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24 July 2014

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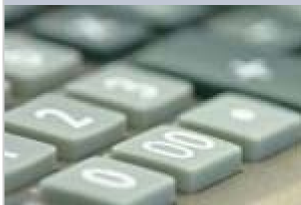

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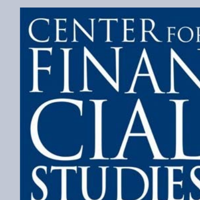

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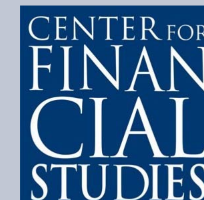

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Financial innovation is a product of the complex interaction between and among the saving and borrowing needs of households, the financing needs of firms, the need to manage risks, developments in financial theory and related fields, and the profit motives of the financial sector. It is typically not inherently beneficial or harmful but derives its qualities from the uses to which it is put. Therefore, it is often close to impossible to predict the possible role of a new financial instrument prior to its introduction in the financial market.

The global financial crisis that began in 2007 provided some telling examples. As Shiller points out in his essay, the securitization of mortgages, even of subprime mortgages, and their breakdown into different risk classes that could be disseminated to portfolios around the world was an a priori positive development. It was subsequent bad use, lack of transparency, and the failure of rating agencies to assess the risk of securitized products that contributed to the ensuing crisis.

A key factor that almost everybody ignored was the behavior of house prices, and in

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Indeed, one can argue that it was too little and too unbalanced rather than too much financial innovation that lay behind the financial crisis. Financial innovation was unbalanced across the debt and asset sides. It focused mostly on providing new types of mortgages and possibilities for borrowing on home equity, but this was not balanced by innovation on the asset side aimed at providing the means of hedging and sharing house price risks across potentially interested parties, such as homeowners and developers.

How can innovation-linked crises be avoided in the future? Stopping all financial innovation is hardly the way, as it kills potentially beneficial new products, or product uses, along with preventing potentially harmful ones. The prevention of future financial crises should instead be the result of combined efforts by governments, regulators, and private markets; and efforts should be targeted toward fostering further useful innovation while preventing excesses and harmful side effects.

In our quest to prevent future crises, we are confronted not only with our limited understanding of asset pricing but also with the unpredictability of how financial products are actually used. Financial institutions themselves have their own management and robust control processes to contain the risk of their productive activities, but, as Otmar Issing points out in his essay, if those who innovate think they cannot be held responsible for the effects of innovations on other agents, they will ultimately not care enough about adverse effects. Hence, policy and regulation need to ensure that the incentives of producers are closely aligned with those of users.

Financial innovation is an incremental, targeted, but still random process that responds to developments in financial theory and related fields, but also to the evolution of regulatory and legal structures and to its own failures. This process needs to be fostered and monitored, rather than banned or assigned to the government. The MIT Press volume is intended to offer a fresh perspective on what financial innovation can contribute but also on how to harness and direct its force toward avoiding future crises.

I hope you will enjoy reading on a variety of topics in this newsletter.

Yours sincerely,
Michael Haliassos

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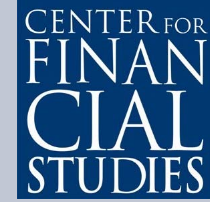

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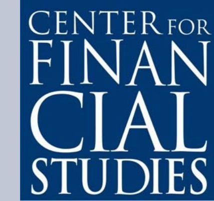

Lord Turner appointed CFS Senior Fellow

Adair Lord Turner of Ecchinswell has been appointed a Senior Fellow of the Center for Financial Studies. "It is a great honour for us to welcome Lord Turner among our Senior Fellows", said Otmar Issing, President of the CFS. "We are very much looking forward to working with him, exchanging thoughts and ideas and getting highly valuable input from him for our research and policy work."

Lord Turner has combined careers in academia, business and public policy. He is a Senior Research Fellow at the Institute of New Economic Thinking and a Visiting Professor at the London School of Economics and at Cass Business School, City University. He was Chairman of the Financial Services Authority from September 2008 until March 2013. Prior to that, he was a non-executive Director at Standard Chartered Bank, United British Media and Siemens. From 2000 to 2006 he was Vice-Chairman of Merrill Lynch Europe, and from 1995 to 1999 Director General of the Confederation of British Industry. Lord Turner became a cross-bench member of the House of Lords in 2005 and was Chairman of the Pensions Commission from 2003 to 2006, and Chairman of the Low Pay Commission from 2002 to 2006. He studied History and Economics at Gonville and Caius College, Cambridge from 1974 to 1978.

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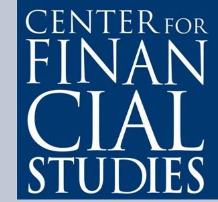

Raghuram Rajan is the Award Winner of the Deutsche Bank Prize in Financial Economics 2013

In 2013 the DB Prize has been awarded to Raghuram Rajan. Jury Chairman and CFS Director Michael Haliassos summarized the view of the international Jury: "Professor Rajan's work spans a remarkably broad range of areas in financial economics most important to the development of economies worldwide. This includes the impact of financial development on growth, banking and financial crises, as well as corporate finance and governance. His work develops novel empirical and theoretical approaches with significant policy implications."

The academic prize is sponsored by the *Stiftungsfonds Deutsche Bank im Stifterverband für die Deutsche Wissenschaft* * and carries an endowment of € 50,000. The CFS awards the prize biannually in partnership with Goethe University Frankfurt.

The Award Winner

Raghuram Rajan is the Eric J. Gleacher Distinguished Service Professor of Finance at the University of Chicago Booth School of Business. He serves as Chief Economic Adviser in the Finance Ministry, Government of India. Previously, he was Chief Economist at the International Monetary Fund (2003-2006). Raghuram Rajan was the President of the American Finance Association in 2011 and he is a member of the American Academy of

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Arts and Sciences.

An original thinker with outstanding contributions to theory and practice

Raghuram Rajan's broad research interests include banking, corporate finance, and the role of finance in economic development. He is one of few economists who warned the world about the financial crisis that eventually broke out in 2008.

Rajan's penetrating analysis of the changing growth experience during the postwar era and of the differences in the nature of the crises faced by the United States and by Southern Europe is essential reading for understanding the current policy dilemmas between austerity and growth facing both sides of the Atlantic. Rajan argued forcefully the futility of excessive spending, the need to focus on sustainable long-term growth in designing short-term measures, and the importance of not forgetting to provide for those most adversely hit by austerity, such as the poor, the young, and the elderly.

His recent book, "Fault Lines: How Hidden Fractures Still Threaten the World Economy", won the Financial Times Business Book of the Year award in 2010. Rajan analyzed the complex interactions between the financial industry, politics, and society, focusing on the role of income inequality in the United States in creating an environment in which financial excesses were tolerated. He demonstrated how rational choices by individuals collectively brought down a flawed financial system.

The Jury

A Jury of international financial experts decides on the recipient of the prize. More information on the Jury and their statements can be found on the **Deutsche Bank Prize website**.

Award Ceremony and CFS Symposium on 26 Sep. 2013

The Award Ceremony

The award ceremony takes place at the beginning of the symposium. **Jürgen Fitschen** (Co-Chairman of Deutsche Bank's Management Board) presents the award to Raghuram Rajan. The laudation will be given by **Douglas Diamond** (Professor of Finance at the University of Chicago Booth School of Business).

The Symposium

Research Session "Banking and Liquidity"

We are honored to announce that **Raghuram Rajan** has also confirmed as the keynote speaker and we are delighted to announce as plenary speakers: **Markus Brunnermeier** (Professor of Economics, Princeton University), **Viral Acharya** (Professor of Economics, New York University Stern School of Business) and **Luigi Zingales** (Professor of Entrepreneurship and Finance, University of Chicago Booth School of Business).

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Policy Panel "Liquidity and Monetary Policy"

The policy panel will be held by **Vítor Constâncio** (Vice-President of the European Central Bank), **Otmar Issing** (CFS President, Jury member of the DB Prize), and **Jeremy Stein** (Governor, Board of Governors of the Federal Reserve System).

For further details on the program and for registration please click on the link:
https://www.ifk-cfs.de/dbprize/2013/symposium.

(A report on the symposium will be given in the next CFS Newsletter)

** Deutsche Bank Donation Fund in the Donor's Association for German Science*

Sabine Kimmel

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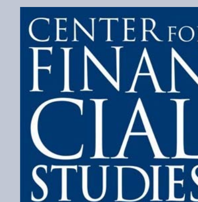
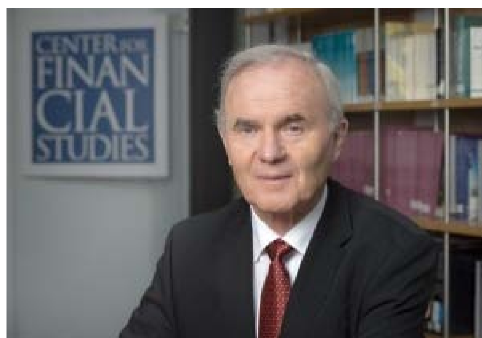


WP 2013/02: A New Paradigm for Monetary Policy?

