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Leibniz Institute for Financial Research SAFE

Dear Marius Luta,

Welcome to the latest edition of *SAFE Update*, the Leibniz Institute SAFE digital newsletter. In this issue, we focus on the potential for shaping European bank resolution in the interests of retail investors and look at research into firms in industries leading the business cycle.

We hope you find this newsletter of interest and would welcome your feedback to the editorial team at newsletter@safe-frankfurt.de.

Focus: Making bank resolution more effective

Flaws for retail investors in Europe's CMDI framework can be fixed

The European Commission is currently revising the bank crisis management and deposit insurance (CMDI) framework, and, from the perspective of researchers at the Leibniz Institute for Financial Research SAFE and the University of Siena, not a moment too soon – especially in respect of bail-inable securities held by retail investors at bank resolution.

In a SAFE Working Paper, Tobias Tröger and Irene Mecatti point out that putting bail-inable debt into the wrong hands undermines the credibility of the bail-in tool. The first applications of the CMDI framework illustrate that bailing-in debt instruments sold to retail customers by ailing banks (self-placements) can cause severe harm to consumers who are financially less secure. Politicians and regulators therefore have strong incentives to bail out bank capital and debt holders, thereby undermining market discipline.

The researchers emphasize that, despite recent reforms, the regulatory framework remains insufficient to address the retail challenge adequately. Tröger and Mecatti believe that retail investors should not be completely excluded from investing in bail-inable securities as such a ban would restrict investment opportunities for retail investors, as well as market liquidity, to an excessive degree, especially in the case of small and medium-sized banks. Crucially, however, as Tröger and Mecatti explain, not all retail investors are suitable risk-takers under all circumstances given that they may lack the necessary capacity to absorb losses and properly assess the risks of their investment.

Accordingly, the paper makes several suggestions to improve the current regime. Given that many retail investors have little or no experience with securities, one proposal is that a high minimum denomination should be made mandatory if subordinated bonds are sold to retail investors. Moreover, the regulatory framework should facilitate adequate risk calculations ex ante by making resolution outcomes as predictable as possible. This would mean not only limiting the discretion of resolution authorities, but also reducing the differences in burden-sharing in resolution under the CMDI on the one hand, and liquidation under national (bankruptcy) laws on the other. Finally, self-placements should be banned outright, with banks instead being required to place their securities through an independent and financially sound investment firm.

[Find the SAFE Working Paper No. 379 here]

Research Highlight: Leading industries perform as indicators

The Leading Premium

by SAFE Bridge Professor Christian Schlag, Mariano

Massimiliano Croce (Finance Department, Bocconi University and Center for European Policy Research), and Tatyana Marchuk (BI Norwegian Business School).

In their paper “The Leading Premium”, forthcoming in the *Review of Financial Studies*, the authors demonstrate that industries which lead the business cycle provide information with the potential to reduce the risk of investing in firms in those which follow.

Based on pre-existing findings about aggregate indicators, Schlag and his colleagues differentiate economic sectors according to their response to an exogenous shock: “leading” industries experience shocks early and thus lead the business cycle, whereas “lagging” sectors are affected at a later date. Although leading and lagging industries are very similar across a wealth of domains, there is a significant lead-lag structure in fundamental cash flows across them, and this lead-lag structure also has an impact on risk premia.

Assuming that industry cash flows are infrequently affected by industry-specific growth shocks which subsequently spread to other industries, the authors develop a new model to show that industries first exposed to an exogenous shock provide valuable anticipated resolution of uncertainty for industries affected with a delay. Since cash flow in leading industries helps to predict the cash flows in lagging ones, firms which operate in the latter bear less conditional cash-flow uncertainty and are thus less risky for investors. This leads to lower expected returns for those firms, i.e. to a lower compensation for risk.

Firms in leading industries, on the other hand, perform as early indicators, and are thus riskier. Consequently, they must offer a higher equity yield to be attractive for investors. According to the authors, this can be up to two percent higher than that of lagging industries on a yearly basis. This difference in equity yield between the different types of industries expresses a premium on advance information – or, in other words, 'the leading premium'.

Furthermore, statistically significant empirical findings on industry-level cash flows in the US illustrate that this premium is highly relevant to explaining the cross-section of stock returns, as leading industries exhibit an average return that is approximately 3.6 percent higher than that of lagging industries.

[Find the research paper here]

#SAFEtheDate

Review
At this year's Leibniz Economic Summit on 14 February, the heads of the economic research

institutes under the umbrella of the Leibniz Association discussed how Europe can withstand a looming recession and retain a strong economic position compared to global competitors such as China and the USA. During the debate, SAFE Director Florian Heider pointed towards the substantial, but as yet untapped potential of a Europe-wide capital markets union. Read the follow-up report and rewatch the video of the event here.

Outlook
Deadlines for two calls of papers for academic conferences which are co-organized by SAFE expire in March 2023. Submissions for the Second Interdisciplinary Workshop "Financial Regulation - Going Green" are accepted until 5 March. The workshop is hosted by the School of Business and Economics at the Humboldt University Berlin and will be held on 4 May; papers for the Annual Meeting of the Central Bank Research Association (CEBRA) can be submitted until 10 March. The CEBRA meeting will be held at the Federal Reserve Bank of New York on 5 July and continues on 6 and 7 July at Columbia University's School of International and Public Affairs, New York City, USA.

Handpicked

Alexander Hillert, Professor for Finance and Data Science and Program Director of the SAFE Data Center, recommends an episode of the New York Time's

podcast *The Daily*:

“Has artificial intelligence become too clever? At first, this question may sound surprising. Yet, with the recent advances in AI’s natural language processing capabilities and the arrival of Open AI’s ChatGPT and Google’s competitor product Bard, the question is highly relevant. After its introduction at the end of 2022, ChatGPT has gone viral, being applied, for example, by students to ‘write’ essays and by doctors to send letters to insurance companies requesting treatment for their patients. While students using ChatGPT to cheat in exams is certainly not a desirable outcome, there could be even more urgent problems in store: what if such algorithms are used to create fake news on an unprecedented scale, for instance? While ChatGPT’s answers to questions are not always correct, they sound pretty convincing and, thus, people might not realize that they were misinformed. Another worry: what happens if ChatGPT is quizzed on sensitive topics (‘How do I build a bomb?’) The NYT's podcast episode tackles these issues head-on and so is absolutely worth listening to.”

Find the podcast episode here

News & Latest

- **News:** Lottery stocks: A gambling proxy for the affluent
- **Video:** SAFE-CEPR Policy Lecture: Stabilizing Financial Markets - Lending and Market Making as a Last Resort
- **SAFE Finance Blog:** Ample liquidity puts the ECB's independence at risk (by Ignazio Angeloni)
- All upcoming events and SAFE publications

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