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Sustainable Architecture for Finance in Europe

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About SAFE

The Research Center SAFE – "Sustainable Architecture for Finance in Europe" – is a cooperation of the Center for Financial Studies and Goethe University Frankfurt. It is funded by the LOEWE initiative of the State of Hessen (Landes-Offensive zur Entwicklung wissenschaftlich-ökonomischer Exzellenz). SAFE brings together more than 40 professors and just as many junior researchers who are all dedicated to conducting research in support of a sustainable financial architecture. The Center has two main pillars: excellent research on all important topics related to finance; and policy advice, including the dissemination of relevant research findings to European decision makers from the realms of politics, regulation and administration.

In order to promote a fruitful exchange with interested parties from politics, academia, business and the media, SAFE issues a newsletter on a quarterly basis. This aims to provide an overview of the Center's ongoing research and policy activities. The SAFE Newsletter succeeds the House of Finance Newsletter, which was published between 2009 and 2012.

SAFE is based at Goethe University's House of Finance, however extends beyond by drawing on scholars from other parts of Goethe University as well as from fellow research institutions. The Center builds on the reputation of the House of Finance institutions, serving as an interdisciplinary think tank on the issue of finance.

Content

Editorial

Michael Haliassos
Director, SAFE

Financial regulation was prominent on the transatlantic agenda in 2014, motivating SAFE and the Center for Financial Studies to co-sponsor a research-based volume, forthcoming from Cambridge University Press (co-edited with E. Faia, A. Hackethal and K. Langenbucher). I share my thoughts on investor/borrower protection.

Households with varying degrees of financial literacy need to plan for retirement and cope with innovation. After the first regulatory steps, focused on informational requirements, familiarity tests and fee-only advice, a lot remains open. I can think of four relevant aspects: the financial product, user characteristics, financial advisors, and producers.

As with drugs, a financial product may be unsuitable for some, harmful at inappropriate levels, and unfamiliar to those who need it. Yet, the "dosage" is hard to assess, less likely to be followed, and not administered under a Hippocratic Oath. The law has focused on whether product attributes conflict with disclosure requirements. Yet, the theoretically optimal or even past use of an instrument provides little guidance as to its likely future use, even with all the right information.

Banning the use of a product by those who are inexperienced is paternalistic, possibly discriminatory and counterproductive (since experience presupposes use). Greater financial sophistication is not synonymous with smaller losses, as it often leads to greater risk exposure. Thus, requiring guidance by unbiased advisors could be a superior alternative. My recent work with Nicola Fuchs-Schündeln has found that East and West Germans of similar characteristics were equally likely to have participated in "capitalist" securities right after reunification. Rather than investor familiarity, the relevant factor may be financial institutions that are themselves familiar with the products and intent on building long-lasting relationships with clients (SAFE Working Paper No. 63).

Fee-only financial advisors should have licenses based on product class and time spent on advice, not unlike pilots. Producers could face requirements promoting transparency on product features, risks, suitability and compensation incentives. As with medical advertising, advertisements for financial products should include "nudges", e.g. "consult your financial advisor". Each product should have a "passport", stating suitability and the range of possible outcomes. If this is electronic, it could adapt to user characteristics.

The ultimate challenge is to bundle regulation with other measures (e.g. early financial education, awareness campaigns and default option), so as to improve financial behavior without stifling innovation. This will require considerable further research.

Yours sincerely,
Michael Haliassos

The Effects of a Low Interest Rate Environment on Life Insurers

Elia Berdin
Goethe University & SAFE

Helmut Gründl
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The current loose monetary policy pursued by many central banks around the world is resulting in extraordinarily low interest rates that are becoming a threat to the stability of the life insurance industry. This is especially the case in countries such as Germany, where products sold in the past with relatively high guaranteed returns still represent a significant share of the total portfolio.

