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Robert C. Merton appointed CFS Distinguished Fellow

11 December 2014

Dear Sir or Madam,

Currently, we are experiencing a broad public debate about the economic value of savings in Germany, not least against the background of historically low nominal interest rates. This debate forces us to recall that savings per se do not create wealth. Rather, it is productive investment that creates wealth. Individual and country-wide savings simply represent a postponement of consumption, a mechanism which has its own economic sense, especially at the level of individual households and even more so for an aging society as a whole. However, savings only add to increases in real wealth if invested at positive real interest rates. In this editorial I will build on two developments in this respect and then introduce our initiative on financial literacy at the CFS.

Uwe Walz
CFS Director

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Research & Policy

Implementing Bail-In Properly

In a Policy Letter, CFS Director **Jan Pieter Krahnen** describes how the recently proposed risk capital buffer for globally operating systemically important financial institutions, "Total Loss Absorbing Capacity" (TLAC), should be implemented.

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Robustness, Validity, and Significance of the ECB's Asset Quality Review and Stress Test Exercise

In a recent White Paper, CFS Fellow **Sascha Steffen** writes about the ECB's Comprehensive Assessment and describes possible shortcomings of the Asset Quality Review and stress test exercise.

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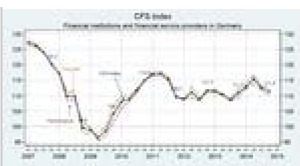
CFS Index: Financial Industry Sentiment Remains Positive in 2014



The **CFS Index** stayed on an almost constant level throughout the year indicating a positive business climate for the German financial industry.

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CFS Presidential Lecture: Axel A. Weber

On 10 September 2014, **Axel A. Weber** gave a CFS Presidential Lecture on opportunities and risks of the European banking sector.

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CFS Colloquium Series

Christian Leuz, **Maximilian Zimmerer**, **Martin Hellwig** and **Harold James** contributed to the CFS Colloquium Series "Risk-taking in the European Economy: Financial Institutions and Markets" in 2014.

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CFS Lecture: Andreas Dombret

During a lecture on 28 November at the CFS, **Andreas Dombret** explained which challenges banking supervisors and risk managers at banks are facing when trying to prevent risks that could lead to crises.

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CFS Lecture: Annamaria Lusardi

Annamaria Lusardi gave first insights into the newly released PISA data at the Center for Financial Studies on 4 November 2014.

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Selected Upcoming Events

Please have a look at selected upcoming **CFS events** in 2015.

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Michael Haliassos, CFS Director, contributed to the "National Strategic Framework for Research and Innovation 2014-2020" for his home country Greece.

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Robert C. Merton appointed CFS Distinguished Fellow

Robert C. Merton has been appointed a Distinguished Fellow of the Center for Financial Studies in September 2014.

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Deutsche Bank Prize in Financial Economics 2015: Preview

2015 marks the academic award's 6th edition. The winner of the forthcoming **Deutsche Bank Prize** will be announced in February 2015.

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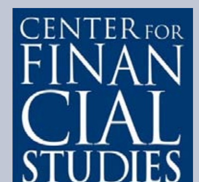

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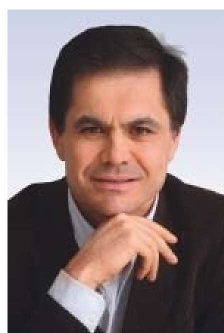
Editorial



Currently, we are experiencing a broad public debate about the economic value of savings in Germany, not least against the background of historically low nominal interest rates. This debate forces us to recall that savings per se do not create wealth. Rather, it is productive investment that creates wealth. Individual and country-wide savings simply represent a postponement of consumption, a mechanism which has its own economic sense, especially at the level of individual households and even more so for an aging society as a whole. However, savings only add to increases in real wealth if invested at positive real interest rates. In this editorial I will build on two developments in this respect and then introduce our initiative on financial literacy at the CFS.

Low returns of German investments abroad

Savings can be invested either domestically or abroad. In both dimensions German households have been and are facing an uphill battle.

Germany has a long history of positive current account balances (the main exception being the 1990s). Especially those in the last decade were pronounced. This led to a significant export of capital and to an accumulation of a net foreign balance vis-à-vis the rest of the world, amounting currently to more than 40 percent of GDP (gross external assets account for more than twice national GDP). This net foreign balance is, however, significantly lower than would be expected given the accumulated current account position. This is due to significant losses on external investments in the last decade. German firms, banks and households lost almost 20 percent of GDP on their foreign investments. In particular with portfolio investments in foreign bonds, Germany lost 8 percent relative to its GDP. At the same time, foreign direct investments of German investors abroad as well as of foreign investors in Germany have gained significantly. This goes along with the observation that German assets abroad have been invested in low-return assets, especially in comparison with U.S. foreign assets. The fact that returns of German investments abroad are low and in many years even negative is not a recent phenomenon stemming from the financial crisis but can be observed in other time periods, too. This observation does not only relate to the investments of German private households but does include them as well.

Historically low interest rates in Germany

For domestic investments, the currently low interest rates on low-risk assets are, without doubt, an important hurdle for the accumulation of wealth and old-age provision. This is, however, not a new development. Also in the past, real interest rates on short-run deposits and savings were associated in very many occasions with negative real interest rates. A glance at the interest rate statistics of Deutsche Bundesbank reveals that, in recent decades, negative real interest rates on savings have been the rule rather than the exception, especially in the 1970s, the early 1990s and since 2010 (see Figure 1). This is quite a remarkable fact given that more than 40 percent of the financial wealth of German households is “invested” in savings accounts and short-term deposits.

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The difference now is that the currently low nominal interest rate environment is also hitting the second main asset class of German households hard, namely insurance contracts that account for roughly 30 percent of financial wealth of households in this country. Returns from insurance contracts (especially life insurances) will definitively decrease significantly in the near future – and have already been doing so in the recent past. Hence, there is little reason to expect that the main bulk of current savings in these two asset classes will add to the accumulation of real wealth of German households.

