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Dear Sir or Madam,

16 December 2015

Following the global financial crisis that began in 2007, immense efforts were undertaken to reform the regulatory and institutional framework for financial institutions and markets. These efforts are only imperfectly coordinated on the international scale. In a forthcoming policy publication (joint with Felix Noth and Ulrich Schüwer), we compare different proposals for reforming the structure of the banking industry: the Volcker rule in the U.S., the Vickers report in the UK, and the Liikanen/ Barnier proposals for the EU. All proposals for bank structural reform aim to reduce the risks believed to emanate from bank trading activities. Our focus is on one major element of these regulatory proposals that has played, and continues to play, a prominent role in the public debate: the separation of trading activities from the more classical banking activities such as deposit-taking and lending.

Jan Pieter Krahnen
CFS Director

more

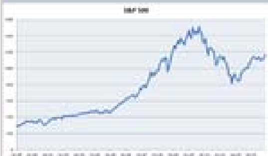
Research & Policy

Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

In a CFS Working Paper, **Otmar Issing** discusses the report of the "Five Presidents" and their proposals to complete Europe's economic and monetary union.

more

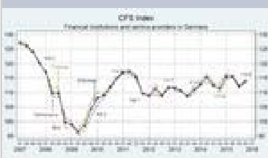
Has Greater Stock Market Participation Increased Wealth Inequality in the US?



Yannis Bilias, Dimitris Georgarakos and **Michael Haliassos** analyse how a wider access to the stock market between 1989 and 2001 in the US has changed wealth inequality among US households.

more

CFS Index: Positive Business Climate in 2015



The **CFS Index** stayed well above the neutral level of 100 points throughout the year, indicating positive developments in the German financial sector.

more

- Editorial

Research & Policy

- Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?
- Has Greater Stock Market Participation Increased Wealth Inequality in the US?
- CFS Index: Positive Business Climate in 2015

Events

- Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross
- Frankfurt – Fudan Financial Research Forum
- Book Presentation: Barry Eichengreen
- CFS Presidential Lecture: Martin Feldstein
- SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan
- Selected Upcoming Events

News

- Financial Regulation: A Transatlantic Perspective
- LOEWE Center SAFE Gets Further Funding

Events

Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

On 24 September, the award ceremony of the **Deutsche Bank Prize in Financial Economics** and an academic symposium in honor of the award winner of 2015, **Stephen A. Ross**, took place at Goethe University Frankfurt.

more

Frankfurt – Fudan Financial Research Forum

On 25 September, the second **Frankfurt – Fudan Financial Research Forum**, co-organized by the CFS and Fudan University took place at the House of Finance.

more

Book Presentation: Barry Eichengreen

On 20 October, **Barry Eichengreen** presented his book "Hall of Mirrors – The Great Depression, The Great Recession, and the Uses – and Misuses – of History" at the CFS.

more

CFS Presidential Lecture: Martin Feldstein

On 29 October, **Martin Feldstein** gave a talk in the CFS Presidential Lecture Series on "Monetary Policy and Financial Markets".

more

SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

On 10 November, **Raghuram Rajan** gave a lecture on "Rules of the Game in the Global Financial System".

more

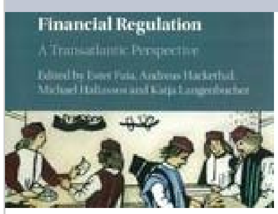
Selected Upcoming Events

Please have a look at selected upcoming **CFS events** in 2016.

more

News

Financial Regulation: A Transatlantic Perspective



The CFS has supported the creation of the book **"Financial Regulation: A Transatlantic Perspective"** which was published by Cambridge University Press in August 2015.

more

LOEWE Center SAFE Gets Further Funding

The **LOEWE Center SAFE** at Goethe University Frankfurt's House of Finance will continue to be supported by the State of Hessen.

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Editorial

Following the global financial crisis that began in 2007, immense efforts were undertaken to reform the regulatory and institutional framework for financial institutions and markets. These efforts are only imperfectly coordinated on the international scale. In a forthcoming policy publication (joint with Felix Noth and Ulrich Schüwer), we compare different proposals for reforming the structure of the banking industry: the Volcker rule in the U.S., the Vickers report in the UK, and the Liikanen/ Barnier proposals for the EU. All proposals for bank structural reform aim to reduce the risks believed to emanate from bank trading activities. Our focus is on one major element of these regulatory proposals that has played, and continues to play, a prominent role in the public debate: the separation of trading activities from the more classical banking activities such as deposit-taking and lending.

The separation of banking activities is an intricate exercise. It is not only difficult to assess the intended consequences of structural interventions in banking – such as improved resolvability, reduced systemic risk and protection of depositor money –, it is even more difficult to anticipate the unintended consequences – e.g. regulatory ambiguity, reduced efficiency of business models and growth of shadow banking. Because the separation of banking activities constitutes a major infringement on the business model of modern day banks, it should be well understood before legislation to its effect is introduced.

The Volcker, Vickers and Liikanen proposals

The structural reform projects currently discussed or implemented in the U.S., the UK, and the EU differ substantially in at least two dimensions. First, with respect to the range of services covered by the separation decree, i.e., which activities are to be separated, and second, with respect to how separation is to be implemented, i.e., what legal, organizational and financial restrictions will be imposed on separated activities.

The Volcker rule draws the 'magic' line dividing prohibited and permitted trading activities between proprietary trading (bank investment in capital markets using a bank's own money, with the intention of profit making for the bank's own account) and non-proprietary transactions. The Liikanen proposal, in contrast to Volcker, does not single out proprietary trading for special treatment, but instead requires that all trading business, be it proprietary or client-oriented, is either prepared for separation in a crisis situation (avenue 1), or effectively separated from retail banking (avenue 2). After considering the Liikanen proposal, the EU Commission, in January 2014, put forth a legislative proposal (Barnier proposal) which recommends an outright ban for proprietary trading for big banks in Europe. Other forms of trading, like market making activities as well as hedging transactions for the banks' own accounts, remain allowed. The proposal does grant the responsible supervisor the power to require the separation of all trading if problems occur that potentially put the whole bank and the wider financial system at risk.

