

## Is Proprietary Trading Detrimental to Retail Investors? 4

Falko Fecht · Andreas Hackethal · Yigitcan Karabulut

## Direct and Indirect Risk-Taking Incentives of Inside Debt 6

Stefano Colonello · Giuliano Curatola · Ngoc Giang Hoang

## It's not the Right Intentions that Count, but the Right Actions 14

Felix Hufeld

## IMPRINT

### **Publisher:**

Prof. Dr. Wolfgang König • Executive Board  
Research Center SAFE  
House of Finance • Goethe University  
Theodor-W.-Adorno-Platz 3  
60323 Frankfurt am Main • Germany

### **Editors:**

Dr. Muriel Büsser  
Prof. Dr. Wolfgang König  
Ulrike Lüdke  
Bettina Stark-Watzinger

### **Contact:**

info@safe-frankfurt.de  
www.safe-frankfurt.de

### **Design:**

Novensis Communication GmbH  
Bad Homburg

3<sup>rd</sup> Edition

Copyright © by the Research Center SAFE,  
Frankfurt am Main

Printed in Germany

## 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

### Research

Is Proprietary Trading Detrimental to Retail Investors? [\\_4](#)

Falko Fecht • Andreas Hackethal • Yigitcan Karabulut

Direct and Indirect Risk-Taking Incentives of Inside Debt [\\_6](#)

Stefano Colonello • Giuliano Curatola •

Ngoc Giang Hoang

### Interview

“People Should Be More Aware of the Flexibility of Law” [\\_8](#)

Matthias Goldmann

### Policy Center

What Microfinance Institutions Can Learn from the German Savings and Cooperative Banks of the 19<sup>th</sup> Century [\\_10](#)

Reinhard H. Schmidt

### Guest Commentary

It's not the Right Intentions that Count, but the Right Actions [\\_14](#)

Felix Hufeld

### News [\\_12](#)

Selected Publications [\\_13](#)

Events [\\_15](#)

## Editorial



Helmut Gründl

International Center for Insurance Regulation & SAFE

When talking about the impact of the persistent low interest rate environment, digitalization or systemic risk on financial institutions and regulation, people tend to think mostly of the banking sector. However, all of these challenges equally affect the insurance sector. Given SAFE's comprehensive approach on financial architecture with all the interdependencies between its actors, also topics of insurance regulation with their impact on consumers and the insurance industry are an integral part of SAFE's research and policy activities. On this topic, SAFE has been collaborating with the International Center for Insurance Regulation (ICIR).

On 6 and 7 September 2017, the two research centers will be hosting the 5<sup>th</sup> Conference on Global Insurance Supervision (GIS) which is co-organized together with the European Insurance and Occupational Pensions Authority (EIOPA) and the World Bank. Over the last years, this conference series has established an international reputation for bringing together representatives from academia, supervision, regulation and industry from all over the world to debate current and future key topics of international insurance supervision and the challenges linked to the implementation of global standards. This year, the conference will focus on three main

topics: The interconnection of micro- and macro-prudential insurance supervision, consumer protection, and climate change & sustainable finance.

With respect to the first topic, the focus will be on questions such as: Is a macro-prudential supervisory approach needed for the insurance sector? Can regulation and supervision contribute to mitigate systemic risks? Or could they even be a source of such risk?

The topic consumer protection will be approached from different regional perspectives: European, Asian, Latin-American and North-African. The idea is to discuss the growing importance of consumer protection in the insurance industry and the challenges for consumer protection in order to deal with specific customer (protection) needs.

With climate change and sustainable finance, the GIS conference will highlight a topic that is of high relevance for both insurers and reinsurers. We will hereby focus on investment and financing instruments that either aim at specific sustainable objectives such as “green investments” or that are suitable to hedge climate risks, such as certain securitization tools. A further important issue will be disaster prevention: How can preparedness and resilience be enhanced? What can the industry contribute?

I am convinced that the 2017 GIS Conference will build on the success of previous years and foster shaping a truly convergent global insurance regulatory framework.

Yours sincerely,  
Helmut Gründl

# Is Proprietary Trading Detrimental to Retail Investors?



Falko Fecht  
Frankfurt School of Finance  
and Management



Andreas Hackethal  
Goethe University  
& SAFE



Yigitcan Karabulut  
Rotterdam School of  
Management,  
Erasmus University

Banks – particularly universal banks – should be well suited to provide guidance to their retail investors in their investment decisions as they have more and better resources to collect and process information than do individual investors. However, as a result of having proprietary trading and retail banking under the same roof, conflicts of interest between banks and their retail customers might arise. In this paper we provide strong suggestive evidence that banks sold underperforming stocks from their proprietary trading holdings into the portfolios of their retail customers. We also show that the stock portfolio performance of customers of banks with proprietary trading was significantly worse than that of customers of banks without proprietary trading desks.

Playing a key role in many financial markets, banks have arguably better stock selection and market timing abilities than individual investors, as banks have more and better resources (e.g. technology, human capital) to collect and

process information. Furthermore, banks can do so at a lower cost due to economies of scale in portfolio management and information acquisition. In addition, banks can obtain superior information about firms through their close lending relationships (Acharya and Johnson, 2007; Ivashina and Sun, 2011). Particularly between banks' proprietary trading and portfolio management units and their retail banking services, economies of scope should exist.

However, financial advice provided to retail investors resembles a “credence good”: Because of their limited financial literacy, households can typically neither ex ante nor ex post assess the exact quality of financial products or services. Several potential agency problems can thus arise between banks and their retail customers. Given their diverse lines of business, such as having proprietary trading and retail banking under the same roof, these agency problems might be particularly severe for universal banks. For example, when actively trading on their own account, to avoid price impact, banks may face incentives to direct their retail customers to those stocks that they sell from

their portfolios, which may not necessarily suit the specific needs of their customers.

