



OFFICIAL MONETARY and FINANCIAL INSTITUTIONS FORUM

Second Meeting in Europe

Europe's place in the world economy

A symposium at De Nederlandsche Bank in Amsterdam, featuring a confidential discussion among selected public and private sector participants.

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SUMMARY OF DISCUSSIONS

Meeting background

The Second OMFIF Meeting in Europe followed the first three meetings in 2010, at Deutsche Bundesbank in Frankfurt on 2-3 March, Bank Negara Malaysia in Kuala Lumpur on 15-17 May and U.A.E. Central Bank on 31 October-2 November. The gathering coincided with a summit meeting in Brussels in which EU leaders discussed further measures to increase euro area stability and improve governance in the light of anxieties over sovereign debt. The discussions were conducted under the Chatham House Rule, i.e. no person can be quoted directly.

Our gathering in Amsterdam took place at a time of renewed question marks over the world economy. The terrible ravages inflicted on Japan by the combination of earthquake, tsunami and radiation represent not only a great human tragedy but also a potential source of economic disturbance spreading well beyond Asia. Across the world, rhetoric on 'currency wars' has been toned down in recent months as the surge of footloose funds into emerging market economies slows, but the spectre of real civil wars has been raised in North Africa and the Middle East.

Structure of Meeting

Alongside our core discussions on the macro-economic picture, asset management and regulatory/supervisory issues, the main symposium in Amsterdam was preceded on 23 March by a forum on official debt management started in Abu Dhabi in November 2010 as well as a dialogue on E-Money launched in Kuala Lumpur in May between the official and private sectors. These meetings had an attendance of 25 and 40 respectively. In addition, there was also an inaugural meeting of the provisionally-named International Academy for Bank Directors (IABD)* which focused on the legal and prudential obligations applicable to directors under national laws and the rules of the Basel Committee on Banking Supervision. The IABD session had an attendance of 25 and was judged a success.

The main meeting started with a dinner on 23 March, following a canal boat reception from the Nederlandsche Bank, continued for a full day on 24 March and ended at 15.00 after lunch on 25 March. The four breakout sessions on 24 March, now a key part of the main OMFIF gatherings and conducive to more focused discussions, were attended by 20-25 people each and covered a broad range of themes. The Rapporteurs then provided their summaries during the first plenary session of 25 March.

Participation at the plenary sessions, including lunches and dinners, averaged 70 delegates, varying between 80 (for the plenary session on 23 March) and 50 (for the plenary session on 24 March).

Participants

The seminar brought together a total of 72 institutions (not counting OMFIF) from 31 countries. Three institutions came from Africa, nine from the Asia-Pacific region, 51 from Europe, three from the Middle East and six from North America. There were 26 central banks (including multinational organisations), 13 national and sub-national government institutions, four debt management agencies, and 29 private sector & academic institutions. Including members of the OMFIF Advisory Board, and including alternates, 123 delegates took part.

* The IABD's name has subsequently been changed to the International Council for Financial Institution Directors (ICFID)

Regional breakdown: Africa: 3 institutions, 3 countries - South Africa (1); Tanzania (1); Nigeria (1); Asia-Pacific: 9 institutions, 7 countries - Russia (2); Australia (1); Indonesia (1); Philippines (1); Thailand (1); China (2); Singapore (1); Middle East: 3 institutions, 2 countries - Lebanon (1); Turkey (2); Europe: 51 institutions, 17 countries - The Netherlands (12); UK (6); Germany (5); Poland (2); Denmark (2); Sweden (2); Luxembourg (1); Albania (1); Italy (1); Belgium (1); Czech Republic (1); Moldova (1); Slovenia (1); Switzerland (2); France (1); Austria (1); Portugal (1); North America: 5 institutions, 1 country - US (6).

People: 123 delegates counting 10 affiliated to OMFIF. People from individual regions and countries were: Africa: 4 - South Africa (1), Tanzania (1), Nigeria (2); Asia-Pacific: 10 - Russia (2); Australia (1), Indonesia (2), Philippines (1), Thailand (1), China (2), Singapore (1); Europe: 89 - The Netherlands (36), UK (19), Germany (12), Luxembourg (3), Sweden (3), Poland (2), Denmark (2), Albania (2), Italy (2), Switzerland (2), Belgium (1), Czech Republic (1), Moldova (1), Slovenia (1), Switzerland (3), France (2), Austria (1), Portugal (1); Middle East: 5 - Turkey (4), Lebanon (1); North America: 9 - US (9).

Main themes

Five inter-related themes permeated the discussions:

1. ***Stability and governance in the euro area.*** There was a generally gloomy tone to deliberations of the euro area's problems, amid frequent references to the accompanying European Union summit in Brussels pondering measures to tighten economic governance in the light of the debt turbulence of the past 12 months. The resignation of the Portuguese prime minister reminded delegates of the acute political pressures caused by austerity in the heavily-indebted states. The overall conclusion was that efforts to improve cohesion and coordination within economic and monetary union (EMU) did not go far enough to guarantee the sustainability of the single currency. The integrated nature of banking and finance within the euro area had been one of the successes of monetary union but now presented a potential source of threat in view of the overhang of debt that would bear down on creditor banks and countries if peripheral members were forced into default or restructuring.
2. ***Challenges for central banking and for national and international policy coordination.*** Speakers voiced an unusual amount of self-criticism about failures to spot the dangers building up through excess leverage in the financial system until it was too late. With both the Federal Reserve and the European Central Bank considering an exit in coming months from extraordinary credit and liquidity measures decided in the wake of the Lehman Brothers collapse in September 2008, a principal issue for discussion was the speed with which central banks could return to 'business as usual'. There was some optimism that, at least in the US, this might be the case. Linked to this was a discussion of the role of the G20 in global policy coordination as well as in steps to achieve international monetary reform – widely regarded as unlikely to achieve any significant breakthrough.
3. ***Financial sector regulation.*** The meeting discussed the re-regulation of the financial sector and, in particular, whether the Basel III reforms, advocated by the G20 and defined largely by work within the Financial Stability Board and the Basel Committee for Banking Supervision, are addressing the right objectives and are likely to be implemented in a way that will meet them. There was considerable discussion on the possible negative impact on growth of increases in capital and liquidity ratios, and whether this and other potential repercussions of tighter regulation represented a worthwhile trade-off for greater stability. Partly on the basis of official assessments, a number of participants pointed out that – although longer-term risks from banking reform are potentially troublesome – their impact is being exaggerated by banking lobbyists.
4. ***Ethical / governance approach to banking, finance and asset management.*** The economic strains of the past four years and the devastating effects on economies and employment of shortcomings in the financial sector and in regulation have heightened calls for a more ethical approach to banking and asset management. Mention was made of how greater shareholder responsibility could lead to beneficial economic outcomes for asset managers by shielding them from exposure to practices that endangered stability. There was considerable interest in an initiative for greater shareholder responsibility, seen as creating beneficial economic outcomes for asset managers by shielding them from exposure to practices that endangered stability.
5. ***Revolutionary effect of e-money.*** The mobile device is revolutionising financial services. Momentum in the wider world of mobile payments will accelerate growth of e-money although e-money is likely to be just one product line in a suite contained in the mobile device. The growth in mobile payments was attributed to massive shipments in mobile devices with smartphones representing an increasing proportion. Meanwhile customer preferences for carrying out financial transactions via mobile devices are leading to ever more sophisticated and seductive applications. The mobile device is likely to increasingly displace the plastic card as the medium for credit and debit card transactions. All this has clear implications for regulation.