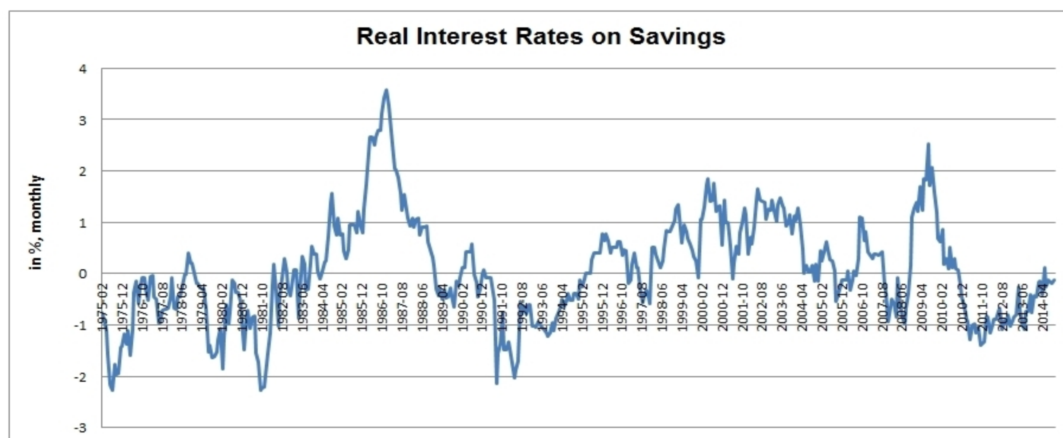

Figure 1, *Source: Deutsche Bundesbank*

(click to enlarge)

Implications

Taking together both facts, there is one obvious and trivial insight: low returns on investments add very little to the accumulation of real wealth. What can be done against this? Besides potential remedies via economic policy which may lift the real rate of return on investment (e.g. through public investment in infrastructure), there is only one route towards long-run accumulation of real wealth: more risk taking.

If the low returns from domestic and foreign investments just reflect a low risk appetite of rational savers, this is obviously an efficient outcome. If, however, low or negative returns on savings are also partially due to the lack of proper understanding of the risk-return trade-off and the important role of diversification as well as of adequate financial products, this is a different ball game. There is empirical evidence that suggests substantial deficits in financial literacy of German savers. In a recent talk at the Center of Financial Studies, Annamaria Lusardi, Professor of Economics at George Washington University School of Business, Head of the Financial Literacy Advisory Team to the OECD and CFS Fellow, stressed on the grounds of ample empirical evidence, that, in most countries, financial literacy is not very well developed, an issue which clearly also holds for German savers as empirical papers show. We see a lack of knowledge not only regarding financial institutions and products but even more so with regard to essential economic concepts such as interest rate compounding and the central role of diversification.

Financial literacy initiative at the CFS

There exists a variety of projects and initiatives aiming to improve financial education in Germany, in many instances driven by the financial industry. The CFS aims to contribute to these initiatives by providing not only a neutral platform for financial education but also by building on the expertise of the Center as well as on experiences collected in other countries to develop concepts and strategies for financial education at the high school level. We view the CFS to be very well endowed to contribute to better financial decision-making in this country. Developments on this front will be reported in future newsletters.

Yours sincerely,
Uwe Walz

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Implementing Bail-In Properly

by Jan Pieter Krahnen, CFS Director

The G20 Summit of the leading industrial and emerging countries on 15/16 November 2014, was again concerned with the question of how the problem of "too big to fail" could be solved. During the financial crisis, systemically important financial institutions were rescued with taxpayer's money because policy-makers and supervisory authorities considered a resolution too risky, fearing contagion effects: the default of one bank was expected to lead other banks into serious trouble.

The G20 member states supported a recent proposal by the Financial Stability Board (FSB) to require a new risk capital buffer for globally operating systemically important financial institutions. The suggested metric, "Total Loss Absorbing Capacity" (TLAC), is composed of Tier-1 capital and loss absorbing debt. In sum, TLAC would amount to about 16 to 20 percent of the risk-weighted assets of a systemically important bank.

The credibility of bail-in in the case of systemically important financial institutions hinges crucially on the design of TLAC and the requirements that will be placed on loss absorbing "bail-in-able" debt. In a crisis situation, "bail-in-able" debt is to be written down or converted into equity. If the supervisory authority continues to fear that a bail-in would seriously affect other important banks, it will shy away from practicing bail-in and, in the end, the taxpayer will again have to bear the costs. This would counteract the intentions of TLAC.

The issue of credible bail-in was addressed by the Liikanen Commission in 2012 and its proposal was recently affirmatively commented on also by the Deutsche Bundesbank. The Liikanen Commission argued that the fear of direct systemic consequences through bail-in could be overcome, if a holding ban were placed on the "bail-in-bonds" of financial institutions. The holding ban would stipulate that these bonds cannot be held by other institutions within the banking sector.

Of course, the question arises who could buy and hold these bonds. The debt holders should not themselves run the risk of refinancing difficulties in case of a bail-in. Thus, appropriate investors would be diversified investment companies with long-term contracts, restrictive cancellation rights and variable payment promises. These criteria are, for instance, fulfilled by life insurance companies and pension funds.

The objective of this endeavor is not to pass risks from one sector to the next. Rather, if designed correctly, the buyers of bail-in-bonds will receive an appropriate coupon for the risks they are taking. When an insurance company safeguards against a risk for a premium, it builds up reserves that can be used to settle any losses occurred. With investments into "bail-in-able debt", it should act accordingly with the coupon received.

Ideally, the banking supervisory authority should know the identity of investors into bail-in bonds and their ability to absorb losses. It will need to oversee that investors do not transfer the default risk of this debt back into the banking sector, for example via Credit Default Swaps or similar instruments. In the end, only a well operating supervisory authority can build the confidence necessary to prevent systemic contagion in case a

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large bank gets into trouble.

For TLAC to make a successful contribution to decreasing the “too big to fail“-problem, a holding restriction for “bail-in-able debt” needs to be implemented. It is essential, that markets believe that loss-absorbing liabilities will, in fact, be bailed-in. This can only be achieved with transparency with regards to the investors. Therefore, requiring loss absorbing debt is a step in the right direction – but, without a holding restriction for banks, it is well-intentioned but not well-designed and would be ineffective.