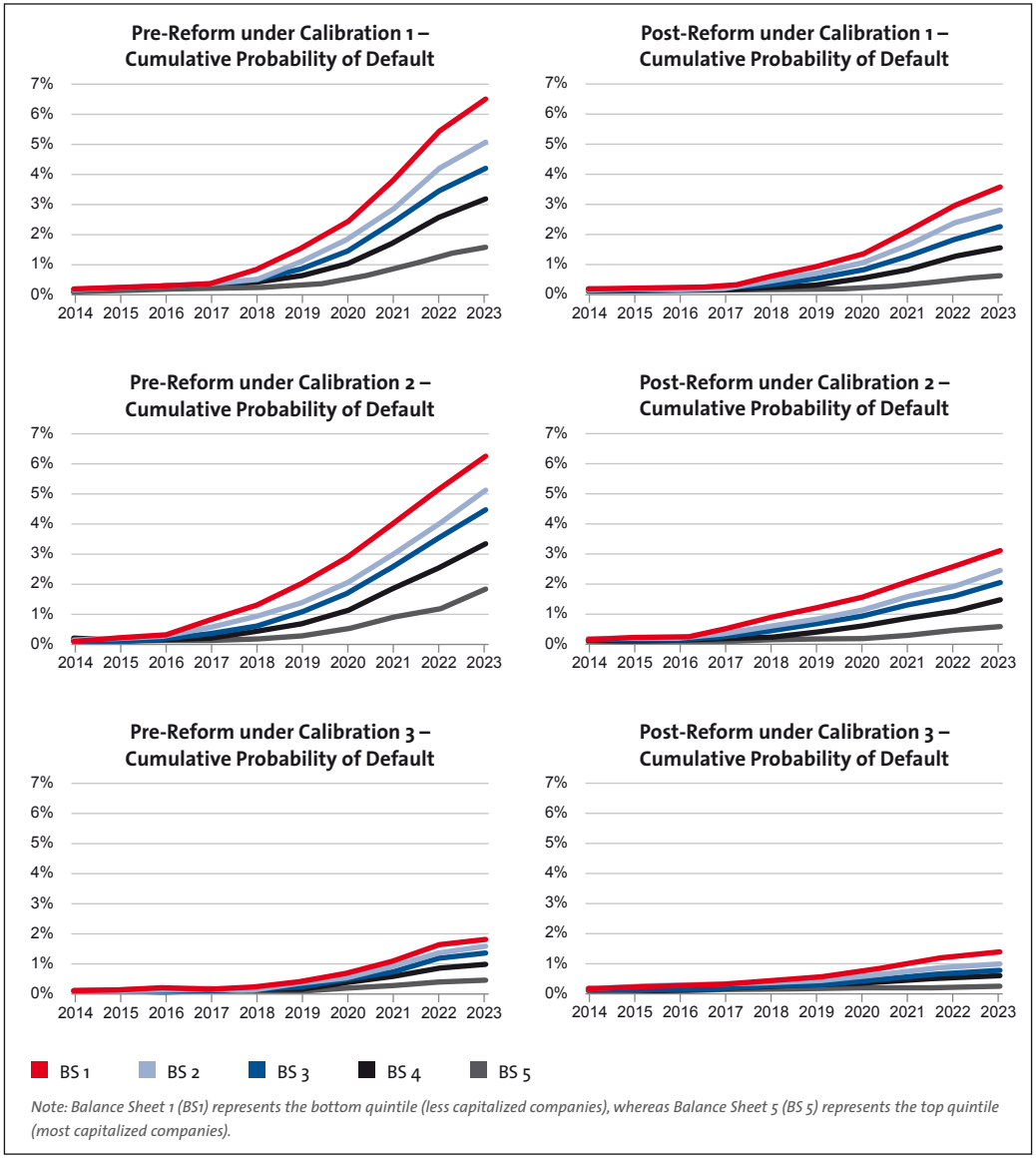
Life insurers typically invest a large part of their portfolios in sovereign bonds. Therefore, the present low interest rates directly affect the rate of return of their portfolios. Moreover, typical life insurance products offered in Europe are sold with a long-term minimum return guarantee, which is set at the inception of the contract and remains unchanged until the contract ends. Life and annuity contracts usually have maturities of 20 to 30 years, meaning that life insurers still hold contracts in their underwriting portfolios that were sold in times when investment guarantees were significantly higher owing to higher bond yields. In addition, the duration of a life insurer's liabilities is typically higher than the duration of its assets. Therefore, under a market consistent valuation of assets and liabilities, i.e. under the forthcoming Solvency II regulation, the current low interest rates increase current liability values more than asset values. This, in turn, reduces the market value of equity capital, thus having a detrimental effect on insurance companies' solvency situation.

The case of the German life insurance industry

In our paper we aim to assess the solvency situation of a typical German life insurer under the incoming Solvency II regulation, i.e. a mark-to-market regulatory regime. Our work also allows us to assess the impact of the newly introduced reform of German life insurance regulation (i.e. the "Lebensversicherungsreformgesetz") on insurers' default probabilities. To do so, we generate a stochastic term structure of interest rates and stock market returns to simulate the investment returns of a stylized life insurance business portfolio in a multi-period setting. Based on empirically calibrated parameters, we can observe the evolution of life insurers' balance sheets over time, in particular their solvency situation. To account for different scenarios and to check the robustness of our findings, we calibrate different capital market settings and different initial situations of capital endowment. Our results suggest that a prolonged period of low interest rates would markedly affect the solvency situation of life insurers, leading to relatively high cumulative probabilities of default for less capitalized companies.

Simulation of different capital market developments

We project the insurers' balance sheets 10 years into the future under different (stochastic) capital market settings and with different initial capital endowments. For this, we consider three calibrations for the simulation of capital market developments: under calibration 1, interest rates with a maturity of 10 years gradually converge towards 2%; under calibration 2, towards 1%; and finally, under calibration 3, towards 3%. We assume five different initial capital endowments, each representing a quintile of the observed capital endowments among German life insurers at the end of 2012. Both the asset and the liability side are modeled by taking into account the time to maturity structure that is typical for the life insurance business: based on publicly available German data, we are able to reproduce a duration mismatch between assets and liabilities of 3.75 years, which is



Note: Balance Sheet 1 (BS1) represents the bottom quintile (less capitalized companies), whereas Balance Sheet 5 (BS 5) represents the top quintile (most capitalized companies).

Figure 1: Cumulative probability of default before and after the 2014 reform of German life insurance regulation

very close to what is being observed in the German life insurance industry. Moreover, we distinguish between the book value balance sheet subject to German GAAP and the market value balance sheet subject to Solvency II rules. The former is used as a basis for the profit participation mechanism typical for life insurance contracts, whereas the latter is used to determine the solvency position of the life insurer.

Implications for the solvency situation of German life insurers

The results of our study suggest that: (i) should interest rates remain at the current level and gradually converge towards 1% (calibration 2), the solvency ratio of a large number of German life insurers would be considerably reduced, with a consequent increase in the probability of default starting as early as 2016; and (ii) a moderate rise in the interest rate level would considerably increase the solvency margin, and thereby reduce the probability of default.

The newly introduced reform of German life insurance regulation substantially improves the situation, especially for less capitalized companies, which would otherwise not be able to bear the losses stemming from their liabilities. Yet, this improvement comes at the expense of lower benefit payments to policyholders, who experience a reduction of the minimum profit participation and therefore a haircut on their claims.

In conclusion, our model is of special interest for three reasons: (i) it allows a realistic calibration of different market conditions and different regulatory features; (ii) it provides insights into the effects of monetary policies on financial institutions which give long-term financial promises, such as life insurers and pension funds; and (iii) it can serve as a tool in the newly introduced "Forward Looking Assessment of Own Risks" (FLAOR), which insurance companies will have to perform under Solvency II regulation.