Discussions in detail

1. Stability and governance in the euro area

'A boulevard of broken promises'

A sombre mood surrounded the discussion of the European sovereign debt crisis and the EU summit on economic governance underway during the OMFIF meeting.

One participant's eye-catching phrase describing the EU's efforts to provide solid foundations for the single currency caught the mood. The road from the Maastricht Treaty was, he said, 'a boulevard of broken promises.' Another participant suggested: 'We have fundamental flaws in the structure of the common currency... A joint bank account is useful, but only if both holders agree on how to operate it. Similarly the instruments governing the common currency will work only if you have a political consensus on how it should function.'

The countries who are members of the euro do not really agree with the governing principles set down in the Maastricht Treaty, he argued, so they ignore them. Thus countries which at the time of entry had over 60% debt levels (Belgium, Greece and Italy) were welcomed in even though these debt ratios were not moving downwards as the Treaty called for. Similarly when France and Germany breached the 3% deficit ratios, they ignored the Stability and Growth Pact and forced the rest of the EU to accommodate them.

The markets saw how flexibly the Treaty was being interpreted and acted accordingly. They saw, for example, that Greece's public finances were not in order - the Greek deficit averaged 7% of GDP in the years after Maastricht and only once met the 3% limit, a participant pointed out. But markets assumed Greece would be bailed out and they were right. On this view moving towards political union or legalising fiscal transfers would not be the answer.

Fundamental disagreements

'Fundamental disagreements on policy' would have to be solved, including the different visions of the way the euro area economy should be governed and what policies should be adopted to achieve its long term objectives, issues that continue to divide its leading members, France and Germany.

As another participant put it, France wants politicians to make key economic policy decisions whereas Germany, with Dutch support, wants the European Central Bank and its price stability objective to govern the euro area's economic policy approach and for countries with serious deficits to resolve their own problems, not be bailed out by surplus countries. In the words of one participant, this discord between France and Germany was 'congenital'.

One European official played down the extent of EMU's problems, arguing they had been caused by a combination of fraud in one country (Greece), the banking crisis, and a 'problematic growth model' in countries like Spain that were over-reliant on real estate. 'We thought we'd never get sick but some countries are, then we have to give them some medicine,' the official said. This view of EMU's difficulties being more narrow-based was disputed by another participant, who said that they rather reflected the fundamental flaws of the 'one size fits all' monetary policy and described the speaker as similar to a tour operator promoting holiday trips on the Titanic.

New governance regime

'One aim of the proposed new EMU governance regime is to pressure countries with heavy debt burdens to reduce debt/deficit ratios towards the 60% level at the rate of 5% of GDP a year. Is this really credible,' one participant asked, adding rhetorically, with regard to the proposed sanctions for failing to pursue this objective, 'Do we really believe that a country like Belgium will ever pay fines?'

Against this background a senior EU official at the meeting said that only if he adopted the most generous tone possible could he describe the new economic governance regime, which EU leaders were at that moment debating in Brussels, as even 'a small step forward.' He said the problems of the euro area did not amount to a 'euro crisis' since the currency as a whole was stable, but rather the failure by individual countries to stick to 'the rules of the game'.

There had been an absence of peer pressure to enforce sound policies, and warning signals such as the rise in the Greek current account deficit to 15% of GDP had been ignored. Efforts by Jean-Claude Trichet, president of the European Central Bank, to present finance ministers with data on rising unit labour costs in certain countries and disparities with the most competitive countries had failed to produce the desired effect. Imbalances within the euro area were 'enormous – bigger than thought.' Countries wished to preserve their sovereignty but they had to accept 'common rules of the game.' If he had known 15 years ago how EMU would work out in practice he would not have recommended his government to join EMU, either in a narrow or wider form of membership, he said.

Another participant insisted that the European Commission's moral authority to pressure EU member states to pursue convergent economic policies ought to be at the centre of the new governance regime. This view which was challenged on the ground that the Commission was inherently too politicised a body to undertake this task.

Maastricht treaty reform

One speaker from a country outside the euro area put the view that the Maastricht criteria on inflation were too rigid and would disbar outside countries with higher inflation rates from joining quickly. There was a general feeling of pessimism about the prospects for rapid EMU enlargement. It was important that the technical issues of the criteria for take-up of new adherents did not discriminate against countries with higher growth that were in a 'catch-up' process and were likely to have higher inflation than core members of EMU. However, it was equally important to state that this was in no way tantamount to acceptance of higher inflation by outlying countries.