*The paper was published as SAFE Policy Letter No. 35 and is available for download **here**.*

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Robustness, Validity, and Significance of the ECB's Asset Quality Review and Stress Test Exercise

by Sascha Steffen,
ESMT European School of Management and Technology
and Fellow of the Center for Financial Studies

The European Central Bank (ECB) took over the regulatory oversight of 128 banks in the euro zone in November 2014. The ECB now effectively assumes roles as both central bank and regulator in charge of the Single Supervisory Mechanism (SSM). In preparation, the ECB conducted a comprehensive assessment of these banks, which included an asset quality review (AQR) and a stress test. The credibility of the ECB might be severely damaged if some banks fail because of legacy assets, soon after it has taken over regulatory oversight. The comprehensive assessment was thus necessary to clean up banks' balance sheets before the start of the SSM.

The banking system in the euro zone is still vulnerable. During the credit boom of 2004-2006, banks invested too much and accrued too much leverage. Importantly, they did not internalize how their behavior affects the entire financial system. This became obvious during the 2007-2009 global financial crisis, as well as during the recent sovereign debt crisis when banks incurred massive losses and needed substantial government support.

2010 and 2011 European Stress Tests

After the 2007-2009 financial crisis, European stress tests, which were designed by the European Banking Authority (EBA), were implemented in 2010 and 2011 as part of macro-prudential oversight. These tests, however, were ineffective. Substantial solvency concerns with respect to some institutions remained and caused a disruption in short-term funding markets in the fall of 2011. The ECB thus implemented a tailor-made monetary policy to support these institutions, further reducing incentives of banks and national regulators to act. A serious comprehensive assessment is imperative to identify and repair existing capital shortfalls within the banking sector to facilitate efficient capital flow, restore credit, and reignite economic growth in the euro zone.

ECB's 2014 Comprehensive Assessment

The ECB faces a trade-off: On the one hand, it wants to maintain its reputation as a central bank and build its reputation as a regulator from the start by comprehensively identifying and valuing the problem assets of the 128 banks. On the other hand, there is the potential for capital shortfalls but no clearly defined backstop should any of the banks falter. The lack of clarity regarding public backstops may have induced the ECB to water down the stress test scenarios. Worse, national regulators may have incentives that induced them to not fully disclose problem assets, yet the ECB depended on information from the national regulators when conducting the comprehensive assessment. National

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regulators might try to keep the capital shortfalls as small as possible, with the intention of, at some point, sharing the burden with other countries. These incentives are particularly strong for countries with weakly capitalized banks and limited fiscal capacity. The trade-off may have weakened the significance of both the ECB's AQR and the stress test exercise.

The AQR was the first part of the comprehensive assessment. As a point-in-time assessment, it should have uncovered the non-performing assets that are still on the balance sheets of the 128 euro zone banks. However, the AQR considered only a fraction of a bank's loan book that had been selected for this exercise. Thus, problem loans might still be hidden in banks' balance sheets, as they were not evaluated. Another concern is that, in general, valuations of loans are very subjective because they usually do not have market prices.

Stress Tests

The design of the EBA 2014 stress test exercise is a substantial improvement over the previous exercises in 2010 and 2011 in various aspects. For example, a larger number of banks were included, the scope of macro shocks as well as country-specific shocks was substantially broader (also compared to the U.S.), a wider range of risks was considered, and national authorities were encouraged to add other country-specific risks as well.

While the purpose of the EBA 2011 stress test was to assess the solvency of individual banks as well as the resilience of the EU banking system, the EBA 2014 stress test exercise focused on the recapitalization of EU banks, i.e., to repair banks' balance sheets by "identifying and implementing necessary corrective action" (ECB, 2013). ECB (2014) states that capital shortfalls have to be covered by raising capital; selling assets should be the exception, and be "distinct from normal operations." This is a positive development since the stress tests in 2011, as well as the capitalization exercise, which required banks to meet a specific capital threshold without actually requiring them to raise capital.

But it might be exceedingly difficult for banks with shortfalls to raise equity themselves and this problem could also extend to short-term funding markets. The ECB may be forced to continue its unconventional measures and start another Long-Term Refinancing Operation (LTRO) program similar to 2011 to avoid a liquidity crisis. In other words, missing backstop mechanisms increase the likelihood that the comprehensive assessment will be substantially diluted to avoid large capital shortfalls and a disruption of short-term funding markets.

Systemic Risk and Implications for Stress Testing

The EBA and ECB are assessing the risk exposures of banks on an individual level; however, they do not account for feedback effects or linkages between banks, or between banks and other parts of the financial system (i.e., they do not conceptualize "systemic risk" and its effect on banks and the macro economy). But it is precisely these linkages that might increase the default risk of banks even though they seem to be well capitalized individually. Thus, linkages should be a key component in future macro-prudential stress tests. Banks are increasingly interconnected through contractual relationships, as well as exposures to similar assets and similar comparable macroeconomic shocks. Because banks do not internalize the risks their behavior creates for the system, they invest too much and accrue too much leverage. Furthermore, even though the number of banks that are part of the EBA 2014 stress test has substantially increased since 2010, future stress tests should consider other non-bank financial institutions, such as insurance firms or hedge funds, in their assessment of systemic risk.

Conclusion

Taken together, the trade-off faced by the ECB, as well as the omission of systemic risk in the assessment, strongly suggest that the ECB may not be able to reach its objective of identifying the problematic assets and cleaning-up the balance sheets of European banks, without putting its reputation in danger and leaving the financial system vulnerable. The ECB may thus have to continue providing assistance to banks about whose solvency one can have serious doubts. Importantly, a sustainable growth path still eludes the euro zone countries.

The paper was published as SAFE White Paper No. 23 and is available for download ***here***.