## **Banks sell, retail customers buy**

We study a unique dataset provided by Deutsche Bundesbank that comprises the individual stock investments of 102 German banks and those of its retail customers for the period from 2005 to 2009. The security holdings of banks in our dataset comprise security positions from proprietary trading, market making and strategic investments. The final data sample represents nearly 63% of the stock investments made by all monetary financial institutions in Germany during the observation period.

Using a series of panel regressions, we first examine the relationship between the stock investments of banks and those of their retail customers at the individual security level and find that, when a bank sells a given stock from its proprietary trading portfolio, its retail customers tend to buy the same stock in that period. The correlation of stock flows between bank and customer portfolios is negative only when banks sell stocks but not when they buy

stocks. Further tests also confirm that this finding is not a mere artifact of banks' market-making activities or retail investors' herding behavior and that it is robust to changes in empirical specifications, variable definitions, sampling restrictions and econometric methods.

### Banks benefit from trading, customers lose

We next analyze whether the observed behavior of banks has any negative implications for the portfolio performance of their retail customers. First, we show that retail customers experience trading losses from those transactions in which they purchase stocks that their banks sell from their proprietary trading portfolio. Second, we find that stocks directly sold by banks to their customers not only significantly underperform stocks that are either held or purchased by banks, but also underperform retail customers' other stock investments in their portfolios.

These results suggest a potential conflict of interest between the proprietary trading activities and retail banking divisions. It is, however, possible that any practice of pushing underperforming stocks into retail client portfolios is overcompensated by superior overall investment advice. We address this possibility by

|                             |        | Banks without proprietary trading | Banks with proprietary trading |
|-----------------------------|--------|-----------------------------------|--------------------------------|
| Raw returns (percent)       | mean   | -0.88                             | -1.05                          |
|                             | median | -1.00                             | -1.09                          |
| One-factor alpha (percent)  | mean   | -0.91                             | -1.06                          |
|                             | median | -1.01                             | -1.09                          |
| Four-factor alpha (percent) | mean   | -0.72                             | -0.89                          |
|                             | median | -0.83                             | -0.92                          |
| Excess returns (percent)    | mean   | 0.03                              | -0.002                         |
|                             | median | 0.01                              | -0.01                          |

**Monthly returns in the Stock Portfolios of Retail Customers:** The table presents the mean and median differences in the stock portfolios of retail customers of banks with and without proprietary trading divisions. Raw returns display what would be realized by holding the same portfolio share of stocks as reported by the end of the previous quarter in each month of the following quarter. Using the monthly returns, we calculate the monthly one-factor and four-factor alphas for each of the customer portfolios. The excess return of a given stock is computed as its monthly return in excess of that of the benchmark portfolio to which the stock belongs.

comparing the stock portfolio performance of customers of banks with proprietary trading units with that of customers of banks without proprietary trading units. Considering several performance indicators, we find that client stock portfolios at banks with proprietary trading desks significantly underperform client portfolios at other banks (see table).

Overall, our results reveal a potential conflict of interest from combining proprietary trading

and retail banking under one roof, which seems to negatively affect the portfolio performance of retail investors.

### Policy implications

These findings have implications for the ongoing discussion about splitting up universal banks and separating their investment banking activity (particularly, proprietary trading) from their commercial and retail banking businesses. Proposals suggesting this separation have

been advanced in the U.S. as a key part of the Dodd-Frank-Act, in the U.K. in the Vickers Report and in the EU in the Liikanen Report. Admittedly, the main aim of these regulatory initiatives is to prevent possible moral hazard problems, i.e. to prohibit banks from using implicit and explicit guaranteed deposits and other bank liabilities to take excessive risks in their proprietary trading. Although our study does not directly contribute to the discussion of this moral hazard problem, our results suggest that such regulation might have the positive side effect of protecting retail investors.

### References

**Acharya, V. V. and T. Johnson** (2007), "Insider Trading in Credit Derivatives", *Journal of Financial Economics*, Vol. 84, pp. 110-141.

**Ivashina, V. and Z. Sun** (2011), "Institutional Stock Trading on Loan Market Information", *Journal of Financial Economics*, Vol. 100, pp. 284-303.

*This paper is forthcoming in the Journal of Finance and available at:*

[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1783679](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1783679)

# Direct and Indirect Risk-Taking Incentives of Inside Debt



Stefano Colonello  
Halle Institute for  
Economic Research

Inside debt constitutes a significant part of executive compensation and mitigates default risks. Moreover, according to the results of several studies, it is an efficient tool to align the incentives of managers to those of bondholders, thereby reducing risk-taking and corporate default. In this paper we argue that not only the direct risk-taking incentive of inside debt but also their interaction with other compensation components (indirect risk-taking) need to be considered. We show that indirect incentives are also important in shaping managerial risk decisions.

The recent finance literature has devoted considerable attention to inside debt, that is managerial pensions and deferred compensation plans whose payment is promised for a future date, normally the retirement date. The pioneering works of Bebchuk and Jackson (2005) and Sundaram and Yermack (2007) illustrate that inside debt is prevalent, constitutes a significant part of executive compensation and mitigates default risk. Moreover, several studies analyze

the implications of inside debt for corporate policies and managerial risk-taking incentives in particular. The general view is that inside debt is an efficient tool to align the incentives of managers to those of bondholders.

However, the ability of inside debt to do so depends on several factors, with the seniority of inside debt in bankruptcy probably being the most important. If CEOs are able to withdraw their inside debt before retirement, they are insured against default risk. As a result, these CEOs are not subject to the risk of losing their inside debt if the company defaults, and the previously described incentive-alignment effect may vanish. Moreover, managerial compensation is comprised of different components, e.g. salary, equity awards and inside debt, each providing different risk-taking incentives.

We build on the framework of Carlson and Lazrak (2010) and study the asset risk choice of a risk-averse manager whose compensation consists not only of a fixed salary and equity awards, but also of deferred compensation and pension plans. This model allows us to examine

theoretically the joint effect of salary, equity compensation and inside debt on managerial risk-taking incentives and credit spreads. We test the model predictions on a sample of U.S. public firms, having CDS contracts traded in the period from 2006 to 2011.