Perspectives for debt within euro area

Consideration that peripheral countries within the euro area would need to restructure their debt was a frequently-recurring theme. One authoritative speaker put forward the view that private sector solutions for problems of indebted countries were likely but these shouldn't be announced in advance – 'constructive ambiguity' was useful here. There was no consensus on what was necessary and supportive to maintain EMU, since different countries had different views about the treatment of creditors and debtors. 'We know we need burden-sharing but we don't know how to go about it.' There was also confusion about how to deal with the international dimensions of debt restructuring – 'Countries' deposit guarantee schemes are national, but savers are international.'

There was a lively exchange on whether the web of cross-border borrowing and lending in the euro area really did mean that debts could not be restructured without individual banks failing, with one speaker demanding concrete evidence that this really would be the case.

There was considerable discussion on the earlier assumption at the beginning of EMU that financing euro area current account imbalances would not be technically or economically difficult. One consequence of this assumption – which has been seriously tested in the market-place over the past 12 months and found to be faulty – was the removal from the Maastricht treaty of the passage in the Treaty of Rome allowing for balance of payments assistance for member countries in difficulty.

One participant pointed out that accumulation of a pool of risk-free assets helped the ECB's task of establishing harmonised economic conditions throughout the Euro area. The notion that all government paper throughout the euro area had become more or less equal in status was however in direct contradiction to the no-bail-out clause in the Maastricht treaty.

2. Challenges for central banking and for national and international policy coordination

Normalisation of interest rates after exceptional post-crisis measures

One participant said there is evidence that the Federal Reserve would soon be moving away from its policy of super-low interest rates, set soon after the financial crisis to support the banking system and spur recovery. But this was likely to be seen only as a very small initial upward movement in interest rates, so small it would not have any significant effect on the performance of the economy.

Such a move would merely signal the Fed's wish to normalise rates, nothing more. It was also, he argued, a misjudgement to suggest that the ballooning of the Fed's balance sheet stemming from its quantitative easing programme would impede this process. It might take several years to reduce the securities holdings which the Fed had taken on to its balance sheet through QE, but this could be done as rates were normalised.

As for countries which were complaining about currency volatility on the foreign exchanges as a result of outflows of dollar liquidity from the US, they had their heads in the clouds, one participant pointed out. With US unemployment around 9%, it was unrealistic to expect the Fed to conduct monetary policy with half an eye on its impact on reserve flows into the coffers of foreign governments. 'Dollar movements on the foreign exchanges have never been a primary concern in the formulation of US monetary policy,' he said.

G20 process

There was also a discussion of the G20 and its role in improving international economic policy coordination. Several participants wondered about the credibility and legitimacy of the G20. One pointed out that if, as seemed to be happening, it was moving towards a system - like the one which operates within the IMF - where the bigger countries have smaller country 'constituents' whom they represent, then surely the most credible way to improve global economic governance is to reform the IMF itself, rather than try to 'beef up' the role of the G20.

At the moment the big debtor countries, notably the US, dominate the voting structure of the IMF at the expense of creditor nations like China. This is surely not sustainable, a participant insisted. The unbalanced voting structure favouring Second World War victors has already helped undermine the legitimacy of the IMF, one participant argued. But the G20 also has serious legitimacy problems. Some smaller countries which are not members are working together to ensure their voices are heard on international policy issues. They are unlikely to accept that, as with the IMF, they should have to communicate through a bigger G20 member. The old question of whether this is, post-Bretton Woods, an international monetary system has not been resolved, one participant noted.

As for the idea that the IMF plays a more assertive role in monitoring and trying to correct global imbalances, another participant insisted that until the issue of burden sharing was resolved, namely the extent to which surplus countries were deemed to have as much responsibility for global rebalancing as deficit countries, it was inconceivable that the IMF could exert a decisive influence on the correction of imbalances and the (arguably) essential associated re-alignment of exchange rates.

Multi-polar reserve currency arrangements

Amid a discussion of the increasing multi-polarity of reserve currency arrangements, there was discussion of the possibility that the IMF could preside over issuance of a redefined SDR including currencies such as the renminbi (assuming progress in capital account convertibility). But one participant wondered whether SDR tinkering would have much impact on deeper issues surrounding international monetary reform. The narrowness and domesticity of China's financial markets, lack of democracy and political control of banks were all seen by one participant as impediments to attainment of international reserve currency status by the Chinese.

Debt management and coordination with policy process

Issues concerning the official sector's response to the financial crisis were prominent at the Debt Management Forum pre-meeting. Two themes came up repeatedly: first whether at an operational level the practice of government debt management needs to change (and much of this discussion focused on the use of derivatives). Second, how and whether debt managers should coordinate their activities with central banks particularly now that, through quantitative easing, central banks are intervening directly in the medium and longer end of the yield curve, traditionally the territory of the debt managers.

Debt managers have come to see interest rate swaps and other derivatives as a key tool in their armoury. Derivatives allow debt managers to issue at the most liquid segments of the yield curve and then swap exposures to the desired maturity, to achieve their portfolio duration objectives. This kind of strategy can also yield considerable cost benefits (one debt manager quoted a reduction in interest costs over 15 years). But there is still misunderstanding about the role of swaps: the group heard of a parliamentary committee questioning whether the DMO should be running a hedge fund

At the same time the discussion recognised the risks; and the financial crisis may have changed the trade-offs. Not only are the markets more conscious of black swans, the management of counterparty and refinancing risks has been brought more clearly into focus. Moreover, extensive derivatives use makes it harder to understand a DMO's exposures; a point some of the press commentary on the euro crisis had overlooked. Most were in favour of transparent disclosure of derivatives use, but some noted that too much transparency too soon risked handicapping the DMO by exposing its position to the market.

There was considerable debate about whether the abnormal market environment of 2008 onwards undermined the rationale for the independence of debt managers and central bankers. The crisis, and the balance sheet responses of many central banks, had brought central banks and DMOs into the same area of the bond market yield curve. How DMOs should react was debated. Several DMOs had come to a pragmatic understanding with their respective central banks; some wondered about more formal agreements or ex-ante guidelines. But most agreed that the underlying model of operational policy independence was sound; and the transparency that it facilitated continued to be a benefit to markets. But there did need to be coherence of debt management, monetary and fiscal policies at a high level; and there was room for day to day operational understandings; both for example have an interest in efficient money markets.