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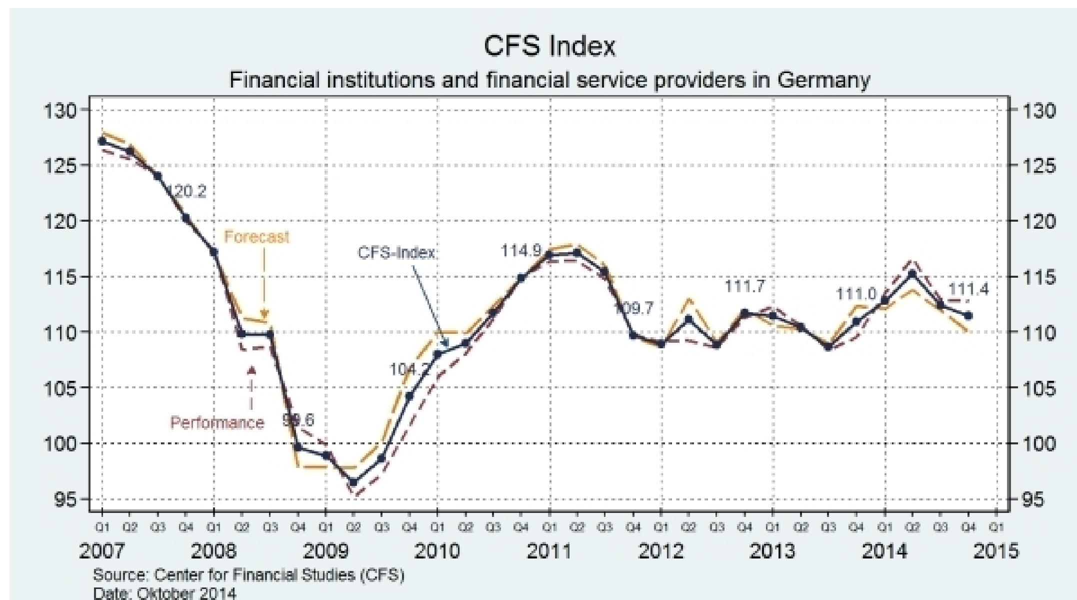
CFS Index: Financial Industry Sentiment Remains Positive in 2014

by Sebastian Frontczak, Center for Financial Studies



At the end of 2014, the CFS Index returned to almost the same level at which it started the year (111.4 points). After the second quarter, when the index increased by 4 points to over 115 points, it seemed that the financial industry may flourish again. However, the drop in the index recorded in the subsequent two quarters reverted this sign of optimism. Nevertheless, the sideways movement at levels being well in the positive territory (above an index value of 100 points) indicates that the financial sector has been growing steadily since 2012, though it is not booming. Throughout this year, it could have been observed that service providers for the financial industry assess their business situation much better than financial institutions. "While service providers, like consultancy and auditing companies, benefit from new regulations in the financial sector, the impact is negative for financial institutions. Because of these opposite effects the CFS Index has moved sideways," Professor Jan Pieter Krahnen, Director of the Center for Financial Studies and academic head of the survey, commented on this development.

Special Surveys

The CFS Index also provides important insight into the professionals' opinion about current developments in German and European economic policies via special surveys carried out each quarter. In 2014 the special surveys touched upon the following topics: European banking union, investment barriers in the EU crisis countries, shadow banking and the ECB's ABS purchasing program.

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The January survey revealed that the implementation of the European banking union was expected but not desired by the financial industry. A large majority of respondents expressed the expectation that there would be a stronger centralization in the medium term regarding banking supervision, banking resolution and deposit insurance. The rate of approval to this development, however, was significantly lower. Especially a centralization of deposit guarantee schemes was not favoured by the majority of survey participants.

In April, the special survey was concerned with investment barriers in the EU crisis countries. The respondents were asked what factors they would consider as being important when investing in one of the southern European economies. The survey showed that around 90 percent of decision makers from German financial institutions and financial service providers regard legal security, a high-quality educational system/human resources as well as a sound infrastructure as important or very important. In order of importance these answers were followed by sound public finances, low regulation or bureaucracy as well as an attractive tax system. 65 percent assessed flexible labor market structures as important or very important. On the contrary, a low wage level was considered less important or not important by a majority of 64 percent.

In a special survey on shadow banking, carried out at the beginning of the third quarter, the financial industry expressed the view that the shadow banking sector is going to grow further. As a response to this issue a vast majority of respondents (80%) expressed the wish for internationally coordinated regulation of the shadow banking sector. However, only one third of survey participants considered the shadow banking sector to have a destabilizing effect on the European financial sector as a whole. "The demand for internationally coordinated regulation of the shadow banking sector is most likely due to banks' desire for a level playing field," Krahnen noted. "Financial institutions are afraid that companies from the shadow banking sector could have a competitive advantage if they are less regulated than banks themselves."

The special survey in October concentrated on the ECB's ABS purchasing program and other measures targeted to stimulate the credit supply in the euro zone. It turned out that the financial industry holds the opinion that neither the ECB's ABS purchasing program, nor purchases of sovereign bonds or further ECB interest rate reductions will be able to stimulate the credit market; What is needed are structural reforms. "The ECB has already exhausted its possibilities to stimulate bank lending," Krahnen said. "Therefore, the financial industry calls for political action to increase bank lending by implementing structural reforms and taking fiscal measures."

More information can be found on the ***CFS Index website****.*

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CFS Presidential Lecture: Axel A. Weber

"European Banking Union Involves Opportunities and Risks"

The financial crisis has induced changes in the banking sector and tighter regulation of financial markets. The changing environment has brought new challenges for banks, Axel A. Weber, Chairman of the Board of Directors of UBS AG, said during a lecture at the Center for Financial Studies. Banks should respond proactively to the new regulatory projects and adjust their business models and balance sheets. According to Weber, the implementation of the banking union is one of the most important projects of the European Union (EU) in the near future. On 10 September, the former president of Deutsche Bundesbank gave a talk at the CFS Presidential Lecture series following an invitation from CFS President Otmar Issing.

The banking union is no guarantee for stability and growth

Overall, Weber regards the implementation of the banking union positive. It could help to break the link between EU member countries and "their" banks and counteract the fragmentation of financial markets in the euro area. For example, after the introduction of the Single Resolution Mechanism and the establishment of a single resolution fund, future decisions about bank resolutions would be made at the European level and no longer at the national level, Weber explained. With the single resolution fund it would also be easier to separate country credit risk from banking risk.