## The relationship among inside debt, CEO ownership and credit spread

We first show that salary is positively correlated with CDS spreads, our proxy for credit spreads. We next illustrate that a negative relation between inside debt and CDS spreads exists. Our result supports the argument that inside debt encourages managerial conservatism and that bondholders value this incentive mechanism. To test the additional implications of our model, we develop a direct and easy-to-replicate text-based measure of inside debt seniority. Using such a measure, we provide evidence that inside debt is associated with significantly lower CDS spreads only if it is highly unsecured.

We proceed to demonstrate that the relation between CEO ownership (fraction of firm equity held by the CEO) and CDS spreads is generally



Giuliano Curatola  
Goethe University  
& SAFE



Ngoc Giang Hoang  
Utrecht University  
School of Economics

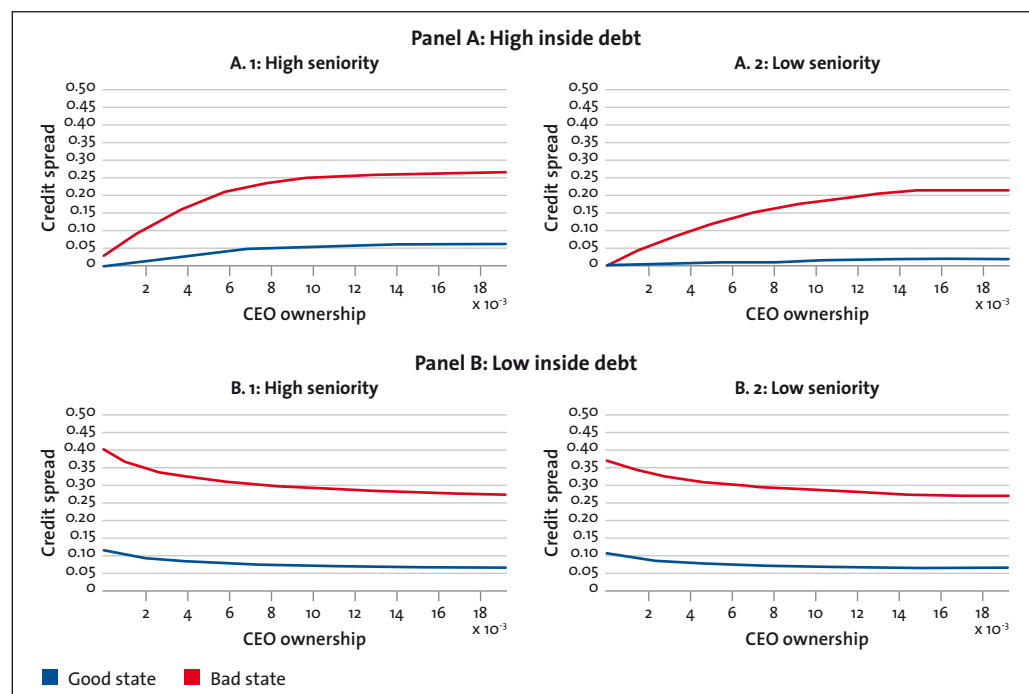
positive and concave. This relation is weaker in the presence of low-seniority inside debt. Further, we explore the state-dependent relation between CEO ownership and credit spreads for different levels of inside debt. In particular, our model predicts that when inside debt is high, the relation between credit spread and CEO ownership is generally positive and stronger in bad times; when inside debt is low, this relation

is negative and does not vary substantially across different economic states (see figures).

Our model also suggests that inside debt may favor managerial conservatism because, in certain economic states, it induces the CEO to avoid default, while a CEO with zero inside debt would choose otherwise. Such a behavior endogenously arises in intermediate states and

only when the ratio of unsecured inside debt to CEO ownership is sufficiently high. Intuitively, when inside debt is large relative to CEO ownership and unsecured in bankruptcy, it is in the best interest of the manager to implement policies that keep the firm afloat rather than gambling for resurrection, a likely behavior for managers whose wealth depends more on equity ownership. The data are consistent with these predictions.

However, inside debt, especially when large and relatively secured, absorbs the fluctuations of a manager's wealth and may induce the manager to take on more risk in reaction to an increase in his/her ownership. As a result, our model predicts a positive and concave relation between the credit spread and CEO ownership. This relation becomes stronger as the seniority of inside debt increases, as long as it is not made absolutely secured.



**Credit spreads and CEO ownership:** Relation between credit spreads and CEO ownership (fraction of firm equity held by the CEO) across different aggregate states in the presence of high inside debt holdings (Panel A) and low inside debt holdings (Panel B), with high-seniority (left) and low-seniority (right) inside debt.

## Summary

To sum up, our study provides three major results. First, our model predicts that the volatility of a firm's assets (chosen by the manager) and thus the credit spreads are increasing in salary. This result depends on the insurance effect of salary. Second, we show that the role of inside debt crucially depends on its seniority. Only unsecured inside debt is effective in aligning the incentives of managers to those of bondholders, which translates into a lower credit spread. Third, inside debt plays an important role in shaping the risk-taking incentives of CEO ownership. In the absence of inside debt, the optimal asset volatility chosen by a risk-averse CEO decreases with CEO ownership. This is so because a risk-averse CEO tries to offset the higher variation in his/her wealth induced by higher ownership by decreasing asset volatility.

## References

- Bebchuk, L. A. and R. J. Jackson** (2005), "Executive Pensions", *Journal of Corporate Law*, Vol. 30, pp. 823-855.
- Carlson, M. and A. Lazrak** (2010), "Leverage Choice and Credit Spreads When Managers Risk Shift", *Journal of Finance*, Vol. 65, Issue 6, pp. 2362-3323.
- Sundaram, R. K. and D. Yermack** (2007), "Pay Me Later: Inside Debt and Its Role in Managerial Compensation", *Journal of Finance*, Vol. 62, Issue 4, pp. 1551-1588.