By Otmar Issing, CFS President



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.

Exit from Unorthodox Measures is a Daunting Challenge

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? When the central bank starts selling assets, is this not a signal to private agents to sell their assets outright before asset prices plummet? 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.

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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.

These are strong arguments for being concerned about an extended period of extremely low interest rates. 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.

The Case for Independence

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. In addition, considering the developments that have taken place over the decades, one should expect that the time of "monetary" macroeconomics and "monetary" policy without "money and credit" will come to an end. Hopefully, this will happen before a new and probably even deeper crisis sets in.

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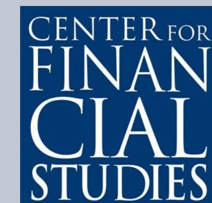

WP 2013/01: Incentives, Systemic Risk and Intransparency. Lessons from the Financial and National Debt Crisis

By Andrej Gill, Steffen Juranek, Christian Lizarazo, Nikolai Visnjic and Uwe Walz

The CFS Working Paper 2013/01 – "Incentives, Systemic Risks and Intransparency: Lessons from the Financial and National Debt Crisis" – resulted from an exploratory study by the Center for Financial Studies for the Federal Ministry for Education and Research (BMBF). The study provides an overview of the current state of scientific literature concerning the reasons, consequences and regulatory implications as well as their potential effects in the course of the financial crisis 2007 to 2010. Against this background, the aim was to derive areas with open questions calling for further research – with special focus on the possibility and necessity of interdisciplinary research. The central key words *incentives, systemic risks* and *(in)transparency* represent the objective to scrutinize the decisive functional mechanisms of modern financial systems with regard to their growth and welfare-increasing effects as well as with regard to their potential underlying crisis patterns. Fundamental aim of the study was to define cornerstones and provide ideas for a potential research program to be tendered by the BMBF.

The CFS team of researchers defined five research areas with corresponding sub-topics where highly relevant, open questions are being posed: Contagion Effects and Systemic Risk; Overall Economy and Financial System/Stability; Corporate Governance and Systemic Risk; Transparency and Financial Systems; Shadow Banking and Regulation (see Figure 1). The areas result directly

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from the structure and the mechanisms of the financial and national debt crisis as well as the resulting regulatory responses. Starting point of the analysis was the thorough understanding of the considerable body of research undertaken in the very recent past. Regulation and its design play a central role. For example, the effects of current regulatory mea- sures have been assessed with regard to existing research, and research deficits have been defined.

I Contagion Effects and Systemic Risk

- Intermediation, Interbank Market and Networks
- Endogenous Networks, Circularity and Systemic Risk
- Equity Requirements, Systemic Risk and Growth
- Risk, Contagion Effects and Cutting off Banks
- Competition, Risk Taking and Financial Stability

II Overall Economy and Financial System / Stability

- Financial Instability, Development of the Overall Economy and Monetary Policy
- Asset Bubbles, Market Related Early Warning Systems and Monetary Policy
- Monetary Policy, Fiscal Policy and high Government Debt
- Real Economy, Welfare and Financial System
- Social Costs, Financial Crises and Crisis Overcoming
- Financial Innovation, Real-Economic Benefit and Regulatory Arbitrage

III Corporate Governance and Systemic Risk

- Compensation, its Components and Choice of Risk
- Society, Shareholders and Managers of Banks
- Supervisory Boards, Composition and Choice of Risk
- Corporate Governance Code, Comparability and Law and Economics

IV Transparency and Financial Systems

- Fair Value Accounting, Financial Stability and Transparency
- Procyclicality, Accounting and Risk Provision
- Rating Agencies, Competition and Obtaining of Information
- Financial Products, Innovation and Transparency

V Shadow Banking and Regulation

- Hedge Funds, Systemic Risks and Regulation
- Credit Guarantees, Liquidity Guarantees and Shadow Banking
- National Regulation, International Financial Markets and Actors
- Regulatory Arbitrage, Functional Regulation and Shadow Banking

Figure 1: Research areas that pose open research questions

Exemplary Results

Rather than provide a comprehensive discussion of all open research questions, we limit the following discussion to a number of important research question with a particular interdisciplinary focus.

One decisive reason for the financial crisis is the **profound interconnectedness of the financial institutions.** Although it is known that this interconnectedness has grown significantly in the last decades, only little can be said about the detailed reasons and extents of this interconnectedness. In the light of the importance of these interconnected structures it is not only necessary to gain much better knowledge about the network structures with the help of disaggregated data but also to sustainably learn about the reasons for the high degree of interconnectivity. Thereby, obviously not only organizational but also personal and social networks – not least with the help of sociological research – have to be investigated.

An often neglected connection is the one between **the intensity of competition and financial stability**. In the light of the fact that many regulatory interventions have clear effects on the intensity of competition and thus on financial stability, this is even more surprising. So far, research has only lead to a blurred picture which speaks even more in favor of a thorough analysis of this relationship not least on the basis of existing data.

A central focus on regulation in general is **the trade-off between financial stability (the cost of financial crises) and the welfare and growth-effects** of a dynamic

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financial system. These connections have already been researched intensively, however mostly only for relatively short terms. A consideration laid out for a long-term from an economic historian point of view would thus provide an elementary contribution to the regulatory debate.

Rating agencies were not only decisive in the financial and economic crisis but they keep on playing a central role in the current politico-economic debate. The scientific basis of this discussion is, however, rather thin. Further analysis, especially concerning the economic role of rating agencies (as institutions to gather information or in the role for regulatory purposes), seems necessary. Furthermore, given the discussion in the EU, it seems to be most important to address the relation between information revelation and competition. Or to put it in other words: Does increased competition lead to more or to less "truth"?

Last but not least, it is imperative from the authors' point of view to endogenize politico-economical and regulatory decisions in economic analysis. Due to the importance of political decisions and decision-makers the exogeneity of political decisions leads to fatal potential distortions. An interdisciplinary co-operation between politics and economic science might produce relief.

Please click **here** to download the complete working paper from the CFS website

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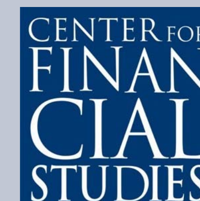

Fair Value Accounting and Procyclicality – Implications for Financial Stability and Regulation

The CFS research project "Fair Value Accounting and Procyclicality – Implications for Financial Stability and Regulation", launched in 2010, lead to two recent papers that analyze the role of financial reporting for financial stability.

"Financial Reporting, Financial Regulation, and Financial Stability: Evidence from German Bank Failures in 2007-2008"

In this paper, Oana M. Georgescu and Christian Laux analyze the failure of Deutsche Industriebank AG (IKB), Landesbank Sachsen Girozentrale (Sachsen LB), and Hypo Real Estate Holding AG (HRE). Looking at these banks is interesting because of specific rules for financial reporting and financial regulation that were in place in Germany. Although the evidence cannot easily be generalized to other banks, some general conclusions can be drawn.

Most importantly, our results show that the interactions between financial reporting and financial regulation are less straightforward than often claimed. All three banks were regulated based on German local GAAP (HGB), not International Financial Reporting Standards (IFRS) even though IKB and HRE were required to publish reports based on IFRS. Thus, some of the most spectacular failures of European banks occurred for banks that were regulated based on historical cost accounting. All three banks took on very high leverage either on-balance sheet (HRE) or off-balance sheet (IKB and Sachsen LB).

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The evidence, although specific, is important for the current regulatory debate. It is important to understand the specific situation to draw general conclusions on the relation between financial reporting, financial regulation, and financial stability. Moreover, the examples show that one can reasonably doubt that bank regulation and reporting based on historical cost alone would have made banks safer.

"Contagion in the Interbank Market: Funding versus Regulatory Constraints"

In this paper, Oana M. Georgescu compares the contagion potential of mark-to-market accounting rules interacting with regulatory constraints in a network of banks. Simulation results show that for high levels of short-term debt relative to liquid asset holdings, the contagion potential arising due to funding constraints is higher than the one due to accounting induced regulatory constraints. Allowing balance sheet valuation to affect the expectations about future insolvency, and implicitly, the roll-over decision of short-term creditors, can amplify systemic risk relative to the case when only regulatory constraints are at play. The paper finds that, beyond the mechanical link that exists between accounting and regulatory constraints, balance sheet valuation per se is not a problem, but rather the vulnerable funding structure of banks during a crisis. This source of vulnerability may be better addressed through adequate macro-prudential tools than via ad-hoc amendments to the accounting regime.