Finally, Vickers proposed a partial separation of UK retail banking services from global wholesale and investment banking services, the so-called "retail ring-fence". The idea behind this separation proposal is to limit public guarantees to ring-fenced banks, as those perform banking services thought to be vital for the economy. Concurrently, the proposal aims at reducing incentives of non-ring-fenced banks for excessive risk-taking. Within Vickers, proprietary trading does not receive any special treatment; it may be practiced within core retail banking and outside of it.

Why proprietary trading should not be prohibited

GO BACK
Return to content list

Editorial

Research & Policy

Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

Has Greater Stock Market Participation Increased Wealth Inequality in the US?

CFS Index: Positive Business Climate in 2015

Events

Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

Frankfurt – Fudan Financial Research Forum

Book Presentation: Barry Eichengreen

CFS Presidential Lecture: Martin Feldstein

SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

Selected Upcoming Events

News

Financial Regulation: A Transatlantic Perspective

For large international banks, trading activities are a natural and an important part of their business model. Such trading may be driven by client orders, both retail and corporate (market making activities), by hedging own or client exposures, or by proprietary trading strategies. In much of the public debate on structural reform, proprietary trading is considered a vice. As such it needs to be curbed or completely shut down, while market making and hedging are seen as positive and valuable services. Perhaps because of its simplicity, regulation has focused on prohibiting proprietary trading.

But is this a wise idea? Our paper substantiates serious doubt. And the doubts about proprietary trading prohibition hold true irrespective of whether proprietary trading is considered a vice or a virtue.

The reason is that under today's complex bank treasury operations, it is extremely difficult to tell the difference between proprietary trading and market making (or even hedging). The difference boils down to a difference of (unobservable) intentions rather than of observable transactions. This diagnosis has important implications for regulation. First, even with proprietary trading prohibition in place, high risk trades that put a bank's own capital at risk are possible – provided they have plausible hedging or market making strategies. Second, and more importantly, the prohibition to engage in proprietary trades may result in banks not offering hedging or market making services, simply because they fear a misclassification as a proprietary trade by the supervisor. Such misclassifications are more likely if the hedging or market making strategy is complex, thus inviting misinterpretations.

What should be done?

We conclude that a more sustainable regulatory policy for bank structural reform would focus on requiring trading operations to be separately capitalized, rather than focusing on proprietary trade prohibition. There is still time to change horses and to pursue a regulatory policy more in line with the intentions of the banking union, namely strengthening market forces in limiting bank risk taking.

Yours sincerely,
Jan Pieter Krahnen

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Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

by Otmar Issing (CFS President)

The European Monetary Union (EMU) represents an unprecedented institutional arrangement. Never before in history have states, while maintaining their individual sovereignties, voluntarily renounced their national currencies in favour of a new common currency and ceded their authority over monetary policy to a supranational central bank. At the inception of the EMU, a large majority of German economists shared the position that political union should come first or at least contemporaneously with monetary union. However, by the time of the introduction of the EMU in 1999, no further progress toward political union had been achieved; in fact, it had not even been attempted.

Today, euro area countries already share a number of elements of political union. Apart from having a supranational central bank and a common currency, they have transferred additional elements of national sovereignty to the supranational level such as exchange rate policy, competition policy and trade policy and, most recently, banking supervision. The Eurozone crisis and the failure of several national governments to live up to their commitments and to reform their economies within the monetary union are now viewed as evidence that Europe must transfer even more competences and spending powers to the European level, and in this way move in the direction of political union.

The Report of the "Five Presidents"

On June 22, the "five presidents" – representing the European Council, the European Commission, the Eurogroup, the European Central Bank and the European Parliament – presented their report "Completing Europe's Economic and Monetary Union" (Juncker et al., 2015 [1]) in which they call for a "deep, genuine, and fair" EMU.

The report aims at turning the euro area in "a place of prosperity based on balanced economic growth and price stability, a competitive social market economy, aiming at full employment and social progress" (p. 4). Who would not support this manifesto? These are goals easily accepted by all countries. To the extent that this is a plea to finalize the single market and to remove remaining barriers to the free flow of people, goods, services and capital, this is indeed consistent with a programme to foster growth and employment. However, the argument that follows – that achieving these goals requires "further steps to complete EMU" – is anything but straightforward.

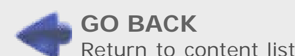
In this context the report demands progress towards a genuine economic union that ensures that "each economy has the structural features to prosper within the Monetary Union" (p. 4). What follows is a long list of objectives, measures and reforms pointing in the right direction. However, all of these arguments are long well known and it is hard to see how national responsibilities, the poor quality of some national institutions and a lack of reform can be overcome by European surveillance and administration.

The Challenges of Limited Fiscal and Political Union

The least complete part of EMU's "unfinished house" is political union. The report insists on parallel developments in the field of fiscal and political integration. It does not plead for a fully-fledged fiscal and political union, only for steps in this direction.

The report advocates for the creation of a European Fiscal Board, which would provide a public yet independent assessment of how national budgets and their execution perform against the economic objectives and recommendations set out in the EU fiscal governance framework. This idea deserves a try.

More controversial is the proposal for a scheme to set up a macroeconomic stabilisation


GO BACK
Return to content list

Editorial

Research & Policy

Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

Has Greater Stock Market Participation Increased Wealth Inequality in the US?