*The full paper was published in the Journal of Corporate Finance (Vol. 45) and is available at: <http://www.sciencedirect.com/science/article/pii/S0929119917303334>*



# “People Should Be More Aware of the Flexibility of Law”



Matthias Goldmann  
Goethe University & SAFE

In this interview, Matthias Goldmann, Junior Professor of International Public Law and Financial Law at Goethe University, emphasizes that legal rules change with their context – a flexibility that is important in times of crisis but conflicts quite often with the expectations of economic actors who neglect the scope of discretion on the part of courts and administration. Matthias Goldmann contributes to the Research Center SAFE and the Cluster of Excellence “The Formation of Normative Orders” and is a Senior Research Affiliate of the Max Planck Institute for Comparative Public Law and International Law in Heidelberg.

**You are studying the role of law in the democratic organization of the economy with a special focus on the financial system. Why finance?**

In finance, law plays a particularly important role. Not only does it provide the framework for all financial activities, it is also the basis of all financial instruments. Even money itself is, in principle, a product of law. Another reason is that the relationship between law and finance seems to me particularly ambiguous, both in respect of how it works in practice and how it is understood in academia. The general public, including financial economists, often seem to understand law in a rather mechanical way. For example, they discuss whether the economy should better be regulated by strict rules or by principles that allow for some discretion on the part of the decision-makers, implicitly assuming that rules are precise, predictable, somehow a-political tools.

**You wouldn't say that rules are precise?**

Not in the sense that many people expect them to be. The basis of rules is language and the

meaning of language depends on its particular context. That makes law by nature uncertain and subject to change. As long as things run smoothly, there are usually no major debates on how to interpret a contract or regulation. However, when the context changes, in particular in case of a crisis, our understanding of the law might change as well, in line with the new political and economic situation. In that way, law is able to accommodate tensions between politics and the economy, rather than increasing them.

To give an example: In November 2012, the European Court of Justice (ECJ) decided that the ESM Treaty did not conflict with the no-bailout clause of Art. 125 of the Treaty on the Functioning of European Union (TFEU). The plaintiff had argued that the original idea behind this Article, to provide an incentive to member states to keep their budget and debts under control, would not allow for any bailouts. This argument – which I also heard many times from economists –

assumes that law is a strict instrument imposing a “red line” with mechanical precision. In its judgment, however, the Court put the emphasis on the purpose of the bailout clause, instead of the drafting history. It held that Art. 125 TFEU should prevent debt crises, but not facilitate the breakup of the Eurozone once a debt crisis occurs. It therefore allowed for bailout policies that are tied to conditions aiming at re-establishing fiscal self-reliance. All of this is within the scope of accepted legal methodology.

“Law has the task to stabilize the economic system, particularly in times of financial or political crises.”

**As a consequence, judges have a larger degree of discretion in interpreting rules than most people would expect.**

Exactly. When I look into several regulatory projects, I try to trace the expectations different parties had when this regulation was enacted. Quite often people expect law to be more stable than it is. But law needs to be flexible. Were it not able to adapt to changing contexts, it is very



likely that economic and financial crises would be much more severe, much more frequent and much more difficult to overcome. The flexibility of law functions as a safety valve. People should be more aware of this when they agree on a regulation or take an investment decision.

**This flexibility seems to add a degree of uncertainty to the entire legal system.**

I would not say so. Uncertainty already exists; it is a fact of life. Law allows us to deal with uncertainty. And it does not give carte blanche to politics. The ECJ, for instance, did not simply rubber-stamp the ESM Treaty, but it stated very precisely under which conditions such an institutionalized form of bail-out would be acceptable. A similar example is the ECJ decision on the OMT program of the European Central Bank (ECB). The ECB established this unorthodox type of monetary politics in a crisis. Against this background, the ECJ accepted it, however within strict boundaries, providing for rigorous checks on the program and, thus, exercising a lot of discipline on the action of the ECB.

**According to your argumentation, financial actors can never be sure whether contracts will**

**be honored. Isn't this confirmed by the sovereign debt crisis in Greece?**

When people do not get their money back after having lent to an overindebted country that, eventually, goes insolvent or implements a sovereign debt restructuring, one should not blame the law, but instead bad investment decisions. Rather than bailing out investors with a huge appetite for risk, law has the task to stabilize the economic system, particularly in times of financial or political crises. I think it did so splendidly in the case of Greece. I would have wished that the case of Argentina had taken a similar path. Here, a New York court ordered Argentina's banks to channel parts of the payments destined for cooperative creditors, who had exchanged their bond instruments, to uncooperative ones. Although the judge was well aware of the financial risks for the debtor state, he decided that enforcement of one creditor's claim would not bring Argentina back into financial trouble. This position totally ignores that such a case takes place – to use the language of game theory – in a setting characterized by multiple, repeat players. Such a narrow focus on the law only makes sense

**“A more proactive use of the Charter of Fundamental Rights would win the EU a lot of popular support.”**

if one blends out the macro perspective. In finance, this is nearly never appropriate.

**If judges have to take the macro context into account when deciding on specific cases, which guidelines should they follow?**

Ensuring respect for basic democratic principles is the best way for a court to take the macro perspective into account. But courts also need to respect the micro perspective, represented by human rights. Last year, the ECJ finally accepted the duty of the European Commission (EC) to respect the European Charter of Fundamental Rights when designing and implementing structural adjustment policies. The case originated from the 2012 financial crisis in Cyprus. The plaintiffs accused the EC for having forced the Cyprus government to require creditors of failing banks, including bond-holders and depositors, to bear a substantial part of the costs. This was seen as a breach of property rights. The ECJ ruled that the EC must ensure that any decision it takes complies with EU law, including its Charter of Fundamental Rights. I am sure that a more proactive use of the Charter would win the EU a lot of popular support. People would not feel so powerless because there is a court that looks into their cases and reverses measures if necessary.

