SAFE
Center of Excellence
Sustainable Architecture for Finance in Europe

Newsletter

at the House of Finance

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Mandatory IFRS Reporting and Changes in Enforcement_4
Hans B. Christensen • Luzi Hail • Christian Leuz

Deposit Insurance for Europe: Proposal for a Scheme with Limited European Liability_10
Jan Pieter Krahnen

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About SAFE

The Center of Excellence SAFE – "Sustainable Architecture for Finance in Europe" – is a cooperation of the Center for Financial Studies and Goethe University Frankfurt. It is funded by the LOEWE initiative of the State of Hessen (Landes-Offensive zur Entwicklung wissenschaftlich-ökonomischer Exzellenz). SAFE brings together more than 40 professors and just as many junior researchers who are all dedicated to conducting research in support of a sustainable financial architecture. The Center has two main pillars: excellent research on all important topics related to finance; and policy advice, including the dissemination of relevant research findings to European decision makers from the realms of politics, regulation and administration.

In order to promote a fruitful exchange with interested parties from politics, academia, business and the media, SAFE issues a newsletter on a quarterly basis. This aims to provide an overview of the Center's ongoing research and policy activities. The SAFE Newsletter succeeds the House of Finance Newsletter, which was published between 2009 and 2012.

SAFE is based at Goethe University's House of Finance however extends beyond by drawing on scholars from other parts of Goethe University as well as from fellow research institutions. The Center builds on the reputation of the House of Finance institutions, serving as an interdisciplinary think tank on the issue of finance.

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Editorial

Michael Haliassos
Director, Center of Excellence SAFE

Our Center of Excellence SAFE has already stretched out its arms extensively into the finance research community, broadly defined. Even the single act of advertising several professorships at once has caused a great stir in the job market, drawn considerable attention to Frankfurt, and mobilized many of our faculty members. We are now on track to fill six junior professorships and seven post-doc positions by the end of the summer, and we are looking forward to welcoming six new full professors by January 2014 at the latest.

In addition, the SAFE Visitors Center has already built up a solid record of bringing to Frankfurt international visitors of a high quality and profile. In the past five months, six researchers from abroad have visited SAFE and the House of Finance for a period of between one week and several months: three "senior visitors" and three junior ones. As "senior visitors", we invite distinguished colleagues to give a Ph.D.-level mini course and either a seminar or a public lecture, but also to enter into an exchange of thoughts and ideas with us, both faculty and students. "Junior visitors" are promising post-docs whom we welcome to further their own research projects here and to gain experience in one of the research areas of SAFE.

In May, our most recent senior visitor, Prof. Fernando Alvarez of the University of Chicago, spent two weeks at our Center. In 2012, he was awarded the prestigious Duisenberg Research Fellowship of the European Central Bank. While visiting SAFE, he taught courses on household portfolio-saving models and the optimal disclosure of interconnected banks. Simon Kwan, Vice President and Head of Financial Research at the Federal Reserve Bank of San Francisco visited us in April. He almost bumped into Alejandro Drexler, an Assistant Professor of Finance at the McCombs School of Business of the University of Texas at Austin, and Menachem Abudy, an Assistant Professor at Israel's Bar-Ilan University. Kimmo Soramäki, CEO of Financial Network Analytics (FNA), visited SAFE in January and February and gave courses on financial networks and "financial cartography".

Hard as it is to call "visitor" somebody we view as one of our own, we are happy to have with us Christian Leuz, Professor of International Economics, Finance and Accounting at the University of Chicago Booth School of Business – a leading scholar in the field of capital markets regulation and accounting transparency. Last year, Christian was bestowed the Humboldt Research Award, which enabled him to spend the whole academic year 2012/13 with us. Not only is it a great pleasure to have him on board, his presence has led to a number of highly interesting courses and seminars, and also added to other academic and policy events. To give you an overview of what he is working on, we showcase some of his recent research on the next two pages.

I hope you will enjoy reading this issue of the SAFE Newsletter and that you will share my view that the future (of finance-related research at Goethe University) is even better than it used to be!

Yours sincerely,
Michael Haliassos

Mandatory IFRS Reporting and Changes in Enforcement

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In recent years, reporting under International Financial Reporting Standards (IFRS) has become mandatory in many countries. The capital market effects around this change have been studied extensively, but the sources of these effects are not yet well understood. Our paper provides a series of tests that distinguish between various possible explanations for the capital market effects that have been observed. Given the continued trend towards IFRS reporting, a better understanding of the consequences of IFRS adoption is of fundamental importance to researchers, policy makers and regulators.

The worldwide switch to IFRS reporting is arguably the biggest reporting change in accounting history. Much of the literature points towards positive capital market effects around the introduction of IFRS, but also shows that these effects are significantly stronger in countries with stricter and better functioning legal systems, and more pronounced in the European Union (EU) than in other regions of the world (see, for example, Daske et al., 2008, and Byard et al., 2011). This variation makes it unlikely that only the accounting standards are at work. Moreover, many countries adopted IFRS reporting at around the same time. This clustering in the timing of standards adoption makes it difficult to empirically isolate the effects of IFRS reporting. Studies analyzing the capital market impact of IFRS reporting could be confounded by unrelated institutional changes and/or economic shocks that happened to occur during the same time period. For example, the EU passed a series of directives to improve financial market regulation, many of which were implemented around the time of IFRS adoption (see Figure 1).

It is also possible that institutional changes are explicitly linked with IFRS adoption. For example, the EU law introducing IFRS reporting requires that Member States take appropriate measures to ensure compliance. As a result, EU Member States may have bundled IFRS adoption with changes in financial reporting enforcement. Such changes raise the possibility that the observed capital market impact reflects enforcement changes, rather than the switch in accounting standards.

