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Newsletter Q2

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Editorial

Ladies and gentleman,
dear friends of the House of Finance,

Almost 30 professors in the areas of finance, money and macroeconomics, and corporate and financial law* moved into the new House of Finance (HoF) building at Frankfurt's Goethe University nine months ago. They were joined by 120 research assistants and 50 administrative staff members.

Together we pursue the vision that interdisciplinary research and teaching provide better answers to the imminent challenges for the financial world. We strive for high quality research that is published widely, including top international journals, as well as for further enhancing the transfer of knowledge towards business and civil society.

We have made substantial progress in integrating the different disciplines in the HoF, in fostering a public-private research and teaching partnership, and in cooperating with the various independent institutes that are also located within the HoF. Moreover, against the background of these immense challenges we still – no wonder – have a very long way to go. In order to provide the general public as well as the numerous HoF stakeholders with concentrated information on this deepening integration process, we have designed this newsletter. The newsletter, which will be issued on a quarterly basis, will also offer some of the latest research findings, plus news about executive education at the HoF. It can be sent to you at your request in either printed or digital format.

Each issue will comprise a description of three research results – of two pages each – complemented by an interview, an editorial, and also some notes on publications produced outside the HoF.

We hope that you will find the newsletter concise, exciting, and highly relevant. We want to ensure that it is as useful as possible, so please let us know if you would like to propose any changes (see page 2 for contact information). We will only have a serious chance of reaching our goals if we deepen the integration within the HoF step-by-step, and if we are capable of appropriately integrating important outside academics and practitioners into our work. Thus, we ask you for your cooperation and we thank you for all your support in this regard.

With best wishes,

Prof. Dr. Dr. h. c. mult. Otmar Issing
Chairman of the Council of the House of Finance

* *In addition, researchers for Information Systems, Mathematics, and Computer Science complement the pool of talent in the HoF.*

In a recent paper, Roman Inderst and Sebastian Pfeil assess the case for forcing financial institutions to defer bonus payments, as it is proposed by numerous top-ranking politicians. The intention here is to thereby realign individual incentives with the long-term risk of financial firms.

Is there a case for REGULATING COMPENSATION *in the Financial Industry?*

Prof. Roman Inderst • Institute for Monetary and Financial Stability (IMFS)

Sebastian Pfeil • Institute for Monetary and Financial Stability (IMFS)

According to conventional wisdom, one of the main factors behind the current financial crisis is the prevalence of bonus-driven compensation schemes in the financial industry. Because investment bankers, mortgage brokers, etc. receive bonuses that are mainly based on yearly or even shorter-term measures of success *(e.g., most extremely in the form of a fixed upfront commission)*, they take little account of the longer-term risks imposed by their specific transactions. Common wisdom then goes on to conclude that because of this, financial institutions have taken on too much risk. Consequently, practitioners as well as academic scholars demand regulatory intervention. In particular, they demand that financial institutions should be forced to defer substantial parts of the bonus pool.

While, at least with hindsight, financial institutions have taken on too much risk *(both with respect to their own interest and with respect to overall financial stability)*, bonus-driven incentive schemes are not the cause, but the means through which this risk imbalance was created. As regards the design of compensation schemes, financial institutions – at least, when they are well governed – trade-off the costs of compensation and incentives so as to maximise profits. The argument that they fail to do so, e.g., as they find themselves in a rat race to attract the best staff, is utter nonsense: for the right risk premium in the form of higher compensation, any banker will accept a more long-term incentive plan. But banks and other financial institutions were obviously not willing to pay this premium or, for that matter, to rein in risk-taking incentives at all.

They themselves had a high appetite for risk.

This suggests, however, that the means to curb risk-taking incentives, provided that this is in the social interest, can be found in the standard toolbox; most notably through stricter capital adequacy requirements. If there is a justification for meddling with firms' internal wage strategies, then at least the proponents of such corrective actions have not proposed a convincing argument so far.

Against this background, one contribution of the theoretical work by Roman Inderst and Sebastian Pfeil is to provide a consistent rationale for regulating compensation in the proposed way. But it equally shows the severe shortcomings of such interference. Their academic work derives in a logically consistent way conditions for when forcing banks to defer bonus compensation will indeed result in less risky transactions. But it also shows that this may have the unintended consequence of leading to a lower quality of assets and higher risk.

At the heart of their analysis, as well as of much of modern banking theory, lie agency problems: in this case, the interaction of an internal agency problem within the financial institution and an external agency problem vis-á-vis the buyers of securities issued by the bank. The internal agency problem stems from delegation, e.g., of loan origination to the respective loan officer.