At the same time, Weber warned that the banking union alone cannot solve all problems of the euro area and will also involve risks. Important elements, like deposit insurance or fiscal policy, will stay on the national level for the time being. Besides, a successful baking union is no guarantee for stability and growth in the euro area. Member countries also need to implement further structural reforms. In some countries, for example, labor costs are still too high to be competitive. Weber also warned not to misinterpret the currently good economic situation in Germany. Here, reforms are also necessary. The sound economic situation is mostly due to the relatively weak euro which is a result of the poor economic environment in other European countries. The international competitiveness of the German export sector has "artificially" been strengthened by the weak euro. However, this situation could quickly change.

Europe is overbanked

An important part of the establishment of the banking union is the comprehensive assessment of banks' balance sheets, Weber said. The results of the Asset Quality Review could make it easier for investors to compare banks across borders. However, according to Weber, the assessment also involves risks because it could again intensify

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the crisis if a lot of banks fail and have to raise new capital. Furthermore, he called for security measures to avoid that speculations are made at the expense of individual banks. Weber also criticized that big banks were generally assessed as problematic. In his view, not the size of a bank matters but how diversified it is. According to Weber, there is evidence that more diversified banks have weathered the crisis comparatively well.

It is difficult for banks in the euro area to increase their capital ratio out of their own resources, for example by retaining profits, in the currently low interest environment, Weber explained. The low interest rates put the margins of banks under pressure. Besides, competition among banks in Europe is high because there are too many financial institutions: "Europe is overbanked." Weber thinks that especially retail banks will be restructured and that smaller banks in the euro area could merge more often in the future.

Otmar Issing and Axel A. Weber (from left)

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CFS Colloquium Series

"Risk-taking in the European Economy: Financial Institutions and Markets"

- ▶ Harold James: *Handling the risks of sovereign defaults: an alternative*
- ▶ Martin Hellwig: *The current reforms in the banking sector are not sufficient*
- ▶ Maximilian Zimmerer: *Investment strategies in the low interest rate environment*
- ▶ Christian Leuz: *Accounting standards and financial stability: need for reform?*

Handling the risks of sovereign defaults

On 3 December, Harold James, Professor of History and International Affairs at Princeton University, gave a talk at the CFS Colloquium Series "Risk-taking in the European Economy: Financial Institutions and Markets". His lecture was a journey through the history of sovereign debt crises ending at the most recent one that we are still experiencing in the euro area.

According to James, government debts in euro area countries had been increasing since the outbreak of the financial crisis, as a result of private sector debt being taken over by governments in the aftermath of bank problems. However, he said, overall the debt levels were still low compared with the U.S. or Japan. Nevertheless, debt in the euro zone is perceived as a threat to stability. Going back in history, there were also examples when sovereign debt had even a stabilizing effect, James noted. In the 1790s, in the aftermath of the American War of Independence, the debts of U.S. member states increased to an unmanageable level and the national government was only able to solve this problem by assuming the debts of the individual states. This mutualization of debts by the government had a stabilizing effect. But there had also been financial crises where

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sovereign debts became unsustainable and resulted in political tensions, James explained. One example is the financial crisis in France in 1787 that ultimately led to the French Revolution, when there was also a large socialization of private debt.

In 1945, after World War II, the International Monetary Fund (IMF) was established as the manager of the international monetary system, but after 1982 found a new role as a manager of sovereign debt crises. There are three aspects to the IMF's approach. Firstly, the IMF is acting as international lender of last resort to overcome temporary liquidity shortages; secondly, the IMF demands a commitment to long-term structural reforms by the country that needs assistance; and, finally, it asks creditors to make concessions such as debt reductions. As James explained, crisis countries would often need an intervention from outside to combat negative developments but, at the same time, reform programs could only be successful if the countries themselves were willing to implement them properly. The IMF has never been able to evolve a systematic mechanism for post-crisis debt reduction.

In 2010, during the recent financial crisis, the IMF designed a rescue program for Greece in cooperation with the European Union, but sacrificed its principle of debt reduction as a way of ensuring debt sustainability. The aftermath produced a great deal of criticism of the Fund's Euro-centrism. According to James, the subsequent bail-in of creditors in Cyprus showed that there was also another way to deal with crisis countries that, in his opinion, could be a blueprint for the future.

At the conclusion, James sketched out a vision in which debt was more disaggregated, and treated as an analogy to an insurance contract. In this view, debt on a big scale is industrial poison: break debt up into little pieces, homeopathic doses, and it becomes benign. Many individual, small-scale bankruptcies are good: they are a sign of a dynamic, experimental society that is willing to take risks. Large agglomerations of publicly held debt, and the aftermath in debt defaults, by contrast are inherently unmanageable.

Martin Hellwig: The current reforms in the banking sector are not sufficient

According to Martin Hellwig, Max Planck Institute for Research on Collective Goods, the current reforms in the financial sector are not going far enough. In Hellwig's view, the 2007-9 crisis could not have been prevented even if today's regulations had already been in place since 2000. On 22 October, during his lecture at the CFS Colloquium Series "Risk-taking in the European Economy: Financial Institutions and Markets", he explained that many reform plans had nothing to do with the crisis but had served other agendas like, for example, the implementation of new European institutions, the regulation of hedge funds and short sales, or the financial transaction tax. The reform of capital requirements for banks was still insufficient as well as the reform of bank resolutions.

Although the new European Bank Recovery and Resolution Directive (BBRD) and the implementation of the Single Supervisory Mechanism (SSM) are large improvements, a resolution of systemically important banks that operate across boarders would still cause great damage for the economy. Also, the resources from bank levies and funds were not sufficient to stabilize the system, Hellwig said. As long as it was not possible to resolve banks without damaging the system, it would hardly be possible to get rid of "zombie" banks – banks that are heavily indebted but cover this up by an unrealistic valuation of their assets – and to reduce excess capacities in the banking sector. As long as these overcapacities still existed, banks would have to take high risks to make profits at all.