There were other unresolved problems. The crisis had exposed the circular linkages between the banking sector (as the owner of much government debt), the government as its guarantor, and the DMO as the ultimate provider of funds to fund this guarantee. Regulatory initiatives also created uncertainty. Debt managers felt that regulatory policymakers had failed to anticipate the combined impact of requiring both banks (via Basel III and the new European capital directive) and insurers to hold much more liquid assets. In many cases the local stock of such assets will be dominated by these concurrent demands, with risks to market distortion.

3. Financial sector regulation

Global and European regulation

Several sessions were devoted to the governance of the financial sector globally, especially within the trans-Atlantic region where the financial crisis erupted in August 2007.

Whereas the Basel II capital adequacy regime developed from 1998 onwards was strongly supported by the world's biggest banks as essentially a deregulatory initiative, Basel III, the new proposals finalised at the end of 2010, are designed to impose much stricter regulation. Not surprisingly the biggest banks are vigorously opposing them, insisting that they will damage banks' business models, constrain lending and so weaken economic recoveries.

A sense of *mea culpa* permeated the meeting with regard to failure of the authorities to spot the scale of the problems building up in the early 2000s. In view of financial market history going back to the 17th century, and the manifold evidence of links between financial innovation, globalisation, asset bubbles and eventual crashes, one participant said he blamed himself for not having done more to highlight the dangers that were growing beneath the surface.

Fundamental changes

There have been a number of fundamental changes in the roles of government finance since the financial crisis erupted.

In the past the debt management, fiscal policy, monetary policies and financial market regulatory policies of governments used to be handled separately. But high government debt levels and fiscal deficits stemming from the crisis and the evidence of feedback loops between macro-economic policies and financial market regulations make it inevitable that these government activities have to be more closely integrated.

This shift has been particularly marked in financial sector regulation itself. Before the crisis governments, central banks and regulators thought that robust regulation of individual financial institutions, under so-called micro-prudential supervision, coupled with price stability produced by the central bank, would stabilise the financial system and the economy as a whole.

Now we know that this assumption was wrong. Hence the need for macro-prudential regulation where the interactions between macroeconomic policy, especially monetary policy, and the activities of the financial sector, from banks to hedge funds, are observed and assessed to see what impact they are having on the economy.

But how does a government operate in this new environment and what are the policy objectives? Monetary policy, for example, aims at price stability and fiscal policy at the sustainability of the government's finances. Regarding the objectives to be set for macro-prudential regulation, it was asked whether this should concentrate on the more limited objective of countering financial vulnerabilities or on a more ambitious goal of sustaining financial stability. There was agreement that, in any case, additional policy instruments, institutions and governance were needed.

Proposals under Basel III

As far as instruments are concerned Basel III has already put forward proposals, for example counter-cyclical capital buffers for banks aimed at countering asset price bubbles. Under this proposal banks will have to put up more capital in response to rapid credit growth. Basel III envisages not only higher capital adequacy requirements for banks but also improved capital quality. Core capital will be restricted to equity and retained earnings and will be required to be a minimum of 4½% of risk weighted assets. As one participant remarked, 'This should mean you cannot borrow your capital anymore.'

On top of this core, however, the Basel III proposals call for a loss-absorbing capital conservation buffer of a further 2½% of risk weighted assets, plus the counter cyclical buffer and a new, non-risk based, leverage ratio to limit the absolute build-up of leverage and so the fall-out from deleveraging when the cycle turns down.

Is this enough? There were plenty of sceptics at the meeting. 'It took ten years for the Basel II proposals to be agreed and even then they were not implemented in the US before the 2007 crash,' one participant remarked. 'Why should Basel III be different?' The response that there is powerful political backing for the new plans, including from US President Barack Obama, was not found to be totally reassuring.

Banks are adept at 'gaming' the regulators and evading controls, another participant pointed out. While Basel II called for an 8% capital ratio, in fact many banks were able to operate with regulatory approval with, in reality, ratios of 1-2%, thus hiding leverage ratios of 50-60 times. The new implied Basel III leverage ratio of around 33 times capital 'is far too high,' a senior policymaker at the meeting said, hinting at a divisive debate underway in official circles, pitting the British and the Swiss against the Americans and several EU countries.

Leverage ratios

A senior government official agreed that historically the proposed 33 times leverage ratio is high. The Swiss authorities are limiting leverage to 20 times,' he added approvingly. He pointed out that academic studies disprove the idea that a more conservative capital adequacy regime would damage bank profits severely and so impair lending capacity and weaken economic growth. Turkish banks already operate with 20% capital ratios without damaging their profitability, one participant noted. A widespread view was that banks are crying 'wolf' when they say the new regulations to be phased in by 2019 are a serious threat to economic growth.

One participant did however worry that by winding up the regulatory pressure on banks, governments were opening the door for regulatory arbitrage and the expansion of the 'shadow banking' sector, the source of many problems that led to the 2007 crisis.

Central to the issue of banks that are deemed so big or complex or interconnected to be allowed to fail are the so-called Systemically Important Financial Institutions (SIFIs). Should they be subjected to more intensive supervision? Required to hold an additional capital buffer? Or required to participate in recovery and resolution programmes?

If so, even in the European Union, let alone globally, there are enormous hurdles to be overcome including the need to harmonise fully legal and reporting requirements across borders and agree comprehensive cross-border burden-sharing. 'This is highly unlikely' one participant insisted.

Macro-prudential regulation

As for the new official institutions which have been set up to deliver macro-prudential regulation, one participant involved in this initiative said that it was a case of 'learning by doing.' Even back-testing new instruments by applying them to events from 2002 could be only a rough guide to how they might work in real time.

The new macro-prudential regulatory institutions, in the euro area the European Systemic Risk Board, in the UK a Financial Policy Committee and in the US the Financial Stability Oversight Council, inevitably, all differ in terms of how they fit in to their host nation's political and governmental structures. They have different members and powers: the US Treasury takes the lead in the US, whereas EU based bodies are led by central banks. None has yet worked out how it will operate and what instruments it will use, it was pointed out.