A crucial conflict of interest arises from the multi-task nature of the agent's job, which typically involves both generating new transactions and, at the same time, performing due diligence in the assessment of such transactions. Deferred compensation can help to overcome this conflict of interest, albeit at a cost, as employees will then require a higher risk and liquidity premium as part of their compensation packages. Short-term and high-powered incentives are, instead, cheaper for the financial institution, albeit leading to the erosion of the quality of deals.

Securitisation allows a financial institution to shed some or even all of the risk, increasing the incentive to resort to such short-term and more high-powered compensation. Rational investors should, at least in the long term and in the absence of other motives *(such as regulatory arbitrage)*, anticipate such behaviour, and shy away from the respective papers. In terms of economic theory, securitisation thus creates a deep-rooted incentive problem between a bank and the potential buyers of the securities it issues. This problem is aggravated by the internal agency conflict within banks themselves.

Without regulatory interference, banks may not be able to credibly commit to a high quality of the securitised assets, i.e., to closely monitor asset quality and to provide their agents with less deal-oriented incentives.

This is where policy interference could come in.

By forcing financial institutions to defer compensation, they could be induced to use the additional, long-term information, e.g., on early default or the (market) re-pricing of certain tranches. The key result of the modeling exercise is to derive conditions when this is, however, counter-productive: it then makes high-powered, deal-oriented incentives relatively cheaper, which further undermines the institution's commitment problem and leads to a decline in average asset quality.

On the other hand, the model helps to delineate the conditions for when such interference could improve social welfare, even when imposed against banks' own interests. This is more likely to be the case when buyers of securities do not properly assess the strategic incentives banks have to erode *(over time)* the quality of securitised deals. But when regulation is willing to micro-manage financial institutions' compensation or their business strategies, regulators could, alternatively, impose limits on securitisation *(e.g., through mandatory retention of "first-loss tranches")*.

Further work will analyse whether and when such policies have indeed the intended consequences of improving social welfare and when this is not the case.

The article is available at:
http://www.wiwi.uni-frankfurt.de/profs/inderst/Corporate_Finance_and_Banking/inderst_pfeil_bankerbonuspay_draft1.pdf

The Crisis of Fair Value Accounting: Making Sense of the Recent Debate

In our article, we attempt to make sense of the current fair value debate and discuss whether many of the arguments hold up to further scrutiny.

The recent financial crisis has turned the spotlight on fair value accounting (FVA) and led to a major policy debate involving, among others, the US Congress, the European Commission as well as banking and accounting regulators around the world. Critics argue that FVA has significantly contributed to the financial crisis and exacerbated its severity for financial institutions in the US and around the world. On the other hand, proponents of FVA argue that it merely played the role of the proverbial messenger that invariably gets shot. In our article, we attempt to make sense of the current fair value debate and derive four main conclusions.

Firstly, much of the controversy about FVA results from confusion about what is new and different about FVA as well as different views about the purpose of FVA. Under both United States Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS), there is a mixed attribute model with a multitude of rules stipulating that some items are reported at fair value and that others are reported at historical cost. Moreover, unrealised gains and losses of items that are reported at fair value may or may not affect net income, depending on their classification. For instance, Financial Accounting Standards 115 (FAS 115), which was already implemented in 1994, requires that both trading securities and available-for-sale securities (AFS) are reported in the balance sheet at fair value. But in the income statement, unrealised gains and losses, i.e., changes in these values, are recognised for trading securities only. In contrast, financial instruments that are held to maturity are reported at amortised costs. Therefore, one has to be careful about the extent to which arguments against FVA apply to current accounting standards or to full FVA for all assets and liabilities. The debate about FVA takes us back to several old accounting issues, like the trade-off between relevance and reliability, which have been debated for decades. Except in rare circumstances, standard setters will always face these issues and trade-offs; FVA is just another example.

In discussing the potential problems of FVA, it is important to also consider the alternative. Even if one is sympathetic to the arguments against FVA, it does not automatically follow that historical cost accounting (HCA) would be better. At times, FVA may not provide relevant information, but in many cases, (amortised) historical cost accounting (HCA) does not provide relevant information either. Even for assets that are held to maturity (e.g., loans), investors might care about current market values. Moreover, it is surprising that some commentators seem to believe that HCA is a sound basis for capital requirements or that the liquidity of an asset should play no role when market values and liquidity play an important role in determining (ongoing) margin or collateral requirements.