**Given their scope of discretion, shouldn't European institutions increase their democratic legitimacy?**

Absolutely. In particular the EC, the ECB and the ECJ are not only the most powerful EU institutions but also those subject to the comparatively lowest levels of democratic control. The supposed loss of control over these institutions is certainly one of the factors that brings people up against the EU and that has contributed to the Brexit decision in the UK. Subjecting these institutions to closer control of the European Parliament would cure at least some of the deficits.

#### Literature

**Goldmann, M.** (2017), “International Investment Law and Financial Regulation: Towards a Deliberative Approach”, in: Hofmann, R., Schill, S. and C. Tams (eds.), *International Investment Law and the Global Financial Architecture*, Elgar, Cheltenham, pp. 57-85.

**Goldmann, M.** (2014), “Adjudicating Economics? Central Bank Independence and the Appropriate Standard of Judicial Review”, *German Law Journal*, Vol. 15, pp. 265-280.

# What Microfinance Institutions Can Learn from the German Savings and Cooperative Banks of the 19<sup>th</sup> Century



Reinhard H. Schmidt  
Goethe University & SAFE

The German savings and cooperative banks of the 19<sup>th</sup> century were precursors of modern microfinance. They provided access to financial services for the majority of the German population, which was formerly excluded from bank funding. Furthermore, they did this at low costs for themselves and affordable prices for their clients. By creating networks of financially viable and stable financial institutions covering the entire country, they contributed significantly to building a sound and “inclusive” financial infrastructure in Germany. A look back at the history of German savings and cooperative banks and combining these experiences with the lessons learned from modern microfinance can guide current policy and be valuable for present and future models of microfinance business.

## **Microfinance in Germany in the 19<sup>th</sup> century**

The economic, social and political situation in Germany in the early and again towards the middle of the 19<sup>th</sup> century was largely similar to

that in most developing countries in the 1970s when modern microfinance was first implemented by Muhammad Yunus. The few existing banks were neither willing nor able to offer financial services to the general public. Funding for poor people and small businesses in agriculture, trade or handicrafts could only be obtained from money lenders or friends and family.

The first savings banks in the late 18<sup>th</sup> century and the first cooperative banks in the mid-19<sup>th</sup> century specialized in a dual sense: At the time they started their respective operations, the savings banks only took deposits whereas cooperatives only granted small loans. Both offered their services to very poor people or very small businesses in the region of their operation and not to the general public. They did not intend to generate profit, but to provide social support and public education instead.

In the early to mid-19<sup>th</sup> century the institutional form of savings banks has been changed from private non-profit to community-based or municipal. Subsequently, savings banks were assigned the additional roles of building a stock of

capital that could be used locally and of granting loans to the entire local community, including local businesses. Until today, serving their respective region, its economy and the entire population is the overarching purpose of savings banks. A profitable business is of course a precondition for being able to fulfill this mandate. Thus, profitability is in a certain sense also an objective, but, at least in principle, one that ranks behind the mandate to support people and region.

The first German cooperatives were funded by charitable institutions or local dignitaries. When this funding turned out to be insufficient to meet the clients’ credit demands, the cooperatives started to also mobilize savings from their clients and used them to lend the money to other clients. They also opened up to a more general local clientele. Thus, in an even shorter span of time, the cooperatives undertook a similar strategic reorientation as the savings banks: From at first being highly specialized financial service providers, they soon turned into genuine financial intermediaries that would today be called “inclusive”

providers of financial services. This was most likely the reason for the stunning success of both groups of popular banks in Germany in the 19<sup>th</sup> century.

### Modern microfinance

The first microfinance institutions that came into existence in the late 1970s and early 1980s at first pursued a poverty-oriented development finance policy and were also highly specialized in a dual sense: They only offered and granted loans to very poor people and very small businesses. This was extremely inefficient. They had annual costs for administration and loan losses that came close to the outstanding volume of their loans. Neither could microfinance in this style reach a significant number of people nor could any appreciable impact

be expected because of the small available credit volume. Having an impact on social and economic conditions presupposes operations of at least some scale as well as a “sustainable” business model that does not depend on a permanent stream of subsidies and possibly even generates a moderate profit.

Rather soon, some microfinance institutions tried to overcome this deficiency and adopted what has come to be called a “commercial approach”. Those that followed this approach around 1990 have grown rapidly since. The growth alone lowered the unit costs of small loans considerably and enabled them to have substantial economic and developmental impact. Only ten years later, this development led to a real microfinance boom.

| Region                        | Microfinance institutions* | Number of active borrowers '000 | Gross loan portfolio (USD) m | Number of depositors '000 | Deposits (USD) m |
|-------------------------------|----------------------------|---------------------------------|------------------------------|---------------------------|------------------|
| Africa                        | 193                        | 5,778.2                         | 8,489.5                      | 17,928.0                  | 9,212.1          |
| East Asia / Pacific           | 136                        | 16,257.5                        | 15,063.7                     | 16,117.9                  | 7,687.2          |
| Eastern Europe / Central Asia | 136                        | 3,082.6                         | 9,899.6                      | 5,091.0                   | 7,664.3          |
| Latin America / Caribbean     | 345                        | 22,495.3                        | 38,843.2                     | 23,708.6                  | 27,293.1         |
| Middle East / North Africa    | 27                         | 2,148.4                         | 1,352.9                      | 465.1                     | 251.0            |
| South Asia                    | 196                        | 66,929.3                        | 18,794.1                     | 35,109.2                  | 6,885.8          |
| <b>Grand Total</b>            | <b>1,033</b>               | <b>116,691.3</b>                | <b>92,442.9</b>              | <b>98,419.8</b>           | <b>58,993.6</b>  |

\*Financial institutions that report themselves as microfinance institutions

Source: MIX Global Outreach & Financial Performance Benchmark Report 2015/[www.mixmarket.org](http://www.mixmarket.org)

Overview of the global microfinance market.