The CFS research project "Fair Value Accounting and Procyclicality – Implications for Financial Stability and Regulation" was funded by the "Frankfurt Institute for Risk Management and Regulation" (FIRM).

Oana Maria Georgescu, Christian Laux

The two papers are available at SSRN:

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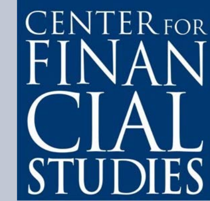

Lord Turner appointed CFS Senior Fellow

Adair Lord Turner of Ecchinswell has been appointed a Senior Fellow of the Center for Financial Studies. "It is a great honour for us to welcome Lord Turner among our Senior Fellows", said Otmar Issing, President of the CFS. "We are very much looking forward to working with him, exchanging thoughts and ideas and getting highly valuable input from him for our research and policy work."

Lord Turner has combined careers in academia, business and public policy. He is a Senior Research Fellow at the Institute of New Economic Thinking and a Visiting Professor at the London School of Economics and at Cass Business School, City University. He was Chairman of the Financial Services Authority from September 2008 until March 2013. Prior to that, he was a non-executive Director at Standard Chartered Bank, United British Media and Siemens. From 2000 to 2006 he was Vice-Chairman of Merrill Lynch Europe, and from 1995 to 1999 Director General of the Confederation of British Industry. Lord Turner became a cross-bench member of the House of Lords in 2005 and was Chairman of the Pensions Commission from 2003 to 2006, and Chairman of the Low Pay Commission from 2002 to 2006. He studied History and Economics at Gonville and Caius College, Cambridge from 1974 to 1978.

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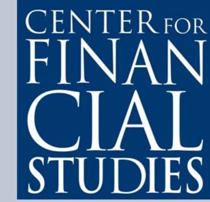

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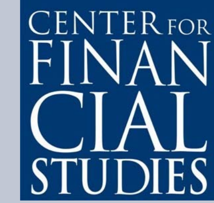

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The academic prize is sponsored by the *Stiftungsfonds Deutsche Bank im Stifterverband für die Deutsche Wissenschaft* * and carries an endowment of € 50,000. The CFS awards the prize biannually in partnership with Goethe University Frankfurt.

The Award Winner

Raghuram Rajan is the Eric J. Gleacher Distinguished Service Professor of Finance at the University of Chicago Booth School of Business. He serves as Chief Economic Adviser in the Finance Ministry, Government of India. Previously, he was Chief Economist at the International Monetary Fund (2003-2006). Raghuram Rajan was the President of the American Finance Association in 2011 and he is a member of the American Academy of

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Arts and Sciences.

An original thinker with outstanding contributions to theory and practice

Raghuram Rajan's broad research interests include banking, corporate finance, and the role of finance in economic development. He is one of few economists who warned the world about the financial crisis that eventually broke out in 2008.

Rajan's penetrating analysis of the changing growth experience during the postwar era and of the differences in the nature of the crises faced by the United States and by Southern Europe is essential reading for understanding the current policy dilemmas between austerity and growth facing both sides of the Atlantic. Rajan argued forcefully the futility of excessive spending, the need to focus on sustainable long-term growth in designing short-term measures, and the importance of not forgetting to provide for those most adversely hit by austerity, such as the poor, the young, and the elderly.

His recent book, "Fault Lines: How Hidden Fractures Still Threaten the World Economy", won the Financial Times Business Book of the Year award in 2010. Rajan analyzed the complex interactions between the financial industry, politics, and society, focusing on the role of income inequality in the United States in creating an environment in which financial excesses were tolerated. He demonstrated how rational choices by individuals collectively brought down a flawed financial system.

The Jury

A Jury of international financial experts decides on the recipient of the prize. More information on the Jury and their statements can be found on the **Deutsche Bank Prize website**.

Award Ceremony and CFS Symposium on 26 Sep. 2013

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The award ceremony takes place at the beginning of the symposium. **Jürgen Fitschen** (Co-Chairman of Deutsche Bank's Management Board) presents the award to Raghuram Rajan. The laudation will be given by **Douglas Diamond** (Professor of Finance at the University of Chicago Booth School of Business).

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We are honored to announce that **Raghuram Rajan** has also confirmed as the keynote speaker and we are delighted to announce as plenary speakers: **Markus Brunnermeier** (Professor of Economics, Princeton University), **Viral Acharya** (Professor of Economics, New York University Stern School of Business) and **Luigi Zingales** (Professor of Entrepreneurship and Finance, University of Chicago Booth School of Business).

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For further details on the program and for registration please click on the link:
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(A report on the symposium will be given in the next CFS Newsletter)

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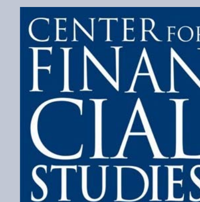

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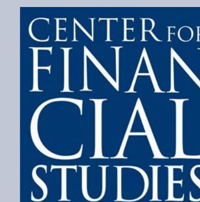
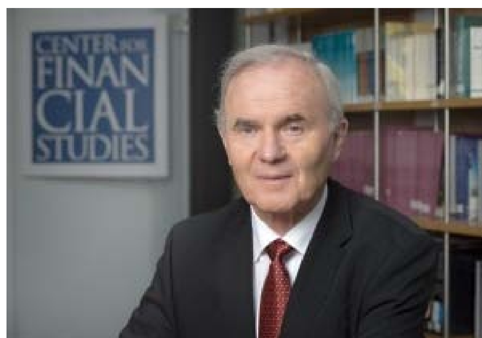


WP 2013/02: A New Paradigm for Monetary Policy?

By Otmar Issing, CFS President



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.

Exit from Unorthodox Measures is a Daunting Challenge

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? When the central bank starts selling assets, is this not a signal to private agents to sell their assets outright before asset prices plummet? 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.

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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.

These are strong arguments for being concerned about an extended period of extremely low interest rates. 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.

The Case for Independence

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. In addition, considering the developments that have taken place over the decades, one should expect that the time of "monetary" macroeconomics and "monetary" policy without "money and credit" will come to an end. Hopefully, this will happen before a new and probably even deeper crisis sets in.

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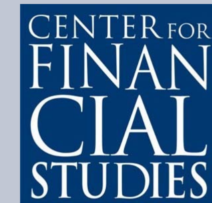

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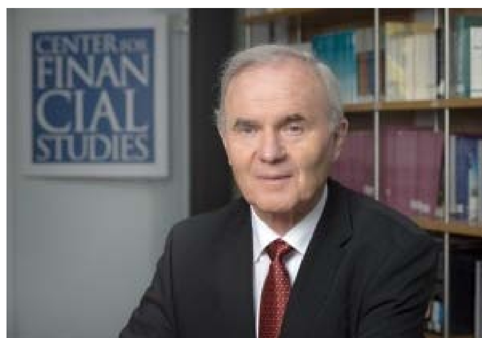

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Exit from Unorthodox Measures is a Daunting Challenge

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These are strong arguments for being concerned about an extended period of extremely low interest rates. 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.

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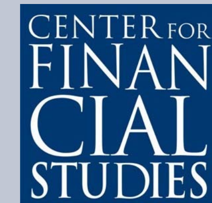

Anshu Jain warns of too much Regulation in Europe

If all currently planned regulations were to be implemented, this would be the end of universal banks in Europe. On 11 June, Anshu Jain, Co-Chairman of the Management Board and the Group Executive Committee of Deutsche Bank, warned of such a development in a lecture about challenges and opportunities for universal banks in

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Europe. Jain's speech was part of the colloquium series „Political and Financial Impulses between Austerity and Growth: A Silver Bullet for Europe?" organized by the Center for Financial Studies.

According to Jain, global universal banks such as Deutsche Bank are institutes that offer all financial products and services from a single source and operate in all major business centers worldwide. Historically, global universal banks therefore came into being mostly in countries with a strong economy, like Germany or the United States. For Jain, it would be a logical step for China to create such a bank in the near future.

Jain admitted that universal banks had made mistakes during the financial crisis – including Deutsche Bank. Their balance sheets had been too big and their business models too complex. The consequence had been systemic and sovereign risk.

However, since the beginning of the crisis, universal banks have been reforming themselves, said the manager with Indian roots. They have increased their capital, reduced compensation and refrained from too complex products.

Nevertheless, Jain pleaded for further regulation in the banking sector. For example, Basel III would contribute to the stability of the financial sector and create a level playing field around the world, which was essential in a globally interconnected financial system, he said.

On the other hand, Jain warned about the unprecedented pace at which the banking sector was being reformed at present and that this could lead to potential risks. As examples he mentioned the higher capital requirements for systemically important financial institutions ("sifis") or the plans for an EU-wide Financial Transactions Tax. Jain referred to estimations that European banks needed around 70,000 additional employees just to comply with Basel III.