Once again, as at the OMFIF meeting in Malaysia in May 2010, questions were raised about whether many elements of the new Basel III accord were particularly relevant to the challenges facing emerging market countries. China's state owned banks don't need more capital or new liquidity rules. China is much more interested in controlling global capital inflows, particularly 'casino capitalism' style speculative flows and speculation in foreign exchange markets which exacerbate exchange rate volatility.

A more general critique came from participants who questioned whether the Basel III plans were doing enough to tackle so-called 'casino capitalism'. Were its proposals, for example the idea of shifting as much over-the-counter derivatives trading as possible into central counter parties, radical enough? One participant argued that 'financial market innovation should not be allowed to run riot at the expense of the real economy.' Others called for stricter licensing of financial products. But, an official participant countered, financial market products are not like food products or drugs, you cannot pre-test them before they are in the market.

Several participants echoed the question of Adair Turner, the head of the UK's Financial Services Authority who asked whether some of these activities fulfilled a socially useful purpose. One participant asked: Shouldn't high frequency trading, 'dark pool' private securities exchanges and 'naked shorting' of stocks be prohibited?

Dynamic provisioning / accounting standards

There were lively discussions about ‘pro-cyclical provisioning’; not least as regards the authority of prudential regulators in a field that is normally the preserve of securities regulators and accounting standards-setting bodies such as the International Accounting Standards Board (IASB). The long-standing rule in UK company law (which is duplicated in the company laws of many other countries) is that provisions can only be set up for known losses and liabilities at the balance sheet date. Accordingly, any excess provisions are in reality “hidden reserves” which can be used to smooth reported results from one year to the next.

The following points were made:

- If the objective of pro-cyclical provisioning is to understate profits in good times and overstate profits (or understate losses) in bad times it is a breach of company law
- If it is intended that the amount of (and movement in) provisions which is above and beyond what would normally be required is disclosed in the financial statements it is doubtful whether the objectives of the prudential regulators will be achieved – since sophisticated users will simply strip out the excess amounts and re-calculate the results of a bank
- No accounting issue arises if additional ‘buffers’ are created by increasing reserves in a boom and designating specific amounts as non-distributable
- ‘Known losses’ can and should reasonably include allowance for losses that have been specifically identified at the balance sheet date which are known statistically to exist in any large loan portfolio. It is only when ‘pro-cyclicality’ goes beyond this point that problems arise with company law
- Bad and doubtful debt provisioning is unconnected with the matter of securities valuation

Analysis of problem countries

An ancillary issue applied to the benchmarks used by fund managers in pinpointing areas of risk on financial markets. While many pension fund and institutional investors spend a lot of effort in defining the extent that a fund manager can deviate from their benchmarks, very little thought is given to the risks of the benchmarks themselves. Fixed income indices are constructed in a way that gives the greatest weight to the countries with the most debt and very little weight to the most creditworthy countries. Immediately before the current crisis, any indexed-oriented investor in European Government bonds would have had greater exposure to debt issued by Spain and Portugal than their exposure to wealthier countries like Austria and the Netherlands. Using net foreign assets to identify the most indebted countries was said by one participant to be a very effective way of spotlighting early on the problems that have developed with countries such as Greece, Spain, Portugal and Hungary, all of which have subsequently found themselves in economic difficulty.

4. Ethical / governance approach to banking, finance and asset management

There was considerable discussion on the impact of the new regulatory environment on the governance of the institutions themselves - for example, whether directors and senior management of banks and systemically important financial institutions can live up to the challenges of the new regulatory environment.

The main theme running through the inaugural meeting of the International Academy for Bank Directors (IABD) was that banks need to embrace and promote a culture of ethical behaviour in all their activities. This is reflected in the following summary of discussions:

1. *Banks everywhere should re-embrace a culture founded on sound ethical values, behaviour and integrity. They should focus on serving customer needs and always do what is best for the customer. Retail banking, in particular, should become a profession and members should be bound by a formal code of ethics.*
2. *Banking regulators need to pay far more attention to culture, behaviour and integrity within banks. The culture of investment banking, which is driven by deals and bonuses, is opposed to the culture of retail banking, which requires a long-term management focus.*
3. *Board directors of banks need to consider other interest groups in addition to shareholders. It is not enough to focus on shareholder value. A long term perspective is also important.*
4. *Bank board composition should be representative of the activities of the bank. Currently more than half of European commercial banks with major retail activities do not have one retail banker on the board!*
5. *Universal banks should only undertake investment banking to the extent that it is necessary to meet the needs of existing corporate clients.*
6. *Universal banks with substantial retail activities should not be dominated by investment bankers.*
7. *Most banks that got into trouble during the crisis suffered from one or more of the following:*
 - *Over-dependency on short-term wholesale funding*
 - *excess concentrations*
 - *weak risk management*
8. *The finance sector has grown far too big in many countries in relation to the size of the real economy.*
9. *Today's banks are often far too complex to manage and supervise. They need to be decomplexified!*
10. *Independence of certain board directors is necessary but not sufficient. Industry knowledge is critical and every board needs a mix of expertise.*
11. *Regulators should pre-certify retail banking products. All too often today products seem designed to exploit customer naivety.*
12. *Some of the big problems in retail banking stem from the activities of brokers. Having said that, banks cannot disclaim responsibility for mis-sold products.*
13. *Retail banks should take great care when offering foreign currency loans such as mortgages to clients in emerging markets. There are far too many examples of mis-selling in this area.*
14. *Being asset-driven is far more risky for a retail bank than being liability-driven.*
15. *UK bank balance sheets were seriously misleading in the years before the crisis - with assets substantially overstated because of the application of international financial reporting standards*

Towards a new framework for responsible shareholder behaviour

Reflections by David Pitt-Watson, Chair and Founder, Hermes Focus Asset Management

The action taken by international regulators in 2008 to 'save' the banks avoided what could have been a catastrophic meltdown. They are to be congratulated. However many observers believe that the risk of a future systemic collapse has not disappeared. Many think that the bankers themselves don't believe the world has changed in any fundamental way.

