3 ACTUALITÉS

1 FINANCIAL STABILITY AND BANKING REGULATION IN GERMANY AND TURKEY

Conference held at the Banque centrale du Luxembourg
on Tuesday, 3 November 2009

under the chairmanship of Yves Mersch,
President of the Banque centrale du Luxembourg

1.1 INTRODUCTORY REMARKS BY PROF. DR. AXEL A. WEBER, PRESIDENT OF THE DEUTSCHE BUNDESBANK

Financial Stability and Banking Regulation in Germany

Introduction

President Mersch

President Yilmaz

Ladies and Gentlemen

First of all, I would like to thank you for the opportunity to speak to you here today on financial stability and banking regulation from both a German and a euro-area perspective. I would like to focus on two issues. First, the institutional responses to the crisis, especially from a central banker's perspective, and second some thoughts on the regulatory issues currently being debated, in particular capital requirements.

Institutional implications of the financial crisis

One of the lessons of the financial crisis is that a more systemic approach to financial markets is needed. But what does that mean for central banks? I would like to raise three topics.

Firstly, the pursuit of financial stability will have to be taken into greater consideration in the operation of monetary policy. The mandate of central banks is usually to maintain price stability. In the case of the Eurosystem, this is our primary objective. The same applies to the Central Bank of the Republic of Turkey. However, price stability and financial stability are interconnected. Disruptions to the financial markets have negative implications for price stability as they have adverse effects on the economic cycle and distort the monetary transmission mechanism.

That is not to say that financial stability should become an explicit target of monetary policy. It is still true that monetary policy is a rather blunt tool when it comes to combating asset price bubbles. Furthermore, one should not over-estimate central bankers' ability to identify asset price bubbles in advance and to determine whether asset price booms have benign or malign reasons. However, financial market developments should be given greater weight when assessing risks to price stability. Financial crises increase the volatility of macro-economic variables such as inflation and growth. For this reason, it is of the essence to use a suitable analytical framework. The two-pillar strategy of the Eurosystem's monetary policy with its prominent role for long-term-oriented monetary analysis is certainly a good basis. Especially during the financial crisis the often-criticised and sometimes ridiculed monetary and credit analysis has proved valuable in monetary policy analysis.

Nevertheless, the analysis of monetary and credit aggregates must be developed further in order to identify undesirable developments on financial markets. Eurosystem staff are currently working towards this goal. Recent IMF research, for example, has shown that, since 1985, house price busts have typically been preceded by significant upward deviations of the credit-to-GDP ratio from its long-term moving average.

Monetary policymakers should also consider the impact their actions have on financial market participants' appetite for risk. This is why I have repeatedly called for a more symmetrical approach that would treat boom and bust episodes not as isolated events but would try to look through the financial cycle in order to steady policy.

While I am opposed to enhancing the mandate of monetary policy and setting financial stability as an additional and independent target, I am in favour of strengthening the role of central banks in this area. This is the second topic I would like to raise. Calls for a more systemic approach are mainly addressed to central banks. Taking into account the wide range of information and data central banks collect in fulfilling their mandate, no other institution is better suited for taking the systemic macro-prudential view. Central banks combine macroeconomic analysis with deep insights into the financial markets stemming from monetary policy as well as payment operations and – in many cases – data from banking supervision. It is therefore obvious that central banks are key when it comes to macro-prudential supervision.

In the Bundesbank, we have decided – as have many other central banks – to establish a financial stability department in order to give this area of increased importance an organisational home. The new department commenced its work in the middle of this year.

Reflecting the pivotal part central banks play in macro-prudential supervision, the ESCB, consisting of the ECB and the national central banks, will play a leading role in the European Systemic Risk Board (ESRB), which is to be established in the next few weeks. The ESRB will be responsible for the macro-prudential oversight of the financial system of the European Union in order to prevent or to mitigate systemic risks to financial stability.

Thirdly, as I mentioned earlier, central banks are partly or fully in charge of banking supervision in many countries. The central banks of Luxembourg and Turkey do not have responsibility for banking supervision. However, in Germany the responsibility for banking supervision has traditionally been shared by the Bundesbank and the Federal Financial Supervisory Authority, or BaFin for short. BaFin was created some years ago by the merger of the federal offices responsible for the supervision of banking, securities trading and insurance. The operational tasks have mostly lain within the Bundesbank's remit, while BaFin is responsible for all sovereign measures.

As you probably know, the new coalition of Christian Democrats and Liberals recently decided to entrust the Bundesbank with banking supervision. Incidentally, giving central banks more responsibility for banking supervision is currently being debated in other countries, too. I would like to take this opportunity to make some remarks on this issue in the German context:

Firstly, collaboration between the Bundesbank and BaFin has worked well, both before and during the crisis. Secondly, the Bundesbank did not ask to be given full responsibility for banking supervision. Rather it was an objective of the political parties that have won the federal elections.

However, the Bundesbank recently declared its readiness to take on more responsibility for financial supervision if this is politically desired. Still, it is of the essence that the future system be compatible with the independence of the Bundesbank, which is laid down by the EU treaty. We believe this is possible. Nevertheless, in our opinion, the new German government would be well advised to closely consult the Bundesbank in the decision-making process at an early stage. In any case, the Eurosystem will have to be consulted before the law is changed.

Supervision of the financial system will have to become more systemically-oriented in the future. This implies that the interconnectedness of financial institutions must be taken into consideration.

Regulatory issues

Institutions matter. However, it would be very unwise to believe that the creation of new bodies at the European or global level and some institutional reform alone will prevent the re-occurrence of a similar crisis. Ultimately, it is the regulation of financial markets that matters when it comes to creating a more resilient financial system.

Basically, making the financial system more stable is a manageable task. The real challenge is to make it more stable without significantly hurting economic productivity. Remuneration schemes, currently a hot topic among the public, are a good example. The disincentive effects of bonuses in terms of short-termism and excessive risk-taking might be prevented by imposing statutory caps on salaries or limiting tax deductibility. However, if interventions are too far-reaching, they may have other disincentive and adverse effects. Therefore it is important to find the right balance. The principles of sound compensation, which were formulated by the Financial Stability Board (FSB) and are now being transposed into national legislation in the G20 and other countries, strike this balance, in my opinion.

Creating level playing fields is another important demand when it comes to seriously improving regulation. Therefore, it is of the utmost importance to further promote the convergence of international and US accounting standards, unless we want to continue to compare apples and oranges. However, in this context I appreciate that the IASB (International Accounting Standards Board) has recently agreed to refrain from broadening the Fair value principle in the IFRS.

Strengthening banks' capital base is certainly the most important, but also the most difficult, task on the regulatory reform agenda. Being involved in the processes of the Basel Committee and the FSB, the Bundesbank appreciates the decision by the G20 to improve the quality and quantity of banks' capital once the financial system has stabilised on a sustainable basis and the economy has recovered. However, we should refrain from unsettling the markets with precise schedules. Getting it right is important.

The impact study of the new capital measures of the Basel Committee on Banking Supervision, which is planned for 2010, should provide some enlightening information. As regards the introduction of a leverage ratio, we are afraid of competitive distortions, in particular owing to differences in accounting standards. We therefore welcome the plan to apply this risk-insensitive measure (at least temporarily) under pillar 2 of Basel II. Basically, we are against deviating from the principle of risk-sensitivity in the Basel framework. In this regard, the commitment of all G20 financial centres to adopt Basel II by 2011 has been a very positive outcome of the Pittsburgh summit.

