, and invest. Drawing on research and connecting corporate finance to the earlier examples from the psychology laboratory, he stated that the categorization of firms can affect dividend policy and that anchoring and inertia can affect bidding in mergers and acquisitions.

Concluding Thoughts on the Financial Crisis

The recent financial crisis can be traced in part to investor psychology and viewed through the lens of behavioral corporate finance. Professor Baker used the extrapolation of real estate prices and the categorization of AAA-rated, securitized debt as two examples. These errors had devastating consequences for the balance sheets of large and systemically important banks.
Looking forward, the fallout of the financial crisis demands that the next era of research focus on the interaction of behavioral finance with the traditional academic approaches to corporate finance, banking, regulation and the agency problems of managers and intermediaries.

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