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Stock Market Returns on Financial Innovations Before and During the Financial Crisis

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Although financial innovation has been a hot topic for several years, little empirical research exists. To allow for an appraisal of the effects of various financial innovations, especially in light of the financial crisis, research can provide valuable input into the discussion. In our study, we try to provide insights into the different kinds of financial innovations, their distribution and their returns, also by testing relevant hypotheses.

We focus on two specific drivers of financial innovations, i.e. complexity and riskiness, as well as the degree of radicalness (a feature common to all innovations), and answer the following questions: (i) How are various kinds of financial innovations distributed? (ii) What are the stock market returns to these financial innovations? (iii) How do the complexity, financial risk and radicalness of financial innovations affect their stock market returns? (iv) How do economic cycles and locations affect the distribution of and stock market returns on financial innovations?

For this purpose, we used an event study and financial expert ratings to investigate the type, success and causes of success of 428 financial innovations by 39 major banks in North America and Western Europe between 2001 and 2010. Our results indicate that security and credit instruments constitute the most common financial innovations, while insurance innovations are the least common and vary substantially according to the economic cycle and location. The average cumulative abnormal stock market returns to a financial innovation are $146 million. They are twice as high in the United States as in Western Europe. Thus, the market considers financial innovations as profitable, and not harmful, despite their apparent responsibility for the financial crisis. Surprisingly, the cumulative abnormal stock market returns to financial innovations are higher in recessions than in periods of economic expansion.

Findings and implications

Securities and credit innovations are the most frequent types of innovation while insurance innovations are the rarest, as indicated by Table 1.

Cumulative abnormal stock market returns to introductions of financial innovations are positive and average $146 million. They are twice as high in the United States as in Western Europe.

Product Group	2001 – 2003	2004 – 2007	2008 – 2010	Total (2001 – 2010)
Securities	38%	43%	36%	40%
Funds	27%	13%	34%	23%
Credit	27%	30%	18%	25%
Account management	8%	13%	9%	11%
Insurances	0%	0%	3%	1%
	N = 37	N = 223	N = 168	N = 428

Table 1: Distribution of financial innovations by product group and time periods

Product Group	2001 – 2003		2004 – 2007		2008 – 2010	
	United States	Western Europe	United States	Western Europe	United States	Western Europe
Securities	36%	64%	15%	85%	16%	84%
Funds	30%	70%	30%	70%	49%	51%
Credit	90%	10%	63%	37%	83%	17%
Account management	100%	0%	43%	57%	40%	60%
Insurances	0%	0%	0%	0%	20%	80%
	N = 37		N = 223		N = 168	

Table 2: Financial innovation in the United States and Western Europe

This result should encourage banks to develop more financial innovations. In addition, the cumulative abnormal returns are higher for more radical innovations – a result consistent with findings in other industries which suggest that more radical innovations allow firms to charge premium prices, ultimately leading to high margins and cash flows.

The share of credit innovations decreases during the financial crisis, but the percentage of fund innovations increases. In Western Europe more securities innovations were introduced, whereas in the United States more credit innovations were advanced. Higher saving rates among European consumers and higher loans among U.S. consumers seem to have incentivized European banks to introduce more security innovations and U.S. banks to focus more on credit innovations. That is, banks appear to react to the requirements of their local markets.

The effect on cumulative abnormal stock market returns is as follows: increasing risk has a positive impact; increasing complexity has a negative impact; and increasing radicalness has a positive impact. The positive impact of risk on cumulative abnormal returns shows that banks do not need to avoid risky financial innovations. Positive returns may have prompted banks to introduce more risky products in the past 15 years. Thus, regulatory authorities cannot rely on self-motivation in financial markets to reduce the number of risky innovations.

The recession has a positive impact on cumulative abnormal returns. Banks should thus act contra-cyclically and introduce innovations during recessions.

Economic conditions moderate the returns to radicalness. Cumulative abnormal returns increase with radicalness during an expansionary period but decrease with radicalness during a recession. Therefore, banks should ensure that radical financial innovations are introduced in periods of expansion rather than during recessions.

Location moderates the returns to riskiness of the innovation. Cumulative abnormal returns increase with risk in the U.S. but they decrease with risk in Western Europe. This dramatic difference in sensitivity to risk suggests that researchers and firms should treat investors differently in the U.S. than in Europe. Therefore, the United States is a more suitable market for launching more risky innovations.

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Interview:
"The Supervisor Should Apply the Existing Rules in a Different Way"

Tobias Tröger
Goethe University & SAFE

Tobias Tröger holds the Chair of Private Law, Trade and Business Law, Jurisprudence at Goethe University Frankfurt since 2011. Since 2013, this chair has been integrated into the Research Center SAFE. Tröger holds a Master of Laws (LL.M.) from Harvard Law School (2004) and a post-doctoral lecturer qualification ("Habilitation") from the University of Tübingen (2011).

Which research questions are you currently focusing on?

I have a corporate governance background that is framing most of my research questions. Within the realm of SAFE, I currently deal with the topics of banking regulation, the new architecture of supervision in the euro area and some of the ramifications that regulation has for non-bank credit intermediation, also known as shadow banking.

One of your recent papers (Tröger 2014a) deals with the newly established Single Supervisory Mechanism (SSM). What are your findings?

A key finding is that we have – as the title suggests – only a mechanism here, a cooperative system, not a new institution. Cooperation and information exchange is required between the ECB on the one hand and the national supervisors on the other in practically all areas of prudential oversight (see Figure 1). The legal framework tries to make sure that this cooperation functions smoothly. But when you look at the agents' incentives within this mechanism, I would not be too confident that this framework will automatically contribute to good supervision. There have to be better incentives, particularly for the national competent authorities (NCA) who will do the supervisory legwork, to cooperate voluntarily and not only under pressure from the ECB. Good supervisory results will depend critically on the information NCAs pass on to the ECB. If the NCAs have their own agenda, they will find ways to report critical data not as diligently or not as timely as they should.