Thus, it is still an open question whether the capital market benefits around mandatory IFRS adoption are indeed attributable to what are arguably improved and globally harmonized accounting standards.

Empirical Approach

We use panel data techniques to analyze quarterly market liquidity data and rely on within- and across-country variation in the timing of IFRS adoption and that of other institutional changes to distinguish between several possible explanations. We analyze market liquidity for several reasons: it has a clear theoretical link to reporting quality; it can be measured over short intervals; and it is less anticipatory in nature than other economic constructs like cost of capital.

Specifically, we explore four potential explanations for the capital market effects observed: (i) the switch from local rules to IFRS reporting played a primary role in positive effects; (ii) the IFRS mandate had capital market benefits only in countries with strong institutions and legal enforcement; (iii) countries that support the introduction of IFRS with changes in enforcement see stronger capital market effects; and (iv) other changes in the institutional environment than the switch to IFRS and/or economic shocks

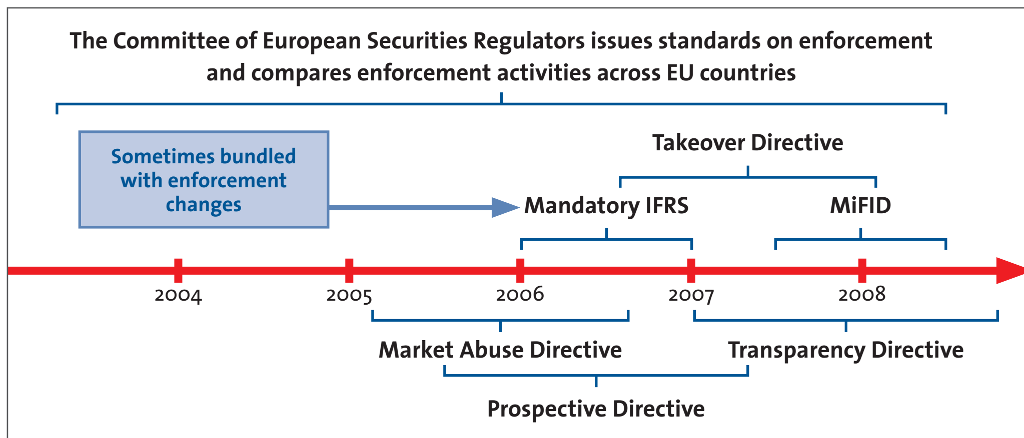

Figure 1: Timeline of selected European regulatory changes around IFRS adoption

unrelated to financial reporting are responsible for the positive effects observed. The study is designed to distinguish between these four explanations.

Results

We show that, across all countries, mandatory IFRS reporting had little impact on liquidity. The liquidity effects around IFRS adoption are concentrated in the countries of the EU. However, we find little evidence that unrelated changes in EU financial market regulation and/or economic shocks can explain the observed liquidity effects, which largely rules out explanation (iv).

Next, we show that liquidity effects are confined to those EU countries that made substantive changes to enforcement around the time they introduced IFRS, which is consistent with (iii). The magnitude of the coefficient estimates suggests an increase in liquidity of between 18 and 23 percent relative to pre-IFRS liquidity levels, which can be translated into average trading cost savings of between USD 0.35 and 1.5 million per year and sample firm.

Our results are inconsistent with the hypothesis that mandatory IFRS reporting has widespread capital market benefits in all countries or only in countries where pre-existing legal institutions are strong and regulatory quality is high, which rules out explanations (i) and (ii). Instead, the results suggest that changes in financial reporting enforcement play a crucial role for the liquidity effects observed (explanation (iii)). We find further evidence for this interpretation by exploiting the fact that some firms had already reported under IFRS on a voluntary basis and should have experienced only minor (or no) changes in accounting standards when IFRS reporting became mandatory. We show that liquidity increases for voluntary IFRS adopters around the time of the IFRS mandate only in countries with concurrent enforcement changes.

In addition, we analyze liquidity effects in countries that changed their enforcement before or after adopting IFRS, but not simultaneously, so that the effects of IFRS and enforcement changes can be investigated separately. The results show that liquidity improves after substantive changes in enforcement but not after IFRS adoption.

Conclusion

In sum, our results generally support explanation (iii) and suggest that changes in enforcement were crucial for the liquidity improvements after the introduction of the IFRS mandate. This evidence does not necessarily imply that IFRS reporting plays no role. One may argue that IFRS reporting was a pre-condition for the enforcement changes to take place or, alternatively, that the liquidity effects would have been smaller without IFRS adoption. However, our results make it unlikely that the change in accounting standards was the primary driver, or a major factor, behind the liquidity effects around IFRS adoption.

These findings highlight the importance of enforcement institutions for global reporting practices. In addition, they should make us (more) cautious about attributing the observed capital market effects to IFRS adoption. Consistent with this conclusion, Daske et al. (2013) examine the capital market effects of voluntary IFRS adoptions by firms prior to the mandate and find that the effects around IFRS adoption often reflect changes in firms' reporting incentives or broader changes in their reporting strategies, and not just the switch in standards.

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The full paper is forthcoming in the Journal of Accounting and Economics and is available at:
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2017160

Why do Contracts differ between Venture Capital Types?

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The contractual relation between venture capitalists and their portfolio firms has received growing attention in recent years. It offers the possibility to study the role of explicit contracts in an environment of complex informational asymmetries and control problems. While there are many theoretical analyses on contract design, empirical studies looking into the details of contractual arrangements, and thereby relating theory with real world data, are still rather rare. This study aims to fill this gap.

In this particular context, the question arises of whether there exists a prototypical venture capital (VC) contract or, rather, whether contracts differ persistently across VC firm types and countries. Therefore, the main objective of our study is to investigate differences in corporate governance and the design of contracts between venture capitalists and their portfolio firms across VC firm types.