That is not because we have failed to regulate the financial sector. The language of financial regulation is bimodal; either the market delivers the intended result, or it is regulated to prevent a bad outcome. Now of course regulation is necessary. But it should be the last resort. The first issue is how to make sure that the institutions in our financial markets are designed to produce overall good behaviour. The objectives include that those who manage our money, working in a framework that includes their own self-interest, generate appropriate, efficient, stable savings and investment products, and that the system contains checks and balances which prevent it from going out of control.

The characteristics of such a system are known. It should be one where each entity in the system is responsible for its actions. It can only be expected to be responsible if it is accountable. Those who call the entity to account will need relevant information, which is independently prepared. And just as a healthy political system hinges on effective scrutiny, so a successful financial system will need the oversight of vigilant market participants, whether they be journalists, pressure groups, other institutions or individuals expressing their concerns.

The seeds of our current crisis can be seen in the lack of these characteristics. Who was responsible for the security offered by toxic CDOs? To whom were they accountable? Were bank balance sheets showing the relevant information when they made no provision for future losses, and so recognised profit before it was earned? Were the credit rating agencies independent?

Here is the broad point. We know what outcomes we want from our capitalist system. We need to design systems and institutions that will produce them.

Let me suggest one specific initiative for OMFIF members. Many countries, either through their sovereign wealth funds, their public pensions systems or their central banks are large holders of shares in banks and other large companies. In a stable system, the board of directors of a bank would be accountable to the shareholders. The shareholders, or their representatives, would in turn act as good owners; scrutinising performance, and ensuring prudent management.

Prior to the crisis they singularly failed in that responsibility. Ask any bank CEO and he will tell you that the shareowners' representatives were trading shares, they were short-term, they encouraged the bank to borrow and lend more, to trade to the limits that the regulation would allow. This was not in the shareholders' best interests. The system was dysfunctional. And most bank executives will tell you that, since then, this behaviour has not changed in any fundamental way.

But we would change that system if our sovereign funds and public pension entities collectively demanded that their money be managed in a different fashion, so that shareholders and their agents worked actively, constructively and in concert to make boards accountable. This wouldn't need new regulation, just an effective assertion of existing shareholder rights.

Indeed OMFIF, across its broad series of operations linking private and public sector institutions in many countries, might form the framework where we can begin to build this initiative and make it work on a global scale.

5. Revolutionary effect of e-money

Delegates to the World e-Money Council agreed on a simple definition of e-money as 'an electronic surrogate for cash' or, even more simply, 'digitised cash'. E-money is stored electronically and must be 'open loop', in other words, 'accepted by natural or legal persons other than the issuer.' This, for example, rules out gift cards.

There was widespread agreement that mobile devices are revolutionising financial services and this channel is already becoming the foundation of e-money delivery. Momentum in the wider world of mobile payments will accelerate growth of e-money although e-money is likely to be just one product line in a suite contained on the mobile device. The growth in mobile payments was attributed to massive shipments in mobile devices with smartphones representing an increasing proportion. Meanwhile customer preference to execute financial transactions through the mobile device is being complemented by ever more sophisticated and seductive applications. The mobile device is increasingly likely to displace the plastic card as the medium for traditional credit and debit card transactions and these transactions may lose transactions to e-money schemes, particularly with the growth of Near Field Communications (NFC)-enabled devices and NFC POS acceptance devices.

While some e-money schemes have proven their ability to be profitable on a standalone basis there was consensus that this is difficult to achieve. It was agreed that e-money profitability can be flattered by the 'substitution effect' within an institution's overall offering where e-money benefits from customers migrating from legacy credit and debit card transactions.

Concern was expressed at the relative weakness of e-money schemes in Europe as opposed to the developing world; the developing world, on the other hand, has a number of notable success stories and this was attributed to the urgent needs of these countries as well as the commitment of regulators to extend financial access both to the population in general and to remote areas. In the developing world in particular, e-money is recognised as the seed of deeper and more sophisticated financial relationships. There is a contrast in the role of mobile network operators in e-money schemes in the developed and developing world. Mobile network operators have a relatively greater role in the developing world as they already have customer relationships with the unbanked.

While a degree of regulatory support in the developing world is evident, in general the balance of e-money regulation was recognised as leaning excessively against innovation with newer players frustrated at being regulated as fledgling operators rather than with reference to their underlying activities.

Lack of technical inter-operability was seen as a major barrier to the development of e-money, particularly in the developed world, and cooperation between schemes was recognised as having potentially synergistic benefits. Similarly, merchant and customer education as seen as critical to the success of e-money. Cash still has a firm grip on the public and is trusted. Meanwhile, the threat of cyber-crime to e-money schemes is real and counter-measures requires collaboration between suppliers.

FULL MEETING PROGRAMME

PROGRAMME

DAY ONE: Wednesday 23 March 2011

PARALLEL PRE-MEETING SESSIONS:
(see page 8 for DEBT MANAGEMENT FORUM and
page 9 for INTERNATIONAL ACADEMY FOR BANK DIRECTORS)