The implementation of a high level, and better quality, of capital requirements in the long run, counter-cyclical capital buffers and higher capital requirements for risky products and off-balance sheet activities are not only in the interest of the public, they should also be in the interest of the banks themselves. On top of that, banks should make greater use of the options they already have to strengthen their capital base, be it by withholding profits or raising private or sovereign capital.

Conclusions

Let me conclude.

Financial stability is not just a buzzword as some critics suggested a few years ago. The financial crisis has proven them wrong. Policymakers have shown their commitment to take decisive steps in order to make the financial system more stable. Now it is up to the central banks and the other players in macro-prudential supervision to enhance the analytical instruments needed to recognise risks to financial stability earlier and more accurately.

Thank you for your attention.

1.2 INTRODUCTORY REMARKS BY DURMUS YILMAZ, PRESIDENT OF THE CENTRAL BANK OF THE REPUBLIC OF TURKEY

Financial Stability and Banking Regulation in Turkey

Esteemed Governors and Distinguished Guests,

It is a great pleasure to be here in Luxembourg to address such a distinguished audience. I would like to thank the Central Bank of Luxembourg for organizing this special event. First I want to share my experiences on the financial stability and banking regulatory developments in Turkey. Then I will present my views on the future of the global financial architecture.

At the outset, let me touch upon the ongoing global financial crisis briefly. In September 2008, the global economy has plunged into the deepest crisis we have witnessed since the Great depression upon the bankruptcy of Lehman Brothers. Just a few months later, almost all economies around the world were in the midst of a full-blown recession due to the massive spillover effects of the liquidity problems and credit crunch.

The sharp increase in risk perceptions resulted in a significant deterioration in short-term credit and money markets - leading to a major liquidity squeeze. Liquidity problems, coupled with solvency crisis, have tested the resilience of the global financial system. Major financial institutions reported huge losses, reputable institutions announced their bankruptcy or rescued by other market participants and governments. Multi-trillion dollars worth of rescue packages were put into effect to prevent a complete meltdown in financial markets.

The global turmoil coupled with credit crunch triggered by the sub-prime meltdown has revealed fundamental weaknesses in the operation, supervision and regulation of the global financial system. In retrospect, it is clear that accommodative monetary policies implemented in developed economies played a major role in the build up of current crisis. Risks were hidden in the system but accumulated continuously, thanks to access to cheap money and use of excess leverage in complex financial instruments. Many thought that the use of such instruments would eliminate the risk factor in their portfolios. But unfortunately, the result was just the opposite. Risks were just mounting up for a massive implosion.

Nonetheless, thanks to the coordinated measures taken by governments and central banks, fears of system wide collapse have dissipated. Recent data displays some signs of recovery in the economic activity and normalization in the global financial markets. However, there are still some risks involved in the global financial system, especially in the Western Banking system. New bout of risk aversion may deteriorate the already fragile banks' balance sheets and feed into the overall banking system. Moreover, as IMF highlighted, not all anticipated write-downs were realized, which in turn imply further potential erosion in the capital structure of the banking system.

It remains to be seen whether recent improvements in the leading indicators will translate into a long lasting and durable recovery, since part of the rebound reflects the impact of the fiscal stimulus packages. Extraordinary policy measures taken since the last quarter of 2008 make it harder to interpret the underlying trends and put us in a cautious stance in extrapolating past patterns into the future.

Esteemed Participants,

At this point let me turn your attention to the developments in Turkey. Turkish economy, which grew for 27 quarters in a row, experienced severe contraction during the last quarter of 2008 and the first half of 2009. The higher share of cyclically sensitive exports, firms' dependence on external financing, and elevated level of production capacity were the factors that exacerbated the severity of the contraction.

Turkey used to be one of the emerging economies with historically high volatility and particular sensitivity to global risk perceptions throughout the 90s. However, this time the impacts of the crisis have remained relatively limited. Sound financial system, low level of household indebtedness and assertive monetary policy stance were the main factors that prevented an outright depression in Turkey.

Our financial system proved to be resilient during the crisis relative to many other emerging economies. Unlike most of its peers, the Turkish banking system did not require any rescue packages or other forms of government support throughout the crisis. In retrospect, the restructuring plans along with the regulatory and supervisory reforms were already put into effect in the wake of 2001 crisis. Banking sector-restructuring efforts, at the cost of imposing a heavy burden on the public budget, enhanced our banking system's resilience to shocks. In some sense, we had already gone through in 2001 what the world has been experiencing today. These regulations have provided our banks with high level of capital adequacy, liquidity and deposit to loan ratios with mild leverage. Balance sheets free of toxic assets and significantly low levels of FX short positions supported the resilience of Turkish banks. In short, the banking sector restructuring program in Turkey paved the way for reaching financial stability and the formation of a sound financial sector.

From a broader perspective, restructuring of the Turkish banking system in the post-2001 period was not a story in itself. On the contrary, there was an array of other provisions that made economic agents to adopt new behavioral norms. Among these, the maintenance of ambitious primary surplus targets should be mentioned first. This not only put fiscal accounts on more rational grounds, but also triggered the banks to resume their traditional role in the economy, -financial intermediary-.

The fundamental change in the monetary policy framework also deserves special attention. The Central Bank of Turkey started implementing inflation targeting regime and it was given independence with the official mandate of price stability. "Financial stability" was set as an auxiliary objective of the Central Bank and the short-term advance channel from the Central Bank to the Treasury was abolished. These developments, coupled with a successful floatation of the national currency, internalized risks to the markets. Potential adverse selection and moral hazard problems, hence, could be effectively avoided. I believe all these helped the banking system and the financial markets as a whole to maintain a resilient and healthy structure.

As of today, the capital adequacy ratio (CAR) of our banking system is close to 20 percent. In the first nine months of this year, the banking sector profit was up more than 30 percent from the same period of last year. Non-performing loans (NPL) constitute about 6 percent of total loans, up 3 percentage points since last September 2008. According to sensitivity analysis conducted by the Central Bank, even if the NPL ratio increases by 15 percentage points to 21 percent, the CAR would remain well above the target limit 12 percent. In this sense, we are confident that Turkey's well-capitalized and sound financial system is capable of supporting the economic activity along the recovery.

Dear Guests,

In addition to the sound structure of the financial system, low level of household indebtedness relative to other emerging economies was another factor that contributed to the resilience of the Turkish economy during the crisis. Monetary tightening implemented by the Central Bank between 2006 and 2008 played a critical role in curbing the lending growth and thus the rise in the household indebtedness. Prudent and preemptive measures taken by the Banking Regulation and Supervision Agency in the last seven years prevented the spread of exchange rate risk among households. The share of foreign currency-denominated loans in the current debt stock of households is rather small compared to other emerging economies, especially those in Central and Eastern Europe. Financial markets seemed to have appropriately appraised these factors, as the risk premium in Turkey deteriorated by a smaller extent during the peak of the crisis.

Parallel to the contraction in the aggregate demand and sharp drop in commodity prices, inflation in Turkey plummeted markedly. With the reversal of global developments fueling inflation in the last quarter of 2008, the Central Bank took prompt action to cut interest rates and adopted a pioneer role among emerging markets. The analysis conducted by the CBT indicates that policy rate cuts totaling 10 percentage points (1000 basis points) have alleviated the severity of the decline in economic activity. In this respect, we focused on containing potential adverse effects of global financial turmoil on the domestic economy without compromising our price stability objective. Additionally, borrowing and lending rate band has been gradually decreased in order to reduce fluctuations in the overnight interest rates. Also, liquidity need of the market in local currency has been provided in a timely fashion and at the required amount.