Observing different contract approaches between different VC firm types does not necessarily imply that different types of venture capitalists apply different corporate governance approaches. The observed differences may also be due to a selection effect. Different types of venture capitalists finance different types of firms and thus need to use different types of contracts. Hence, it is crucial to disentangle the firm selection effects and the actual differences in the corporate governance approaches between VC firm types. In order to do so, the present study will apply different matching procedures.

Typology of VC Firms

The literature distinguishes between two types of venture capitalists: independent VC firms, which share the common objective of maximizing only monetary returns, and captive VC firms, whose objectives are complementary to the "assets" of the largest investor in the captive VC entity. These differences in objective entail that captive and independent venture capitalists finance different companies and develop different financing skills. Hence, each type of VC firm should have its own specific corporate governance approach and its own contract design.

Indeed, the literature has underlined these differences. Independent VC firms are normally active investors and thus tend to hold significant control rights and use contract mechanisms which allow for active intervention (see, for example, Cumming and Johan, 2009). Captive venture capitalists, on the other hand, provide less active support to their portfolio firms. Hence, our first hypothesis is that contracts between captive venture capitalists and their portfolio firms reflect this and include fewer measures that allow for active intervention on the part of the venture capitalist.

Furthermore, the academic literature often states that there also exist differences in corporate governance among the group of independent venture capitalists. It is noted, for example, that, in Europe, nationally operating VC firms are less hands-on than their internationally oriented counterparts (see, for example, Landier, 2003). Our second hypothesis aims at investigating the claim that international venture capitalists provide – via contract design – more monitoring and advice to their portfolio companies.

Empirical Approach

For the analysis, we use a proprietary, hand-collected data set from the German KfW Banken-

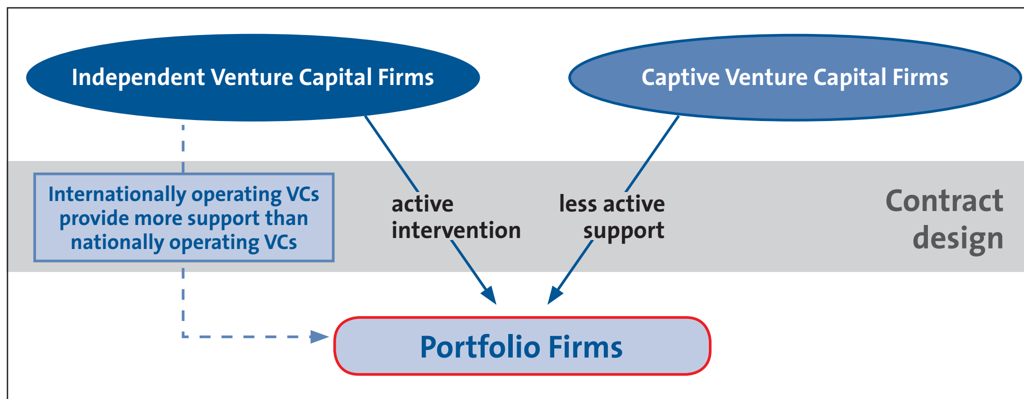

Figure 1: Contract design features across different types of venture capital firms

gruppe, which supports innovative German firms by promoting venture capital investments. Venture capitalists have to apply for this support by submitting the key details of their relationship with the portfolio firm, most notably, the term sheets, the business plans and the shareholder agreements involved. This gave us the unique opportunity to collect detailed information on the relationship between the venture capitalist and its portfolio firm based on actual contract data.

The existing empirical research on venture capital issues normally limits itself to taking into account an unspecified potential VC firm type effect (regarding contract design, investment behavior, active engagement as well as performance) by using different dummy variables or by looking into the differences in contracts between types of venture capitalists (see, for example, Cumming and MacIntosh, 2006). In order to disentangle the corporate governance effect and the selection effect, we apply a matching approach. Rather than only testing for the significance of such a dummy variable for VC firm type, we are able to give a comprehensive picture of the differences in contract design between types of VC firms after controlling for selection.

No Prototypical VC Contract

Our main finding is that there is no prototypical VC contract, but that there exist significant differences in corporate governance across the different types of VC firms, even when these are financing similar companies. In fact, independent venture capitalists use significantly more contract mechanisms that allow for active intervention than captive venture capitalists, though the differences are not significant with respect to control mechanisms. So, our first hypothesis is partially supported by the data.

In addition, our results confirm our second hypothesis that international independent venture capitalists are – via the design of their contracts – more active relative to national counterparts providing more advice to their portfolio firms. Nevertheless, the differences with respect to monitoring are much less pronounced.

Furthermore, these results have important implications for cross-country comparisons. They show that observed differences in contract design may rather be due to differences in the market composition of the respective VC industries than due to actual differences in the behavior of specific types of VC firms. Given that there are no legal or institutional peculiarities pertaining to the German VC market, we think that our results can be applied in a rather straightforward way to other VC markets even if they do not display such a wide variation in VC firm types.

Besides the fact that our results have important lessons regarding differences in corporate governance approaches across different types of VC companies, they also have important implications for assessing observed changes in contract design over time. Our findings imply that it is crucial to relate changes in contract design over time not only to learning effects but also to potential changes in the composition of the VC pool with respect to different types of VC firms. This is also crucial for cross-country comparisons of VC contracts because differences here may also be due to differences in the composition of the VC market and not (only) to the varying level of sophistication of the venture capitalists present.