How could the mechanism be improved?

The current legal framework only provides the "stick": sharp tools to discipline the NCAs.

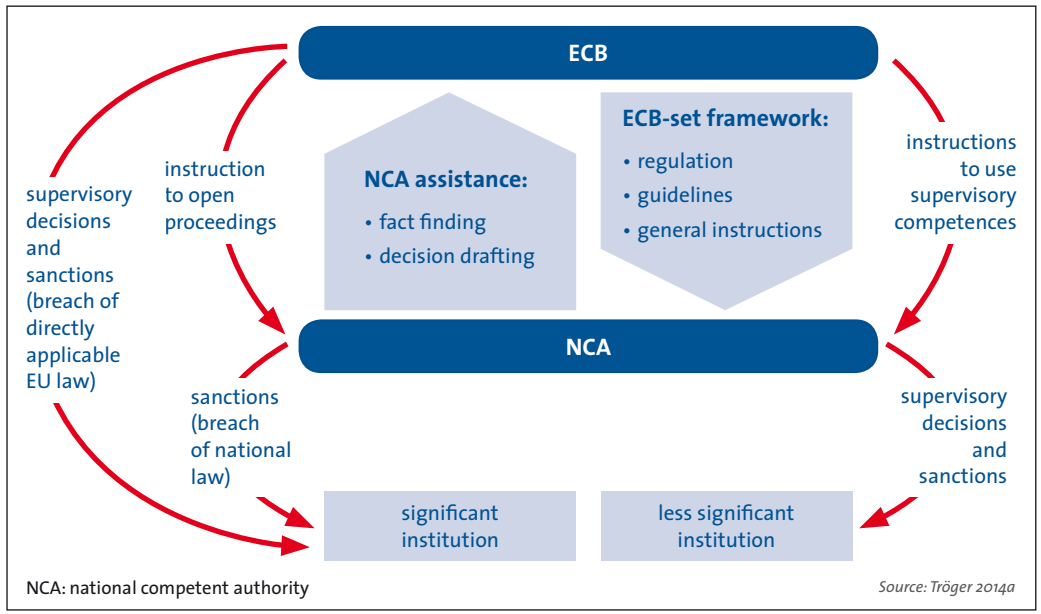

Figure 1: The Single Supervisory Mechanism

This is certainly necessary, given that we have seen captured national regulators in the past who were not willing to come down hard on financial institutions they were supervising. But we also need a "carrot". The regulation that governs the cooperation between NCAs and the ECB regards the latter as superior. This is the wrong approach. It is crucial that the national agencies, who bring the knowledge of the markets and institutions to the table, have positive incentives to go the extra mile. That can come, for example, from career paths that run across the SSM. Another opportunity lies in the design of the joint teams that are set up between ECB and NCAs. They should be set up in a way that NCA-representatives not only serve as drudges for the ECB gentry but that they get the impression that their work is valued and needed. You have to create a new culture, the spirit of a common endeavor, which is the supervision of euro area banks. These aspects are totally lacking so far.

This new setting aims at a better regulation and supervision of banks. How about regulatory arbitrage? Do we need more specific rules?

In my view, it is not possible to react to regulatory arbitrage by coming up with an ever more detailed and complex regulatory system every two weeks. Rather, we should focus on applying existing rules in a different way. A paper of mine (Tröger 2014b) explores this idea: if the rational of a rule applies, then the rule should be enforced despite a financial product's or transaction's appearance. If we stick to a legalist interpretation of prudential regulation, we will open up massive regulatory arbitrage opportunities.

It is always a challenge for the regulator not to hinder beneficial financial innovation and, at the same time, prevent regulatory arbitrage. Take the example of securitization: there is, of course, an efficiency story here. If you transfer risk from people who cannot bear it to those who can bear it, this is efficient. But we have seen in the past that securitizations were designed in a way that allowed accountants and supervisors to acknowledge that the securitized loans were no longer on the bank's balance sheet and the exposures had zero risk weight while, in fact, the bank was still carrying the risks of these products through liquidity facilities, guarantees and other arrangements. This example demonstrates that the prudential rule of demanding capital against a bank's risky assets, no longer applied due to a narrow construction by lawyers. The consequence should be that even if an innovation falls outside of the wording of a rule, but remains within its spirit, then the rule should still apply.

This may work for the regulation of financial institutions. But if actors change their institutional set-up in order to step outside of the regulated realm, can regulatory discretion also help here?

It is true that, up to now, we have a very entity-centered approach to regulation by tying it to a bank license. This creates enormous opportunities to escape regulation by finding a way of doing precisely the same business, while not technically being a bank. However, it is clearly the same rational that has driven the original prudential regulation that we want to apply to certain occurrences in the shadow banking sector. In a recent, very influential paper, Claessens and Ratnovski (2014) argue: everything that needs a backstop is a shadow bank. And very many products in the shadow banking sector are, in fact, ultimately backed by the banking system. So, here you have the link. If you enforce capital requirements that are put on this ultimate backstop, you will take the economic viability from a lot of regulatory arbitrage models. We will need some more empirical studies to what degree this assumption is true. This kind of data-based normative research can be ideally conducted in the interdisciplinary environment at SAFE.

That sounds like you need an omnipotent supervisor.

The financial crisis has taught us that supervisors on the ground understood pretty well what was going on. In the U.S., the on-site supervisors even documented that they saw highly hazardous exposures to certain risks. But frequently they did not feel backed by their own institution so they did not take any consequences. Thus, again, we have to change the cultural setting and tell these people that we want them to take action.