We used our foreign exchange reserves primarily to support our banking system. We acted as a blind broker in the FX Market between the financial institutions and shouldered the counte party risk to facilitate the flow of FX liquidity in the system. Moreover, the maturity of the foreign exchange deposits borrowed by banks from the Central Bank in the FX Deposit Markets was extended and the lending rates were slashed.

Additional FX liquidity in the amount of USD 2.5 billion was provided to the banking system through a 200 basis points reduction in the FX required reserves ratio. And lastly a couple of weeks ago, the required reserve ratio for Turkish Lira was reduced from 6 percent to 5 percent. By this cutback, a permanent liquidity that is equivalent to approximately TL 3.3 billion has been provided to the banking system.

As a consequence of the measures taken by monetary and fiscal authorities, market interest rates today is below the pre-global crisis level in both nominal and real terms. Having neutral interest rates at lower levels during economic recessions is an expected development in well-functioning economies, but it has never been experienced in Turkey before. This development should be perceived as an indicator of the normalization of the Turkish economy.

Distinguished Participants,

Following the developments in the Turkish economy and the banking system, now I want to continue with my views on the future of the global financial architecture. In order to prevent future crises, we definitely need a reformulation of international standards and rules in order to reform the global regulatory infrastructure. Thanks to the global efforts, lessons derived from the crisis have already started to initiate dramatic changes in the global financial architecture. In the recent G-20 meetings in Pittsburgh and the World Bank-IMF Annual Meetings which took place in Istanbul, member countries confirmed their commitments to the principles of strengthening transparency and accountability, enhancing sound regulation, promoting integrity in financial markets, and reinforcing international cooperation.

In this context the Financial Stability Board (FSB) has been established to address systemic vulnerabilities and to develop and implement strong regulatory and supervisory policies on a global scale. Stronger capital structure, fair compensation schemes, improved accounting standards, revitalizing the securitization markets and broadening supervisory and regulatory base to include shadow banking system are the hot topics for the policy makers.

We strongly support the promotion of the standards that will enhance financial stability through reducing the likelihood of banks getting into difficulties and improving the resilience of the financial sector. We must lay the foundations for a solid infrastructure to ensure that a global crisis of this scale will never happen again. Crisis prevention should be given utmost importance since the next step would be crisis resolution where the public authorities might have to intervene into the markets. These interventions have become less preferred due to the concerns about long-term outcomes such as creating moral hazard among financial institutions. As an example, a capital surcharge for systemically important banks is an option to tackle systematic risk and limit the market advantages that intermediaries derive from being too-big-to-fail or too-connected-to-fail. But the role of such large institutions in supporting the global economy via presenting the benefits of diversification should not be overlooked. Therefore, it is crucial that the effects of reform should be consistent with market efficiency and avoid rigidities that could impair growth, job creation and financial innovation or increase the cost of financial services for customers.

I think that regulators and supervisors should develop effective risk-based supervision systems and continuously analyze the dynamics in the global financial system cautiously in order to prepare their contingency plans. The ongoing crisis has revealed that preventive measures put in place at the local level are not capable of effectively addressing the global problems. Close collaboration among supervisors and regulators at home and in host countries of financial institutions is critical. Central banks and other regulatory institutions should make their findings public through regular reports to increase the risk awareness in the financial markets. As the Central Bank of Turkey, we publish semiannual financial stability reports for this purpose.

All in all, we all agree on the necessity that global supervisory and regulatory architecture should be sustained all around the world without any black holes like tax havens and countries with lax regulations in order to prevent regulatory arbitrage. All these reforms are easier said than done. So it is yet to be seen whether we will be successful on implementing these measures and achieve our goal of sound and stable global financial system.

In conclusion, central banks and other policy makers should identify the risks to the financial stability and manage the crises in coordination with other related parties. The relative calm in global financial markets in recent months should not lead to indolence. Cooperation between regulatory institutions should not be only limited to times of financial distress. Policy makers should focus on creating action plans in good times to better cope with problems should they arise.

As I conclude my speech, I would like to extend my gratitude to the Central Bank of Luxembourg for organizing this pleasant event.

Thank you for your attention.

2. 5TH ECONOMIC FORUM BELGIUM-LUXEMBOURG-ARAB COUNTRIES

Speech given by
Mr. Yves Mersch,
Governor of the Banque centrale du Luxembourg,

on the occasion of the 5th Economic Forum Belgium-Luxembourg-Arab Countries,
Brussels, 17th November 2009

Excellencies, Governor, ladies and gentlemen, good morning,

I am very pleased to be here today, and I would like to thank the *Arab-Belgium-Luxembourg Chamber of Commerce* for inviting me and especially its general secretary Mr. Hijazin.

Based on the agenda of this 5th Economic Forum, I am looking forward to hearing and learning and to explore potential partnerships opportunities between Luxembourg and the Arab countries in the field of Islamic finance, which receives an increasing attention.

In this perspective, I welcome and consider as essential such conferences that promote greater awareness of important developments within international banking. Despite its traditional approach, Islamic finance is a key "innovation" in the financial area since the seventies and I expect that today's conference will provide an excellent opportunity to exchange information and ideas on current issues relating to this important sector.

While efficient reactions to the global financial and economic crisis have been taken by government and central banks worldwide to stabilise the financial conditions of banks and reduce funding pressures, this unprecedented turmoil reinforces the need to revisit our economic and financial paradigm. The crisis suggests to some to deviate from markets driven economies and behaviours and to explore more ethical and humanistic values to drive sustainable value creation.

One stream in this context is Islamic finance promoting an alignment with the real economy. Based on its prohibition of leverage activities, its principles of justice and participation, Islamic finance is said to contribute to the reduction of the risk perception in the economy and hence its safe recovery[1].

Specialists estimate the volume of Islamic investments to exceed USD 750 billions and the pool of investible assets in the countries of the Persian Gulf and South East Asia to reach USD 5,000 billions[2].

In this part of the world, a non negligible part of the European population has ethical investment and placement needs based on the Shari'ah that have, so far, not yet appropriately been addressed by the conventional banking offering. As of today, more than 38 millions Muslims live in Europe, representing more than 5% of the population[3]. Government and financial institutions alike try to cater for these needs.

Intrinsic difficulties for Islamic financial institutions remain however related to the management of their liquidity and I will review how central banks have engaged into different initiatives to solve these issues so far. I will also share with you some considerations on the challenges that may arise when introducing Islamic financial services into the European framework.

1 Chris Morris (2009) *et al., "Has the crisis shown the strengths or the weaknesses of Islamic finance?"*, IFM Global Market Monitor, 21 October.

2 Gilles Saint Marc (2008), *"Finance islamique et droit français"*, presentation to the Finance Commission of the French Senate, 14 May, page 3.

3 Luis Lugo (2009) *et al., "Mapping the Global Muslim Population"*, Pew Forum on Religion & Public Life, October.

As central bankers in Europe, we welcome a wide variety of banking approaches such as the Islamic one [4]. Our purpose is to focus on the implications for safety and soundness of institutions engaging in Islamic finance and ultimately their potential risk for the banking system. As a result, while banking authorities are committed to adapt and to be accommodating for Islamic finance within the European regulatory framework, it is crucial to continuously ensure a level playing field, requiring from Islamic financial institutions the same high licensing and supervision standards to those expected from conventional ones.