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http://link.springer.com/article/10.1007/s11187-011-9388-6

Government Policies, Residential Mortgage Defaults, and the Boom and Bust Cycle of Housing Prices

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The genesis of the current financial crisis can be traced back to the housing sector. Easy access to cheap mortgage credit resulting from lax mortgage underwriting standards, coupled with liberal government mortgage lending policies, increased the demand for housing, causing an unprecedented rise in home prices – the housing price bubble. Indeed, the 2003 American Dream Downpayment Initiative provided increased financing for low income families. Between 2004 and 2007, Fannie Mae and Freddie Mac became the largest buyers of subprime and Alt-A mortgages, stimulating the growth of the subprime mortgage market. Following several legislative initiatives, Fannie Mae and Freddie Mac purchased over USD 6 trillion of mortgages from 1992 to 2008. This growth in housing prices was not sustainable. As interest rates rose, subprime mortgage defaults eventually increased to unprecedented levels, and because the supply of new home buyers became exhausted, home prices collapsed.

We develop a micro-based macro model for residential home prices in an economy where defaults on residential mortgages negatively affect housing prices. Our model enables us to study the impact of subprime defaults on prime borrowers and the impact of various government policies on the housing market boom and bust cycle. We show that subprime mortgage defaults, via their impact on aggregate housing prices and aggregate incomes, increase the incidence of prime mortgage defaults. There is a subprime default contagion effect. Secondly, we show the relative impact of various government fiscal and monetary policies for improving the housing market.

Although much has been written on measuring the effects of house prices on foreclosures and lending channels (e.g. Campbell, Giglio and Pathak, 2009), less has been written on the effect of housing prices on the macroeconomy. Mian, Sufi and Trebbi (2011) examine the negative price and real effects of foreclosures on durable consumption and residential investment. Favilukis, Ludvigson and Van Nieuwerburgh (2012) develop a two-sector general equilibrium model with production in housing and non-housing sectors to study the determination of equilibrium interest rates and aggregate output.

The Impact of Subprime Mortgage Defaults

Our paper extends this growing literature by building a micro-based macro model that captures the impact of the housing sector in terms of changing prices and foreclosures on macroeconomic variables, such as interest rates and aggregate income. In this regard, we construct a dynamic simulation model wherein we can analyze the impact of subprime mortgage defaults on prime defaults, housing prices, interest rates and aggregate income. This, in turn, enables us to study the relative impact of various government policies on these evolutions. The policies affect the economy through exogenous shifts to particular parameters in the relevant evolutions and thereby have an impact on default rates and house prices. The simulated evolutions capture the equilibrium dynamics in the economy because the evolutions are calibrated to market data using direct estimation, wherever possible, and the parameters of previous studies, where necessary. Furthermore,

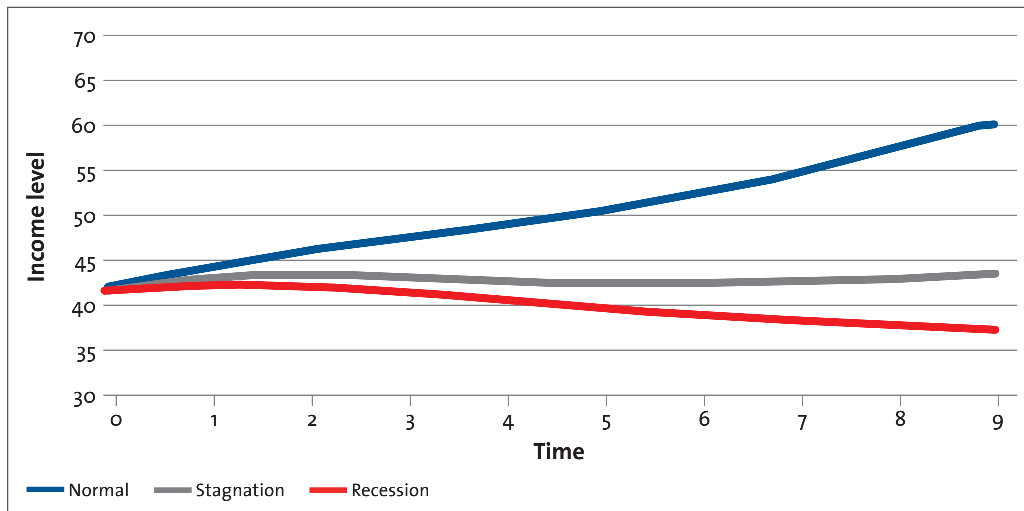

Figure 1: Monthly income level under the bubble scenario for different economies.

these simulations enable us to address the relative impact of various governmental policies, such as monetary policy, easy credit, and tax rebates on home prices and mortgage defaults.

The economy underlying our simulation model consists of four markets: (i) aggregate production, represented by aggregate income; (ii) a bond market, represented by the riskless spot rate of interest; (iii) the housing market, represented by an aggregate housing price index; and (iv) a mortgage market. All four markets are represented by the evolution of correlated price processes subject to the same random shocks across time. All four markets' price processes are interrelated, with feedback loops in both directions, except in the case of the bond market.

The mortgage market consists of a finite number of borrowers, each of whom purchases a house. The borrowers are of two types: prime or subprime. Prime borrowers have a higher credit quality. The personal income process for a borrower depends on his credit quality and the economy's aggregate income. The higher aggregate income and credit quality, the more extensive the borrower's personal income process, all else being constant (see Figure 1). All borrowers are issued fixed rate mortgage loans where the loan rate and down payment depend on the borrower's credit quality. The higher the credit quality, the lower the loan rate and the higher the down payment.

How to Defuse a Bursting Bubble

To understand the impact of various regulatory policies, such as monetary policy, easy credit, and tax rebates on housing prices and mortgage defaults, we calibrate the parameters of this system to match those in the U.S. economy, and we simulate the various paths implied by our dynamic economy. Our first comparative static documents the impact of these policies on reducing the impact of a bursting home price bubble, while the second comparative static studies whether these government policies can create such bubbles. Fiscal policies relating to direct government rebates or a loosening of borrowing standards have less of an impact than monetary policy.