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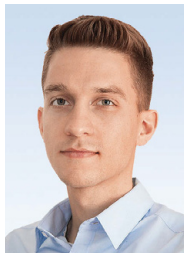
The Regulation of Repo Markets: Incorporating Public Interest through a Stronger Role of Civil Society

Matthias Thiemann
Goethe University & SAFE



Marius Birk
Goethe University

The tumultuous events of the recent financial crisis, which led to a median accumulated output loss of 25% of GDP in advanced OECD countries, spelled out, once more, the importance of a stable and well-functioning financial system for growth and general welfare. Many believe that the crisis was caused by a failure in financial regulation and oversight. This failure was only partially created by a lack of an understanding of risks. It was also caused by a lack of action. As Charles Goodhart has put it: "Virtually all of the major central banks and international financial institutions had been warning about the underpricing of risk and excessive leveraging by 2006-07. The Bank for International Settlements (BIS) had been warning about it for years". But if regulators had an understanding of the systemic risks that were building up, what prevented them from acting to mitigate these?

In a recent SAFE White Paper, we analyze the market for sale and repurchase agreements (repo market), as an example of a market in which the short-comings of regulatory action are still highly apparent. The repo market was at the heart of the financial crisis of 2007 and still endangers financial stability today. In this market, loans that last from one night to up to one year are granted against collateral, typically government bonds or notes. Customers in the repo market include banks (the largest fraction), institutional money managers, insurance companies, hedge funds, and non-financial corporations that actively manage their cash flows. While there are also repo brokers, dealers and multilateral clearing houses, in Europe, bilateral clearing remains common. As a result, information about market transactions is incomplete and obscure. The opacity of data for transactions in these markets is a central element of the risk related to repo transactions.

Repo instruments have distinct benefits for buyers and sellers. A seller can use a repo transaction to finance himself at very competitive interest rates, often better than the conditions of a secured loan. This is especially important when the seller is not a bank and does not have access to the interbank market. The seller is able to do so without liquidating his securities, instead, he just sells them for a limited amount of time. For the buyer of the security, a repo transaction provides an opportunity to invest excess money reserves in a way that reduces credit risk, due to the legal transfer of the pledged security. Furthermore, a buyer can use the obtained asset to attain financing himself. The ensuing collateral chains increase liquidity in financial markets.

Pro-cyclicality reinforces crisis dynamics

A central concern regarding financial stability is that repo markets reinforce crisis dynamics. "Haircuts" of repo transactions, i.e. the differences between the values of the securities pledged and the loans received, tend to be pro-cyclical. In the upswing, haircuts are reduced. In a moment of crisis, they become very large. This pro-cyclicality leads to liquidity shortfalls in times of crisis for those institutions relying on the repo markets for financing. Furthermore,

collateral chains transfer shocks from one failing institution to the system due to the interconnectedness they create. As a result of these two effects, repo markets contribute to systemic risk. Lastly, the "safe harbor clause", which exempts collateral used in repo transactions from bankruptcy proceedings, creates incentives for those granting loans not to properly engage in due diligence when extending credit. In sum, in an upswing, repo transactions contribute to large credit growth. In crisis times, liquidity deteriorates and fire sales of assets pledged as collateral create loss spirals and spill-over effects for the industry.

From a social welfare perspective, the negative externalities individual market participants in repo markets impose on other market participants justify regulatory action. Indeed, the Financial Stability Board (FSB) promotes qualitative standards for methodologies used to calculate haircuts and also numerical haircut floors for non-centrally cleared securities financing transactions in which financing against collateral other than government securities is provided to non-banks. With respect to the issue of re-use of collateral, the G20 leaders have tasked the FSB to evaluate the systemic risks emerging from collateral chains and the possibility of limiting them, but no action has been taken so far. With respect to the idea of altering the standard safe harbor clause, the FSB has stopped actions altogether.

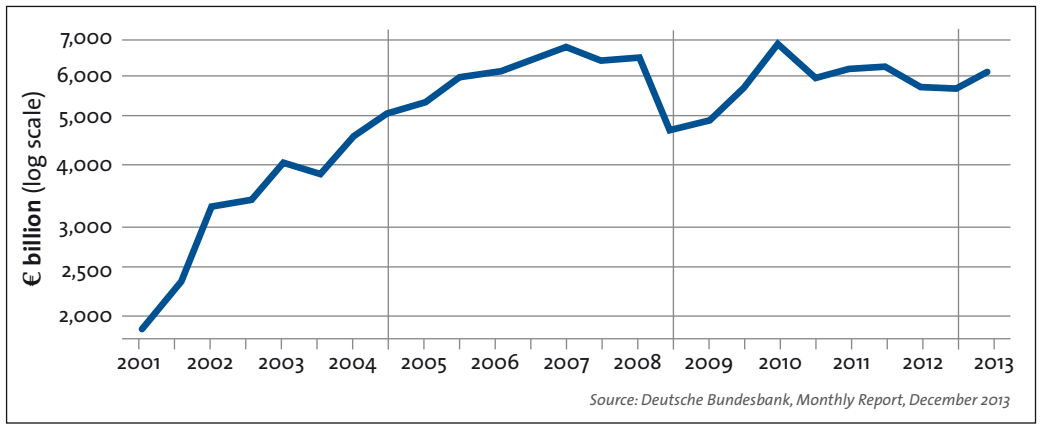


Figure 1: Repos and reverse repos transacted by financial institutions active in Europe (geographical definition), including European branches of non-European institution (semi-annual levels)

Concerted regulatory effort needed

Regulatory inaction before the crisis may have resulted from the difficulty for the regulator to justify actions on the basis of risks which had not yet materialized. Those who would have benefitted from earlier interventions, namely the public at large, did not understand the technical details of transactions and, thus, did not organize support for regulations. Reluctance to regulate now may stem from the fact that the "money-like" attributes of repos are valued so highly by industry and politics, that this overrules any concerns for financial stability. To eliminate the shortcomings which remain in this market, a concerted effort by public activists, critical scientists and regulatory authorities would be necessary.