Secondly, there are legitimate concerns about marking asset values to market prices in times of financial crisis once we recognise that there are ties to contracts and regulation or that managers and investors may care about market reactions over the short term. However, it is not obvious that these problems are best addressed with changes to the accounting system. These problems could also (and perhaps more appropriately) be addressed by adjusting contracts and regulation. Such adjustments already exist. For example, regulatory capital as calculated by US banking regulators is not affected by changes in the fair value of AFS debt securities, unless they are sold or the impairments are "other-than-temporary". Therefore, a shock to AFS debt securities has the same effect on Tier 1 regulatory capital under FVA and HCA for US banks. Moreover, the concern about the downward spiral is most pronounced for FVA in its pure form, but it does not apply in the same way to FVA as stipulated by US GAAP or IFRS. Both standards allow for deviations from market prices under certain circumstances (e.g., prices from fire sales). Thus, it is not clear that the standards themselves are the source of the problem.

However, as our third conclusion highlights, there could be implementation problems in practice. It is important to recognise that accounting rules interact with other elements of the institutional framework, which could give rise to unintended consequences. For instance, we point out that managers' concerns about litigation could make a deviation from market prices less likely even when this would be appropriate. Concerns about Securities Exchange Commission enforcement could have similar effects. At the same time, it is important to recognise that giving management more flexibility to deal with the potential problems of FVA also opens the door for manipulation. For instance, managers could use deviations from allegedly depressed market values to avoid los-

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ses and impairments. Judging from evidence for other areas in accounting (e.g., loans and goodwill) as well as the US savings and loans crisis, this concern should not be underestimated. Thus, standard setters and enforcement agencies face a delicate trade-off (e.g., between contagion effects and timely impairment).

Fourthly, we emphasise that a return to HCA is unlikely to be a remedy for the problems with FVA. HCA has its own set of problems, and it is possible that for certain assets they are as severe, or even worse, than the problems with FVA. For instance, HCA likely provides incentives to engage in so-called "gains trading" or to securitise and sell assets. Moreover, lack of transparency under HCA could make matters worse during crises.

We conclude our article with several suggestions for future research.

The article is forthcoming in Accounting, Organizations and Society and available at SSRN: http://ssrn.com/abstract=1392645

TABLE 1: Key Accounting Rules

		Balance Sheet	Income Statement	Effect on Tier 1 and Tier 2 Capital (FDIC and Federal Reserve)
Equity investment; debt securities; securitized assets	Trading Assets	Reported at FV	FV changes through income statement	Changes in FV affect Tier 1 capital through effect on earnings
	AFS Securities	Reported at FV	FV changes are reported in OCI no effect on income unless realized: a) sales or b) OTTI, in which case the asset is written down to FV; no reversal of write-down Effect on income statement akin to HCA with write-downs to FV if OTTI	OCI affects shareholders' equity, but adjustments for regulatory purposes so that unrealized FV changes in OCI of • AFS debt securities have no effect on Tier 1 or Tier 2 capital • AFS equity securities reduce Tier 1 capital if net loss • AFS equity securities (includible in Tier 2 capital) increase Tier 2 capital if net gain
	HTM Securities	Reported at HC unless OTTI, in which case the asset is written down to FV; subsequent recovery in fair value not recognized until security is sold.		
Direct investment in loans	HFI	Reported at HC net of loan loss reserves and tested for impairments for probable losses (if event has been incurred as of measurement date)		Realized losses and write-downs affect Tier 1 capital through effect on earnings
	HFS	Reported at lower-of-cost or fair value – declines recognized in income		
Fair value option (FAS 159)		Entities are allowed to elect FV measurement (FV through income statement) for most financial assets and liabilities • Applied on instrument by instrument basis • Irrevocable once selected		Adjustments so that unrealized FV changes due to changes in the bank's own creditworthiness have no effect on Tier 1 or Tier 2 capital

AFS – Available for sale
HTM – Held to maturity
HFI – Held for investment
HFS – Held for sale
FV – Fair value
HC – Historical cost
OCI – Other comprehensive income
OTTI – Other than temporary impairments
FDIC – Federal Deposit Insurance Corporation

The Role of Cultural Intelligence for the Emergence of Negotiated Culture in IT Offshore Outsourcing Projects

By Robert Gregory, Michael Prifling, Roman Beck, and Wolfgang König

Through a qualitative case study in the financial services sector, we demonstrate how cross-cultural differences can be „negotiated" in practice in order to reap the economic benefits from IT offshore outsourcing.