Although banking authorities in Europe are certainly not competent in religious issues and do not intend to replace the official Muslim scholars to take a position and interpret *Shari'ah* precepts, it is important that the banking and financial authorities become more familiar with the principles and practices specific to Islamic finance in order to make appropriate supervisory and regulatory judgments.

As early as 2005, the Banque centrale du Luxembourg was the host of an awareness programme co-organised in Luxembourg with the Islamic Financial Services Board. This was followed by various efforts, supported notably by the Luxembourg government, the fund administrators, the University in order to identify obstacles to solve and opportunities to enhance for the development of Islamic Finance in Luxembourg.

The Government has instructed the tax authorities to come up with proposals in order to have a level playing field and ensure tax neutrality for *Shari'ah*-compliant transactions (essentially Sukuk and Murabaha).

I have participated, along with a number of my colleagues of other central banks, in several conferences both in Europe, the Gulf region and South East Asia, in an effort to stay abreast of developments in this market and to emphasize our continuing interest in this [5].

This flexible approach for Islamic investment products and services out of Luxembourg originated in the late seventies, when the *Islamic Banking System Holdings Limited Luxembourg* was established as first Islamic financial institution in Europe. This was followed by the establishment of *Takafol S.A.* [6], a life insurance company in December 1982 [7]. Those initiatives paved the way for future successful Islamic development which was continuous since then. According to the most recent statistics, there are today 15 Sukuk listed in Luxembourg for a combined value of EUR 5 billions [8]. Luxembourg is the first jurisdiction in a non Muslim country [9] for the domicile of *Shari'ah*-compliant funds with nearly 40 funds managed and promoted by leading global investment companies [1]. Earlier this year, a major German bank launched its new platform, domiciled in Luxembourg, called *Al Mi'yar* to facilitate the issuance of *Shari'ah*-compliant securities.

Some of the features of *Shari'ah*-compliant investment are designed to attract Western investors looking for socially responsible investment schemes and who are not only interested in the risk/reward relationship of their investment, but who are also concerned with issues of accountability and social responsibility. As you all know, based on the precepts of the *Shari'ah*, Islamic funds invest in ethical and non leveraged enterprises which for those reasons have a low risk profile.

4 Christian Noyer (2009), *"Global stability, the future of capital markets and Islamic Finance in France"*, Euromoney Seminars, Islamic Paris Conference, Paris, 29 September;

5 *"3rd Islamic Financial Services Forum: The European Challenge"*, jointly organised with the Financial Stability Institute and hosted by Banque de France on Islamic liquidity management, Paris, 3 March 2009;

6 Now denominated *Solidarity Takafol* S.A, based in Luxembourg;

7 Parker (2009), *"Luxembourg promotes as domicile of choice for funds"*, Arab News, 18 May;

8 Amount and number as of 28 October 2009, source Bourse de Luxembourg. For information, on 12 August 2009, the Luxembourg stock exchange has listed a €1.5 billion Sukuk issued by Petroliam Nasional, Malaysian state owned Oil Company.

9 Luxembourg is the 4th domicile for *Shari'ah*-compliant funds in the world with 7% of them following Malaysia (23%), Saudi Arabia (19%) and Kuwait (9%) – see Ernst & Young's *Islamic Funds & Investment Report 2009*, page 72.

Despite the relative success of Islamic financial services in Luxembourg regarding notably the investment funds and the Sukuk, not all of the regulatory challenges raised by these Islamic institutions have been resolved — challenges that arise from looking to introduce Islamic financial principles into a regulatory framework that was structured without these principles in mind. However, these issues are not specific to Luxembourg only and exist in the whole western countries [10].

One example of issues that precisely fits into the role of a central bank is the absence of an appropriate market of *Shari'ah* instruments to facilitate the management of the liquidity needs of Islamic banks or Islamic financial institutions and funds.

The prohibitions of interest rate as well as the lack of a dedicated infrastructure and adequate instruments prevent the Islamic banks from developing a viable value proposition: rejecting leverage and speculative transactions, Islamic banks need to have greater amount of capital and to sustain a higher liquidity ratio than their conventional counterparts. As a result, their activities turn to be less profitable and less competitive compared to those of their conventional counterparts when addressing the same customer segment. The structural obstacles together with the lack of technical and contract standardization ultimately prohibit Islamic financial institutions from succeeding in the competitive financial landscape where consumers make rational choice not only driven by religious principles.

In order to facilitate the emergence of a resilient Islamic financial market in Europe, we have to adapt and shape the infrastructure and supervisory environment to allow efficient and cost effective trading and clearing for a significant number of investment-grade Islamic financial papers across the whole maturity spectrum. In this perspective, it is worth noting that in the current turbulent period, raising finance through Sukuk issuance appears to be cheaper than recurring to conventional bonds due to the burgeoning demand for Islamic instruments [11].

To reflect the specific needs of *Shari'ah*-compliant finance, the AAOIFI (*Accounting and Auditing Organization for Islamic Financial Institutions*) and the IFSB (*Islamic Financial Services Board*) are working on developing international supervisory standards for instance to improve the corporate governance frameworks or implement capital adequacy and risk management standards for Islamic financial institutions [12].

In closing, let me emphasize that the Banque centrale du Luxembourg has applied for membership to the Islamic Financial Service Board and would be the first central bank in Europe to participate to this international standard setting organisation. We also second staff to become familiar with Islamic finance and study the before mentioned issues, notably liquidity management.

Despite the lack of detailed and scientific studies about the potential effect of Islamic finance on the price and financial stability, the resilience of Islamic banks to the recent crisis [13] practically demonstrates the positive diversification effect they could play, contributing therewith to a systemic equilibrium. Moreover, Islamic finance acts as a natural hedging scheme restricting excessive credit boom in so far as it links the supply of financing (what would conventional banks call credit) to the growth rate of the economic activity.

Thank you very much.

10 Cf. Gilles Saint Marc (2008), *"Finance islamique et droit français"*, presentation to the Finance Commission of the French Senate, 14 May, page 3. Cf. *"3rd Islamic Financial Services Forum: The European Challenge"*, jointly organised with the *Financial Stability Institute* and hosted by Banque de France on Islamic liquidity management, Paris, 3 March 2009;

11 Robin Wigglesworth (2009), *"Islamic bonds spark rush of international interest"*, Financial Times, 10 November; "Has the crisis shown the strengths or the weaknesses of Islamic finance?", Global Market Monitor, 21 October.

12 Norbert Hellmann (2009), *"Finanzkrise taucht Islamic Banking in ein neues Licht"*, Frankfurt Börsen-Zeitung, 10 November.

13 13 Durmus Yilmaz (2009), *"Islamic Finance: During and after the global financial crisis"*, Istanbul, 5 October.