First and foremost, such a concerted effort should push for more transparency: for a proper monitoring process, regulators, such as the FSB, need more data. A new accounting framework needs to be created, which would trace, among other things, the flow of collateral. Furthermore, the "Global Legal Entity Identifier System", an initiative with the goal of providing all legal entities and other organizations operating on the financial market with a unique identifier (see SAFE Newsletter Q3 2014, p. 3), needs to be supported. Interest groups should push for the issue of safe harbor to be put back on the agenda for regulatory action. Lastly, the concerted effort should seek limitations in the capacity to repledge assets and support for prudent haircut practices.

The full article is available at: http://safe-frankfurt.de/repo-markets

EU Commissioner Meets with Goethe University Students

On 30 January, Jyrki Katainen, Vice-President of European Commission – responsible for jobs, growth, investment and competitiveness – visited the House of Finance to discuss the EU Investment Plan with students from Goethe University. Katainen's visit to Frankfurt was part of his 28-country European roadshow to promote the Plan; an initiative which aims to mobilize public and private investments in the real economy of at least €315 billion over the next three years.

Katainen called for more integration in Europe in order to strengthen the Single Market, to increase investment, to support social development (particularly in the areas of education and employment) and to coordinate efforts related to foreign policy and security. He explained that the idea behind the special fund created under the Plan is to enhance private investment by providing risk sharing and technical assistance for investment projects. On the question of whether the fund will simply support projects that would have taken place anyway, Katainen noted that the Plan will focus on high risk projects that could not be realized without public assistance.

Austerity and Growth – Concepts for Europe

Against the background of the European debt crisis, SAFE, in the fall of 2013, had issued a call for projects on the topic "Austerity and Economic Growth: Concepts for Europe", with the objective of soliciting research proposals focusing on the nature of the relationship between austerity, debt sustainability and growth. Each of the five funded projects brought forth an academic paper and a shortened, non-technical policy brief. These policy papers are now presented in a collection of policy letters, edited by Alfons Weichenrieder.

The first paper by Alberto Alesina, Carlo Favero and Francesco Giavazzi looks into the question of how fiscal consolidations influence the real economy. Harris Dellas and Dirk Niepelt emphasize that fiscal austerity is a signal that investors use to tell apart governments with high and low default costs that accordingly will have a high or low probability of repayment. The paper by Benjamin Born, Gernot Müller and Johannes Pfeiffer, looks at the impact of austerity measures on government bond spreads. Oscar Jorda and Alan M. Taylor, in the fourth contribution, put into question whether the narrative records of fiscal consolidation plans are really exogenous. The final study by Enrique Mendoza, Linda Tesar and Jing Zhang suggests that fiscal consolidation should largely depend on expenditure cuts, rather than tax increases that may fail, when fiscal space is exhausted.

Several SAFE Researchers Receive DFG Funding

Five SAFE professors have secured funds for a second three-year period for their research projects under the "Financial Market Imperfections and Macroeconomic Performance" priority program of Deutsche Forschungsgemeinschaft (DFG). The central purpose of this program is to advance research in Germany at the intersection of macroeconomics and financial economics. In particular, the program aims at contributing to a better understanding of the way various financial market imperfections affect financial market stability, macroeconomic volatility and long-run economic growth. The five related projects are:

- Debt Market Imperfections and Macroeconomic Implications (Coordinators: Ester Faia, Jan Pieter Krahnen)
- Implications of Financial Market Imperfections for Wealth and Debt Accumulation in the Household Sector (Coordinator: Michael Haliassos)
- Real Effects of a Bank Liquidity Shock on Bank Lending Decisions and Corporate Investments (Coordinators: Rainer Haselmann, Beatrice Weder di Mauro)
- The Welfare Effects of Social Security with Individual and Aggregate Risk: A Macroeconomic Analysis (Coordinator: Alexander Ludwig)

Bernd Skiera First in Handelsblatt Ranking

Bernd Skiera, Professor for Electronic Commerce at Goethe University and a member of the Managing Board of the e-Finance Lab, has achieved first place in the latest ranking of prolific current research in the field of business administration published by the German business daily Handelsblatt. The ranking is based on publications in recognized international journals by researchers in the German-speaking region who have worked in this area during the last five years. Since 1999, Skiera has held the Chair of Electronic Commerce at Goethe University; one of the first of its kind in Germany. He is also head of the Real-Time Advertising Competence Center and a contributor to SAFE. His research focuses on electronic commerce and online marketing, customer management, and pricing. For example, he develops models that use information about a firm's customer base to determine its financial value. Skiera primarily conducts empirical research and works closely with companies when developing research models.

Towards a Capital Markets Union in Europe

On 19 January 2015, Nicolas Véron, Senior Fellow at Bruegel, held a SAFE Policy Lecture on the prospects for a Capital Markets Union (CMU) in Europe. Under this headline, the European Commission plans to strengthen the non-bank segment of Europe's financial system. CMU would aim at rebalancing bank-based and non-bank financing, thereby making Europe's financial system more efficient, competitive and resilient in times of financial crisis.

Véron sketched two possible approaches that the Commission may employ for CMU: an "industrial policy" approach, which would essentially select individual credit market segments and financing instruments to be developed further by a harmonized European framework. The more difficult approach, very likely also the more effective one for fostering a growth-friendly environment, would be the so-called "ordoliberal" approach, whereby framework conditions for financial markets would be adjusted to provide the basis for the development of efficient financial services and contractual arrangements. In this context, Véron highlighted a number of current regulations which would need to be reviewed; ones related to insolvency and debt restructuring frameworks, tax laws, supervision and resolution of financial institutions, the prudential frameworks for insurers and pension funds, as well as accounting and auditing standards.