The boom did also have its downsides which cumulated to a microfinance crisis shortly after the outbreak of the general financial crisis in 2008. The initial public offerings of the Mexican microfinance institution Compartamos and its Indian peer SKS-Microfinance for instance attracted hedge funds, private equity and other investors who were only interested in making as much profit as possible and did not care about social and developmental effects. Further, the merit of creating and supporting thousands of extremely small “enterprises” has at best a limited developmental impact. There is also a risk of over-indebtedness and increasing default rates if too many credit facilities are offered and people can easily take out several loans from different lenders. Hence, a more “inclusive” approach, where institutions provide their services to the entire local community including small and even some mid-sized enterprises, proved to be more successful. This idea of “inclusive finance” which benefits the entire population has now been widely accepted.

### What can we learn from history?

All microfinance institutions which are considered successful have chosen a path similar to the German savings and cooperative banks of the 19th century. Even though most of them had started to operate as dually specialized institutions, they all changed their strategy to

become true financial intermediaries, which grant loans and also mobilize clients’ deposits, as well as “inclusive” local banks, serving a more broadly defined local clientele to increase the scale of operations and to stabilize the banks’ revenue base.

Hence, important conditions of success are that relevant institutions do not specialize, neither in terms of services nor clientele. Instead, they should be set up as true financial intermediaries that offer loans, take local deposits and provide additional elementary financial services such as payment services. Moreover, they should aspire to be inclusive financial institutions that cater to a broader class of clients in order to survive and have a positive impact. Both the history of savings and cooperative banks in Germany and the history of modern microfinance clearly support these general conclusions, which may provide a guidance for current development finance policy and practice.

### Reference

**Schmidt, R. H., Seibel, H.-D. and P. Thomes** (2016), “From Microfinance to Inclusive Banking: Why Local Banking Works”, Wiley-VHC, Weinheim.

The full text is available as SAFE White Paper No. 48 at: [www.safe-frankfurt.de/microfinance](http://www.safe-frankfurt.de/microfinance)

# News

## Former Greek Finance Minister: 2017 Make-or-Break Year



When George Papaconstantinou became finance minister in 2009, Greece was on the verge of bankruptcy. Seven years, nine finance ministers and three bailouts later, Greece has still not recovered from the debt crisis. In a SAFE Policy Lecture on 9 May, Papaconstantinou looked back to the causes and evolution of Greece's debt crisis and addressed current perspectives. "Greece needs massive international investments in order to get rid of its unsustainable debt pile and to grow again," he said. Yet, the former finance minister expects that after the end of the third bailout in 2018 a fourth has to follow suit. It will take some time until the austerity efforts show an impact, he said. According to Papaconstantinou, 2017 will be the make-or-break year regarding the question of whether EU countries will continue to demand more austerity measures from Greece. He hopes for a policy change after the German federal elections.

## Thomas Wieser Demands More Risk Sharing in the European Union



The European Union may have come to a turning point in post-war history, Thomas Wieser, President of the Eurogroup Working Group and the Economic and Financial Committee of the European Union, stated at a SAFE Policy Lecture on 30 May. Brexit and increasing populism in Europe indicated a threatening rescission of established structures for cooperation. However, it would be naïve and dangerous to speed up European integration in order to fight this development because of the current anti-European atmosphere, Wieser said. Instead, he called for more democratic legitimacy of European institutions. The Austrian takes an optimistic view on the German-French tandem: "It has a good chance to move things forward," he said. However, Germany would need to engage in more risk sharing with its European partners, he claimed.

## How to Make Finance More Sustainable



To improve the contribution of the financial sector to sustainable growth, key financial actors such as insurance companies, asset managers, stock exchanges and credit rating agencies should adopt a more long-term oriented strategy, Christian Thimann claimed at a SAFE Policy Lecture on 6 July. Thimann is Chairman of the EU High-level Expert Group on Sustainable Finance and the Group Head of Regulation, Sustainability and Insurance Foresight at AXA Group. In his view, short-term horizons in financial markets make it difficult to invest in projects which take environmental, social and governance aspects into special account. Hence, a change of perspective would be necessary to finance long-term needs such as job creation, innovation and infrastructure, and accelerate the shift to a low carbon and resource-efficient economy.

## Grants for House of Finance Scholars

Alexander Ludwig, SAFE Professor of Public Finance and Debt Management, and Nicola Fuchs-Schündeln, Professor of Macroeconomics and Development, will receive funding by the NORFACE-DIAL (Dynamics of Inequality Across the Life-course) program for an international research project on "Trends in Inequality: Sources and Policy." Team members in the partner institutions are Per Krusell (Institute for International Economic Studies IIES), Mariacristina De Nardi (University College London) and Giulio Fella (Queen Mary University of London).

Ester Faia, Professor of Monetary and Fiscal Policy, has been awarded a Fritz-Thyssen grant for a project with Gianmarco Ottaviano (London School of Economics) on "Global Banks: Theoretical, Empirical and Regulatory Aspects".

The SAFE Data Center, headed by Horst Entorf, has been awarded funding by the Deutsche Forschungsgemeinschaft to set up a data repository to support and enhance finance research. This is a joint initiative with the Goethe University Library Johann Christian Senckenberg and the Hessian Library Information System HeBIS.

## Brigitte Haar in BaFin Council

Brigitte Haar, Law Professor at Goethe University Frankfurt and a member of the SAFE Scientific Board, was confirmed as a member of the Administrative Council of the German Federal Financial Supervisory Authority (BaFin) by the German Ministry of Finance. Brigitte Haar has been a member of the Administrative Council and of the Consumer Board since 2013. The Administrative Council monitors the management of BaFin, supports the authority in the performance of its supervisory functions and decides on its budget.

# Selected Publications

**Bick, A. and N. Fuchs-Schündeln** (2017)

“Quantifying the Disincentive Effects of Joint Taxation on Married Women’s Labor Supply”, American Economic Review Papers & Proceedings, Vol. 107, Issue 5, pp. 100-104.

**Billio, M., Getmansky, M. and L. Pelizzon** (2017)

“Financial Crises and the Evaporation of Diversification Benefits of Hedge Funds”, H. K. Baker and G. Filbeck (eds.), Hedge Funds: Structure, Strategies, and Performance, New York, Oxford University Press, Chapter 24.