CFS Index: Positive Business Climate in 2015

Events

Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

Frankfurt – Fudan Financial Research Forum

Book Presentation: Barry Eichengreen

CFS Presidential Lecture: Martin Feldstein

SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

Selected Upcoming Events

News

Financial Regulation: A Transatlantic Perspective

function for the euro area. The five presidents argue that the Stability and Growth Pact should remain the "anchor for fiscal stability" (p. 18), observance of its existing rules should be a prerequisite to arguing in favour of an additional "euro area–wide fiscal stabilisation function" (pp. 14–15). Over time, however, the Pact has lost more and more respect, and the present European Commission has downgraded it to a measure applied on the basis of pure political discretion. Under these circumstances, how can the five presidents' statement that "we need to reinforce trust in the common EU fiscal governance framework" (p. 14) be taken seriously?

Similar to previous proposals for a "European finance minister", the report suggests establishing a euro area treasury to enable the "joint decision-making on fiscal policy" required in a fiscal union (p. 18). The authors make clear that this partial transfer of national fiscal sovereignty needs arrangements for democratic accountability, legitimacy and institutional strengthening.

These are all moves in the direction of a political union. However, the combination of *limited* transfer of fiscal sovereignty and *limited* democratic legitimacy is a dangerous path to follow. Limited democratic legitimacy will prevail as long as the transfer of fiscal sovereignty is not based on changes in national constitutions.

Political union in Europe cannot be attained through the back door by steadily eroding national sovereignty over fiscal policy. Violating the principle of "no taxation without representation" is a dangerous approach to deepen European integration (Issing, 2008).

[1] *Elsewhere, page numbers in parentheses are references to this report.*

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The paper was published as CFS Working Paper No. 521 and is forthcoming in International Finance.

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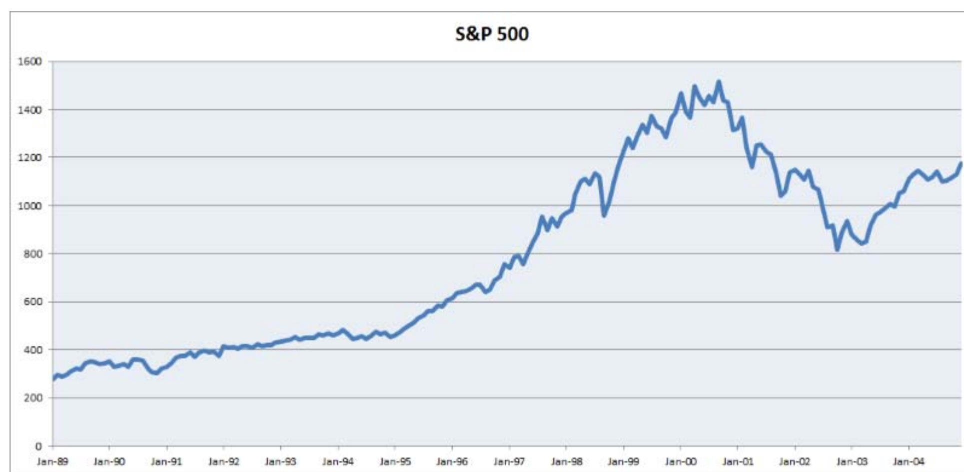
Has Greater Stock Market Participation Increased Wealth Inequality in the US?

by Yannis Bilias (Athens University of Economics and Business), Dimitris Georgarakos (Deutsche Bundesbank) and Michael Haliassos (CFS Director)

Household investments in risky assets, especially direct and indirect stock holdings, grew substantially between the late 1980s and 2001 in the US. By early 2000, about half of US households had invested in stocks, partly in response to stockholding opportunities introduced through individual retirement accounts and defined contribution pension plans, but also due to reduced costs of investing in mutual funds.

A sizeable expansion of the stockholder base is often thought of as facilitating wealth enhancement and reducing wealth inequality by widening access to the equity premium. Favilukis (2013) points to a conflict between this inequality-reducing factor and a stock market boom that tends to widen the wealth gap between stockholders and non-stockholders. In addition, we note that stocks are complicated and management-intensive financial instruments that create challenges for stock market entrants with limited financial sophistication and jeopardize their position in the wealth distribution. The combination of these factors makes the link between stock market participation and wealth inequality quite ambiguous.

We use three waves of the US Survey of Consumer Finances to examine the period 1989-2001, characterized by large changes both in participation of US households in the stock market and in stock returns. Our empirical investigation incorporates factors relating to financial sophistication but finds that the movement in stock returns dominated the expansion of the stockholder base in determining the overall evolution of wealth inequality. Specifically, we do not find evidence that widening access to the stock market during this period was associated with a progressively less unequal distribution of either stock wealth or net wealth among US households.



(click to enlarge)

Figure 1: S&P 500 stock market index between January 1989 and January 2004. *Source: http://finance.yahoo.com*

Existing literature has established that certain household characteristics (e.g. higher wealth and education) increase the likelihood of stock market participation. A largely unexplored implication of an expanding stockholding pool is that its composition in terms of investors' characteristics and of their respective tendencies to allocate wealth to stocks

GO BACK
Return to content list

Editorial

Research & Policy

Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

Has Greater Stock Market Participation Increased Wealth Inequality in the US?

CFS Index: Positive Business Climate in 2015

Events

Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

Frankfurt – Fudan Financial Research Forum

Book Presentation: Barry Eichengreen

CFS Presidential Lecture: Martin Feldstein

SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

Selected Upcoming Events

News

Financial Regulation: A Transatlantic Perspective

can also change. Our methodology allows us to study changes in the composition of the stockholder pool during the stock market boom and following the burst of the internet bubble in 2000. We are able to show that smaller investors were drawn in during the boom, but bigger investors stayed in following the bubble burst.