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The full paper has been accepted for publication in Real Estate Economics and is available at:
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2212740

Deposit Insurance for Europe: Proposal for a Scheme with Limited European Liability

Jan Pieter Krahnen
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Of the three major institutional projects being planned under the overall Banking Union for Europe (common banking supervision, bank restructuring and deposit insurance), the creation of a European deposit guarantee scheme faces the strongest political reservations. Joint and several liability beyond national borders – be it with regard to the liabilities of individual states or the protection of bank depositors – faces significant opposition. Also from an economic perspective, there are strong reasons against a comprehensive mutualization of liability. There is the danger that a general assumption of liability by a European structure would negatively impact the efforts necessary at the national level to control and contain banking risks.

However, it should not be forgotten that there are also important reasons in support of a merger of national deposit guarantee schemes. The limited credibility of a national deposit guarantee scheme must be mentioned here – especially if the economies concerned are small or cover only a few individual institutions. The weak protection offered by small states to their depositors creates the risk of an (in)solvency nexus between banks and states. Furthermore, due to the increasing number of institutions active in retail banking across Europe, there is a growing risk of crisis-related contagion effects that extend beyond national borders.

Arising from the above is the demand for a solution to the European liability problem that meets two requirements: First, the deposit guarantee scheme should present a credible protection of deposits. Second, the mutualization of liability must be designed such that moral hazard is minimized.

The Current Two-Stage Model

The existing model for a European deposit guarantee scheme – the so-called "two-stage model" – only meets the first of these two requirements. A simple assumption of the liability for the savings deposits of all of Europe's banks by a European fund would indeed have a liability mutualization effect – including the above-mentioned negative risk incentives. For this reason, a replacement of a national deposit guarantee scheme by a comprehensive European solution is to be rejected just as much as a two-stage solution, whereby European protection is second to the existing national protection. This is because, under a two-stage solution, moral hazard is not only particularly high, but also related to a lax first stage of national deposit insurance – and is thus particularly problematic. Both a one-stage and a two-stage concept for a European deposit guarantee scheme rightly meet with great political resistance and probably have little prospect of realization.

A Three-Stage Scheme with Limited European Reinsurance

The alternative three-stage model presented here includes two essential structural innovations: a European reinsurance at the second stage of insurance, and a national government insurance for major losses at the third and ultimate stage of the insurance scheme.

Stage 1 consists of the existing national deposit guarantee model in a largely unchanged manner. Bank deposits of up to a certain amount – e.g. EUR 20,000 – are insured under this scheme. The national fund charges risk-related fees from its member banks and accumulates capital in a special fund. The fund is backed by a guarantee of the national government. Furthermore, subsequent to a damage incidence, it can raise contributions by way of special charges.

Stage 2 takes over the excess losses up to a pre-specified maximum amount per account, or per account holder. For example, the liability of this second stage could be limited to EUR 100,000. Over time, sufficient guarantee assets will also be built up in a dedicated reserve fund, financed via risk-related fees and, where necessary, special charges. With an insurance covering deposits between EUR 20,000 and EUR 100,000, this second European stage of the alternative proposal operates similar to a disaster reinsurance scheme: damages beyond those assumed by the primary insurance will be covered up to a predetermined maximum amount.

Stage 3 involves those major damages arising from bank insolvencies which exceed the scope of the national primary insurance plus the European reinsurance. For these cases, it is foreseen that claims above the coverage provided are, in turn, charged to the national treasury. In other words, the first and last stages of the alternative proposal will be covered by national funds. The middle stage of the European deposit guarantee concept, in contrast, will be covered at the common, European level.

Further Considerations

- The extent of the European liability on stage 2 should vary in size according to the home state of an institution, for example, being a multiple of the national deposit guarantee provided under the first stage. If this multiple were to be "four", then the European protection would account for a further EUR 80,000 above the EUR 20,000 secured at the national level.

- The two lower stages would each charge their own premium, which allows for the build-up of an appropriate asset base. Over time, these fund assets would lend credibility to the commitments made under the deposit guarantee scheme.

- For a transitional period, the provisioning of the asset base could be made possible by a loan from the ESM. The loan would be paid off gradually whilst the asset base is slowly built up via premiums and special charges.

- With regard to the national first stage, it should be ensured that there is a level playing field. All national organizations should feature comparably high premiums and a building up of asset volumes in order to ensure that recourse to European reinsurance follows a comparably high own contribution.

The full article is available at:
http://safe-frankfurt.de/policy-publications

Selected Policy Center Publications

Böcking, H.-J., Gros, M., Worret, D. (2013)
„Stellungnahme zu aktuellen Formulierungsvorschlägen für Änderungen am Deutschen Corporate Governance Kodex",
Policy Letter No. 5/2013, SAFE Policy Center

Gründl, H. (2013)
„Stellungnahme zum Gesetzentwurf der Bundesregierung: Finanzkonglomerate-Aufsichtsgesetz",
Policy Letter No. 7/2013, SAFE Policy Center

Krahnen, J. P., Kemmer, M. (2013)
"Zukunft der Universalbanken",
Policy Letter No. 9/2013, SAFE Policy Center

Krahnen, J. P., Mayer, T. (2013)
„Managementvergütung im Bankensektor",
Policy Letter No. 4/2013, SAFE Policy Center

Langenbucher, K. (2013)
„Legal aspects of gender balance on corporate boards in Germany",
White Paper No. 2/2013, SAFE Policy Center

Orphanides, A. (2013)
„What happened in Cyprus",
Policy Letter No. 6/2013, SAFE Policy Center

Remsperger, H. (2013)
„Zentralbankpolitik: Überforderung statt Langeweile?",
White Paper No. 3/2013, SAFE Policy Center

A Behavioral Perspective on Transparency

On 15 and 16 March, the SAFE Transparency Lab (Program Director: Guido Friebel), co-organized the European Workshop on Experimental and Behavioral Economics that brought together views on some of the behavioral foundations for transparency. Under the heading "Information, Communication, Transparency: Foundations for Financial Decisions", the presentations and discussions focused on transparency issues related to the financial markets and consumer behavior.