Most critical in Jain's view were regulations that question the universal banking system itself. These include the Liikanen report in the EU, the Vickers Commission's proposals in the UK and the recently passed German Bank Separation Law, which is supposed to be implemented by 2016. Although these proposals differ in detail they are all headed in the same direction: separation of investment banking activities, trading and market making from deposit and lending activities. Their impact on universal banks is hard to predict because it depends on how regulation authorities will interpret them, said Jain. But if all these proposals were to be implemented according to plan, this would be the end of universal banks in Europe.

Jain vehemently warned about such a development. In his opinion, universal banks contributed to the stability of the financial system, because they were more diversified and provided crucial liquidity to the financial markets. The recent crisis had shown that rather more specialized institutes got into trouble and also contributed to systemic risk. Strict regulations in Europe could also create a competitive disadvantage for European compared to US universal banks because no comparable regulation has been planned in the United States so far.

Jain admitted that universal banks had an advantage compared to other banks: they benefitted from lower funding rates because of their "too big to fail" status – markets were taking into account that these "sifis" would probably be saved by the government if they got into trouble. But this advantage was, according to Jain, compensated by higher costs for complex regulation requirements and higher levies which mostly affected systemically important institutions.

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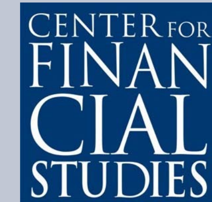

Axel Weber on Global Banking in a new Regulatory Environment

On 13 February, Axel Weber, Chairman of the Board of Directors of UBS, former President of Deutsche Bundesbank, and CFS Senior Fellow, gave a lecture about "Opportunities and challenges for the global financial sector in a new regulatory

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environment: A Swiss perspective". The speech was part of the CFS Colloquium series "Mission completed? Consequences of regulatory change on the financial industry" and attracted a large audience.

Weber started by giving an outline of macroeconomic developments within the Eurozone and comparing it to international trends. In his view, economic prospects have been improving over recent months: "We have made it through the worst." However, he said, the economy was only recovering slowly and the Eurozone as such was still stuck in recession. As many structural problems were still not resolved, EU policymakers remained obliged to find the right solutions.

While instrumental in preventing a meltdown in financial markets, according to Weber, central banks approached the limits of their mandate when intervening during the current crisis. As a complement to structural reform and fiscal consolidation, they could only help buy time for the necessary measures to be put in place. But as substantial reforms could not be expected before the German Bundestag elections in September, pressure on central banks to keep financial market tensions and volatility at bay would be further increasing. However, central banks could not live up to all the expectations directed at them and it was important to clearly state also the boundaries of central bank powers. Specific reforms necessary to achieve long-term solutions had to be implemented by governments.

Looking West and East, in Weber's view the US and Asia would grow stronger compared to Europe in the next years, and consequently the financial sector as well as businesses generally had to prepare for that shift in economic gravity. UBS had accordingly already been investing strongly in these markets.

Returning to Europe, Weber touched on the situation in a number of selected Eurozone member states. In his opinion, Greece would stay in the Eurozone even if the government lagged behind with the implementation of reforms, and debt dynamics were still not sustainable. In contrast, Ireland was developing more positively, although there were still budgetary and debt challenges. Spain presented a case for concern in his view. The country had to implement further austerity measures in order to achieve sustainable public finances and it couldn't be ruled out that Spain would have to apply for financial support from the EU at some stage. Extremely high unemployment rates meant a very significant political and social challenge, with no clear or even quick solutions available. Prospects for Portugal were slightly better as the country was committed to do what is necessary, even if the country still had a long way to go on its reform path and further pain was lying ahead. Italy remained a key cause for uncertainty about the Eurozone. One reason was the upcoming election, which Weber said could be an obstacle in the way to fiscal consolidation. Finally, Weber warned that the situation in France was deteriorating as crucial reforms were not forthcoming and the fiscal situation remained dire, ultimately risking a downgrade of the country by rating agencies.

Weber then described the effects of the new regulatory environment for financial markets in general and on UBS in particular. While the regulatory tightening was to be welcomed to make the system as such more stable, Weber regretted that long-term planning for banks was complicated by the ongoing uncertainties about the end state of the future regulatory environment, as still many important elements were in flux. It was moreover important to regulate financial markets globally in such a way as to create a level playing field for banks operating worldwide.

As an early mover, UBS had reacted to the emerging new conditions with profound

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strategic changes: investment banking activities were to be reduced in scope and size, to focus more on customer orientation and offer less complex, less risky and also less capital-intensive products. Establishing a level playing field for all banks was now essential, as otherwise adjusting quickly could still result in being a disadvantage.

Weber criticized plans for an outright separation of investment and commercial banking activities, as there was no empirical evidence that universal banks as such were part of the past problems in the financial sector. On the contrary, also specialized banks, like Lehman Brothers, or insurance firms such as AIG, had failed. It was often down to institute-specific issues, determining the best setup for – or problems at – individual institutions.

In view of the interactions between the financial and the real economies, coordinating the introduction of regulatory measures with the prevailing economic developments was essential. In this respect, it was a good decision to introduce Basel III only step by step until 2019.

After the lecture, in the Q&A part, Weber was asked about the single greatest threat to a sustainable financial architecture in Europe. In his opinion, this was the ultra-loose monetary policy globally. It risked sparking inflation, which could cause particular problems for the poorer parts of a population. Moreover, currency effects of these policies risked antagonizing trading partners facing the adverse consequences of what could be perceived as competitive devaluations. Weber also feared that bubbles could arise in financial markets, with loose monetary policy sowing the seeds of a new crisis in some years' time. This crisis, he said, was like a chameleon: it always changed its appearance.

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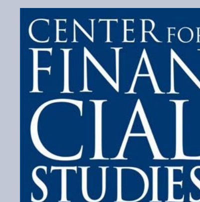

Robert C. Merton on a New Approach for Analyzing and Managing Macrofinancial Risks

On January 21, Robert C. Merton, Nobel Laureate and Distinguished Professor of Finance at the MIT Sloan School of Management, gave a special lecture at Goethe University Frankfurt entitled "On a New Approach for Analyzing and Managing Macrofinancial Risks." The guest lecture, organized under the auspices of the Deutsche Bank Prize in Financial Economics, attracted more than 600 participants.

Merton explained how credit risk can be built up from the micro to the macro level, and proceeded to use this framework to present the evidence of the interconnection and the feedback loops of credit risk between sovereigns and financial institutions.

In order to understand the development of the recent financial crisis it is crucial to have a clear grasp of the building up of credit risk. To do so, he started by explaining the similarities between purchasing risky

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debt (or loans/mortgages) and issuing a put option. In fact, the buyer of risky debt can be thought of as being engaged in two different financial activities: risk-free lending and writing (aka shorting) a guarantee of the promised payment on the risky debt, which is insurance writing. The holder of a guarantee, in case of a default, receives the full promised payment on the debt instead of whatever value of assets is recovered from the defaulting entity. Therefore, the value of the guarantee is equal to a put option on the assets of the borrower. It follows that whenever the value of the underlying corporate or housing asset drops due, for example, to market fluctuation, the value of the guarantee increases, but the value of the debt decreases and the risk profile increases in a non-linear fashion. The same effect on debt value occurs if the volatility of the underlying assets increases, even if the value of those underlying assets remains unchanged.

The next step is to use this equivalence to analyze the effect of risk on banks and to understand how the building up of risk has been underestimated before the recent financial crisis.

In fact, banks issue loans and the value of their debt is subject to the fluctuations of the underlying assets. After a negative shock, the value of the loan book decreases and its risk profile increases even in the absence of arrears. However, this feature has not been taken sufficiently into consideration and had led to the overlooking of the building up of credit risk.

Moreover, all governments guarantee their banks implicitly or explicitly. This means they write a guarantee on the banks' assets and, while their exposure to risk is very low during normal times, it might increase steeply during crisis. The situation becomes worse since most sovereigns encourage their banks to buy government debt. In fact, this is equivalent to a guarantor writing a guarantee on its own guarantor. When there are multiple sovereign and multiple banks that hold each others assets, feedback loops of risks between sovereigns and banks can develop.

However, it is possible to map the interconnection and the feedback loops between the institutions involved. Merton, with various coauthors, analyze the connectivity between banks, insurance companies and sovereigns (due to limited data availability), quantifying the credit risk of each institutions and sovereigns and how they affect each other. They propose to use the expected loss ratio to measure how the change in the credit of one entity affects the other. Having computed the credit risk of an institution or a sovereign, they compute how much it influences other institutions and sovereigns and build the connectivity between the institutions in the sample.

They show how the degree of connectedness changes over time and how it increased dramatically from before the crisis to the peak of the crisis. It is important to monitor these relationships because they vary over time depending on underlying conditions. Even though they are not structural and it might not be possible to envisage policies to prevent them from occurring, it is worthwhile to measure and monitor their developments in order to be prepared for them.