**Curatola, G.** (2017)

“Portfolio Choice and Asset Prices when Preferences are Interdependent”, Journal of Economic Behavior & Organization, Vol. 140, pp. 197-223.

**Deuflhard, F., Georganakos, D. and R. Inderst** (2017)

“Financial Literacy and Savings Account Returns”, forthcoming in Journal of the European Economic Association.

**Donadelli, M., Jüppner, M., Riedel, M. and C. Schlag** (2017)

“Temperature Shocks and Welfare Costs”, Journal of Economic Dynamics and Control, Vol. 82, pp. 331-355.

**Goetz, M.** (2017)

“Competition and Bank Stability”, forthcoming in Journal of Financial Intermediation.

**Kraft, H., Schwartz, E. and F. Weiss** (2017)

“Growth Options and Firm Valuation”, forthcoming in European Financial Management.

**Siekman, H., Cahn, A., Florstedt, T., Langenbucher, K., Redenius-Hövermann, J., Tröger, T. and U. Segna** (eds., 2017)

“Festschrift für Theodor Baums zum siebzigsten Geburtstag”, Mohr Siebeck, Tübingen.

**Thiemann, M. and J. Lepoutre** (2017)

“Stitched on the Edge: Rule Evasion, Embedded Regulators, and the Evolution of Markets”, American Journal of Sociology, Vol. 122, Issue 6, pp. 1775-1821.

**Wandt M.** (2017)

“Transparency of Insurance Contract Terms”, Festschrift für Ioannis K. Rokas, Nomiki Bibliothiki (forthcoming).

## Recent SAFE Working Papers

**Donadelli, M., Jüppner, M., Riedel, M. and C. Schlag** (2017)  
“Temperature Shocks and Welfare Costs”, SAFE Working Paper No. 177.

**Curatola, G. and I. Dergunov** (2017)  
“International Capital Markets with Time-Varying Preferences”, SAFE Working Paper No. 176.

**Gropp, R. and D. Radev** (2017)  
“International Banking Conglomerates and the Transmission of Lending Shocks across Borders”, SAFE Working Paper No. 175.

**Gropp, R. and D. Radev** (2017)  
“Social Centralization, Bank Integration and the Transmission of Lending Shocks”, SAFE Working Paper No. 174.

**Kamga, M K. and C. Wilde** (2017)  
“Liquidity Premia in CDS Markets”, SAFE Working Paper No. 173.

**Khalifa, A., Caporin, M., Costola, M. and S. Hammoudeh** (2017)  
“Systemic Risk for Financial Institutions of Major Petroleum-based Economies: The Role of Oil”, SAFE Working Paper No. 172.

More information on the SAFE Working Papers can be found on <http://safe-frankfurt.de/working-papers>

# It's not the Right Intentions that Count, but the Right Actions



Felix Hufeld  
President of the Federal  
Financial Supervisory  
Authority (BaFin)

The Greek poet Aesop is credited with having said, “Do nothing without a regard to the consequences.”<sup>1</sup> A maxim that was accurate in the 6<sup>th</sup> century BC is not necessarily wrong today. Quite the reverse, in fact: For intentions to have their desired effects in the long term, those responsible must not lose sight of the associated risks. An example from current affairs are politically desirable investments in long-term infrastructure projects and environmentally-friendly and climate-friendly forms of investment (green finance).

We do indeed have good reasons for wanting to promote such investments. Firstly, the window of opportunity within which scientists believe it is still possible to limit the rise in global average temperatures to 2°C is in danger of closing; secondly, according to estimates by the B20<sup>2</sup>, investment in infrastructure projects will need to rise to approximately USD 3.3 trillion p.a. by 2030.

Infrastructure investments and green finance offer new long-term investment opportunities, especially for insurers and institutions for occupational retirement provisions. The persistent low interest rate environment is a particularly motivating factor for individual market participants to unlock new investment opportunities. No regulator would even consider fundamentally questioning the importance of these investments to society. However, we do not just have the right to ask “how”: A responsible regulator has an obligation to do so.

In 2016, the European Commission created the framework for infrastructure investments of this type by reducing the own funds requirements for insurance undertakings under Sol-

veny II. Legislators have also enacted rules and regulations for sustainable green finance and require, for example, that insurers include a non-financial statement regarding ecological issues in their management report from the 2017 financial year onwards.

The fact that infrastructure investments are long-term and illiquid does not necessarily mean that they could not be a potential danger to the stability of the financial system. It requires a great deal of time and effort to assess these risks. Infrastructure investments demand specialist knowledge that many insurers are yet to acquire. When companies that are subject to Solvency II invest in infrastructure, there are comprehensive requirements that they have to meet, in particular the standards required as part of the prudent person principle<sup>3</sup>. From a supervisory perspective, these measures are reasonable and appropriate.

At present, the Commission is creating further investment opportunities in infrastructure – so-called “infrastructure corporates” – as part of the European Capital Markets Union project. Furthermore, the spread risk factors for invest-

ments in infrastructure corporates are to be significantly reduced in comparison with the factors currently set out in the standard formula. Here the Commission is acting contrary to the technical advice of the European Insurance and Occupational Pensions Authority (EIOPA). In my opinion, a better way to achieve the goal would be to carry out a precise, risk-appropriate calibration of these factors in the standard formula.

To summarize: Good intentions are not enough. Investments which are desirable from a political point of view must also be appropriately regulated and supervised. The job of regulation here is not to favor individual products and play midwife to the birth of privileged types of investment onto the financial market. The goal still has to be to create reliable framework conditions for all market participants and, above all else, to uphold the integrity and stability of the markets. Overdoing it by opening the floodgates and creating the risk of large-scale market disturbances in the future would do nothing more than damage the credibility of, and confidence in, badly needed green finance activities.

<sup>1</sup> Aesop's Fables: “The Two Frogs” (Townsend 139).

<sup>2</sup> Business 20 (B20) has been the official platform for dialogue between the G20 and the business community since 2010. The objective of the B20 is to represent the combined interests of the entire business community of the G20 with a single voice.