PRE-MEETING SESSION: WORLD E-MONEY COUNCIL

- 08.30 Registration
- 09.00 Welcome & opening remarks
Hans Brits, Head of Payment Systems Policy Department, De Nederlandsche Bank, Amsterdam
Introductions by meeting chairman
Chris Gabriel, former Chief Executive, Zain Africa, Bahrain & co-chairman, World E-Money Council, Dubai
- 09.15 MORNING SESSION I – The Mobile payments revolution: *are we at the tipping point?*
Peter Kinahan, Director of Research and Editorial, Lafferty Group
- 10.00 MORNING SESSION II – Regulation versus innovation: perspectives from Europe
Prof. Ron Berndsen, Head of Department, Oversight, De Nederlandsche Bank, Tilburg University
Nives Coppari, Officer – Market and Payment System Oversight Department, Banca d'Italia
- 10.45 Coffee break
- 11.00 MORNING SESSION III – Getting the incentives right to drive cashless payments
David-Jan Janse, Commercial Manager, Rabobank, Eindhoven
Marnix Blom, Product Manager – Cards, Currence, Amsterdam
- 12.15 MORNING SESSION IV – Trends in cyber crime and the impact on securing the payments network for next generation payments
Jeroen Herlaar, Business unit Manager, Cybercrime, Fox-IT, Rotterdam
Raymond Kleijmeer, Policy Advisor, De Nederlandsche Bank, Amsterdam
Colin Whittaker, VP Payments Systems Risk, Visa Europe, London
- 13.30 LUNCH HOSTED BY DE NEDERLANDSCHE BANK
- 14.30 AFTERNOON SESSION I - Examining viable alternative instruments to replace physical cash
David Hunter, CEO, Ukash, London
Andrea Gnetti, Head of Mass Market Clients Italy, Unicredit, Bologna
- 15.45 Coffee break
- 16.00 AFTERNOON SESSION II – The “trickle-up” effect in e-money innovation from emerging to developed markets
Chris Gabriel, former Chief Executive, Zain Africa, Bahrain
Jane Zavalishina, CEO, Yandex.Money, Moscow
- 17.00 CONCLUDING ROUNDTABLE

PROGRAMME

DAY ONE: Wednesday 23 March 2011

PARALLEL PRE-MEETING SESSIONS:
(see page 7 for WORLD E-MONEY COUNCIL and
page 9 for INTERNATIONAL ACADEMY FOR BANK DIRECTORS)

PRE-MEETING SESSION: DEBT MANAGEMENT FORUM

10.00 Registration / refreshments

11.00 Opening remarks by meeting chairman
Mike Williams, Founder and former Chief Executive, UK Debt Management Office

MORNING SESSION I – Innovation in debt management practice

Use of Derivatives / Innovations in Issuance Techniques / European Sovereign Issuance

Speakers:

Erik Wilders, Director, Netherlands' Debt Management Office
Thomas Olofsson, Head of Debt Management, Swedish National Debt Office
Dr. Carl Heinz Daube, Managing Director, German Federal Finance Agency
Martha Oberndorfer, Managing Director, Austrian Federal Financing Agency
Jacob Ejlsing, Advisor, Government Debt Management, Danmarks Nationalbank

13.00 End of morning session

13.00 LUNCH HOSTED BY DE NEDERLANDSCHE BANK

14.00 AFTERNOON SESSION I – Policy coordination, understanding new linkages

- Ensuring that monetary policy, fiscal policy and debt management policy broadly cohere
- Preventing conflicting operational moves by debt managers and central banks

Speakers:

Prof. Hans J. Blommestein, Head of Bond Market and Public Debt Management Unit, OECD
Prof. Lex Hoogduin, Executive Director, De Nederlandsche Bank
Michael Kock, Senior Economist, Research Department, South African Reserve Bank
Dirk H. Kranen, Division Chief, European Department, German Ministry of Finance

15.20 Coffee break

15.45 AFTERNOON SESSION II – The Challenge of Emerging Markets

Speakers:

Taşkın Temiz, Deputy Director General of Public Finance, Undersecretariat of Treasury, Turkey
Jeffrey D. Lewis, Director, Economic Policy and Debt Department, The World Bank Group

17.00 Session close

PROGRAMME

DAY ONE: Wednesday 23 March 2011

PARALLEL PRE-MEETING SESSIONS:
(see page 7 for WORLD E-MONEY COUNCIL and
page 8 for DEBT MANAGEMENT FORUM)

PRE-MEETING SESSION: INTERNATIONAL ACADEMY FOR BANK DIRECTORS

- 09.00 Registration
- 10.00 Opening remarks and introductions by meeting chairman
Michael Lafferty, Co-chairman, IABD
- 10.30 MORNING SESSION I – The new regulatory environment - can bank directors live up to Basel III Principles?
Speakers:
Prof. Abdul Rahman, Co-chairman, IABD, Professor of economics and finance, Telfer School of Management, University of Ottawa
Hanne Meihuizen, Senior Policy Advisor, De Nederlandsche Bank
- 11.30 MORNING SESSION II – Culture and behaviour in banks and financial conglomerates
Speaker:
Dolf van den Brink, former Member of the Managing Board, ABN AMRO Bank and Professor of Financial Institutions, University of Amsterdam
- 12.30 End of morning session
- 12.30 LUNCH HOSTED BY DE NEDERLANDSCHE BANK
- 13.30 AFTERNOON SESSION I - Culture and behaviour in banks - the DNB approach
Speaker:
Wijnand Nuijts, Head of Department, Expert Centre Culture, Organisation and Integrity, De Nederlandsche Bank
- 14.30 AFTERNOON SESSION II – Lessons for banks from the world’s leading retailers
Speaker:
Hans Eysink Smeets, Chairman and Managing Director, Eysink Smeets Business Consultants
- 15.30 Coffee break
- 15.45 AFTERNOON SESSION III – Lessons from the crisis
Discussion led by **Nathan Bostock**, Head of Restructuring & Risk, Royal Bank of Scotland
- 16.45 IABD Roundtable & headline conclusions
- 17.15 Session close

18.00 CANAL BOAT RECEPTION

20.00 WORKING DINNER HOSTED BY DE NEDERLANDSCHE BANK

Europe's Place in a Changing World Economy

Introduction by **David Marsh**, Co-chairman, OMFIF

Dr. Nout Wellink, President, Nederlandsche Bank

What the world has learned from the financial crisis – and how we need to improve

Introduction by **Frank Scheidig**, Global Head of Capital Markets, DZ Bank, Vice-chairman, OMFIF Advisory Board

Dr. James Bullard, President, Federal Reserve Bank, St. Louis

Followed by dinner discussion

22.00 End of dinner

PROGRAMME

DAY 2: Thursday 24 March 2011

10.00 OPENING OF OMFIF MEETING

Opening remarks

Dr. Nout Wellink, President, De Nederlandsche Bank

10.15 PLENARY SESSION I – The new world economic balance

- Policy responses in advanced and emerging economies and the outlook for currency and asset relationships
- International financial architecture
- Lowering structural barriers to economic growth