Selected Publications

Angeloni, I., Faia, E., Lo Duca, M. (2015)
"Monetary Policy and Risk Taking",
forthcoming in Journal of Economic Dynamics and Control.

Berdin, E., Gründl, H. (2015)
"The Effects of a Low Interest Rate Environment on Life Insurers",
forthcoming in Geneva Papers on Risk and Insurance.

Bursian, D., Fürth, S. (2015)
"Trust Me! I am a European Central Banker",
forthcoming in Journal of Money, Credit and Banking.

Haar, B. (2014)
"Implementing liability on the basis of model case procedures – the example of the German Capital Markets Model Case Act (KapMuG)",
Gorton, L., Kleineman, J., Wibom, H. (Eds.), Functional or dysfunctional – the law as a cure? Risks and liability in the financial markets, International legal symposium in honour of the 50th anniversary of the Marianne and Marcus Wallenberg Foundation, Stockholm Center for Commercial Law Publication Series No. 22.

Kraft, H., Kroisandt, G., Müller, M. (2014)
"Assessing the discriminatory power of credit scores under censoring",
Journal of Credit Risk, Vol. 10, Issue 4, pp. 71-94.

Langenbucher, K. (2014)
"Vorstandsvergütung – zwischen Vertragsrecht und 'say on pay'",
Tröger, T., Karampatzos, A. (Eds.), Gestaltung und Anpassung von Verträgen in Krisenzeiten, Tübingen: Mohr Siebeck, pp. 137.

Siekmann, H. (2014)
"Kommentierung des Notenbankrechts, der Gemeinschaftsaufgaben und des gesamten Finanzverfassungsrechts: Abschnitt VIII a (Art. 91 a bis 91 e) und Abschnitt X (Art. 104 a bis 115) des Grundgesetzes sowie von Art. 88, 120, 120 a, 125 c, 143 c und 143 d Grundgesetz",
Sachs, M. (Ed.), Grundgesetz, 7th edition, München, 2014.

Tröger, T. (2014)
"Das Vertragsrecht der Krise",
Tröger, T., Karampatzos, A. (Eds.), Gestaltung und Anpassung von Verträgen in Krisenzeiten, Tübingen: Mohr Siebeck, pp. 49-74.

Recent SAFE Working Papers

No. 83 **Grüning, P.**
"International Endogenous Growth, Macro Anomalies, and Asset Prices"

No. 82 **Vogel, E., Ludwig, A., Börsch-Supan, A.**
"Aging and Pension Reform: Extending the Retirement Age and Human Capital Formation"

No. 81 **Binder, J.-H.**
"Resolution Planning and Structural Bank Reform within the Banking Union"

No. 80 **Mendoza, E. G., Tesar, L. L. , Zhang, J.**
"Saving Europe?: The Unpleasant Arithmetic of Fiscal Austerity in Integrated Economies"

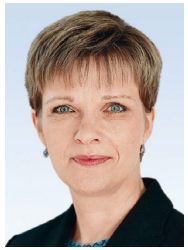
No. 79 **Jordà, Ò., Taylor, A. M.**
"The Time for Austerity: Estimating the Average Treatment Effect of Fiscal Policy"

No. 78 **Dellas, H., Niepelt, D.**
"Austerity"

No. 77 **Born, B., Müller, G. J., Pfeifer, J.**
"Does Austerity Pay Off?"

No. 76 **Alesina, A., Favero, C., Giavazzi, F.**
"The Output Effect of Fiscal Consolidation Plans"

Untangling the Risks of Banks and Governments Will Take More Than a Banking Union



Claudia Buch
Vice President,
Deutsche Bundesbank

The European banking union raises high expectations. Its uniform prudential standards are intended to improve bank stability and boost financial market integration, and it is expected to untangle the risks of banks and governments. Yet the banking union alone will not be able to achieve these aims. Rather, it will need to be soundly anchored and augmented in three different ways.

First, the Single Resolution Mechanism (SRM) is designed to force private investors to participate in risks that materialise. But for this to happen, the new rules will need to be applied rigorously, and exceptions to the bail-in of creditors must be minimised.

Resolution authorities can exercise a degree of discretion which allows them to exempt private creditors from the bail-in regime if it is thought that a full bail-in poses a threat to financial stability. This exposes the authorities to a conflict of interest. The higher the losses assumed by private creditors, the greater the risk of potential negative effects impacting on the stability of the financial system. The lower the private loss absorption, however, the higher the costs for government budgets – and the lower the disciplining effect for investors as well.

The U.S. systemic risk exception model is of interest for implementing the liability principle and permitting as few exceptions from the bail-in of creditors as possible. Here, the principle of bailing in creditors can only be deviated from in systemic crises. Each deviation must be approved by a majority of the relevant decision-making bodies. This may be a sensible approach to strengthening the credibility of resolution regimes and to being capable of acting during systemic crises at the same time.

Second, credibly separating the risks of banks and governments requires further regulatory action. The resilience of credit institutions will be strengthened by the implementation of Basel III and the additional capital requirements for systemically important financial institutions. But this is not enough. We need to put an end to the preferential treatment afforded to government debt instruments. Sovereign bonds, like other bank exposures, need to be backed by capital. What is more, the existing limits on large exposures should be gradually extended to cover sovereign debt as well.

Third, the capital markets in Europe need to be nurtured and integrated. Cross-border investment allows opportunities and risks to be better shared. This strengthens the resilience of the financial system.

Comparison with the United States shows that equity holdings there are dispersed much more widely throughout the entire country than they are in Europe. If a negative shock hits an industry or a specific region, then this loss is spread widely beyond that region. The same applies to positive developments. Through dividends, equity investors participate directly in economic risk and in gains and losses. Creditors, on the other hand, are not exposed to losses – except in the case of insolvency.