Our analysis has three novel features: First, we employ econometric methods of counterfactual analysis to decompose changes in the entire distribution of stockholding levels into changes in a) the composition of the US stockholder pool, in terms of characteristics, attitudes, and practices over these periods, and b) the contribution of these characteristics to stockholding levels. We show that changes in the composition of the US stockholder pool have played a key role in shaping the distribution of equity wealth holdings. In particular, we find evidence that during the stock market upswing between 1989 and 1998, there was a shift in the composition of the stockholder pool towards characteristics systematically related to smaller stockholding levels. Yet, stock market entries and exits around the burst of the Internet bubble resulted, by 2001, in a stockholder pool with owner characteristics typically related to more sizeable stock holdings.

Second, we show that inequality in stock holdings became quantitatively important for overall net wealth inequality, despite the relatively small share of stocks in household wealth (e.g., compared to that of the main residence).

The third finding is that a significant part of these relevant changes in the composition of the stockholder pool refers to changes in investors' financial attitudes and practices likely to be linked to financial literacy and sophistication.

Our finding that the movement in stock returns dominated the expansion of the stockholder base in determining the overall outcome for wealth inequality is consistent with our findings on the changing composition of the stockholder pool, namely that smaller investors were drawn into the pool at the time of the stock market upswing, as these are less likely to experience large wealth gains from the equity premium. It is also consistent with the significant changes in stock wealth inequality that we find among owners of stocks.

Consistent with our third finding, there is accumulating evidence of differential financial sophistication and tendency of certain demographic groups to mishandle stock investments. Such tendencies could further limit the wealth gains from entering the stock market. Campbell (2006) argues that households with lower education and resources are more prone to 'investment mistakes' in terms of (non)participation, (under)diversification, and (lack of) debt refinancing. By highlighting the importance of household characteristics, their financial attitudes and practices for net wealth inequality, our findings contribute to the debate on the importance of financial education, advice, and well-designed default options, as responsibility for retirement financing is shifted from Social Security to households, challenging disproportionately the small and less sophisticated investors.

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The paper, originally circulated under the title "Equity Culture and the Distribution of Wealth", is forthcoming in the Review of Income and Wealth.

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CFS Index: Positive Business Climate in 2015

by Sebastian Frontczak (CFS)

After an optimistic start at the beginning of 2015 and favourable first two quarters, the CFS Index lost the impetus in the second half of the year. Nevertheless, the index stayed well above the neutral level of 100 points, indicating positive developments in the German financial sector. The CFS Index is composed of four sub-indices: revenues, earnings, investment volume and employment level. In 2015, the weakest of these sub-indices was the employment level of financial institutions, which regularly dropped below the neutral benchmark of 100 points, indicating layoffs. Similar to 2014 the group of service providers was in general much more optimistic about its economic situation than financial institutions.

Special Surveys

The CFS Index survey provides information not only on the current business sentiment in the German financial system. Thanks to carefully chosen topics of special surveys that are carried out each quarter, the CFS Index delivers a unique insight into views of the financial industry on economic policies being currently discussed and introduced at the European level. In 2015, the special surveys investigated, inter alia, two issues: the plan to strengthen the Economic and Monetary Union in Europe and the Capital Markets Union proposal.

The survey about the plan to strengthen the European Monetary Union (EMU) carried out in July was based upon the report by five presidents – Jean-Claude Juncker (EU Commission), Donald Tusk (Euro Summit), Jeroen Dijsselbloem (Eurogroup), Mario Draghi (ECB) and Martin Schulz (European Parliament) – in which they proposed specific measures that should be implemented in three stages until 2025. Stage 1 described as "deepening by doing" calls for using existing instruments and the current Treaties to boost competitiveness and structural convergence, achieving responsible fiscal policies at the national and euro area level, completing the financial union and enhancing democratic accountability. In stage 2, titled "completing EMU", the Presidents describe far-reaching actions that have to be launched to make the convergence process more binding, through for example a set of commonly agreed benchmarks for convergence which would be of legal nature, as well as a euro area treasury. In the final stage the Presidents assume that once all previous steps are fully in place, a deep and genuine

GO BACK
Return to content list

- Editorial

Research & Policy

- Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?
- Has Greater Stock Market Participation Increased Wealth Inequality in the US?
- CFS Index: Positive Business Climate in 2015

Events

- Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross
- Frankfurt – Fudan Financial Research Forum
- Book Presentation: Barry Eichengreen
- CFS Presidential Lecture: Martin Feldstein
- SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan
- Selected Upcoming Events

News

- Financial Regulation: A Transatlantic Perspective

EMU would provide a stable and prosperous place for all citizens of the EU Member States that share the single currency, attractive for other EU Member States to join if they are ready to do so.

The CFS Index survey revealed that the German financial industry is in general in favour of strengthening the Economic and Monetary Union and agrees to a reform agenda which goes even beyond the existing EU Treaty. However, not all presented solutions are welcomed by the survey participants. One of the controversial issues is the European Deposit Insurance Scheme. More than half of the survey participants (55%) do not consider an isolated implementation of the scheme to be efficient. Almost as many participants (53%) also reject an implementation of a European Deposit Insurance Scheme as part of a reform package which could include further measures towards a political and fiscal union in Europe.

In October, the topic of the special survey was the Capital Markets Union (CMU). According to the European Commission, the CMU should give new possibilities, especially for small and medium enterprises, to reduce the costs of financing and to develop sources of financing other than bank credit. Moreover, EU Member States with small markets and a high growth potential can gain from better ways to channel capital and investments into their projects, whereas Member States with more developed capital markets will benefit from greater cross-border investments and saving opportunities. Besides, integrated financial and capital markets can help Member States, especially those inside the euro area, to absorb economic shocks.

The answers to the CFS Index survey showed that the German financial sector does not see any particular effects on economic growth in Germany following the introduction of the CMU. Nevertheless, around 60% of the survey participants still consider the CMU as a useful supplement to the European Banking Union. Professor Jan Pieter Krahnen, Director of the Center for Financial Studies and Academic Head of the survey, commented to this result: "The German financial industry seems not to expect that the Capital Markets Union will enhance equity financing of small and medium-sized enterprises as intended by the European Commission. Accordingly, the positive impact on economic growth in Germany is considered rather small."