Merton argued that the main limitation of current models is that they do not embed structural uncertainty that has proved relevant in the analysis of credit risk and feedback loops. Merton proposed to look at fiscal policy, monetary policy and financial stability as an integrated system. In particular, monetary policy actions should take into considerations also the impacts on financial stability.

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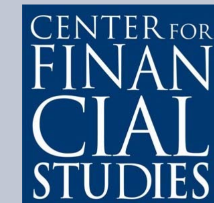

George Soros asks Germany to Lead or Leave the Euro

Germany should leave the European Monetary Union or accept Eurobonds. This was the core message of George Soros, Chairman of Soros Fund Management, when speaking in Frankfurt on 9 April. Soros gave a lecture on "How to Save the European Union from the

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Euro Crisis" following an invitation from the CFS. More than 1200 people as well as numerous journalists attended the event which was part of the CFS Presidential Lecture Series hosted by Otmar Issing, President of the CFS.

According to Soros, Germany is in the driver seat to combat the crisis. So far, the German government had only done the minimum necessary to save the Euro. Therefore, it was partly responsible for the misery. Soros warned that the European Union could break up if the recession in the crisis countries continued and the gap between debtor and creditor countries grew.

Soros provided two alternatives for Germany: "Lead or leave" – take a dominant position or leave the common currency union. In Soros opinion, the Euro could also survive without Germany. If Germany left, the Euro would automatically depreciate, the value of government debt would decrease and highly indebted countries could regain their competitiveness.

In contrast, Germany should introduce the Deutsche Mark again, which would then automatically appreciate. Thus, the German economy would lose competitiveness and German banks and companies would have to incur losses on their claims and investments denominated in Euro.

The alternative offered by Soros was to issue Eurobonds – common European government bonds. Their introduction would decrease the risk that crisis countries could not repay their debt. Their interest burden would diminish and they would have to save less, which would accordingly stimulate economic growth. Conversely, interests would rise in countries with a good creditworthiness, like Germany, because these had to finance part of the default risks of the crisis countries.

Otmar Issing dissented from Soros' suggestion by referring to the principle of „No taxation without representation". The consequence of introducing Eurobonds would be that German tax payers would indirectly finance other countries' debts, he said. This redistribution of public money would lack a transparent vote and therefore democratic legitimacy. An exit from the Euro, on the other hand, would first of all have negative political consequences. Germany would be maneuvered onto the political sidelines and the stability in the European Union as a whole would be endangered.

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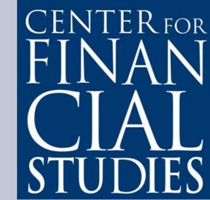

Towards a new European Banking Supervisory Authority

On 25 April, Dr. Elke König, President of the Federal Financial Supervisory Authority (BaFin), gave a speech on the future structure of banking supervision in the European Union. She discussed in particular the future role of BaFin and other national authorities once the single supervisory mechanism for the Eurozone is introduced. Her speech was part of the Colloquium Series "Political and Financial Impulses between Austerity and

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Growth: A Silver Bullet for Europe?" organised by the Center for Financial Studies.

According to König, the financial crisis had shown that national supervisory structures were no longer capable of meeting the challenges of globalisation. Large banks in particular operated increasingly across national borders. National authorities' abilities to identify and avert possible risks could not keep pace. On a European level it would thus be essential to implement the planned single supervisory mechanism, given that the legal framework within the European Union allowed for such a strong mechanism. The new single supervisory mechanism could increase financial stability in the Eurozone. Further steps on the global level, on a probably weaker legal basis, would need to follow.

In this context, König pointed out that the supervisory structure in a given country would not always allow conclusions to be drawn about actual supervisory activities there. The legal and political environment had a huge influence on how a supervisory authority carried out its duties. There was always a risk that a national authority would feel committed to its home market and would apply home country bias in its decisions. This would impede the objective of EU-wide legislation of creating a level playing field in all countries.

The harmonisation of supervision was important because a single European market could only work if European legislation was uniformly implemented and applied in all countries, said König. During the crisis in particular confidence had suffered and led to a growing fragmentation of markets. The planned single supervisory mechanism, consisting of the European Central Bank (ECB) and national authorities like BaFin, could help to restore confidence.

König pointed out that the introduction of the single supervisory mechanism in the Eurozone still left an important role for the European Banking Authority (EBA), which is responsible for the European Union as a whole. It would be important to manage the respective roles to avoid overlap, duplication or unnecessary tensions, said König.

The single supervisory mechanism for the Eurozone will rely significantly on the contribution of national supervisory authorities, like BaFin, which will continue to play an important role in supervision. The single supervisory mechanism will require national expertise in the supervision of those large banks that will be directly supervised by the ECB. Here, the plan is to work with joint supervisory teams composed of staff from the ECB and competent national authorities in order to exploit the superior know-how of national authorities regarding the local market and related risks. National authorities will retain supervisory responsibility for smaller banks, albeit within an ECB framework. This means that within the single supervisory mechanism the ECB can set general guidelines for the supervision of smaller banks and will monitor national authorities' compliance with supervisory standards.

König stressed that, even with the new single supervisory mechanism, banking union was still far from being complete. For example, a European framework for bank resolution was urgently needed. So far the idea had been to establish bank resolution authorities only at national levels and not for the entire Eurozone, like banking supervision. König welcomed this decision because a uniform bank resolution system in the Eurozone was not possible under existing law. In contrast to banking supervision law, which had been harmonised to a great extent, there were too many national differences in legislation relating to banking resolution. König therefore concluded that a single European bank resolution system would not be possible without a change in the

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European treaties.

Ina Christ

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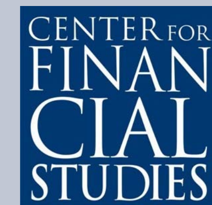

CFS Conference on Operational Risk

On 22 March 2013, a CFS Conference on Operational Risk (Management and Measurement) took place at the House of Finance. It was jointly organized by CFS/Goethe University (Thomas Kaiser and Mark Wahrenburg) and the Fraunhofer Institute for Industrial Mathematics (Nataliya Horbenko and Peter Ruckdeschel).

After a welcome address by Thomas Kaiser, four academics who had been selected based on their submitted papers presented their current research on operational risk management and measurement. Not surprisingly, the focus of the presentations was on the measurement part of the conference. Philipp Sturm (University of Tübingen) and Ahmed Barakat (Lancaster University) shared their work results on characteristics of operational risk losses. Alberto Suarez (Universidad Autonoma de Madrid) and Sandra Paterlini (EBS University and CEQURA) discussed new methods for quantifying operational risk based on loss data.

The conference's best paper award was granted to Sandra Paterlini for her outstanding paper on *Operational-Risk Dependencies and the Determination of Risk Capital* (co-authored by Stefan Mittnik and Tina Yener).

Four practitioners from banks, regulatory bodies and consultancies presented unsolved problems in applied operational risk management and measurement. Walter Dutschke

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(Institute of Operational Risk) and Christine Mährle (Eurogroup Consulting) started with the most qualitative/managerial aspects of operational risk: incentive systems and early warning systems. Ramona Bruhns (BaFin) talked about scenario analysis in operational risk models while Michael Kalkbrenner (Deutsche Bank) shared his quest for explanatory operational risk models inspired by credit risk modeling.

The conference closed with an extensive panel discussion about "potential ways forward". In addition to Thomas Kaiser, Peter Ruckdeschel and Mark Wahrenburg, Petra Merl (HypoVereinsbank) and Andreas Saemann (Deutsche Bank) discussed how the operational risk discipline is likely to develop in the coming years and what academics and practitioners could contribute to this development. While there was some controversy concerning the question how much approaches for operational risk measurement will converge in the next years, all panelists and participants shared the view that operational risk is going to become more important in the near future.

Intensive discussion with the audience showed a keen interest to repeat this conference in a similar format which the organizers were happy to accommodate. The proceedings of the conference as well as potentially additional papers are scheduled to be published by the end of 2013 in a special edition of the *Journal of Operational Risk*.

Thomas Kaiser

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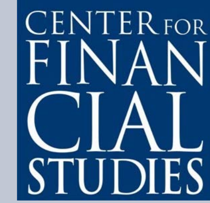

Selected Upcoming Events

04 Sep 2013	*CFS Presidential Lecture* **Rolf E. Breuer**: "Zur Entwicklung der Finanzmärkte – Beobachtungen eines Zeitzeugen"
20/21 Sep 13	*CFS Conference* **European Conference on Household Finance**
26 Sep 2013	*Award Ceremony & CFS Symposium* **The Deutsche Bank Prize on Financial Economics 2013**

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25 Nov 2013	*CFS Lecture* **Andreas Rödder**: "Primat der Politik? Die Entstehung der Europäischen Währungsunion"
04 Dec 2013	*CFS Colloquium* **Jean-Claude Trichet**: "Is the Euro at Risk?"