About 50 experimental economists, including 19 PhD candidates, from nine countries presented and discussed new academic work in this area. The research presented dealt, among other issues, with investors' financial decision making, the costs and benefits of delegated regulation, the emergence and implications of money illusion, and the psychological costs of cheating. One of the lessons drawn from the experimental evidence in the lab and elsewhere is that, where investors and consumers are lacking information about relevant parameters, such as the profitability or risk exposure of assets or the behavior of the people managing them, a financial system will ultimately be destabilized. Transparency appears to be an important input into the stability of a financial system, and a lack of transparency constitutes a dangerous trigger for crisis. This applies to subprime real estate and government bonds alike.

Call for Proposals: Austerity and Economic Growth

SAFE is calling for proposals for academic research projects on "Austerity and Economic Growth: Concepts for Europe". The objective is to promote papers that examine the nature of the relationship between austerity, debt sustainability and growth. A special focus will be on the impact of austerity programs on the real economy and the effects on consumption, investment, jobs and growth. Researchers are invited to submit proposals with a compact research outline. An international committee of high-calibre referees chaired by Alfons Weichenrieder will select five projects to receive a grant of EUR 10,000 each. The researchers will be asked to present their work at a SAFE conference in Frankfurt and to transfer their results to a policy publication. Deadline for submission is August 31st. More information can be found on the SAFE website.

SAFE hosts May Meeting of Review of Economic Studies

On 13 and 14 May, the Center of Excellence SAFE hosted a May meeting of The Review of Economic Studies at Goethe University's House of Finance – one of three in Europe. Every year since 1989, in line with the Review's tradition of encouraging the work of young economists, seven of the world's most promising doctoral students in economics and finance have been selected to present their research at major universities across Europe. Among this year's presenters were graduates from Harvard University, Yale University, MIT, Columbia University and Northwestern University. The Frankfurt meeting was organized by Nicola Fuchs-Schündeln, coordinator of the SAFE Graduate Program and a member of the Review's Editorial Board, as well as Ctirad Slavik, Assistant Professor of Macroeconomic Theory.

Brigitte Haar appointed to the BaFin Administrative Council

Brigitte Haar, Chair of Private Law, German, European, and International Business Law, Law and Finance, and Comparative Law, has been appointed to the BaFin (Germany's Federal Financial Supervisory Authority) Administrative Council for a five-year term by the Federal Ministry of Finance. Apart from its responsibility to decide on BaFin's budget, the Administrative Council has the task to monitor the organization's management and to advise the BaFin with regard to its supervisory duties.

Journal of Accounting Research Conference in Frankfurt

In a one-off departure from the longstanding tradition of holding the conference in Chicago, the 2013 Journal of Accounting Research Conference was held at Goethe University in Frankfurt on 17 and 18 May. The conference was organized by Christian Leuz (Chicago Booth School of Business and SAFE) with the support of the SAFE Transparency Lab. More than 150 accounting researchers from leading US departments discussed current research. Topics included the impact of frequent reporting on managerial short-termism, the effects of information shocks on dividend payouts, and borrowers' disclosure behavior when bank health is declining. The day before the conference, 30 PhD students and faculty members from Chicago Booth and Goethe University met at a workshop in which students presented their work and collected suggestions on how to improve. The Transparency Lab will continue this format for upcoming events.

Controversial Debate on Banking Regulation

On 19 April, Theodor Weimer, Board Spokesman of the HypoVereinsbank, and Jan Pieter Krahnen, Director of the Center of Excellence SAFE and the Center for Financial Studies, discussed the implications of new banking regulations on systemic stability and competition. The talk was part of the SAFE Policy Center series on structural reforms in the European banking sector.

Weimer admitted that the banking sector had taken too much risk before the crisis while having only a low capital endowment. Therefore, a better regulation of the banking sector is necessary. Regulators should, however, take care that they do not threaten the existence of smaller banks by imposing too many costly rules. As an example, Weimer pointed to the Liikanen Group's recommendation to separate commercial banking and market making activities from customer-related business.

Krahnen, who was in fact a member of the Liikanen Group, replied that this recommendation was necessary to make bank resolution possible even if banks are linked to each other. However, he rejected the "Liikanen light" proposal of the German government that plans to cut off proprietary trading, but not trading on behalf of customers and market making. Splitting up these activities is nearly impossible, Krahnen said. He added that if this proposal were to be implemented, disproportionate costs would arise in relation to the increase in stability.

Selected Publications

Bülbül, D. (2013)
"Determinants of trust in banking networks",
Journal of Economic Behavior & Organization, Vol. 85, January 2013, pp. 236-248.

Cahn, A., Müchler, H. (2013)
"Produktinterventionen nach MiFID II – Eingriffsvoraussetzungen und Auswirkungen auf die Pflichten des Vorstands von Wertpapierdienstleistungsunternehmen",
Zeitschrift für Bank- und Kapitalmarktrecht (BKR), Vol. 2, pp. 45-55.

Faia, E., Lechthaler, W., Merkl, C. (2013)
"Labor Selection, Turnover Costs and Optimal Monetary Policy",
forthcoming in Journal of Money, Credit and Banking.