As it is not possible to properly resolve large banks, prevention is key. However, to appropriately address this issue, the causes of the crisis need to be analyzed first. As opposed to the US, this has not happened in Europe so far. The extent of the crisis was not only due to bad loans, for example for real estate in the U.S., Ireland or Spain, but also to the high interconnectedness and the high indebtedness of banks. Both causes have triggered the crisis in different ways so that also moderate regional losses have endangered the global financial system. The reforms agreed on since 2008 would hardly counteract these developments.

According to Hellwig, the increase in capital requirements for banks by Basel III is small and mostly thanks to "improvements in the management of risk weights" and not to

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increasing the liable capital. The risk weighting is still not appropriate and prone to manipulation; also, it creates incentives for artificial interconnectedness. When talking about bank liquidity, people would discuss whether mortgage securitizations should be considered as "liquid" or not – even after the experiences of 2007! Little thought has been given to the genuine problem, the dependence of banks on money market funds, and to the possibility of runs to and by money market funds. Structural measures (Volcker, Liikanen) were dominated by nostalgia and illusions: The separation of investment and commercial banks in the U.S. had caused the crisis in the eighties that had nothing to do with investment banking and that was very expensive for taxpayers; Lehman Brothers, as an investment bank, did not have any deposits but still was systemically important. The structural problem would have to be tackled practically. The question was which structures were the best to manage surpluses from customer deposits, to ease the effects of contagion during a crisis and to make bank resolutions easier. So far these questions remain unanswered.

Investment strategies in the low interest rate environment

On 8 October, Maximilian Zimmerer, member of the Management Board of Allianz SE, Investments, gave a lecture at the CFS Colloquium Series "Risk-taking in the European Economy: Financial Institutions and Markets." He explained which challenges investors have to face in the currently low interest rate environment and which investment strategies the Allianz Group pursues.

The low interest rates, Zimmerer said, are challenging private investors for example with regard to old-age provision. For instance, if a person invests money for the duration of 30 years to get an amount of 100,000 euro for his retirement, the necessary seed capital would depend heavily on the interest rate. If interest rates are on average 7%, a seed capital of 13,137 euro would be enough, while 55,207 euro are needed, if interest rates are only at 2%. Thus, the saving rate had to increase tremendously to ensure old-age provision, Zimmerer pointed out.

The Allianz Group invests most of its capital (89%) in fixed-interest investments, Zimmerer explained. Prior to the introduction of Solvency II, a reform of the insurance supervision law in Europe, the share was significantly lower. According to Zimmerer, insurance companies today choose less risky investments as a consequence of the introduction of Solvency II. Also, the investment periods of life insurances have increased since Solvency II.

Zimmerer criticized that not all regulations of Solvency II were effective. For example, EU government bonds do not need backing with capital while shares have to be covered with 39-49% equity capital and real estate with 25%. This evaluation does not take into account that government debt can also be risky, Zimmerer said. On the contrary, the capital backing of shares and real estate is too high, in his view, and therefore insurance companies invested less in these asset classes.

As a consequence of the low market interest rates the returns on several other asset classes, such as shares or "Pfandbriefe", are also declining. This is because the returns are composed of both the market interest rate and a risk premium. At present, not only market interest rates are decreasing but also the risk premia. The reason is that, in the low interest rate environment, a lot of investors are searching for investment opportunities with high returns. Accordingly, many asset classes are overvalued. Therefore, if a new crisis will break out, high price losses would be likely, Zimmerer said. In the currently low interest rate environment higher returns could be made by investing, for example, in non-listed investments or infrastructure.

Did fair-value accounting contribute to the financial crisis?

Since the beginning of the financial crisis, many critics have argued that fair-value accounting (e.g. IFRS) has amplified the crisis and increased financial instability. Under fair-value accounting standards, bank assets or liabilities are marked to market: that is, they are declared according to current market prices instead of book values. Thus, all gains and losses are

immediately recognized in income statements. At a CFS Colloquium on 8 July, Christian Leuz, Joseph Sondheimer Professor of International Economics, Finance and Accounting at the University of Chicago Booth School of Business and CFS Research Fellow, nevertheless cited empirical evidence to make the case that fair-value accounting did not contribute to the crisis. Indeed, recent empirical analyses have not found a strong link between financial reporting standards and financial stability.

Leuz explained that financial accounting provides information for prudential regulation, market participants as well as for bank management. For example, regulators look at financial accounting figures when deciding on capital requirements for banks, and bank managers rely on this data when taking risk management decisions. However, Leuz warned, we should not overestimate the importance of accounting data. Financial reporting is usually not the only source of information available; indeed, regulators often make significant adjustments to the reported numbers for their own purposes (e.g. applying prudential filters). Similarly, investors do not solely rely on accounting information, but also consider other factors such as the overall macroeconomic situation, analyst reports or newspaper articles. Thus, Leuz concluded, these numbers have no significant effect on financial stability.

Empirical studies have shown that, before the crisis, bank assets were often overvalued in accounting reports; hence, according to Leuz, the crisis saw no excessive write-downs, but rather the write-downs that did occur served simply to mark the value of these assets closer to their fundamental value. Although there might have been downward spirals or asset fire sales in certain markets, evidence suggests that these effects were not due to the use of fair-value accounting standards. During the crisis, banks usually did not report their real exposures, and disclosures were mostly made quite late. As examples, Leuz mentioned the cases of IKB and Sachsen LB, both of which issued press releases assuring markets that they had no problems just days before being bailed out. According to Leuz, such a lack of transparency contributes to financial instability as much as the disclosure of negative information on banks.

Finally, Leuz argued that historical cost accounting (e.g. HGB) – accounting standards valuing assets at their original acquisition costs instead of at current market prices – does not make any difference for financial stability, and does not result in lower leverage compared to fair-value accounting. For example, though several German banks that got into trouble during the crisis, like IKB or HRE, were regulated based on German historical cost accounting standards rather than fair-value accounting standards, these banks were just as highly leveraged as their peers. In Leuz's view, capital requirements can contribute more to avoiding high leverage than any specific accounting rules.

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CFS Lecture: Andreas Dombret

"The Challenge of Financial Regulation"

During a lecture on 28 November at the Center for Financial Studies, Andreas Dombret, member of the Executive Board of Deutsche Bundesbank, explained which challenges banking supervisors and risk managers at banks are facing when trying to prevent risks that could lead to crises. Dombret stressed that crises were usually unpredictable and thus occurred unexpectedly – the current financial crisis was no exception to this.