Culture can "make or break" an IT offshore project

In a recently published international bestseller, Thomas Friedman suggests that the world is "flat" in the sense that globalisation has enlarged the competitive markets for "global players" to a global scale *(Friedman 2005)*. One of the business opportunities derived from globalisation involves taking advantage of IT offshore outsourcing, namely the sourcing of IT-related products and services from low cost countries such as India.

At first sight, it seems as if the world really has become "flat", as the title of Friedman's book indicates, and that distance no longer matters. However, the reality is that firms are having a hard time when it comes to IT offshoring due to various obstacles, including cultural differences. Empirical research has revealed that critical factors such as coping with differences in culture or social behaviour can determine success in reducing such "extra costs" and in managing the risks of client-vendor distance (Dibbern et al. 2008).

Since 2007 we have been analysing a large-scale IT project aimed at re-engineering a core banking system for a large European bank.

A vendor company from India was contracted for this project. Our analysis comprises 46 qualitative expert interviews, including additional field observations from work conducted in India.

The Emergence of a "Negotiated Culture"

For IT offshore project members with diverse socio-cultural backgrounds to interact efficiently with each other, a cognitive understanding of the other person's behaviour is crucial. The individual must also be able to carefully and delicately elicit the objective cultural elements of behaviour. Culture is thereby defined as having subjective (rules, norms, roles, and values) and objective components (legal, economic, political, religious, and educational systems), as

TABLE 1: Client Behaviour and Vendor Adaptation

Client Behaviour	Vendor's Cognitive (C), Motivational (M), and Behavioural (B) Cultural Intelligence
#1) Frank/direct communication and transparency	Learned about client's communication style through face-to-face interactions (C); started to recognise that transparency and openness in communication was important to avoid misunderstandings (M); adapted behaviour by saying "no" and communicating critical issues openly to the client when necessary (B).
#2) Desire for perfection (100% solution)	Learned about client's desire for perfection when first vendor deliverables and unmet client expectations led to conflicts and discussions (C); developed appreciation for client's focus on high quality, which stimulated a motivation to improve the quality of deliverables (M); improved the quality of deliverables and focused more strongly on details (B).
#3) "Zero risk" approach: extensive controlling for operational risks	Learned about the project's context and developed a deeper understanding of the associated risks (C); started to recognise the negative implications of possible risks (M); adapted the intensity and frequency of tests before delivering new software modules for the client to activate (B).

TABLE 2: Vendor Behaviour and Client Adaptation

Vendor Behaviour	Client's Cognitive (C), Motivational (M), and Behavioural (B) Cultural Intelligence
#1) "Just do it and get things done" attitude, focus on implementation	Learned that vendor staff under-emphasised planning, but worked fast and efficiently to get implementation tasks done (C); started to recognise the advantages of getting things done quickly, even in critical times (M); invested more time in structuring, assigning, and later controlling implementation tasks in order to give the vendor more guidance and assistance, and to capitalise on the vendor's strengths (B)
#2) Focus on workability of results rather than perfection	Learned after receiving the first vendor deliverables that the vendor's attitude to quality differed from own expectations (C); recognised that initial expectations were partly unrealistic and that more effort had to be invested in communicating expectations to the vendor (M); adapted initial expectations and engaged in detailed questioning of results in order to stimulate a sense of perfection on the part of vendor staff (B).
#3) Avoiding confrontations and displeasing or disagreeing with anyone	Learned about vendor's attitude towards conflicts, the "face-saving" mentality, and the role given to respect (C); started to respect vendor's attitude and noticed that behaviour was deeply rooted in values and beliefs that could not be changed (M); focused on interpreting hidden messages, phrasing questions adequately (e.g., by avoiding "yes/no" questions), and acknowledged the importance of respect in interpersonal interaction (B).

Ang and Inkpen suggest (2008). In our case study, we observed numerous adaptations from both sides, with each having a cognitive, a motivational, and a behavioral dimension (see Tables 1 and 2). Besides cognitive understanding, a motivation for cross-cultural interaction was required. Over time, client and vendor staff learned about each other and developed a deeper cognitive sympathy for each other's culture. This, combined with high motivation to interact with each other, led to culturally intelligent behaviour, which ultimately resulted in mutual trust.