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

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Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

Jan Pieter Krahnen, Stephen A. Ross and Jürgen Fitschen (from left)

On 24 September 2015, the award ceremony of the Deutsche Bank Prize in Financial Economics and an academic symposium in honor of the award winner of 2015, **Stephen A. Ross**, Franco Modigliani Professor of Financial Economics and Professor of Finance at the Massachusetts Institute of Technology, took place at Goethe University Frankfurt. Ross is the sixth recipient of the Deutsche Bank Prize in Financial Economics.

Jan Pieter Krahnen, Chairman of the Jury and Symposium Organizer, CFS Director and Professor of Finance at Goethe University Frankfurt, opened the event and welcomed the speakers and the audience in Frankfurt. In his opening address, he emphasized the high quality of the academic selection process of the award, which is independent from the funding side, and that aims at honoring exceptional academic research that contributed to the foundation of the discipline and that can be applied to policy and practice. In his speech, Krahnen summarized the view of the international Jury as follows:

"Professor Ross' work spans a remarkably broad scope of areas in financial economics, ranging from the pricing of assets in financial markets, both in the cross-section and over time, to the role of information and incentives in financial contracting, but mostly helped developing the basic concepts and methods that describe how markets value financial assets, how these assets can be designed and how portfolios of such assets can be managed efficiently."

Award Ceremony

In honoring Stephen Ross' work, **Jürgen Fitschen**, Co-Chief Executive Officer of Deutsche Bank AG, focused mainly on his most profound contributions to economic theory and their influence on financial practice and policy during the past 25 years. He

GO BACK
Return to content list

Editorial

Research & Policy

Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

Has Greater Stock Market Participation Increased Wealth Inequality in the US?

CFS Index: Positive Business Climate in 2015

Events

Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

Frankfurt – Fudan Financial Research Forum

Book Presentation: Barry Eichengreen

CFS Presidential Lecture: Martin Feldstein

SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

Selected Upcoming Events

News

Financial Regulation: A Transatlantic Perspective

cited Ross' groundbreaking contributions in understanding and analyzing principal-agent relationships in the decision-making process and possible conflicts of interest that may arise and stressed the importance of these frameworks as basis of modern corporate finance. He also reminded of Ross' extensive work in arbitrage and option pricing theory and its practical usefulness.

In the laudatory speech, **Philip H. Dybvig**, Boatmens Bancshares Professor of Banking and Finance at the Washington University in St. Louis, emphasized how Ross' work influenced his research and the work of other scholars in the field and at the same time had an impact on practice due to his habit to test his theoretical work empirically and thereby constantly questioning its significance for the real world. Dybvig presented a broader overview of the topics Ross contributed to and talked about some of his most pathbreaking papers in agency and arbitrage pricing theory.

In his acceptance speech, **Stephen A. Ross** thanked his family, colleagues, former students and co-authors and expressed his gratitude for receiving this important and well-respected prize.

CFS Symposium "What Market Prices Tell Us"

Plenary Lecture: "Term Structure of Interest Rates"

Robert C. Merton, Nobel Prize Winner 1997 and School of Management Distinguished Professor of Finance at the Massachusetts Institute of Technology, focused on the interest-rate model that Ross developed with John Cox and John Ingersoll exemplifying Ross' work and the history and development of interest rate models.

Plenary Lecture: "Historical Asset Prices (Long Term Series)"

K. Geert Rouwenhorst, Robert B. and Candice J. Haas Professor of Corporate Finance at Yale University, talked about historical asset prices and contracts and their long-term returns and survivorship. In his speech, he emphasized that financial history has proven that in order to understand what average return investors can expect we need to look at all financial contracts that were available for investment, including those that did not survive. Further he stressed that many successful innovations experienced a very slow start and that failure of contracts to survive can often be linked to poor return experience and government intervention.

Keynote Lecture: "The Recovery Theorem"

In his keynote lecture, Deutsche Bank Prize winner **Stephen A. Ross** discussed the forecasting of prices in fixed income and equity markets before he focused on models that are used to understand derivatives and option markets and extract the information the prices of these instruments contain about the distribution of future returns. Further he concentrated on the binomial model and the Black Scholes Merton model, which are the most successful models in economics, and pointed to the shortcoming of these models in capturing how much of a high put price can be explained by high risk aversion and how much by a high probability of a crash. He further argued that because of the success of option pricing theories, we have lost the basic

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intuitions of insurance in derivatives markets to some extent. Finally, he talked about the recovery theorem and how to apply this concept in order to determine risk aversion and the market's probabilities for equity returns.

Policy Panel "Understanding Efficient Markets: Limits of Policy Influence"

The symposium ended with a panel discussion, chaired by **Jan Pieter Krahnen** on "Understanding Efficient Markets: Limits of Policy Influence." Participants included, **Eugene F. Fama**, Award Winner of the DB Prize 2005, Nobel Prize Winner 2013, and **Robert R. McCormick**, Distinguished Service Professor of Finance at the University of Chicago, **Martin F. Hellwig**, Director of the Max Planck Institute for Research on Collective Goods and Professor of Economics at the University of Bonn, and **Josef Zechner**, Jury member 2005 and Professor of Finance and Investments at the WU Vienna University of Economics and Business. Eugene F. Fama discussed the limits of central bank power, while Martin F. Hellwig focused on market efficiency and Josef Zechner talked abut the interactions between monetary policy and asset prices and emphasized the relevance of several channels such as financial institutions, delegated portfolio management, and the market's risk preferences.

Robert C. Merton, Stephen A. Ross and Eugene F. Fama (from left)

Zoe Tsesmelidakis

Videos of the speeches are available **here**.