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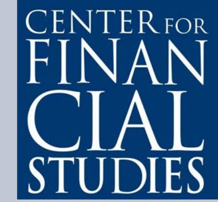

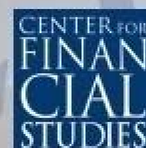

WP 2013/01: Incentives, Systemic Risk and Intransparency. Lessons from the Financial and National Debt Crisis

By Andrej Gill, Steffen Juranek, Christian Lizarazo, Nikolai Visnjic and Uwe Walz

The CFS Working Paper 2013/01 – "Incentives, Systemic Risks and Intransparency: Lessons from the Financial and National Debt Crisis" – resulted from an exploratory study by the Center for Financial Studies for the Federal Ministry for Education and Research (BMBF). The study provides an overview of the current state of scientific literature concerning the reasons, consequences and regulatory implications as well as their potential effects in the course of the financial crisis 2007 to 2010. Against this background, the aim was to derive areas with open questions calling for further research – with special focus on the possibility and necessity of interdisciplinary research. The central key words *incentives, systemic risks* and *(in)transparency* represent the objective to scrutinize the decisive functional mechanisms of modern financial systems with regard to their growth and welfare-increasing effects as well as with regard to their potential underlying crisis patterns. Fundamental aim of the study was to define cornerstones and provide ideas for a potential research program to be tendered by the BMBF.

The CFS team of researchers defined five research areas with corresponding sub-topics where highly relevant, open questions are being posed: Contagion Effects and Systemic Risk; Overall Economy and Financial System/Stability; Corporate Governance and Systemic Risk; Transparency and Financial Systems; Shadow Banking and Regulation (see Figure 1). The areas result directly

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Figure 1: Research areas that pose open research questions

Exemplary Results

Rather than provide a comprehensive discussion of all open research questions, we limit the following discussion to a number of important research question with a particular interdisciplinary focus.

One decisive reason for the financial crisis is the **profound interconnectedness of the financial institutions.** Although it is known that this interconnectedness has grown significantly in the last decades, only little can be said about the detailed reasons and extents of this interconnectedness. In the light of the importance of these interconnected structures it is not only necessary to gain much better knowledge about the network structures with the help of disaggregated data but also to sustainably learn about the reasons for the high degree of interconnectivity. Thereby, obviously not only organizational but also personal and social networks – not least with the help of sociological research – have to be investigated.

An often neglected connection is the one between **the intensity of competition and financial stability**. In the light of the fact that many regulatory interventions have clear effects on the intensity of competition and thus on financial stability, this is even more surprising. So far, research has only lead to a blurred picture which speaks even more in favor of a thorough analysis of this relationship not least on the basis of existing data.

A central focus on regulation in general is **the trade-off between financial stability (the cost of financial crises) and the welfare and growth-effects** of a dynamic

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financial system. These connections have already been researched intensively, however mostly only for relatively short terms. A consideration laid out for a long-term from an economic historian point of view would thus provide an elementary contribution to the regulatory debate.

Rating agencies were not only decisive in the financial and economic crisis but they keep on playing a central role in the current politico-economic debate. The scientific basis of this discussion is, however, rather thin. Further analysis, especially concerning the economic role of rating agencies (as institutions to gather information or in the role for regulatory purposes), seems necessary. Furthermore, given the discussion in the EU, it seems to be most important to address the relation between information revelation and competition. Or to put it in other words: Does increased competition lead to more or to less "truth"?

Last but not least, it is imperative from the authors' point of view to endogenize politico-economical and regulatory decisions in economic analysis. Due to the importance of political decisions and decision-makers the exogeneity of political decisions leads to fatal potential distortions. An interdisciplinary co-operation between politics and economic science might produce relief.

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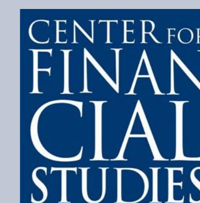

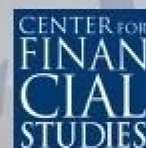

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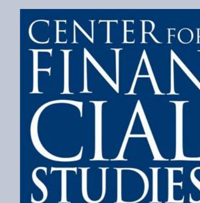

Fair Value Accounting and Procyclicality – Implications for Financial Stability and Regulation

The CFS research project "Fair Value Accounting and Procyclicality – Implications for Financial Stability and Regulation", launched in 2010, lead to two recent papers that analyze the role of financial reporting for financial stability.

"Financial Reporting, Financial Regulation, and Financial Stability: Evidence from German Bank Failures in 2007-2008"

In this paper, Oana M. Georgescu and Christian Laux analyze the failure of Deutsche Industriebank AG (IKB), Landesbank Sachsen Girozentrale (Sachsen LB), and Hypo Real Estate Holding AG (HRE). Looking at these banks is interesting because of specific rules for financial reporting and financial regulation that were in place in Germany. Although the evidence cannot easily be generalized to other banks, some general conclusions can be drawn.

Most importantly, our results show that the interactions between financial reporting and financial regulation are less straightforward than often claimed. All three banks were regulated based on German local GAAP (HGB), not International Financial Reporting Standards (IFRS) even though IKB and HRE were required to publish reports based on IFRS. Thus, some of the most spectacular failures of European banks occurred for banks that were regulated based on historical cost accounting. All three banks took on very high leverage either on-balance sheet (HRE) or off-balance sheet (IKB and Sachsen LB).

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"Contagion in the Interbank Market: Funding versus Regulatory Constraints"

In this paper, Oana M. Georgescu compares the contagion potential of mark-to-market accounting rules interacting with regulatory constraints in a network of banks. Simulation results show that for high levels of short-term debt relative to liquid asset holdings, the contagion potential arising due to funding constraints is higher than the one due to accounting induced regulatory constraints. Allowing balance sheet valuation to affect the expectations about future insolvency, and implicitly, the roll-over decision of short-term creditors, can amplify systemic risk relative to the case when only regulatory constraints are at play. The paper finds that, beyond the mechanical link that exists between accounting and regulatory constraints, balance sheet valuation per se is not a problem, but rather the vulnerable funding structure of banks during a crisis. This source of vulnerability may be better addressed through adequate macro-prudential tools than via ad-hoc amendments to the accounting regime.

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Oana Maria Georgescu, Christian Laux

The two papers are available at SSRN:

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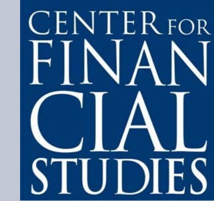

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The CFS research project "Fair Value Accounting and Procyclicality – Implications for Financial Stability and Regulation" was funded by the "Frankfurt Institute for Risk Management and Regulation" (FIRM).

Oana Maria Georgescu, Christian Laux

The two papers are available at SSRN:

- Financial Reporting, Financial Regulation, and Financial Stability: Evidence from German Bank Failures in 2007-2008
- Contagion in the Interbank Market: Funding versus Regulatory Constraints

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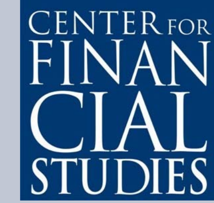

Anshu Jain warns of too much Regulation in Europe

If all currently planned regulations were to be implemented, this would be the end of universal banks in Europe. On 11 June, Anshu Jain, Co-Chairman of the Management Board and the Group Executive Committee of Deutsche Bank, warned of such a development in a lecture about challenges and opportunities for universal banks in

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Europe. Jain's speech was part of the colloquium series „Political and Financial Impulses between Austerity and Growth: A Silver Bullet for Europe?" organized by the Center for Financial Studies.

According to Jain, global universal banks such as Deutsche Bank are institutes that offer all financial products and services from a single source and operate in all major business centers worldwide. Historically, global universal banks therefore came into being mostly in countries with a strong economy, like Germany or the United States. For Jain, it would be a logical step for China to create such a bank in the near future.

Jain admitted that universal banks had made mistakes during the financial crisis – including Deutsche Bank. Their balance sheets had been too big and their business models too complex. The consequence had been systemic and sovereign risk.

However, since the beginning of the crisis, universal banks have been reforming themselves, said the manager with Indian roots. They have increased their capital, reduced compensation and refrained from too complex products.

Nevertheless, Jain pleaded for further regulation in the banking sector. For example, Basel III would contribute to the stability of the financial sector and create a level playing field around the world, which was essential in a globally interconnected financial system, he said.

On the other hand, Jain warned about the unprecedented pace at which the banking sector was being reformed at present and that this could lead to potential risks. As examples he mentioned the higher capital requirements for systemically important financial institutions ("sifis") or the plans for an EU-wide Financial Transactions Tax. Jain referred to estimations that European banks needed around 70,000 additional employees just to comply with Basel III.