Florstedt, T. (2013)
"Finanzkrise als Krise der Normbehauptung",
Zeitschrift für Bankrecht und Bankwirtschaft (ZBB), Vol. 2, p. 81ff.

Friebel, G., Guriev, S. (2012)
"Whistle Blowing and Incentives in Firms",
Journal of Economics & Management Strategy, Vol 21, Issue 4, pp. 1007-1027.

Haar, B. (2013)
"Normanerkennung, -befolgung und Economic Behavior – eine Studie zu Verbindlichkeitsstrukturen im Wirtschaftsrecht am Beispiel der Corporate Governance",
Goethe-Universität Frankfurt am Main Arbeitspapier Nr. 1/2013, forthcoming in Archiv für Rechts- und Sozialphilosophie.

Haferkorn, M., Zimmermann, K. (2013)
"Securities Transaction Tax and Market Quality – The Case of France",
forthcoming in 40th Annual Meeting of the European Finance Association, Cambridge, UK.

Hebous, S., Zimmermann, T. (2013)
"Estimating the effects of coordinated fiscal actions in the euro area",
European Economic Review, Vol. 58, pp. 110–121.

Hengelbrock, J., Theissen, E., Westheide, C. (2013)
"Market Response to Investor Sentiment",
forthcoming in Journal of Business Finance and Accounting.

Imbierowicz, B., Wahrenburg, M. (2013)
"Wealth transfer effects between stockholders and bondholders",
The Quarterly Review of Economics and Finance, Vol. 53, Issue 1, pp. 23-43.

Kraft, H., Steffensen, M. (2013)
"A dynamic programming approach to constrained portfolios",
European Journal of Operational Research, Vol. 229, pp. 453-461.

Langenbucher, K. (2013)
"Insider Trading in European Law",
Bainbridge (Ed.), Research Handbook on Insider Trading, Edward Elgar.

Schlereth, C. (2013)
"Pricing Plans for a Financial Advisory Service",
forthcoming in European Journal of Marketing (EJM).

Wandt, M. (2012)
"Transparenz als allgemeines Prinzip des Versicherungsrechts",
in Gedächtnisschrift für Ulrich Hübner, pp. 341-353.

Recent SAFE Working Papers

No. 21 **Corradin, S., Gropp, R., Huizinga, H., Laeven, L.**
"Who Invests in Home Equity to Exempt Wealth from Bankruptcy?"

No. 20 **Adams, Z., Füss, R., Gropp, R.**
"Spillover Effects among Financial Institutions: A State-Dependent Sensitivity Value-at-Risk Approach"

No. 19 **Gropp, R., Gruendl, C., Guettler, A.**
"Hidden Gems and Borrowers with Dirty Little Secrets: Investment in Soft Information, Borrower Self-selection and Competition"

No. 18 **Weichenrieder, A. J., Zimmer, J.**
"Euro Membership and Fiscal Reaction Functions"

No. 17 **Kraft, H., Seifried, F. T.**
"Stochastic Differential Utility as the Continuous-Time Limit of Recursive Utility"

No. 16 **Ascheberg, M., Branger, N., Kraft, H.**
"When Do Jumps Matter for Portfolio Optimization?"

No. 15 **Kraft, H., Munk, C., Seifried, F. T., Wagner, S.**
"Habits and Humps"

No. 14 **Bursian, D., Faia, E.**
"Trust in the Monetary Authority"

No. 13 **Laurent E. Calvet, Paolo Sodini**
"Twin Picks: Disentangling the Determinants of Risk-Taking in Household Portfolios"

No. 12 **Bluhm, M., Faia, E., Krahnen, J. P.**
"Endogenous Banks' Networks, Cascades and Systemic Risk"

No. 11 **Branger, N., Kraft, H., Meinerding, C.**
"How Does Contagion Affect General Equilibrium Asset Prices?"

No. 10 **Eisert, T., Eufinger, C.**
"Interbank network and bank bailouts: Insurance mechanism for non-insured creditors?"

No. 9 **Eufinger, C., Gill, A.**
"Basel III and CEO compensation in banks: Pay structures as a regulatory signal"

No. 8 **Angeloni, I., Faia, E., Lo Duca, M.**
"Monetary Policy and Risk Taking"

A New Paradigm for Monetary Policy?

Otmar Issing
Center for Financial Studies

The financial crisis starting in 2007 unavoidably triggered memories of the Great Depression and its dire economic, political and social consequences. From the many studies on that period, one clear message has emerged: the follies of that time must be avoided, and the world must be saved from a repetition of that disaster. As a result, all major central banks reduced their interest rates to exceptionally low levels. In fact, the expansionary monetary policy was extended beyond the zero bound by also implementing several kinds of so-called "unorthodox" measures.

This timely reaction to the crisis prevented the collapse. However, exit from unorthodox measures is a daunting challenge. In the context of the zero bound, it is very difficult to calculate the monetary policy stance and the impact of any changes – withdrawing liquidity and/or raising interest rates? How will markets react? The process is complicated by the fact that a period of extremely low interest rates contributes to higher risk-taking, masks underlying weaknesses in balance sheets, and makes the financial sector increasingly vulnerable to a change of regime.

Extremely low interest rates also have an effect on governments: they are hardly conducive to fiscal discipline. And huge stocks of government bonds expose central banks to economic risks and political pressure. Paradoxical as it seems, the very consequence of large unorthodox measures by central banks could be that they contribute to or even create a situation of fiscal dominance.

Under these circumstances, when should the central bank consider raising interest rates? The answer depends crucially on the assessment of the economic situation and implicit risks to price stability. Where economic problems are caused by a collapse of financial markets, the result is much different from a "normal" cyclical downturn. If economic problems are not of a monetary nature, there is certainly no argument for further quantitative easing. Given the situation today, the case for ending the period of zero interest rates becomes more and more relevant.