Adaptation and learning by both client and vendor project members led to the emergence of a "negotiated culture", which can be defined as the sum of compromises and innovations that are negotiated around those differences in behaviours and expectations that are problematic in a given cross-cultural setting. The model in Figure 1 provides a summary of this process.

FIGURE 1:

Summary:

In summary, our case analysis delivers some answers as to how managers for the above client can reduce extra costs in an IT offshore outsourcing project. Client and vendor companies need to foster and enable the development of cultural intelligence.

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The Euro – Nominal Stabilization versus Destabilization of Real Values

„It is time for the ECB to put its governance and public image on to a broader footing.“

David Marsh is a strategic adviser and banker combining expertise in marketing and communications. He previously worked with the German consultancy company Droege and the Hawkpoint and Flemings financial groups, after a journalistic career at the Financial Times and Reuters.

The euro zone brings stabilization of nominal exchange rates, but this is accompanied by destabilization of real values between some member states.

David Marsh reports in his new book, „The Euro – the Politics of the New Global Currency", that in the last 10 years the „Italian euro" has gained more than 40 per cent in value against the „German euro."

Newsletter: *Where does the euro zone face these discrepancies and how long can these be financed?*

David Marsh: According to a report on competitiveness by the European Commission, the distortions are most serious in the case of Greece, Portugal and Spain.

Measuring real (inflation-adjusted) exchange rate changes is difficult, but the Commission reckons that – without EMU – the weaker currencies would have had to be adjusted downwards by 30 per cent against the D-mark over the past 10 years, that is, if it were to still exist.

Newsletter: *By which means may these discrepancies be balanced?*

David Marsh: In a monetary union, current account deficits for weaker, less competitive states are financed automatically, since there is no exchange risk. However, if the deficits become ever larger, investors demand a higher risk premium, i.e., the interest rate rises.

Currency risk is eliminated, but there is still credit risk - and this is what we see happening now, with the widening of yields on debt instruments from the less competitive EMU states.

Newsletter: *What will happen if competitive distortions persist?*

David Marsh: The European Commission report makes for some worrying reading with regard to the sharp rise in net external liabilities for Greece, Portugal and Spain, which were between 80 to 100 per cent of GDP in 2007 against near-balance in 1995. The Commission says that in the period 2007-'10, *„most countries with overvalued real exchange rates are expected to losefurther competitiveness while undervalued economies will continue to gain competitiveness."* If this happens, then a further rise in unemployment is near inevitable in the weaker states as they seek to bring down their labour costs.

Newsletter: *What will happen next?*

David Marsh: Europe's recovery will be patchy. It is likely to be led by Germany and other export-orientated northern countries. Debt-burdened southern and western nations – all suffering from low competitiveness, large current account deficits and financial imbalances – will lag behind.

The ECB has cut rates repeatedly since October. The real problems will arise when they start to increase again.

Newsletter: *What would you propose that the ECB should do?*

David Marsh: I believe the ECB needs to do more to explain its policies. It is time for the ECB to put its governance and public image on to a broader footing.

Representing the ECB's policies is too big a job for just one person, so President Jean-Claude Trichet needs to share the burden.

Lack of Leadership? – How GBS is responding to the current crisis

What is the role of business schools in regard of the current financial and economic crisis? – This is a legitimate question to ask. And making reference to the rather short history of public Business Schools in Germany does not serve as an excuse. On a global level it is safe to say that there is room for improvement of business education of graduates and executives.

With the re-design of the Goethe Executive MBA program and the set-up of the new full time MBA program GBS has taken clear measures to enhance the education of current and future business leaders. For classes starting in autumn 2009 all of GBS´ MBA students will participate in a special High Performance Leadership Coaching track for their personal development during the program.

It is a compulsory ingredient and spans over the entire length of the programs.

This leadership coaching track comprises plenum and peer sessions as well as individual one-on-one coaching. The process starts with a reflection on the participants´ leadership competencies and the definition of personal development goals. The process is guided right from the start by professional coaches with a proven track record in international business and executive coaching. In addition participants expand their own capabilities to coach and are encouraged to constantly seek learning opportunities. Apart from these well designed learning processes in its MBA programs, there is now a variety of open enrollment leadership and strategy programs offered by GBS.

In this context GBS is particularly enjoying the co-operation with the de Baak management training center in the Netherlands. de Baak evolved from the largest employer organization in the Netherlands and looks back on more than 60 years of experience in management development. At the same time GBS carefully increases its own instructor pool in the fields of leadership and strategy.

The learning processes of the open enrollment programs are equally well designed.