<sup>3</sup> Insurers are obliged to fulfil not only the provisions of section 124 of the German Insurance Supervision Act (Versicherungsaufsichtsgesetz – VAG), but also the requirements of the EIOPA Guideline 28 on System of Governance with regard to the assessment of non-routine investment activities.



# Events

## September

|                             |   |
|-----------------------------|---|
| 1 – 2 Sep                   | <b>SAFE/Goethe University Conference<br/>15<sup>th</sup> Annual Conference on Quantitative Marketing and Economics</b>  |
| 6 – 7 Sep                   | <b>5<sup>th</sup> Conference on Global Insurance Supervision<br/>The Future (Re)Insurance Landscape:<br/>Different Perspectives, Inspiring Dialogue</b><br>Co-organized by ICIR, SAFE, EIOPA and World Bank |
| 8 Sep<br>9.00 am – 5.30 pm  | <b>Fachkonferenz Verantwortung<br/>Aktuelle Entwicklungen im CSR- und Nachhaltigkeitsmanagement</b><br>Co-organized by GBS and Frankfurt Business Media   |
| 13 Sep<br>9.00 am – 5.30 pm | <b>CFS Conference<br/>3. Konferenz für Finanztechnologie</b>  |
| 14 Sep<br>5.30 – 6.30 pm    | <b>IMFS Distinguished Lecture</b><br>Speaker: Jens Weidmann, Deutsche Bundesbank  |
| 21 – 22 Sep                 | <b>SAFE Summer Academy 2017<br/>Developing Capital Markets in Europe</b>  |
| 26 Sep                      | <b>4<sup>th</sup> SAFE Asset Pricing Workshop</b>   |
| 26 Sep                      | <b>SAFE/CFS RegTech Conference</b>  |

## October

|                          |   |
|--------------------------|---|
| 4 Oct<br>12 pm – 1.30 pm | <b>SAFE Panel Discussion<br/>Bail-In at Noon</b>  |
| 9 Oct<br>5.00 pm         | <b>EFL Jour Fixe<br/>Co-Evolution of Bitcoin and Darknet Markets</b><br>Speaker: Christian Janze, E-Finance Lab |

17 Oct  
2.15 – 3.45 pm

17 Oct  
4.15 – 5.30 pm

18 Oct  
5.30 – 7.00 pm

20 – 21 Oct

24 Oct  
2.15 – 3.45 pm

24 Oct  
5.30 – 7.00 pm

26 Oct  
9.30 am – 5.30 pm

27 Oct

**Frankfurt Macro Seminar – Joint with SAFE**  
Speaker: Lutz Kilian, University of Michigan

**Finance Seminar – Joint with SAFE**  
Speaker: Hans-Joachim Voth, University of Zurich

**Visiting Professorship of Financial History – Public Lecture**  
Speaker: Hans-Joachim Voth, University of Zurich

**SAFE Conference  
The Law and Finance of Related Party Transactions**  
Co-organized with the University of Oxford

**Frankfurt Macro Seminar – Joint with SAFE**  
Speaker: Alex Michaelides, Imperial College London

**CFS Colloquium  
Deutscher Corporate Governance Kodex:  
Eine kritische Bestandsaufnahme**  
Speaker: Theodor Baums and Rolf Nonnenmacher, Deutscher Corporate Governance Kodex

**CFS Conference  
Frankfurt Summit on Network Analysis**

**5<sup>th</sup> Frankfurt Conference on Financial Market Policy  
How Much Union does Europe Need?  
Promises and Challenges of Mutualization**  
organized by the SAFE Policy Center

## November

|                          |  |
|--------------------------|--|
| 2 Nov<br>2.15 – 3.45 pm  | <b>Frankfurt Macro Seminar – Joint with SAFE</b><br>Speaker: Felicia Ionescu, Federal Reserve System   |
| 2 – 3 Nov                | <b>SAFE/CEPR Conference<br/>Macroeconomics and Growth Programme Meeting</b>  |
| 6 Nov<br>5.30 – 7.00 pm  | <b>CFS/IBF Lecture<br/>Keynes the Investor</b><br>Speaker: David Chambers, Cambridge University  |
| 7 Nov<br>2.15 – 3.45 pm  | <b>Frankfurt Macro Seminar – Joint with SAFE</b><br>Speaker: Martin Brown, University of St. Gallen  |
| 9 Nov<br>5.30 – 7.00 pm  | <b>CFS Presidential Lecture</b><br>Speaker: Thomas J. Jordan, Schweizerische Nationalbank  |
| 9 Nov                    | <b>SAFE/ICIR Policy Lecture<br/>Digitalization – Insurance - Solvency II</b><br>Speaker: Nathalie Berger, European Commission  |
| 14 Nov<br>2.15 – 3.45 pm | <b>Frankfurt Macro Seminar – Joint with SAFE</b><br>Speaker: Frederic Malherbe, London Business School   |
| 21 Nov<br>2.15 – 3.45 pm | <b>Frankfurt Macro Seminar – Joint with SAFE</b><br>Speaker: Jaume Ventura, Universitat Pompeu Fabra   |
| 23 Nov                   | <b>ICIR Frankfurter Vorträge zum Versicherungswesen<br/>Die Umsetzung der IDD und deren Auswirkungen auf den Versicherungsvertrieb</b><br>Speaker: Matthias Beenken, FH Dortmund |
| 28 Nov<br>2.15 – 3.45 pm | <b>Frankfurt Macro Seminar – Joint with SAFE</b><br>Speaker: Andreas Fabereng, Statistics Norway   |
| 30 Nov<br>6.00 – 7.45 pm | <b>CFS Lecture/Festakt</b><br>Speaker: Rolf Breuer, prev. Deutsche Bank, et al.  |





**LOEWE**

Exzellente Forschung für  
Hessens Zukunft

**SAFE | Sustainable Architecture for Finance in Europe**  
A Cooperation of the Center for Financial Studies and Goethe University Frankfurt