3. CREDIT DEVELOPMENTS IN LUXEMBOURG

Speech by
Mr. Yves Mersch,
Governor of the Banque centrale du Luxembourg,

on the occasion of the Gala CFO World 2009,
Luxembourg, 25 November 2009

Introduction

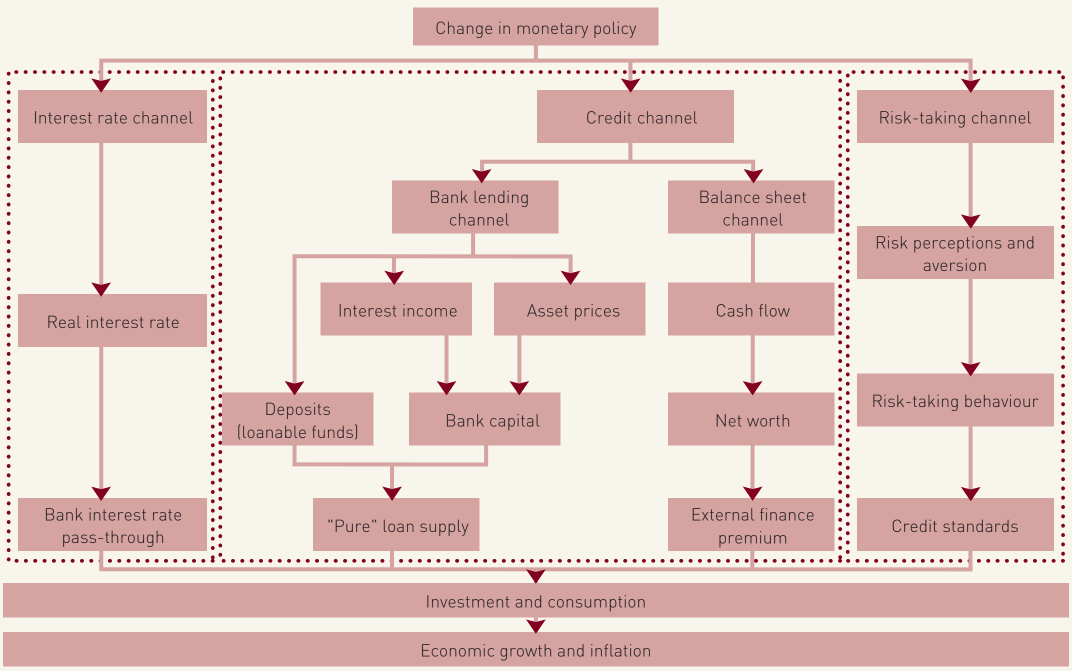
Ladies and Gentlemen,

It is a great pleasure for me to be here today and I very much appreciate the opportunity to talk about credit developments in Luxembourg. In times like these the issue could not be more pertinent. Bank lending constitutes one of the most important sources of external financing. To many small- or medium-sized enterprises (SMEs) in particular, bank loans are the only means of external financing available; rather than raising funds directly, for instance through the issuance of bonds or shares, they have to go through a bank to obtain the necessary funds to finance their activities. The importance of credit intermediation cannot be overstated, and a healthy and well-functioning financial sector is therefore part and parcel of a healthy and well-functioning economy.

It goes without saying that a central bank, or a system of central banks, has a keen interest in credit developments. Indeed, credit growth is tightly interlinked with economic activity and inflation developments. Before I talk about actual credit developments in Luxembourg, let me say a few words about the main monetary policy transmission channels involving banks.

Monetary policy transmission channels involving banks

Chart 1
The main monetary policy transmission channels involving banks



Source: ECB

While most monetary policy transmission channels go through the banking sector, either through the price of credit or through credit volumes, central banks can affect the supply of loans as well as the demand side.

Take the traditional interest rate channel. Cuts in the policy rate affect the investment and consumption decisions of businesses and households only to the extent that they are actually passed on through the banking sector. Banks determine the extent of the pass-through and their lending rates in turn impinge on the demand for loans from firms and households. Note that it is the real rather than the nominal interest rate which matters in this decision-making process. The underlying assumption is that some prices and wages are inflexible (or "sticky") in the short run. This implies that the aggregate price level adjusts slowly over time, entailing that falls in the nominal interest rate also lead to falls in the real interest rate. This is an important distinction, as it provides a mechanism that enables monetary policy to stimulate the economy even if nominal interest rates hit their zero lower bound. Indeed, an expansion in the money supply can raise expected inflation, thus lowering the real interest rate and providing further stimulus to the economy through the interest rate channel.

Adjustments in short-term interest rates are also transmitted to long-term rates, which ultimately determine investment decisions and decisions about durable consumer expenditure. The expectations hypothesis of the term structure of interest rates is but one mechanism which explains how short-term interest rates may affect long-term rates, namely through an average of expected future short-term rates.

While the interest rate channel largely affects loan demand through the price of credit, monetary policy can also influence loan supply through the so-called credit channel. The credit channel proceeds from the assumption that there are frictions in financial markets, such as asymmetric information and moral hazard. A key function of banks is to overcome such information and incentive problems by screening and monitoring borrowers. The credit channel is made up of two sub-channels. The first is the bank lending channel and works through the liability side of banks' balance sheets, which in turn triggers certain adjustments on the asset side. Thus, an expansionary monetary policy tends to increase loan supply by raising the availability of funds for banks. The empirical evidence on the existence of a bank lending channel in the euro area is rather mixed though.

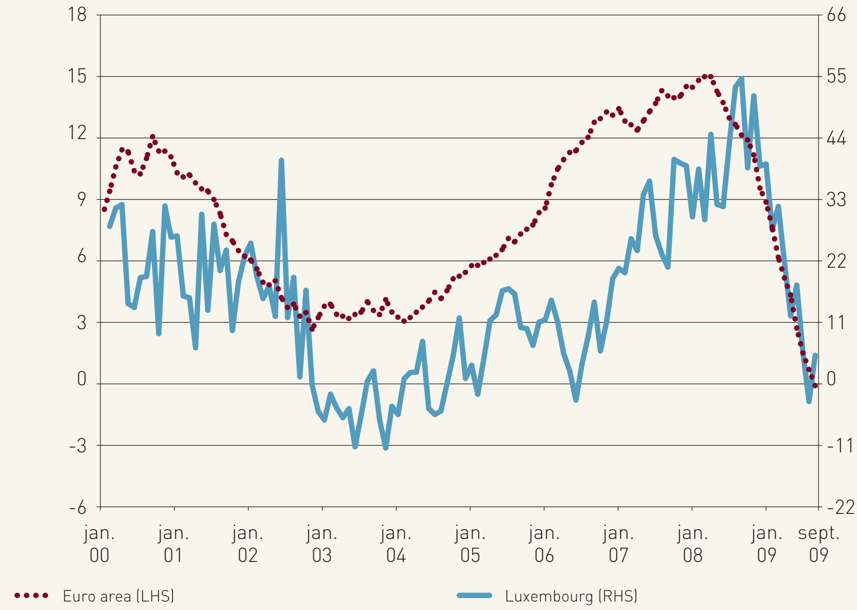
However, the bank lending channel can also work through banks' capital positions. Cuts to the policy rate and a steepening yield curve can raise banks' net interest income, which in turn affects profitability and hence bank capital. The available evidence indicates that this only holds for countries where banks lend predominantly at fixed long-term rates, however. In fact, the opposite effect is found in countries where banks lend largely at floating or short-term rates. In this context, it should be mentioned that corporate loans in Luxembourg are by and large floating rate loans (or loans with an interest fixation period up to one year), as are mortgage loans; only consumer loans are primarily granted at fixed rates. However, asset price rises following a reduction in policy rates may also raise bank capital through positive valuation effects on banks' trading books.

The second sub-channel of the credit channel is called the balance sheet channel and works through changes in the quality of the borrower. Through its impact on cash flows and collateral values, monetary policy can affect borrowers' net worth, which is inversely related to their external finance premium. Owing to the pro-cyclicality of net worth, the external finance premium is thus counter-cyclical and therefore magnifies the impact of changes in short-term rates on credit availability. This spills over into consumption and investment, and finally into economic growth. This mechanism is also known as the "financial accelerator".