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Frankfurt – Fudan Financial Research Forum

On 25 September, the second Frankfurt – Fudan Financial Research Forum, co-organized by the Center for Financial Studies (CFS) and Fudan University, Shanghai, took place at the House of Finance. The conference was co-organized by **Michael Haliassos** of CFS and **Xian Xu** of Fudan University and consisted of three sessions, which included research presentations, a policy panel and presentations on available research databases at Fudan University, Goethe University Frankfurt and the European Central Bank (ECB).

The Forum was opened by **Michael Haliassos**, Director of the CFS, **Raimond Maurer**, Dean of the Faculty of Economics and Business Administration at Goethe University Frankfurt, **Yugang Chen**, Director of the Social Science Research Department at Fudan University, and **Pan Rui**, Director of the Confucius Institute Frankfurt. In the introduction, all speakers stressed the multi-faceted research exchange between Fudan University and Goethe University/CFS in recent years.

In the research session, five research papers were presented. First, **Rainer Haselmann**, Professor of Finance, Accounting and Taxation at Goethe University Frankfurt, talked about his paper "The Limits of Model-Based Regulation". In this paper, Haselmann investigated how the introduction of complex, model-based capital regulation, a key innovation of BASEL II, affected credit risk of financial institutions. He found that, counter to the stated objectives, there is an adverse effect of complex regulation and concluded that simpler rules may increase the efficacy of financial regulation.

Second, **Dan Li**, Associate Professor at the School of Economics, Fudan University, presented her paper "Policy Distortion in Capital Allocation: Evidence from a Fiscal Stimulus Plan". Li examined policy distortion in capital allocation across firms using loan-level data covering the period from 2006 to 2010 from one of the largest state-owned banks in China. For her analysis, she exploited the policy announcement of a fiscal stimulus plan in November 2008 as an exogenous shock to the banks' loan allocation to show that policy intervention resulted in capital misallocation between state-owned firms and private firms and between firms in priority industries and firms in other industries.

Third, **Emanuel Mönch**, Head of Research at Deutsche Bundesbank, talked about his paper "Decomposing Real and Nominal Yield Curves". In the paper, the authors develop an affine term structure model for the joint pricing of real and nominal bond yields that explicitly accommodates liquidity risk premia and allows to address a number of important questions about the transmission of monetary policy.

The fourth paper was presented by **Xian Xu**, director of the China Insurance and Social Security Research Center, Fudan University. In his paper, Xu shows that politicians'

GO BACK
Return to content list

Editorial

Research & Policy

Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

Has Greater Stock Market Participation Increased Wealth Inequality in the US?

CFS Index: Positive Business Climate in 2015

Events

Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

Frankfurt – Fudan Financial Research Forum

Book Presentation: Barry Eichengreen

CFS Presidential Lecture: Martin Feldstein

SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

Selected Upcoming Events

News

Financial Regulation: A Transatlantic Perspective

pressure to climb the career ladder increased bank risk exposure in their region. Chinese local politicians set growth targets in their region that are relative to each other, he said. Growth is stimulated by debt-financed programs which are mainly financed via bank loans. In his study, Xu found that the respective local bank risk increased if the performance incentive of the politician was stronger.

The last research paper "Empirical Properties of Inflation Expectations and the Zero Lower Bound" was presented by **Mirko Wiederholt**, Professor of Macroeconomics at Goethe University Frankfurt. Currently, the central bank's nominal interest rate target is at zero in 22 out of 34 OECD countries, Wiederholt explained. Against this background, in his study, Wiederholt presented and used a New Keynesian model with a zero lower bound to investigate how shocks are propagated when the zero lower bound on the nominal interest rate is binding, as well as what policies are effective under these circumstances.

In the ensuing policy panel chaired by **Michael Haliassos**, **Lijian Sun**, Director of the Financial Research Center at Fudan University, **Jun Zhang**, Dean of the School of Economics, Fudan University, **Carlos Montalvo**, Executive Director at EIOPA, and **Giacomo Caviglia**, Head of Division of Supervisory Oversight and NCA Relations at the ECB, presented and discussed recent policy issues in China and Europe. Sun talked about the role of the Asian Infrastructure Investment Bank (AIIB) for Chinese overseas investments. Zhang discussed possible policy implications of China's overdose of credit. Montalvo explained EIOPA's role in shaping the prudential framework for insurers and pension funds, while Caviglia talked about the new approach to banking supervision in Europe.

In the final session, **Xian Xu**, **Carlos Sanchez Munoz**, Deputy Head of the Statistics Development and Coordination Division at the European Central Bank, and **Horst Entorf**, Program Director of the Data Center at the Research Center SAFE, presented a range of interesting research databases available at their respective institutions and explained how scholars can get access to these data for research purposes.

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Book Presentation: Barry Eichengreen

In his latest book, Barry Eichengreen, Professor of Economics and Political Science at the University of California, Berkeley, analyses similarities between the 2008 global financial crisis and the Great Depression in 1929. On 20 October, he presented his book "Hall of Mirrors – The Great Depression, The Great Recession, and the Uses – and Misuses – of History", published by Oxford University Press. The event was jointly organized by the Center for Financial Studies and the Institute for Banking and Financial History Research.

In this talk, Eichengreen stressed the importance of history, arguing that this is the lens through which both the public and elected officials view current problems. Accordingly, the history of the Great Depression shaped how policy makers perceived and responded to the 2008 Global Financial Crisis, he said. Both crises occurred against the backdrop of sharp credit booms, dubious banking practices, and a fragile and unstable global financial system. But while the Great Depression caused a catastrophic collapse of the financial system, in 2008 policy makers were able to prevent the worst.

In the 1930s, central bankers across the world stuck to the gold standard, a system of fixed exchange rates between currencies and gold that had dominated the international monetary system for decades. To preserve the gold standard, most monetary authorities hesitated to loosen monetary policy dramatically, which worsened the recession. Only in 1933, for example, did the U.S. abandon the gold standard and the economy began to recover.