For programs with a focus on personal and leadership development the learning process spans over a period of 6 to 12 weeks (with up to 6 class days) and fosters the implementation of learnings. In addition to its strong roots in Goethe University's faculty GBS sees itself in a clear responsibility to develop a network of experts and to provide new impulses for leadership and organizational developmentGBS is highly interested in connecting with executives and leaders in the corporate world as well as in the public administration and the non-profit sector. To listen to your questions and jointly seek novel solutions is one of GBS´ key goals.

GET IT TOGETHER!

NEWS LINES:

Goethe Business School offering NEW open enrollment programs starting September 09:

Leading Change – practical skills and applications
► starts 07 October

Managing People – new Skills and perspectives
► starts 30 September

Impactful Communication – personal presence and influence
► starts 19 October

Right strategic Moves – a systematic approach to outmaneuver the competition
► starts 09 September

FRM - Financial Risk Manager
► starts 05 October

Find out more about these and other courses on www.gbs.uni-frankfurt.de/open enrollment

Teambuilding activities set foundation for good teamwork from the start.

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Research outside the House of Finance

Verschuldung im Mehrebenensystem – Debt in the Multi-Layered German Public Administration System
Katleen Knop, University of Bonn, Baden-Baden, 2008
(in German only)

Government deficits and government debt have always been important topics for economists, lawyers and politicians. Various attempts to slow these down in Germany (and other countries) were finally showing some success, partially due to legal requirements under the European Union Treaty of ???. In the course of the present crisis, however, this development has totally reversed, and now both figures are skyrocketing at an unprecedented speed.

Nonetheless, the sluggish pursuit of reforming federal fiscalism in Germany (Föderalismusreform II) briefly gathered pace before the end of the present parliamentary session. An amendment to the legal rules for both the federal and the state levels (Schuldenbremse) was pushed through the country's parliamentary bodies. This is primarily based on a proposal by prominent members of the German Council of Economic Experts. In this context, a book by Katleen Knop, Verschuldung im Mehrebenensystem (Baden-Baden, 2008), can be highly recommended. It offers an in-depth analysis of the various rules for government deficits at the municipal, state, federal and European levels and – more crucially - their coordination. The quality of the argument and the amount of details presented are far above those for the material underlying present constitutional amendments, which is almost unanimously considered "abysmal" by the legal community. Reading this book could have prevented the profound ignorance of the present rules displayed by some economists in parliamentary hearings. But who looks at a book of 450 pages instead of a thin 10-page article?

"The Panic of 2007," in Federal Reserve Bank of Kansas City, Maintaining Stability in a Changing Financial System, Proceedings of the Economic Policy Symposium 2008
Gary Gorton, Yale School of Management, New Haven

How could the securitisation of a bunch of dodgy U.S. mortgages trigger the largest economic crisis since the Great Depression? What are these subprime mortgages, and how exactly did their securitisation work? Why did banks make loans that they knew would almost certainly go bad? Gary Gorton's contribution to the 2008 Jackson Hole Symposium, the world's foremost gathering of monetary policymakers, takes the reader through the nuts and bolts of subprime mortgages, their origins, and their interaction with securitisation of bank loans. Gorton is uniquely qualified to provide this survey, being both an eminent historian of banking crises and for several years an advisor to AIG on the design of structured financial products.

The paper substantiates several surprising and controversial claims: the fact that borrowers would default as soon as house prices would stop rising was a surprise to no one, but a conscious design feature of subprime mortgages; and securitisation as such does not have to lead to financial fragility, but did so only in connection with subprime mortgages whose value is unusually sensitive to that of the underlying assets. This paper is required reading for anyone who wishes to understand the origins of the crisis we are finding ourselves in today.

Available at: http://www.kc.frb.org/publicat/sympos/2008/Gorton.03.12.09.pdf

"Deciphering the Liquidity and Credit Crunch 2007-2008,"
Journal of Economic Perspectives, Volume 23 (1), pp. 77-100
Markus K. Brunnermeier, Princeton University

Brunnermeier provides an excellent analysis of events that caused the financial market crisis in 2007 and 2008. His paper explains how relatively modest losses from mortgage delinquencies amplified and led to a severe financial crisis. The first part of the paper describes recent banking industry trends: the "originate and distribute" model and the shortening of the maturity structure of banks. It provides an event logbook on the major developments in the capital markets and the financial sector during the crisis until the end of 2008. The paper's main contribution is its explanation of the amplifying mechanisms behind the financial turmoil.