Dombret noted that research indicates that people are naturally risk-averse and therefore the question would arise why banks had taken such high risks before the financial crisis. Dombret explained that the picture changes if people did not have their own but other peoples' money at stake. In this case their willingness to take higher risks would rise. Also, moral hazard would play an important role when it came to risk taking. For example, Dombret said, crises have become more frequent since deposit insurance schemes were implemented and central banks became the lenders of last resort. Furthermore, during the recent financial crisis banks were saved with taxpayers' money if they got into trouble and were considered as too-big-to-fail. This implicit insurance policy increased banks' willingness to take higher risks. Dombret came to the conclusion that "if we want to make banks care about risks, we have to restore the balance between liability and control."

To achieve this objective, Dombret considered a bank resolution mechanism necessary that allowed banks to fail without threatening financial stability. Only if such a mechanism was in place, banks would have incentives to manage their risks in a prudent manner. Therefore, Dombret welcomes the introduction of the Single Resolution Mechanism (SRM) in Europe in 2016. Besides, the G20 member states supported a proposal that aims to improve banks' capital structures, he said. The proposal would provide that systemically important banks have to hold a certain amount of total loss-absorbing capacity which ensured that banks' owners and creditors would have to bear the costs of failure and not taxpayers.

Besides, Dombret said, even the ability of risk managers at banks to assess risks properly was limited. Studies had shown that even professionals were not able to adequately predict risks in the financial market, like for example the housing bubble of 2004-2006. Also statistical models used by banks could only to some degree measure potential risks. According to Dombret these models have often been criticized for not being able to adequately capture "high-severity-low-probability" risks. Furthermore, there could always be extreme events that appear completely unexpected and thus could

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not be managed with statistical models by risk managers or banking supervisors, Dombret explained. In his view, capital buffers can protect banks against both expected and unexpected shocks. Therefore, financial regulation had focused on increasing capital requirements for banks, he said.

The full speech by Andreas Dombret is available here.

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CFS Lecture: Annamaria Lusardi

"Financial Literacy Skills for the 21st Century"

In July 2014, insights into financial literacy skills of students based on the 2012 Programme for International Student Assessment (PISA) were released for the first time on a global level. Annamaria Lusardi, Professor at the George Washington School of Business and Academic Director of the Global Financial Literacy Excellence Center, chaired the Financial Literacy Expert Group that designed the assessment. On 4 November 2014, she presented a first analysis of the newly released data at the Center for Financial Studies and explained how the module on financial literacy has been created.

According to Lusardi, financial literacy is getting more important because of the increased complexity of financial services, shrinking welfare systems and shifting demographics. These issues force people to take more personal financial responsibility. Students already have to take important decisions at a young age that impact their future financial well-being like, for example, continuing their education or starting to work earlier. Besides, also young people have access to financial products.

The 2012 PISA module on financial literacy is the first-ever international assessment of financial literacy skills of 15-year-old students. 18 countries participated in the test as for example Australia, the U.S., Italy or Spain – Germany did not take part in this module. In some of the participating countries financial literacy has not been taught in school so far.

The objective of the assessment was to show whether students in different countries are well prepared for future challenges and to provide information for parents, teachers and policy-makers about where improvements were necessary, Lusardi said. One challenge in designing the questions for the assessment was to find issues that work for 15-years-olds all around the world as financial services or payment systems differ across countries, she explained.

Lusardi showed some of the first results of the PISA data: Students in Shanghai-China are the top performers of all participants and students from Colombia had the worst results. U.S. students achieved an average level. Lusardi expects students from Asian countries and Finland to be among the top performing students if these countries had participated in the assessment. Overall, 15% of students only achieved a level of financial literacy skills that is below the very basic financial knowledge whereas 10% of students were at the highest possible level.

The level of financial literacy of students is not necessarily higher in richer countries or in countries with more developed financial markets, Lusardi explained. However, she showed that the socio-economic background, such as income or education of parents, is

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an important determinant of financial literacy. The PISA data also reveals that financial literacy skills are highly correlated with mathematical skills and that students perform better when they are attending a school in an urban location compared to schools in rural areas.

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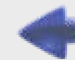
19 Feb 2015	CFS Presidential Lecture **Jens Weidmann**, *President of the Deutsche Bundesbank* "Münzen – Banknoten – Cybergeld: Folgen für die Geldpolitik"
26 Feb 2015	CFS Colloquium **Adair Lord Turner**, *CFS Senior Fellow and Institute for New Economic Thinking* "Risk: The Global Perspective"
11 Mar 2015	**The ECB and Its Watchers XVI**
19 Mar 2015	**CFS Conference on Operational Risk**
23 Mar 2015	CFS Colloquium **Hyun Song Shin**, *Bank for International Settlements*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National Strategic Plan for Research and Development in Greece

As a member of the Greek National Council for Research and Technology (NCRT) appointed for the period 2010-13, Michael Haliassos, CFS Director, contributed to the "National Strategic Framework for Research and Innovation 2014-2020" for his home country Greece. The NCRT 2010-13 consisted of eleven scientists representing all disciplines. This body submitted a proposed strategic plan to the Greek government which was officially released in August 2014.

To promote the advancement of research, technology and innovation in Greece, the strategic plan proposed by the authors seeks to identify areas of existing research strength and excellence that can be further advanced to become engines for progress and growth in Greece, as well as flaws inherent to the present system. The authors write: "The adoption and implementation of this Plan can signal a decisive shift to a stronger and more sustainable growth path for Greece, with R&D supporting a commitment to a knowledge-based economy that fosters innovation. It can also promote parallel reforms that will impact on governance and management; public expectations; and social inclusion." They express their hopes that this concrete strategic plan is soon followed by an implementation plan by the Government of Greece.

To download the study please follow this link.

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Robert C. Merton appointed CFS Distinguished Fellow

Robert C. Merton has been appointed a Distinguished Fellow of the Center for Financial Studies in September 2014. "We are honored to welcome the Nobel Laureate Robert C. Merton among our Distinguished Fellows," Otmar Issing, President of the CFS, said. "The CFS is looking forward to collaborating with him and to sharing views and ideas about current research topics."