The lessons learnt from the 1930s allowed policy makers in 2008 to avoid the errors that led to the Great Depression. The complete collapse of the banking system was avoided by, for example, quickly providing large amounts of liquidity to the markets or applying extensive fiscal stimulus programs, Eichengreen said. However, he argued that this success was the mother of failure: while the painful plunge in the 1930s has led to radical reforms in the financial system (e.g. the 1933 Glass-Steagall Act in the U.S.), the reform legacy of the current crisis is much weaker. Also, Eichengreen criticized that monetary policy measures and fiscal stimulus were not used more aggressively to boost post-crisis recovery and that some countries, such as Germany, have done too little to help weaker European countries with large fiscal deficits and eliminate the internal imbalances of the Euro Area.

GO BACK
Return to content list

- Editorial

Research & Policy

- Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?
- Has Greater Stock Market Participation Increased Wealth Inequality in the US?
- CFS Index: Positive Business Climate in 2015

Events

- Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross
- Frankfurt – Fudan Financial Research Forum
- Book Presentation: Barry Eichengreen
- CFS Presidential Lecture: Martin Feldstein
- SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan
- Selected Upcoming Events

News

- Financial Regulation: A Transatlantic Perspective

- LOEWE Center SAFE Gets Further Funding

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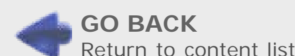
CFS Presidential Lecture: Martin Feldstein

On 29 October, Martin Feldstein, Professor of Economics at Harvard University and President Emeritus of the National Bureau of Economic Research, gave a talk in the CFS Presidential Lecture Series, following an invitation from CFS President Otmar Issing. Feldstein spoke about the Federal Reserve's (Fed) unconventional monetary policy measures after the 2007 financial crisis. He warned that those policies and the resulting extremely low interest rates could cause risks to financial stability in the future.

As the recession after 2007 was different from usual business cycle downturns, it could not be reversed by traditional monetary policy measures, Feldstein explained. Accordingly, the Fed's attempt to curb the adverse consequences by lowering short-term interest rates failed and the crisis spread to Europe. Given the ineffectiveness of monetary policy, the U.S. government decided to implement a large fiscal stimulus program in 2009.

However, in Feldstein's view, this program was not enough to generate a healthy recovery. The Fed then decided to introduce unconventional monetary policy measures, such as Quantitative Easing, and committed to keep short-term interest rates low for a considerable period of time. These measures worked very well and the economy recovered. However, Feldstein warned that the Fed's unconventional monetary policy measures have caused a variety of risks in financial markets which could threaten financial stability when interest rates get back to normal. For example, the very low interest rates have induced investors and lenders to reach for yield by taking increased risks in their investing and lending decisions, Feldstein said. The increased risk taking has resulted in a mispricing of assets that could generate problems when the Fed normalizes interest rates.

Feldstein spoke in favor of a gradual and predictable rise in interest rates in the U.S. According to him, this will be more successful than a rapid and unanticipated rise. However, there is no guarantee that the adjustment will be smooth, he stated. Feldstein concluded that, during times of a severe crisis such as in 2007, a combination of revenue-neutral fiscal policy and traditional monetary policy measures is likely to work better than introducing unconventional monetary policies.



GO BACK
Return to content list

Editorial

Research & Policy

Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

Has Greater Stock Market Participation Increased Wealth Inequality in the US?

CFS Index: Positive Business Climate in 2015

Events

Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

Frankfurt – Fudan Financial Research Forum

Book Presentation: Barry Eichengreen

CFS Presidential Lecture: Martin Feldstein

SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

Selected Upcoming Events

News

Financial Regulation: A Transatlantic Perspective

- LOEWE Center SAFE Gets Further Funding

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SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

On 10 November, Raghuram Rajan, Governor of the Reserve Bank of India, gave a talk on "Rules of the Game in the Global Financial System". The lecture was jointly organized by the SAFE Policy Center, the Center for Financial Studies (CFS) and Deutsche Bundesbank. Jens Weidmann, President of the Deutsche Bundesbank, and Otmar Issing, President of the CFS, welcomed the speaker and the audience in Frankfurt.

In his speech, Rajan stated that global economic growth has remained low since the 2008 financial crisis and that there is high pressure on central banks around the world to foster more growth. After the crisis, many countries launched large fiscal stimulus programs to boost growth but these programs only worked temporarily, he said. Therefore, central banks decreased interest rates in order to encourage investments and demand. However, this measure had only limited success and, as interest rates hit the zero lower bound, unconventional monetary policy measures were implemented.

Rajan expressed the concern that these measures could create problems for financial stability in the future and that they cause large negative spillover effects to other countries. The countries were forced in a sort of prisoner dilemma, he said, because every country has to implement expansionary monetary policy measures in order to avoid negative effects from the expansionary monetary policy measures taken on elsewhere. No one will be able to end this policy on his own. All in all, the positive effects of this policy are only temporary while the negative effects will increase the longer this policy is implemented. Therefore, Rajan called for collective action by central banks to end unconventional monetary policy measures jointly.

Video of the lecture

GO BACK
Return to content list

- Editorial

Research & Policy

- Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?
- Has Greater Stock Market Participation Increased Wealth Inequality in the US?
- CFS Index: Positive Business Climate in 2015

Events

- Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross
- Frankfurt – Fudan Financial Research Forum
- Book Presentation: Barry Eichengreen
- CFS Presidential Lecture: Martin Feldstein
- SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan
- Selected Upcoming Events

News

- Financial Regulation: A Transatlantic Perspective

- LOEWE Center SAFE Gets Further Funding

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Editor: Ina Christ, Press and Public Relations Officer

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Selected Upcoming Events

19 Jan 2016	CFS Lecture Series "Risk & Regulation" **Henning Dankenbring**, *KPMG* "Finanzmärkte und Banken im Wandel: Was zeichnet gute Regulierung aus?"
02 Feb 2016	Book Presentation **Adair Lord Turner**, *CFS Senior Fellow* "Between Debt and the Devil"
03 Mar 2016	CFS Conference on Reputational Risk Management
14 Mar 2016	CFS-Schmalenbach-Lecture **Reinhold Achatz**, *ThyssenKrupp*
22 Mar 2016	CFS Presidential Lecture **Wolfgang Schäuble**, *Federal Minister of Finance*

GO BACK
Return to content list

Editorial

Research & Policy

Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?