Brunnermeier argues that the crisis was characterised by the interaction of decreasing funding liquidity, the ease with which market participants can borrow money by using assets as collateral, and decreasing market liquidity, the ease with which market participants can raise money by selling assets. Amplification mechanisms were: borrowers' balance sheet losses that forced deleveraging and caused loss and margin spirals; decreasing lending due to moral hazard and precautionary hoarding of liquidity by financial intermediaries; runs on issuers of commercial paper and other securities without deposit insurance; and an interwoven network of financial institutions.

Brunnermeier concludes that the current financial crisis is special as regards the extent of securitisation and the opaque web of interconnected obligations, but otherwise surprisingly close to a „classical" banking crisis. His paper provides some important insights into the current financial crisis and convincingly demonstrates the fragility of the global financial architecture.

Kick-off conference:

Doctoral programme in Law and Economics of Money and Finance (LEMF)

The new LEMF doctoral programme directed by Professors Brigitte Haar (Law School) and Uwe Walz (Economics), starting in autumn 2009, will offer in-depth academic training to highly qualified international postgraduates from both disciplines.

On May 15th and 16th, the programme was launched by a kick-off conference with international guest speakers. This was titled *"Law and Economics of Money and Finance in Times of Financial Crisis"*, and focused on many topics, including sovereign wealth funds, international liquidity regulation, and retail banking.

Conference on the European framework directive Solvency II at the House of Finance

The Institut für Versicherungsrecht (directed by Professor Manfred Wandt) together with Professor Meinrad Dreher (University of Mainz) and the Deutsche Verein für Versicherungswissenschaft organized a conference – *"Solvency II in der Rechtsanwendung"* – on the legal implications of this European framework directive.

The conference, which covered topics such as capital requirements for insurance undertakings, disclosure and transparency requirements, and the supervisory powers of public authorities, attracted more than 140 practitioners.

The Macroeconomic Model Data Base

This project, headed by Professor Volker Wieland (CFS), is part of an EU-sponsored joint initiative by several European research institutions: *"Modelling and Implementation of Optimal Fiscal and Monetary Policy Algorithms in Multi-Country Econometric Models"* or MONFISPOL.

It aims to build up an archive of macroeconomic models based on a common computational platform, and provide various tools for systematically comparing these models.

Eurex endows House of Finance Assistant Professorship

The derivatives exchange and clearing house Eurex has agreed to finance an assistant professorship for derivatives at the House of Finance for a period of six years.

The relevant contracts were signed on May 13th, 2009, by Andreas Preuss (Deutsche Börse AG and Eurex) and representatives from Goethe University and the House of Finance.

House of Finance researchers successful in winning best paper awards!

Jingjing Chai, Chair for the Investment, Portfolio Management, and Pension Finance team, has won the *DZ Karriere Preis* (an award for young academics) for her diploma thesis.

Dr. Ralph Rogalla, Chair for the Investment, Portfolio Management and Pension Finance team, has received the *Frankfurter Preis für Versicherungswissenschaft* for his diploma thesis.

A former research assistant at the Institut für Versicherungsrecht, **Dr. Bastian Ganster**, was one of three laureates for the *Frankfurter Preis für Versicherungswissenschaft*.

Dr. Michael Marx, also formerly a research assistant at the Institut für Versicherungsrecht, was awarded the *Walter Kolb Prize by the city of Frankfurt*.

Professor Maurer leads a panel discussion at the 10th European Asset Management Congress

During the conference held at the Deutsche Bundesbank in Frankfurt on May 13th, 2009, Professor Maurer led a panel discussion with some prominent participants on the impact of the financial crisis on the regulatory framework. There was a special emphasis on topics like the new European regulatory draft for the supervision of alternative investment fund managers or the levelling of regulatory standards for investment products.

House of Finance shines in Academic Study

A study by the Thurgauer Wirtschaftsinstitut was recently published in the Handelsblatt newspaper which confirms the strong position of Goethe University's business administration branch. Our professors are ranked second, when compared to their peers in the rest of Germany, in terms of publishing articles in renowned international journals. In addition, HoF professors achieved a second place in the study's Finance category, just below the University of Zurich.

Professor Schlag submits LOEWE proposal

The Hessische Ministerium für Wissenschaft und Kunst has accepted a LOEWE proposal called "Puzzles in Finance" that was coordinated by Professor Christian Schlag.

This proposal is concerned with investigating aspects of asset management under a comprehensive approach. A final decision on the proposal is expected by end July.