A final monetary policy transmission channel involving banks I wish to allude to is the risk-taking channel. Low interest rates and abundant liquidity may decrease risk aversion and encourage risky investments, as well as leading to laxer credit standards. This raises the supply of bank loans and can have a significant impact on credit growth.

The evolution of credit volumes

Chart 2
Corporate credit developments in Luxembourg and in the euro area, annual growth rate
(in %)

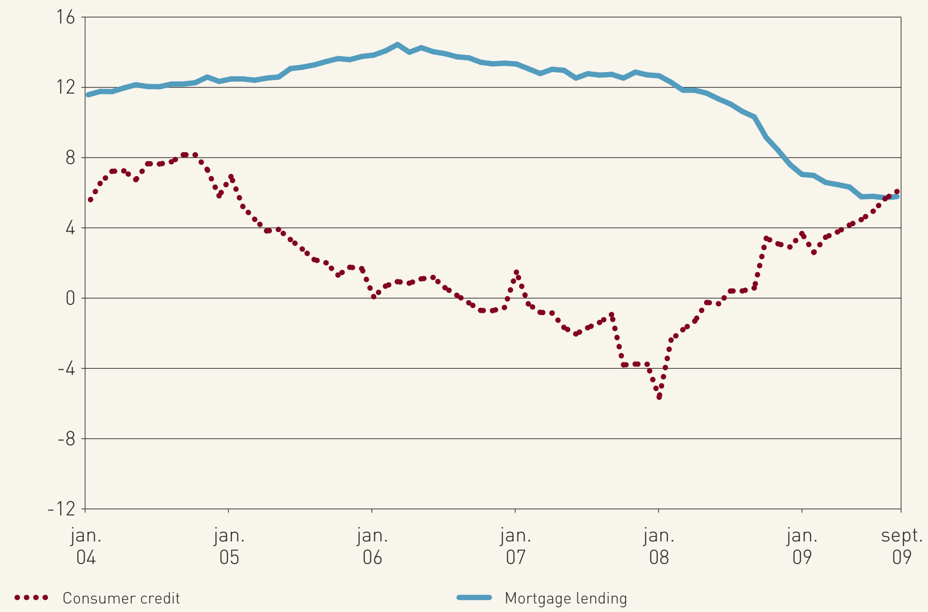


Sources : BCL, ECB

So much for the theoretical background. Let me now move on to how corporate credit volumes have actually evolved in Luxembourg, and how those developments tie in with those at the euro area level. My intention is not to identify the workings of the different monetary policy transmission channels in Luxembourg – this would be a Herculean undertaking! However, it is helpful to keep the theoretical underpinnings in mind when looking at the actual credit developments and the potential underlying explanatory factors.

As you can see in the chart, the underlying trend developments in Luxembourg and at the euro area level coincide, despite the higher volatility in the Luxembourg data. Most notably, corporate credit dynamics rose continuously up until 2008, when they began to unwind rather rapidly, first in the euro area at large and shortly thereafter also in Luxembourg. The pace and magnitude of the decline in the loan dynamics are particularly worrying, with below or near zero growth rates in the third quarter 2009. It is worth emphasising that roughly one year ago, in September 2008, the annual progression of corporate loan volumes in Luxembourg peaked at 54%!

Chart 3
Household credit developments in Luxembourg, annual growth rate
(in %)



Source : BCL

As for credit to households, the annual progression of mortgage lending has been on a downward trend since 2006, long before the crisis. However, this downward trend accelerated considerably and the annual growth rate recently stabilised just under 6%. Consumer credit has been progressing steadily since 2008, which represents a trend inversion compared to the preceding years. All in all, household loan dynamics have been much more benign than corporate credit developments.

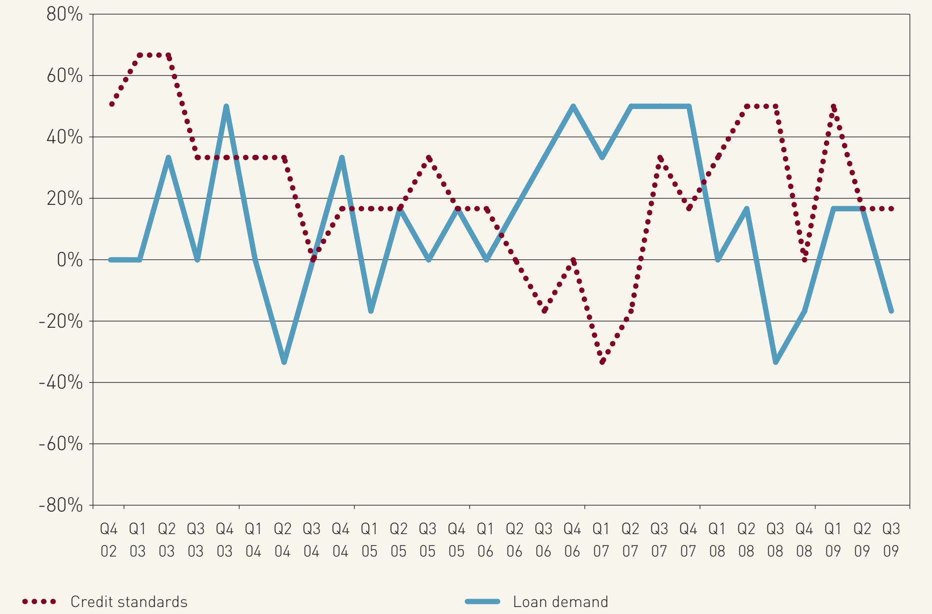
This raises the question as to how and why the corporate credit cycle could take such a rapid U-turn. While the obvious answer is that banks refuse to grant loans in the wake of the financial crisis, this is but one side of the coin.

Disentangling demand and supply

Indeed, the Bank Lending Survey or BLS – a euro area-wide bank survey on quarterly credit developments – strongly indicates that the sharp slowdown in corporate credit expansion is owing to both supply- and demand-side factors.

The graph plots the net unweighted responses provided by the participating banks from the Luxembourg BLS sample. A positive "net percentage" indicates that, relative to the preceding quarter, banks have tightened their credit standards or reported higher loan demand by firms. Conversely, if the respective line is below zero, this points to an easing of banks' credit standards or a fall in loan demand.

Chart 4
The evolution of credit standards and loan demand in Luxembourg
(net percentages)