The integration of the capital markets may have increased in Europe, but the ownership structures of many enterprises are nonetheless strongly national. Improved market integration is hindered by differences in national taxation and legal systems, by varying market practices and, not least, by political factors.

In short: the banking union is a major step forward for the euro area and a key building block for greater stability. Yet the banking union alone cannot resolve the challenges the euro area faces, which is why further progress and action are crucially important in the areas outlined above.

Events

March

Monday, 4th
5.00 pm
CFS Lecture
Speaker: Matthias Danne, DekaBank

Monday, 4th –
Tuesday, 5th
DFG-SAFE Workshop
Financial Market Imperfections and Macroeconomic Performance

Friday, 6th
SAFE Workshop
Say-on-Pay

Friday, 6th
SAFE Policy Center Lecture
Speaker: Kiyohiko Nishimura, University of Tokyo

Tuesday, 10th
IMFS-CEPR Research Conference
Global Banking and Bank Resolution

Wednesday, 11th
CFS-IMFS Conference
The ECB and Its Watchers XVI

Tuesday, 10th –
Wednesday, 11th
SAFE Conference
Second International Conference on Sovereign Bond Markets

Tuesday, 17th
4.15 pm – 5.30 pm
Finance Seminar – joint with SAFE
Speaker: David Solomon, USC Marshall School of Business

Thursday, 19th
CFS Conference on Operational Risk
Speaker: Thomas Kaiser, Goethe University and KPMG

Monday, 23rd
5.30 pm
CFS Colloquium
Financial Markets in an Interconnected World: the View from the BIS
Speaker: Hyun Song Shin, BIS

April

Friday, 10th –
June, Friday, 5th
GBS Open Course
Financial Stability and Regulation
Speaker: Norbert Metiu, Deutsche Bundesbank

Friday, 10th –
June, Friday, 5th
GBS Open Course
Household Finance
Speaker: Steffen Meyer, Leibniz University Hannover

Friday, 10th –
Saturday, July, 4th
GBS Open Course
Ethics in Finance
Speaker: Eberhard Schnebel, Commerzbank

Saturday, 11th –
Saturday, June, 6th
GBS Open Course
Mergers and Acquisition
Speaker: Christian Rauch, Goethe University

Tuesday, 14th
2.15 pm – 3.45 pm
Frankfurt Seminar in Macroeconomics – joint with SAFE
Speaker: Charles Gottlieb, University of Cambridge

Tuesday, 14th
4.15 pm
Finance Seminar – joint with SAFE
Speaker: Jonathan Brogaard, University of Washington

Wednesday, 15th –
Friday, 17th
9.00 am – 6.00 pm
GBS Finance Training
The Basics of Financial Risk Management
Speaker: Björn Imbierowicz, Goethe University

Friday, 17th –
Saturday, 18th
9.00 am – 5.00 pm
GBS Finance Training
Negotiations in Financial Markets. Close deals that add value
Speaker: Thomas Mosk, Goethe University

Tuesday, 21st
2.15 pm – 3.45 pm
Frankfurt Seminar in Macroeconomics – joint with SAFE
Speaker: Stefania Albanesi, New York Fed

Tuesday, 21st
4.15 pm – 5.30 pm
Finance Seminar – joint with SAFE
Speaker: Daniel Paravisini, London School of Economics

Friday, 24th –
August,
Saturday, 1st
GBS Open Course
Risk Management
Speaker: Mark Wahrenburg, Goethe University

April, 25th –
July, Friday, 31st
GBS Open Course
Global Asset Allocation
Speaker: Raimond Maurer, Goethe University

Tuesday, 28th
2.15 pm – 3.45 pm
Frankfurt Seminar in Macroeconomics – joint with SAFE
Speaker: Dan Silverman, Arizona State University

Tuesday, 28th
4.15 pm – 5.30 pm
Finance Seminar – joint with SAFE
Speaker: Michael Weber, Chicago Booth School of Business

May

Monday, 4th
5.00 pm
EFL Jour Fixe
Reunited after all? Consumer Debt Differences between East and West
Speaker: Philipp Blommel, E-Finance Lab

Tuesday, 5th
2.15 pm – 3.45 pm
Frankfurt Seminar in Macroeconomics – joint with SAFE
Speaker: Kjetil Storesletten, University of Oslo

Tuesday, 5th
4.15 pm – 5.30 pm
Finance Seminar – joint with SAFE
Speaker: Alessandro Previtero, Ivey School of Business, University of Western Ontario

Saturday, 9th –
June, Saturday, 13th
GBS Open Course
Bank Management
Speaker: Axel Wieandt, Valovis Bank

Tuesday, 12th
2.15 pm – 3.45 pm
Frankfurt Seminar in Macroeconomics – joint with SAFE
The Impact of Economic and Climate Risks on the Social Cost of Carbon
Speaker: Thomas Lontzek, University of Zurich

Tuesday, 12th
4.15 pm – 5.30 pm
Finance Seminar – joint with SAFE
Speaker: Martin Oehmke, Columbia Business School

Thursday, 14th –
Saturday, 16th
LEMF Mini-Course
Mergers and Acquisitions
Speaker: Randall S. Thomas, Vanderbilt Law School

Monday, 18th
ICIR Seminar on Insurance and Regulation
Corporate Governance in Insurance Regulations
Speaker: Monica Mächler, Deutsche Börse and Zurich Insurance Group

Monday, 18th –
Tuesday, 19th
SAFE Conference
Regulating Financial Markets

Please note that for some events registration is compulsory.

CFS Center for Financial Studies | EFL E-Finance Lab | GBS Goethe Business School | ICIR International Center for Insurance Regulation | ILF Institute for Law and Finance | IMFS Institute for Monetary and Financial Stability | LEMF Ph.D./Doctorate Program Law and Economics of Money and Finance

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