Most critical in Jain's view were regulations that question the universal banking system itself. These include the Liikanen report in the EU, the Vickers Commission's proposals in the UK and the recently passed German Bank Separation Law, which is supposed to be implemented by 2016. Although these proposals differ in detail they are all headed in the same direction: separation of investment banking activities, trading and market making from deposit and lending activities. Their impact on universal banks is hard to predict because it depends on how regulation authorities will interpret them, said Jain. But if all these proposals were to be implemented according to plan, this would be the end of universal banks in Europe.

Jain vehemently warned about such a development. In his opinion, universal banks contributed to the stability of the financial system, because they were more diversified and provided crucial liquidity to the financial markets. The recent crisis had shown that rather more specialized institutes got into trouble and also contributed to systemic risk. Strict regulations in Europe could also create a competitive disadvantage for European compared to US universal banks because no comparable regulation has been planned in the United States so far.

Jain admitted that universal banks had an advantage compared to other banks: they benefitted from lower funding rates because of their "too big to fail" status – markets were taking into account that these "sifis" would probably be saved by the government if they got into trouble. But this advantage was, according to Jain, compensated by higher costs for complex regulation requirements and higher levies which mostly affected systemically important institutions.

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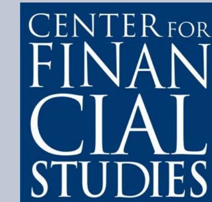

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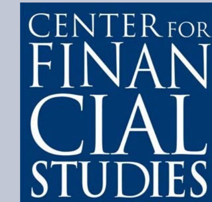

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environment: A Swiss perspective". The speech was part of the CFS Colloquium series "Mission completed? Consequences of regulatory change on the financial industry" and attracted a large audience.

Weber started by giving an outline of macroeconomic developments within the Eurozone and comparing it to international trends. In his view, economic prospects have been improving over recent months: "We have made it through the worst." However, he said, the economy was only recovering slowly and the Eurozone as such was still stuck in recession. As many structural problems were still not resolved, EU policymakers remained obliged to find the right solutions.

While instrumental in preventing a meltdown in financial markets, according to Weber, central banks approached the limits of their mandate when intervening during the current crisis. As a complement to structural reform and fiscal consolidation, they could only help buy time for the necessary measures to be put in place. But as substantial reforms could not be expected before the German Bundestag elections in September, pressure on central banks to keep financial market tensions and volatility at bay would be further increasing. However, central banks could not live up to all the expectations directed at them and it was important to clearly state also the boundaries of central bank powers. Specific reforms necessary to achieve long-term solutions had to be implemented by governments.

Looking West and East, in Weber's view the US and Asia would grow stronger compared to Europe in the next years, and consequently the financial sector as well as businesses generally had to prepare for that shift in economic gravity. UBS had accordingly already been investing strongly in these markets.

Returning to Europe, Weber touched on the situation in a number of selected Eurozone member states. In his opinion, Greece would stay in the Eurozone even if the government lagged behind with the implementation of reforms, and debt dynamics were still not sustainable. In contrast, Ireland was developing more positively, although there were still budgetary and debt challenges. Spain presented a case for concern in his view. The country had to implement further austerity measures in order to achieve sustainable public finances and it couldn't be ruled out that Spain would have to apply for financial support from the EU at some stage. Extremely high unemployment rates meant a very significant political and social challenge, with no clear or even quick solutions available. Prospects for Portugal were slightly better as the country was committed to do what is necessary, even if the country still had a long way to go on its reform path and further pain was lying ahead. Italy remained a key cause for uncertainty about the Eurozone. One reason was the upcoming election, which Weber said could be an obstacle in the way to fiscal consolidation. Finally, Weber warned that the situation in France was deteriorating as crucial reforms were not forthcoming and the fiscal situation remained dire, ultimately risking a downgrade of the country by rating agencies.

Weber then described the effects of the new regulatory environment for financial markets in general and on UBS in particular. While the regulatory tightening was to be welcomed to make the system as such more stable, Weber regretted that long-term planning for banks was complicated by the ongoing uncertainties about the end state of the future regulatory environment, as still many important elements were in flux. It was moreover important to regulate financial markets globally in such a way as to create a level playing field for banks operating worldwide.

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Weber criticized plans for an outright separation of investment and commercial banking activities, as there was no empirical evidence that universal banks as such were part of the past problems in the financial sector. On the contrary, also specialized banks, like Lehman Brothers, or insurance firms such as AIG, had failed. It was often down to institute-specific issues, determining the best setup for – or problems at – individual institutions.

In view of the interactions between the financial and the real economies, coordinating the introduction of regulatory measures with the prevailing economic developments was essential. In this respect, it was a good decision to introduce Basel III only step by step until 2019.

After the lecture, in the Q&A part, Weber was asked about the single greatest threat to a sustainable financial architecture in Europe. In his opinion, this was the ultra-loose monetary policy globally. It risked sparking inflation, which could cause particular problems for the poorer parts of a population. Moreover, currency effects of these policies risked antagonizing trading partners facing the adverse consequences of what could be perceived as competitive devaluations. Weber also feared that bubbles could arise in financial markets, with loose monetary policy sowing the seeds of a new crisis in some years' time. This crisis, he said, was like a chameleon: it always changed its appearance.

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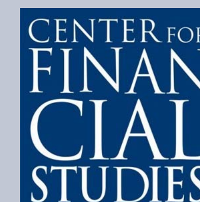

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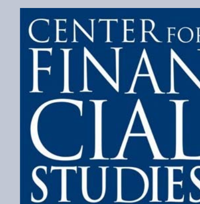

Robert C. Merton on a New Approach for Analyzing and Managing Macrofinancial Risks

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Merton explained how credit risk can be built up from the micro to the macro level, and proceeded to use this framework to present the evidence of the interconnection and the feedback loops of credit risk between sovereigns and financial institutions.

In order to understand the development of the recent financial crisis it is crucial to have a clear grasp of the building up of credit risk. To do so, he started by explaining the similarities between purchasing risky

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debt (or loans/mortgages) and issuing a put option. In fact, the buyer of risky debt can be thought of as being engaged in two different financial activities: risk-free lending and writing (aka shorting) a guarantee of the promised payment on the risky debt, which is insurance writing. The holder of a guarantee, in case of a default, receives the full promised payment on the debt instead of whatever value of assets is recovered from the defaulting entity. Therefore, the value of the guarantee is equal to a put option on the assets of the borrower. It follows that whenever the value of the underlying corporate or housing asset drops due, for example, to market fluctuation, the value of the guarantee increases, but the value of the debt decreases and the risk profile increases in a non-linear fashion. The same effect on debt value occurs if the volatility of the underlying assets increases, even if the value of those underlying assets remains unchanged.

The next step is to use this equivalence to analyze the effect of risk on banks and to understand how the building up of risk has been underestimated before the recent financial crisis.

In fact, banks issue loans and the value of their debt is subject to the fluctuations of the underlying assets. After a negative shock, the value of the loan book decreases and its risk profile increases even in the absence of arrears. However, this feature has not been taken sufficiently into consideration and had led to the overlooking of the building up of credit risk.

Moreover, all governments guarantee their banks implicitly or explicitly. This means they write a guarantee on the banks' assets and, while their exposure to risk is very low during normal times, it might increase steeply during crisis. The situation becomes worse since most sovereigns encourage their banks to buy government debt. In fact, this is equivalent to a guarantor writing a guarantee on its own guarantor. When there are multiple sovereign and multiple banks that hold each others assets, feedback loops of risks between sovereigns and banks can develop.

However, it is possible to map the interconnection and the feedback loops between the institutions involved. Merton, with various coauthors, analyze the connectivity between banks, insurance companies and sovereigns (due to limited data availability), quantifying the credit risk of each institutions and sovereigns and how they affect each other. They propose to use the expected loss ratio to measure how the change in the credit of one entity affects the other. Having computed the credit risk of an institution or a sovereign, they compute how much it influences other institutions and sovereigns and build the connectivity between the institutions in the sample.

They show how the degree of connectedness changes over time and how it increased dramatically from before the crisis to the peak of the crisis. It is important to monitor these relationships because they vary over time depending on underlying conditions. Even though they are not structural and it might not be possible to envisage policies to prevent them from occurring, it is worthwhile to measure and monitor their developments in order to be prepared for them.

Merton argued that the main limitation of current models is that they do not embed structural uncertainty that has proved relevant in the analysis of credit risk and feedback loops. Merton proposed to look at fiscal policy, monetary policy and financial stability as an integrated system. In particular, monetary policy actions should take into considerations also the impacts on financial stability.