Quarterly Event Calender

JULY

Wednesday, 1st

- Finance Brown Bag Seminar (12.00pm): *"An Incentive Based View on Insurance Distribution and Regulation,"* Speakers: Uwe Bloos, Oliver Schellenberger, Goethe University
- Seminar in Economics (4.15pm): *"Using the Kalman Filter to Extract and Test for Common Stochastic Trends 1,"* Speakers: Yoosoon Chang, Bibo Jiang and Joon Y. Park
- IMFS Public Lecture (5pm): *"Regulatory Responses to the Financial Crisis,"* Speaker: Peter Praet, Executive Director, National Bank of Belgium

Wednesday, 1st/Thursday, 2nd

- Goethe Business School/European Supervisor Education Initiative Conference: *"How to contribute to financial stability - Educating supervisors as an integral part of European financial supervision"*

Monday, 6th,

- Ph.D. Brown Bag Seminar (12.15pm)
- EFL Jour Fixe (5pm): *"CAPM & Co Revisited - Modeling Risk and Return on Private Equity Funds,"* Speaker: Timo Litty, E-Finance Lab

Tuesday, 7th,

- Finance Seminar (5.15pm) with Philip Bond from the Wharton School of The University of Pennsylvania – title to be announced

Wednesday, 8th,

- Finance Brown Bag Seminar (12pm): *"Measuring the Cost Efficiency of German Mutual Fund Complexes: A Frontier Analysis,"* Speaker: Alexander Schäfer, Goethe University

Friday, 10th

- IMFS Symposium (2.00 p.m.): *"Gesetzgeberische Maßnahmen zur Verhinderung der Übernahme börsennotierter Unternehmen im Wege des 'Anschleichens'"*, Speaker: Prof. Dr. Dres. h.c. Theodor Baums, ILF; Prof. Dr. Roman Inderst, IMFS; Dr. Roger Müller, Deutsche Börse AG

Monday, 13th

- Ph.D. Brown Bag Seminar (12.15pm)

Tuesday, 14th

- Finance Seminar (5.15pm): *"Why foreign banks withdraw from abroad,"* Speaker: Oskar Kowalewski, Warsaw School of Economics
- Seminar in Economics (5.15pm): *"Leadership in Collective Action,"* Speaker: Esther Hauk, Instituto de Análisis Económico, Barcelona

Thursday, 16th

- IMFS Working Lunch (12pm): *"Budget Deficits, Debt, and Interest Rates,"* Speaker: Prof. Thomas Laubach, Goethe University

Monday, 20th

- Ph.D. Brown Bag Seminar (12.15pm)

Monday, 27th,

- Ph.D. Brown Bag Seminar (12.15pm)

AUGUST

Monday, 24th to September 4th: ILF Summer School *"Bank und Kapitalmarktrecht"*

SEPTEMBER

Thursday, 3rd

- HoF Brown Bag Seminar (12pm), Speaker: Prof. Christoph Kühn, Frankfurt MathFinance Institute

Friday, 4th

- CFS Conference: *"The ECB and Its WatchersXI"*, Speaker (among others): Prof. Volker Wieland, Goethe University and CFS – time to be announced

Monday, 7th

- EFL Jour Fixe (5pm), Speaker: Michael Chlistalla, E-Finance Lab

Wednesday, 9th

- IMFS Public Lecture (5.00 p.m.): *"Erfahrungen mit der Sanierung eines Landeshaushaltes"*, Speaker: Dr. Thilo Sarrazin, Senator a.D., Vorstand der Deutschen Bundesbank
- CFS Colloqium (5.15pm): *"Management der Finanzmarktkrise aus der CFO-Sicht,"* Speaker: Dr. Strutz, Commerzbank AG

Thursday, 17th

- EFL Fall Conference: *"Neun Thesen für die Zukunft des Privatkundengeschäfts"*

Wednesday, 17th/Thursday 18th

- CFS Seminar: *"Zinsprodukte: Analyse und Bewertung"*

Thursday, 24th

- HoF Brown Bag Seminar (12pm): *"Now or Never: Use the Financial Crisis to Get Serious about Customer Equity Reporting,"* Speaker: Prof. Bernd Skiera

Wednesday, 30th

- CFS Symposium (12pm): *"DB Prize in Financial Economics"* – a scientific discussion on themes highlighted in the work of Professor Robert Shiller, Yale University, New Haven

For further details please visit our homepage:
www.hof.uni-frankfurt.de/veranstaltungen

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