Has Greater Stock Market Participation Increased Wealth Inequality in the US?

CFS Index: Positive Business Climate in 2015

Events

Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross

Frankfurt – Fudan Financial Research Forum

Book Presentation: Barry Eichengreen

CFS Presidential Lecture: Martin Feldstein

SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan

Selected Upcoming Events

News

Financial Regulation: A Transatlantic Perspective

- LOEWE Center SAFE Gets Further Funding

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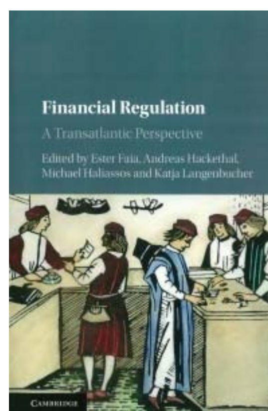
Financial Regulation: A Transatlantic Perspective



Shortly before the first anniversary of the Single Supervisory Mechanism, a comprehensive book volume analyzes the far reaching reforms of financial regulation currently being implemented in Europe. The volume on "Financial Regulation: A Transatlantic Perspective", published by Cambridge University Press, provides readers with an overview of the recent changes in regulation of the financial sector, an assessment of the interplay with monetary policy, and how the two affect the lending, saving and borrowing behavior of banks and households. Edited by Ester Faia, Andreas Hackethal, Michael Haliassos and Katja Langenbucher, all professors at Goethe University Frankfurt, the volume features contributions from renowned scholars from the fields of economics and law as well as from practitioners active in the reform developments. The creation of the book was supported by the SAFE Policy Center and the Center for Financial Studies.

The volume offers a comparison between the European experience of the financial crisis and subsequent changes in financial regulation and those in the United States. While there are differences between the reforms undertaken in Europe and those envisaged in the U.S., there are also many similarities. The first part of the book highlights reforms which, in both jurisdictions, are based on the common understanding that curtailing systemic risk in financial markets requires a shift of focus from micro- to macro-prudential regulations. In its second part, the book sets a pathway for a gaping hole in the current apparatus of European regulation, namely provisions for investors' and borrowers' protection. While the U.S. Dodd-Frank Act introduces norms and regulations for investors' protection, a sound and comprehensive framework for investor protection is yet to be developed and widely applied in Europe. These aspects, as the ones relating to bank regulation, have very important legal implications, many of which are discussed throughout the volume.

The process of financial regulation in Europe is proceeding at impressive pace. The research-based analyses in the book will help readers to understand the conflicting priorities and complicated decisions in the process of framing the new European architecture for finance and whether the new legislation can be expected to make the financial system more stable and to ultimately foster growth and prosperity in Europe.

"Financial Regulation: A Transatlantic Perspective" at Cambridge University Press

GO BACK
Return to content list

- Editorial

Research & Policy

- Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?
- Has Greater Stock Market Participation Increased Wealth Inequality in the US?
- CFS Index: Positive Business Climate in 2015

Events

- Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross
- Frankfurt – Fudan Financial Research Forum
- Book Presentation: Barry Eichengreen
- CFS Presidential Lecture: Martin Feldstein
- SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan
- Selected Upcoming Events

News

- Financial Regulation: A Transatlantic Perspective

- LOEWE Center SAFE Gets Further Funding

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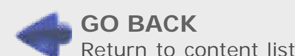
The LOEWE Center SAFE at Goethe University Frankfurt's House of Finance will continue to be supported by the State of Hessen. This was announced by the Hessen State Ministry of Higher Education, Research and the Arts on 30 November. The Research Center SAFE – "Sustainable Architecture for Finance in Europe" – is a cooperation of the Center for Financial Studies and Goethe University Frankfurt. SAFE is dedicated to the analysis of European financial markets and their regulation and has been funded by the Hessian research excellence initiative LOEWE since 2013. The Ministry now announced that it will provide SAFE with 5 Mio. Euro for 2016 and with the prospect of further 10 Mio Euro for 2017 and 2018. This was decided by the LOEWE Administrative Commission based on the votes of external referees and the funding recommendations by the LOEWE Program Council.

"SAFE serves the objective to design financial markets more sustainably, i.e. to regulate their excesses in the interest of society: a central task of politics which is, in this context, being stimulated by academia. It is good that this important research can be continued," Birgitta Wolff, President of Goethe University, said.

"We are very happy that the work we achieved in the last three years convinced the academic referees and the State Government," Jan Pieter Krahnen, Academic Director of SAFE and Director of the Center for Financial Studies, said. "The positive mid-term evaluation encourages us to proceed with great commitment in our projects in the areas of research and policy advice and to lay the foundations for a continuation of SAFE beyond the LOEWE funding."


GO BACK
Return to content list

- Editorial

Research & Policy

- Completing the Unfinished House: Towards a Genuine Economic and Monetary Union?
- Has Greater Stock Market Participation Increased Wealth Inequality in the US?
- CFS Index: Positive Business Climate in 2015

Events

- Deutsche Bank Prize 2015: CFS Symposium in Honor of Stephen A. Ross
- Frankfurt – Fudan Financial Research Forum
- Book Presentation: Barry Eichengreen
- CFS Presidential Lecture: Martin Feldstein
- SAFE Policy Center/ CFS/ Bundesbank Lecture: Raghuram Rajan
- Selected Upcoming Events

News

- Financial Regulation: A Transatlantic Perspective

- LOEWE Center SAFE Gets Further Funding

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