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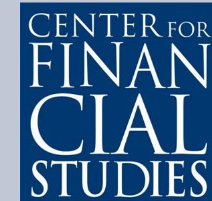

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Laura Moretti

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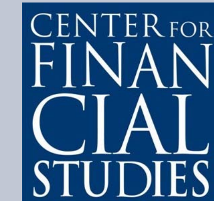

George Soros asks Germany to Lead or Leave the Euro

Germany should leave the European Monetary Union or accept Eurobonds. This was the core message of George Soros, Chairman of Soros Fund Management, when speaking in Frankfurt on 9 April. Soros gave a lecture on "How to Save the European Union from the

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Euro Crisis" following an invitation from the CFS. More than 1200 people as well as numerous journalists attended the event which was part of the CFS Presidential Lecture Series hosted by Otmar Issing, President of the CFS.

According to Soros, Germany is in the driver seat to combat the crisis. So far, the German government had only done the minimum necessary to save the Euro. Therefore, it was partly responsible for the misery. Soros warned that the European Union could break up if the recession in the crisis countries continued and the gap between debtor and creditor countries grew.

Soros provided two alternatives for Germany: "Lead or leave" – take a dominant position or leave the common currency union. In Soros opinion, the Euro could also survive without Germany. If Germany left, the Euro would automatically depreciate, the value of government debt would decrease and highly indebted countries could regain their competitiveness.

In contrast, Germany should introduce the Deutsche Mark again, which would then automatically appreciate. Thus, the German economy would lose competitiveness and German banks and companies would have to incur losses on their claims and investments denominated in Euro.

The alternative offered by Soros was to issue Eurobonds – common European government bonds. Their introduction would decrease the risk that crisis countries could not repay their debt. Their interest burden would diminish and they would have to save less, which would accordingly stimulate economic growth. Conversely, interests would rise in countries with a good creditworthiness, like Germany, because these had to finance part of the default risks of the crisis countries.

Otmar Issing dissented from Soros' suggestion by referring to the principle of „No taxation without representation". The consequence of introducing Eurobonds would be that German tax payers would indirectly finance other countries' debts, he said. This redistribution of public money would lack a transparent vote and therefore democratic legitimacy. An exit from the Euro, on the other hand, would first of all have negative political consequences. Germany would be maneuvered onto the political sidelines and the stability in the European Union as a whole would be endangered.

Ina Christ

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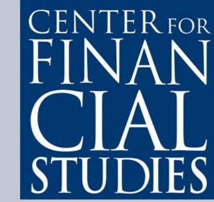

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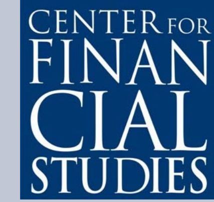

Towards a new European Banking Supervisory Authority

On 25 April, Dr. Elke König, President of the Federal Financial Supervisory Authority (BaFin), gave a speech on the future structure of banking supervision in the European Union. She discussed in particular the future role of BaFin and other national authorities once the single supervisory mechanism for the Eurozone is introduced. Her speech was part of the Colloquium Series "Political and Financial Impulses between Austerity and

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Growth: A Silver Bullet for Europe?" organised by the Center for Financial Studies.

According to König, the financial crisis had shown that national supervisory structures were no longer capable of meeting the challenges of globalisation. Large banks in particular operated increasingly across national borders. National authorities' abilities to identify and avert possible risks could not keep pace. On a European level it would thus be essential to implement the planned single supervisory mechanism, given that the legal framework within the European Union allowed for such a strong mechanism. The new single supervisory mechanism could increase financial stability in the Eurozone. Further steps on the global level, on a probably weaker legal basis, would need to follow.

In this context, König pointed out that the supervisory structure in a given country would not always allow conclusions to be drawn about actual supervisory activities there. The legal and political environment had a huge influence on how a supervisory authority carried out its duties. There was always a risk that a national authority would feel committed to its home market and would apply home country bias in its decisions. This would impede the objective of EU-wide legislation of creating a level playing field in all countries.

The harmonisation of supervision was important because a single European market could only work if European legislation was uniformly implemented and applied in all countries, said König. During the crisis in particular confidence had suffered and led to a growing fragmentation of markets. The planned single supervisory mechanism, consisting of the European Central Bank (ECB) and national authorities like BaFin, could help to restore confidence.

König pointed out that the introduction of the single supervisory mechanism in the Eurozone still left an important role for the European Banking Authority (EBA), which is responsible for the European Union as a whole. It would be important to manage the respective roles to avoid overlap, duplication or unnecessary tensions, said König.

The single supervisory mechanism for the Eurozone will rely significantly on the contribution of national supervisory authorities, like BaFin, which will continue to play an important role in supervision. The single supervisory mechanism will require national expertise in the supervision of those large banks that will be directly supervised by the ECB. Here, the plan is to work with joint supervisory teams composed of staff from the ECB and competent national authorities in order to exploit the superior know-how of national authorities regarding the local market and related risks. National authorities will retain supervisory responsibility for smaller banks, albeit within an ECB framework. This means that within the single supervisory mechanism the ECB can set general guidelines for the supervision of smaller banks and will monitor national authorities' compliance with supervisory standards.

König stressed that, even with the new single supervisory mechanism, banking union was still far from being complete. For example, a European framework for bank resolution was urgently needed. So far the idea had been to establish bank resolution authorities only at national levels and not for the entire Eurozone, like banking supervision. König welcomed this decision because a uniform bank resolution system in the Eurozone was not possible under existing law. In contrast to banking supervision law, which had been harmonised to a great extent, there were too many national differences in legislation relating to banking resolution. König therefore concluded that a single European bank resolution system would not be possible without a change in the

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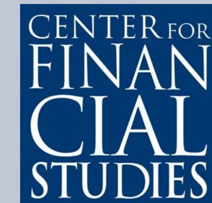

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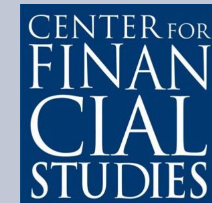

CFS Conference on Operational Risk

On 22 March 2013, a CFS Conference on Operational Risk (Management and Measurement) took place at the House of Finance. It was jointly organized by CFS/Goethe University (Thomas Kaiser and Mark Wahrenburg) and the Fraunhofer Institute for Industrial Mathematics (Nataliya Horbenko and Peter Ruckdeschel).

After a welcome address by Thomas Kaiser, four academics who had been selected based on their submitted papers presented their current research on operational risk management and measurement. Not surprisingly, the focus of the presentations was on the measurement part of the conference. Philipp Sturm (University of Tübingen) and Ahmed Barakat (Lancaster University) shared their work results on characteristics of operational risk losses. Alberto Suarez (Universidad Autonoma de Madrid) and Sandra Paterlini (EBS University and CEQURA) discussed new methods for quantifying operational risk based on loss data.

The conference's best paper award was granted to Sandra Paterlini for her outstanding paper on *Operational-Risk Dependencies and the Determination of Risk Capital* (co-authored by Stefan Mittnik and Tina Yener).

Four practitioners from banks, regulatory bodies and consultancies presented unsolved problems in applied operational risk management and measurement. Walter Dutschke

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(Institute of Operational Risk) and Christine Mährle (Eurogroup Consulting) started with the most qualitative/managerial aspects of operational risk: incentive systems and early warning systems. Ramona Bruhns (BaFin) talked about scenario analysis in operational risk models while Michael Kalkbrenner (Deutsche Bank) shared his quest for explanatory operational risk models inspired by credit risk modeling.

The conference closed with an extensive panel discussion about "potential ways forward". In addition to Thomas Kaiser, Peter Ruckdeschel and Mark Wahrenburg, Petra Merl (HypoVereinsbank) and Andreas Saemann (Deutsche Bank) discussed how the operational risk discipline is likely to develop in the coming years and what academics and practitioners could contribute to this development. While there was some controversy concerning the question how much approaches for operational risk measurement will converge in the next years, all panelists and participants shared the view that operational risk is going to become more important in the near future.

Intensive discussion with the audience showed a keen interest to repeat this conference in a similar format which the organizers were happy to accommodate. The proceedings of the conference as well as potentially additional papers are scheduled to be published by the end of 2013 in a special edition of the *Journal of Operational Risk*.

Thomas Kaiser

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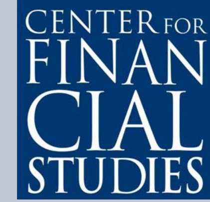

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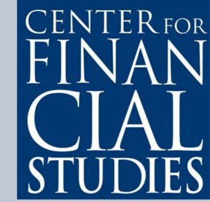

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20/21 Sep 13	*CFS Conference* **European Conference on Household Finance**
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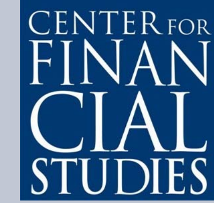

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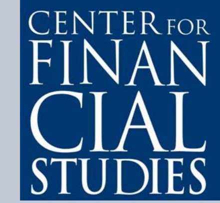

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