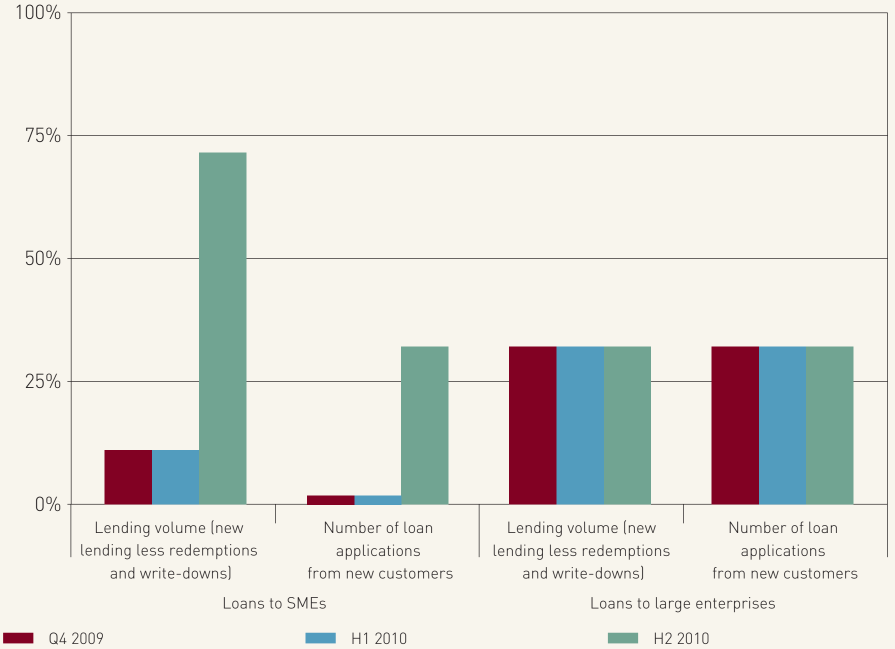
Source : BCL

As you can see in the chart, the survey results suggest that banks have been tightening credit standards since the onset of the financial crisis, making it more difficult for companies to finance their activities; lending standards have been tightened in particular for large enterprises. At the same time, however, the period of high loan demand ended shortly after the onset of the financial crisis, and net demand even turned negative on several occasions. The slowdown in loan dynamics is therefore owing to the combined impact of tighter credit standards on the one hand and a deceleration or fall in loan demand on the other.

You may have noticed that the slowdown in loan dynamics is lagging the tightening cycle: while the progression of loans to companies peaked in the third quarter 2008 before it slowed down rather rapidly, the BLS suggests that banks were already tightening credit standards since the early stage of the crisis in the second half of 2007. In other words, the information on credit standards from the BLS serves as a lead indicator. While the correlation between loan growth and credit standards is not perfect, the available evidence suggests that loan growth will stabilise shortly and subsequently pick up in the course of 2010.

This prediction is in line with an ad hoc survey we carried out very recently. The survey questionnaire was sent to four banks with a combined share of roughly 50% of the corporate credit market in Luxembourg. In one of the questions, the four participating banks were asked how they expect corporate lending volumes to evolve. For consistency, the BLS methodology has been used and the results are thus expressed as net percentages. However, the results of the ad hoc survey have been weighted according to the sample shares of the individual banks, while the BLS results are unweighted owing to methodological reasons.

Chart 5
Expectations regarding lending volumes and loan applications from new customers
(weighted net percentages)



Source : BCL

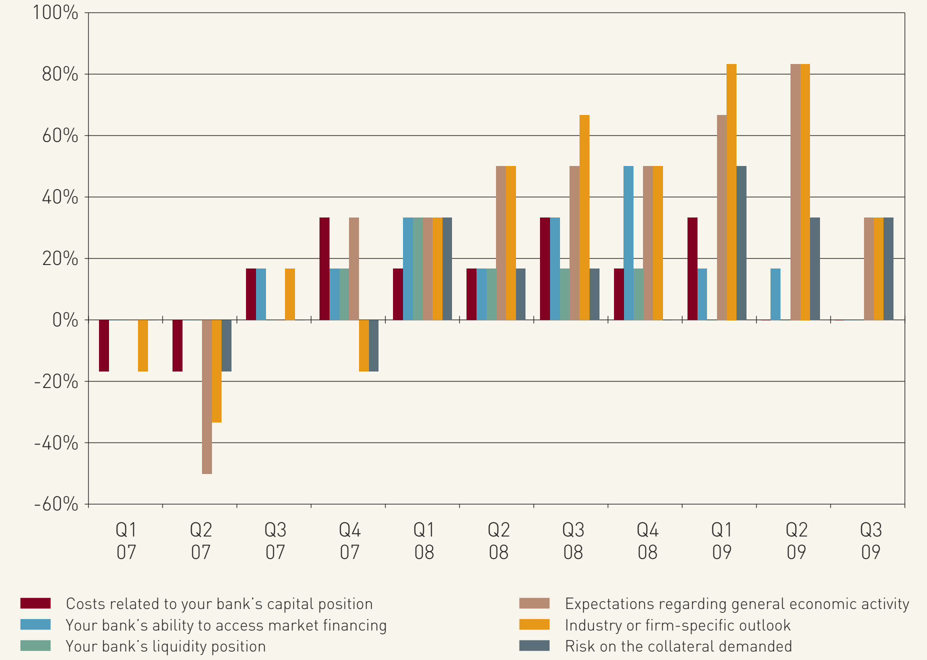
As you can see in the chart, the survey results point to a moderate pickup in lending volumes, while lending to SMEs is even likely to accelerate considerably in the second half of 2010. New lending is expected to be the main driver behind the pickup in overall lending volumes, which also encompass loan repayments and write-downs. Banks do not expect a substantial change in loan redemptions over the forecast horizon. As for write-downs on loan portfolios, they do anticipate a rise in write-downs in Q4 2009 and H1 2010, but their mitigating impact on loan dynamics is expected to dissolve entirely in the second half of 2010. Of course, given that banks' expectations pertain to lending volumes rather than credit standards per se, the expected rise in corporate lending should be seen as the interplay of demand and supply.

Some information on the demand side more specifically is also available from this ad hoc survey, though. It should be borne in mind that demand is rather difficult to predict, however; moreover, it is worth emphasising that the survey was addressed to loan officers and therefore naturally reflects the assessment of the lender rather than the borrower's point of view. Be that as it may, as you can see in that same chart the four sample banks also expect the number of loan applications from new customers to rise, in particular as regards large enterprises. Loan applications from new SME customers, however, are not expected to rise significantly until the second half of 2010.

There is little doubt that the corporate credit outlook is improving. Nevertheless, it remains legitimate to ask why banks have tightened their credit standards in the first place. First of all, not all banks have. In the BLS, the highest net percentages recorded in one single quarter have not exceeded 50%, the equivalent of 3 banks. Second, the results from the BLS are not weighted by bank size – in line with the methodology applied at the euro area level – otherwise you would see that the tightening is in fact not nearly as broad-based as it seems. But of course the question remains as to why some banks are tightening their lending standards, thereby reducing the supply of loans to enterprises. It is tempting to blame the tightening entirely on the financial crisis. In a way, this is also correct. However, the impact of "pure" supply-side constraints is not nearly as large as one would think. In other words, while it is true that a number of banks are more reluctant to grant loans to companies, this is not solely attributable to market access or to the cost of funds and balance sheet constraints. Indeed, as the next slide shows, the major reason banks have become more reluctant to grant loans to firms is that their risk perceptions have risen sharply.

Since the onset of the financial crisis in 2007, the various explanatory elements pertaining to the banks' cost of funds and balance sheet constraints have indeed contributed to tighter lending standards. However, it is obvious from the chart that the role of these explanatory factors is secondary, while it is banks' risk perceptions that have played a key role. Risk perceptions pertaining to the industry- or firm-specific outlook in particular have contributed to more stringent lending standards. If banks have chosen to restrict lending, it is therefore largely because of the economic downturn; admittedly, "pure" supply-side elements which constrain banks and thereby leave them no choice but to decrease lending volumes also played a role, but a much smaller one than is commonly believed. This evidence can easily be linked up to the theoretical background on monetary policy transmission channels expounded earlier: "pure" supply-side factors pertain to banks' availability of funds, i.e. to the bank lending channel, whereas risk perceptions relate to the quality of the borrower, i.e. to the balance sheet channel.