Apart from the issue of exiting from unorthodox measures, the worldwide discussion has focused on the need for a new monetary policy regime with an appropriate institutional arrangement. The case for independence seemed settled with the experience that inflation correlates negatively with the degree of independence of the central bank. What is the reason for this new discussion? Under present institutional arrangements, i.e. representing de jure independence, it is the politics of central banks which meets with criticism.

When the extremes of following a strict rule and pure discretion are excluded, the distinction between rules and discretion becomes a matter of degree. "Rules with discretion" seems to be a rather vague concept. This is, however, not the case once the basic idea is respected that the rule should be the compass and deviations from the rule have to be explained. A rule-based monetary policy facilitates transparency and makes it clear that accountability is related to the achievement of the final goal. Independence from political influence allows the central bank to take the appropriate monetary policy decisions. For an independent central bank with a clear mandate to maintain price stability, accountability is restricted to a "technocratic" task. If the central bank's independent status is exposed to strong political opposition, giving up independence de facto may be seen as an option to preserve de jure independence. However, this would come at the expense of undermining the fundament of independence for the central bank.

Greater flexibility and tolerance for inflation, closer coordination with fiscal policy at home, and a broader mandate including financial stability are the main arguments for a reorientation of monetary policy. In light of that, one might ask for a new paradigm for the conduct of monetary policy. But, learning the right lesson would rather bring us to a recollection of lost or ignored principles. The new debate on the status of central banks demonstrates that the consequences of "rules versus discretion" should be reconsidered and the independence of the central bank should be preserved via a single mandate and corresponding behavior on the part of the central bank.

A longer version has been published as CFS Working Paper 2013/2 and is available at:
www.ifk-cfs.de/publications/working-papers

Events

July

Monday, 1st
5.00 pm

EFL Jour Fixe
Uncoordinated Circuit Breakers in Fragmented Markets
Speaker: Kai Zimmermann, E-Finance Lab

Wednesday, 3rd
7.30 pm

ILF Guest Lecture
Reforming Securities and Derivatives Trading in the EU: Public vs. Private Markets
Speaker: Guido Ferrarini, University of Genoa

Wednesday, 3rd
5.15 pm

Applied Microeconomics & Organization Seminar
Speaker: Fabian Herweg, LMU Munich

Sunday, 7th – Tuesday, 9th

Conference
Marketing Strategy Meets Wall Street III

Wednesday, 10th
5.15 pm

Applied Microeconomics & Organization Seminar
Speaker: Dorothea Kübler, TU Berlin

Thursday, 11th
12.15 – 13.45 pm

Frankfurt Seminar in Macroeconomics
Speaker: Greg Veramendi, Arizona State University

Thursday, 11th

LEMF Seminar
Why Do Retail Investors Make Costly Mistakes? An Experiment on Mutual Fund Choice
Speaker: Jill E. Fisch, Institute for Law and Economics , University of Pennsylvania Law School

Tuesday, 16th
8.30 – 9.30 am

SAFE Policy Center Gesprächsreihe zu Strukturreformen im Europäischen Bankensektor
Wiederherstellung privater Haftung und die zukünftige Rolle der Aufsicht
Speaker: Elke König, Bundesanstalt für Finanzdienstleistungsaufsicht, Jan Pieter Krahnen, SAFE & CFS

Tuesday, 16th
4.15 pm

Finance Seminar
Speaker: Lubos Pastor, University of Chicago Booth School of Business

Thursday, 18th
12.15 – 13.45 pm

Frankfurt Seminar in Macroeconomics
Recession Scars and the Growth Potential of Newborn Firms in General Equilibrium
Speaker: Petr Sedlacek, University of Bonn

Thursday, 18th
7.00 pm

Goethe Business School – Information Session
Part-time-Master in Finance
Speaker: Uwe Walz, Goethe University

Monday, 22nd
5.15 pm

Applied Microeconomics & Organization Seminar
Speaker: Katja Seim, Wharton School, University of Pennsylvania

August

Monday, 12th – Saturday, 17th
10.00 am – 5.00 pm

LEMF Summer School 2013
Law and Economics of Banking
Speaker: Gérard Hertig, ETH Zurich
Geoffrey Parsons Miller, New York University

Monday, 26th – Friday, 6th

ILF Summer School
Banking and Capital Markets Law

Tuesday, 27th

ILF Conference with Hogan Lovells

Friday, 30th

SAFE Policy Center Summer Academy
International Financial Stability: Thought Leadership and Best Practice in Addressing European Banking Regulation
Organization: Günter Beck, SAFE & University of Siegen

September

Thursday, 5th – Friday, 6th

ICIR Jahreskonferenz
Global Insurance Supervision

Thursday, 18th
7.00 pm

Goethe Business School – Information Session
Part-time-Master in Finance
Speaker: Uwe Walz, Goethe University

Wednesday, 18th – Saturday, 21st
9.00 am – 6.00 pm

Four Day Finance Seminar
Financial Risk Management

Friday, 20th – Saturday, 21st

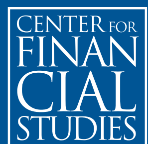
European Conference on Household Finance

Thursday, 26th
12.00 – 5.30 pm

Deutsche Bank Prize in Financial Economics – Award Ceremony and Symposium
Banking, Liquidity, and Monetary Policy

Please note that for some events registration is compulsory.

CFS Center for Financial Studies
EFL E-Finance Lab
ICIR International Center for Insurance Regulation
ILF Institute for Law and Finance
LEMF Doctorate/PhD Program in Law and Economics of Money and Finance



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