Merton is the School of Management Distinguished Professor of Finance at the MIT Sloan School of Management and University Professor Emeritus at Harvard University. In 1997, he received the Alfred Nobel Memorial Prize in Economic Sciences for a new method to determine the value of derivatives. Besides, he will be a jury member of the Deutsche Bank Prize for the second time in 2015. Merton conducts research in the field of finance theory, including lifecycle and retirement finance, optimal portfolio selection, capital asset pricing, pricing of derivative securities, credit risk, loan guarantees, financial innovation, the dynamics of institutional change, and improving the methods of measuring and managing macro-financial risk.

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Deutsche Bank Prize in Financial Economics 2015: Preview

2015 marks the academic award's 6th edition. The winner of the forthcoming Deutsche Bank Prize will be announced in February 2015. The award itself will be presented on 24 September 2015 at Goethe University Frankfurt as part of an international academic symposium in honor of the award winner.

In September 2014, the Jury signaled the start of the award proceedings for the sixth time. Over 4,500 professors from 58 countries were invited to submit suggestions for nominees online until the end of November 2014. The pool of invaluable nominations provided by the international network of distinguished academics guides the Jury's award winner selection process and ensures that it reflects, in part, the winner's stand within the scientific community.

Since 2005, the groups of Jury members have consisted of 39 distinguished professors with backgrounds from Europe, North America, Latin America, Asia and the South Pacific. Members of the international Jury for 2015 include the professors **Guillermo Calvo** (Columbia University), **David Folkerts-Landau** (Deutsche Bank's Group Chief Economist, Global Head of Market Research and member of the Group Executive Committee), **Michael Haliassos** (CFS Director), **Otmar Issing** (CFS President), **Nobuhiro Kiyotaki** (Princeton University) and **Holger Kraft** (Goethe University). CFS Director **Jan P. Krahnen** is serving as the Chairman of the Jury 2015. Furthermore, the Jury includes the professors **Robert C. Merton** (Nobel Prize Winner; Massachusetts Institute of Technology), **René M. Stulz** (Ohio State University), **Uwe Walz** (CFS Director) and **Mirko Wiederholt** (Goethe University).

Next year, on 26 January 2015, a CFS workshop on financial crises will also be held at Goethe University under the auspices of the Deutsche Bank Prize. The Jury members Professor **Guillermo Calvo** and Professor **Nobuhiro Kiyotaki** will talk about their latest research.

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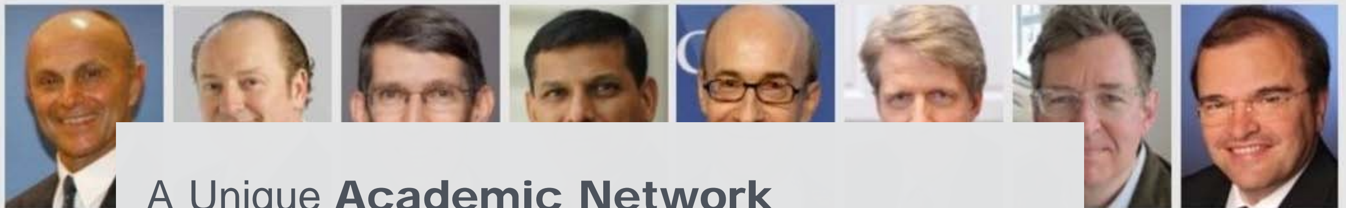

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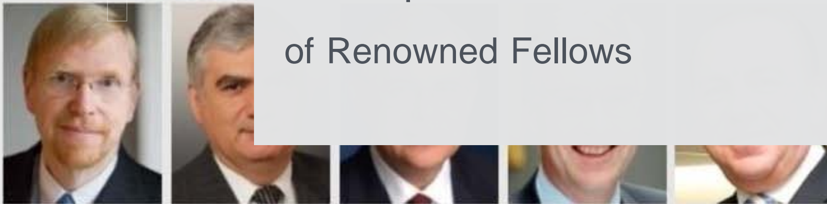

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conducts independent and internationally oriented research in important areas of Finance. It serves as a forum for dialogue between academia, policy-making institutions and the financial industry. It offers a platform for top-level fundamental research as well as applied research relevant for the financial sector in Europe.

CFS PEOPLE

"Good policy needs rigorous, state-of-the-art economic analysis, combined with sound judgement. It is necessary to critically mirror the "new" against the "old" – both in theory and with regard to political circumstances. Economic research conducted in such a way remains theory, but a theory that does not solely rely on a model."

Otmar Issing, CFS President

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Lutz Kilian

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CFS WORKSHOP

Deutsche Bank Prize – Workshop on Financial Crises

26 January 2015, 5.30-7.00 pm
Speaker: Guillermo Calvo and Nobuhiro Kiyotaki

Link to the event

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The Deutsche Bank Prize in Financial Economics honors internationally renowned economic researchers whose work has a marked influence on research concerning questions of financial economics and macroeconomics, and has led to fundamental advances in economic theory and practice.

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Dr. Jens Weidmann, Präsident der Deutschen Bundesbank

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"Cheap oil is no reason for further quantitative easing"

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The state of banking regulation

An opinion piece in “Capital Online” by CFS Director Jan Pieter Krahnen

10 December 2014

"Regulation is an unpopular business"

An interview with Jan Pieter Krahnen in today's Börsen-Zeitung

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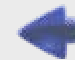
19 Feb 2015	CFS Presidential Lecture **Jens Weidmann**, *President of the Deutsche Bundesbank* "Münzen – Banknoten – Cybergeld: Folgen für die Geldpolitik"
26 Feb 2015	CFS Colloquium **Adair Lord Turner**, *CFS Senior Fellow and Institute for New Economic Thinking* "Risk: The Global Perspective"
11 Mar 2015	**The ECB and Its Watchers XVI**
19 Mar 2015	**CFS Conference on Operational Risk**
23 Mar 2015	CFS Colloquium **Hyun Song Shin**, *Bank for International Settlements*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