Chart 6
Explanatory factors underlying the tightening of credit standards
(net percentages)

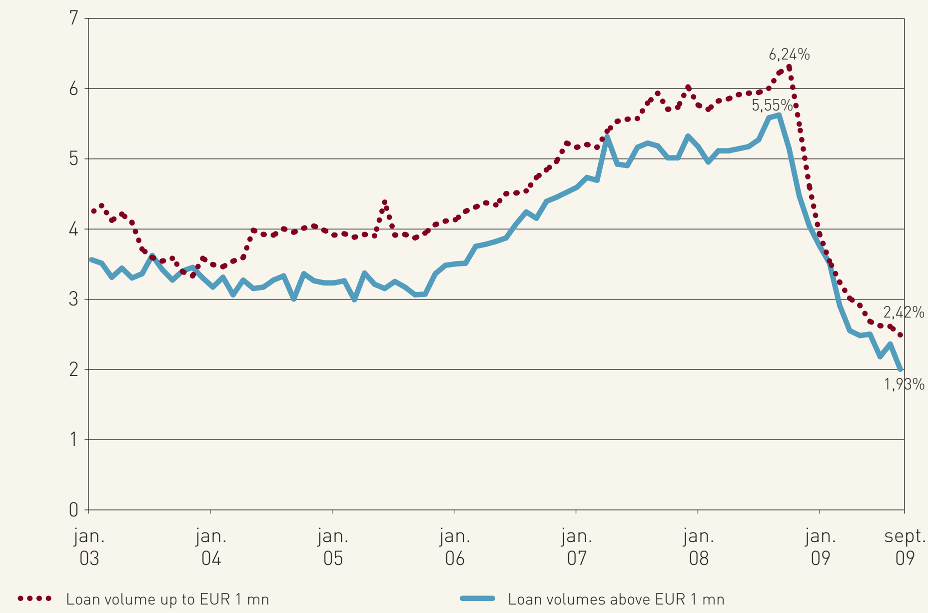


Source : BCL

How have banks implemented their tighter credit standards? The available evidence indicates that banks have strongly cut their lending rates, seemingly suggesting that tighter credit standards have been implemented through an adjustment of non-price rather than price conditions.

The chart plots the evolution of lending rates in Luxembourg, available through the Eurosystem reporting framework since 2003. The data indicate that loans to enterprises are usually floating rate loans (or loans with an interest fixation period up to one year); the chart therefore plots flexible (or short-term) lending rates on new business. Moreover, interest rates may differ substantially

Chart 7
Floating (or short-term) corporate lending rates on new business in Luxembourg



Source : BCL

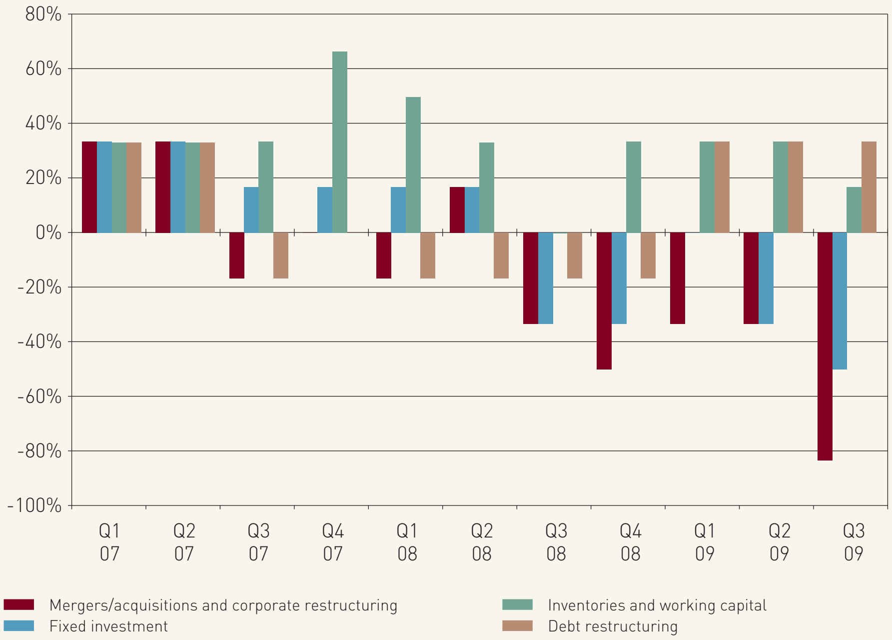
depending on the size of the underlying loan granted to the counterparty, which is why the reporting framework requires banks to distinguish between small and large loans. As you can see in the chart, there was a substantial reduction in corporate lending rates – for both small and large loans – in line with the monetary policy easing in the euro area. Peak-to-trough, lending rates on small loans have fallen from 6.24% to 2.42% in the twelve months up to September 2009; lending rates on large loans have fallen from 5.55% in September 2008 to 1.93% in September 2009.

However, the reporting framework provides no breakdown by geographical origin of the counterparty; this is unfortunate given that the lending rates are volume-weighted and that about three quarters of outstanding corporate loan amounts granted to companies in the euro area are actually granted to non-domestic enterprises.

The available information does suggest, however, that corporate lending rates have come down sharply, while banks have at the same time reported tighter credit standards. How can this information be reconciled? Were the stricter lending standards implemented through non-price factors, such as loan covenants or collateral requirements? Once again, the answer comes from the BLS. The survey does not point to a substantial tightening of non-price lending conditions, but rather to higher margins. Most notably, banks have signalled higher margins on riskier loans. This scores well with the rise in risk perceptions already noted earlier in the context of explanatory factors underlying the tightening of lending standards. Moreover, it is consistent with non-survey data: margins, as given by the difference between lending rates and three-month EURIBOR rates, have risen since late-2008.

I have talked extensively about the supply of loans. This is because central banks collect a lot of information from the banking sector, either through statistical reporting requirements or in the framework of voluntary surveys banks participate in. Information on the demand side is sparse, which is why I have only mentioned it cursorily, in the context of the BLS and the ad hoc survey we carried out. The BLS does encompass further demand-side questions which are worth looking at in more detail though. Further to this, the next chart plots the key explanatory factors underlying the evolution of loan demand.

Chart 8
Explanatory factors underlying the evolution of loan demand
(net percentages)



Source : BCL

You will remember that loan demand began to slow down in 2008. The chart shows that there are various elements pulling loan demand in opposite directions. Financing needs pertaining to fixed investment and, most notably, to mergers and acquisitions and corporate restructuring, have exerted strong downward pressure on loan demand. At the same time, financing needs pertaining to inventories and debt restructuring have pulled loan demand in the opposite direction. Because there are countervailing factors, the evolution of loan demand is somewhat volatile; however, there is no questioning the fact that generally loan demand has come down since the onset of the financial crisis, in spite of some quarter-on-quarter fluctuations.

Conclusion

To conclude, let me emphasise that the slowdown in corporate loan dynamics is at this stage not fully demystified. What we know for a fact is that loan volumes have ceased to expand at double-digit rates. Although the pace at which loan growth rates have come down is startling, the annual progression of corporate credit has mostly remained positive for now. Moreover, the available information suggests that corporate lending should recover soon and pick up pace in the course of 2010.

I have focused on the supply side because, as a matter of fact, central banks have much more information on lenders than on their counterparties. However, I also underscored that the tightening in credit standards is not as broad-based as the underlying data would suggest. This leaves the demand side, but comprehensive and reliable information on the borrower is notoriously difficult to come by. Perhaps this gap can to some extent be filled at today's conference.

Thank you for your attention.