Speakers:

Henk Brouwer, Executive Director, De Nederlandsche Bank

Michael Kock, Senior Economist, South African Reserve Bank

Juma Reli, Deputy Governor, Bank of Tanzania

Session chairman: **David Marsh**, Co-chairman, OMFIF

12.15 End of Session I

12.30 LUNCH HOSTED BY DE NEDERLANDSCHE BANK

14.00 End of lunch

14.00 PLENARY SESSION II – Challenges facing Europe: Institutional and structural reform

- Enhancing financial sector integration in the capital markets and payments area
- Crisis resolution mechanism
- Improving the Eurosystem: a central bank agenda

Speakers:

Joanne Kellermann, Executive Director, De Nederlandsche Bank

Prof. André Sapir, Senior Fellow, Bruegel

Prof. Turalay Kenç, Board Member, Central Bank of Turkey

Paweł Kowalewski, Director, Euro Area Integration Department, National Bank of Poland

Ruud Lubbers, former Prime Minister, The Netherlands

Klaas Knot, Director of Financial Markets, Ministry of Finance of the Netherlands

Frederik Bolkestein, former European Commissioner for Internal Market and Services

Dirk H. Kranen, Division Chief, European Department, German Ministry of Finance

Session chairman: **Lord Meghnad Desai**, Chairman of the Advisory Board, OMFIF

16.00 End of Session II

16.00 Coffee break

16.30 BREAKOUT SESSIONS

Each Breakout Group (in smaller circles of around 15 people) will be guided by a Chairman and Rapporteur, with Speakers and Respondents.

Group I – Cooperation in Europe in the wake of market turbulence

- Progress in debt relief and reduction
- Stability of the euro
- Prospects for EMU enlargement
- Governance / Surveillance of competitiveness and budgetary policy

Chair: Aerd Houben, Division Director, Financial Stability, De Nederlandsche Bank

Speakers:

Paweł Kowalewski, Director, Euro Area Integration Department, National Bank of Poland

Dr. André Szász, former Executive Director, De Nederlandsche Bank

Prof. André Sapir, Senior Fellow, Bruegel

Emérico Zautzik, Head, Central Banking Department, Banca d'Italia

Rapporteur: Jacob Dajani, Head of Treasury Markets, Thomson Reuters

Group II – International shifts in banking, insurance and financial market regulation

- Effects of the G20/FSB process
- Market structures and financial stability: regulating OTC markets
- Will European banks become weaker on a global scale?

Chair: Michael Lafferty, Co-chairman, OMFIF

Speakers:

Dr. Paul Hilbers, Division Director, Supervision Policy, De Nederlandsche Bank, Professor, Nyenrode Business University

Songzuo Xiang, Deputy Director, International Monetary Research Institute, Renmin University of China

Turalay Kenç, Board Member, Central Bank of Turkey

Dick Harryvan, former chief executive, ING Direct

Rapporteur: Stewart Fleming, St Antony's College, University of Oxford

Group III – Latest trends in asset management for pension funds and public sector investors

- Currency diversification
- Are European assets attractive to worldwide investors?
- Pension fund asset allocation
- Ageing and the European pension challenge
- Shareholder responsibility
- The divergent outlook for emerging and developed economies

Chair: Joanne Kellermann, Executive Director, De Nederlandsche Bank

Speakers:

Keith Ambachtsheer, President, KPA Advisory Services

Olaf Sleijpen, Division Director, Pension Supervision, De Nederlandsche Bank

Andy Seaman, Partner, Stratton Street Capital

Michael Kaimakliotis & Marina Shargorodska, Quantum Global Wealth Management

Rapporteur: Martijn Schrijvers, Senior Policy Advisor, De Nederlandsche Bank

Group IV – Collateral and liquidity

- Relevant trends in international liquidity and collateral
- Given these trends, what kind of infrastructures do banks want/need?
- What will CCBM2 bring them? What kind of infrastructural solutions would be possible at the global scale to facilitate the international transfer of liquidity and/or collateral?
- What is the role of central banks in building/facilitating infrastructures?

Chair: Daniela Russo, Director General Payments and Market Infrastructure, European Central Bank

Speakers:

Jeannette Capel, Senior Economist, De Nederlandsche Bank

Prof. Ron Berndsen, Professor of Financial Infrastructure and Systemic Risk, Tilburg University

Rapporteur: Hans Brits, Head of Department, Payments Systems Policy, De Nederlandsche Bank

18.00 End of Breakout Sessions

19.00 Reception

19.30 WORKING DINNER HOSTED BY DE NEDERLANDSCHE BANK

Introductory remarks from:

David Pitt Watson, Founder & Chair, Hermes Focus Asset Management

Keynote address: Europe's future

Yves Mersch, Governor, Central Bank of Luxembourg

21.30 End of dinner

PROGRAMME

DAY 3: Friday 25 March 2011

09.00 PLENARY SESSION III

Reports from the Working Groups followed by discussion

10.30 Coffee/ tea break

11.00 PLENARY SESSION IV: The future of the financial sector

- Financial sector supervision: a task for central bankers?
- Basel III and the international banking landscape
- Narrow banking: is there a need to go beyond the Dodd-Frank bill?
- Maintaining financial stability with macroprudential policies

Speakers:

Vitor Constâncio, Vice-President, European Central Bank

Prof. Lex Hoogduin, Executive Director, De Nederlandsche Bank

Dr. André Szász, former Executive Director, De Nederlandsche Bank

Prof. Niels Thygesen, Emeritus Professor of Economics, University of Copenhagen

Hans Hoogervorst, Chairman of the Executive Board, Dutch Financial Markets Authority

Lord Meghnad Desai, Chairman of the Advisory Board, OMFIF

Frederik Bolkestein, former European Commissioner for Internal Market and Services

Session chairman: Michael Lafferty, Co-chairman, OMFIF

13.00 LUNCH HOSTED BY DE NEDERLANDSCHE BANK

15.00 End of lunch

END OF MEETING

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