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Leibniz Institute for Financial Research SAFE

Dear Marius Luta,

Welcome to the latest edition of *SAFE Update*, the Leibniz Institute SAFE digital newsletter. In this issue, we focus on what we know about the holders of bail-in-able securities in the European banking union and look at research into investment decisions.

We hope you find this newsletter of interest and would welcome your feedback to the editorial team at newsletter@safe-frankfurt.de.

Focus: How to track bail-in-able debt in European banking

Better data needed to foster market discipline

The European resolution framework for banks requires credit institutions to build up a minimum level of capital and bail-in-able debt by 2024. Yet whether market discipline in the banking sector will actually be effective depends on how credible the bail-in threat really is, which in turn hinges on how transparent the holdings of bail-in-able debt actually are. According to the findings of an international research team around the Leibniz Institute SAFE, this transparency is, at best, limited.

In an analysis requested by the Committee on Economic and Monetary Affairs (ECON) of the European Parliament, the researchers put the crisis management instruments of the European Bank Recovery and Resolution Directive under scrutiny. A central observation is that bail-in is effective when neither retail investors nor other banks hold a significant share of a bank's bail-in-able debt. Measured by the data available, however, to a significant degree, the opposite is the case. At the same time, the researchers note that data on bail-in debt are, to all intents and purposes, not publicly available – and that neither national nor supranational supervisory and resolution authorities have direct access to them.

To find out who is holding bail-in-able bank debt, the research team used publicly-available statistics provided by the European Central Bank on securities holdings by sector and further data from the German Federal Financial Supervisory Authority for 25 German banks. Their empirical findings lead the researchers to two key recommendations to ensure greater market discipline in European banking: disclosing data and refining regulation.

Accordingly, data on bail-in-able debt holdings should be fully disclosed to all investors, banks, supervisory and resolution authorities, and central banks.

Regulatory refinements should feature a clear upper bound for the application of the bail-in tool (bail-in maximum), a minimum denomination requirement for eligible liabilities, and limits on individual ownership of bail-in-able debt for banks (concentration limits).

Read the full analysis in SAFE White Paper No. 92

Research Highlight: Asset allocation choices

How to alleviate correlation neglect
in investment decisions

by SAFE Professor Christine Laudenbach, Michael Ungeheuer (Aalto University), and Martin Weber (University of Mannheim; Centre for Economic Policy Research, London).

In their paper “How to alleviate correlation neglect in investment decisions”, forthcoming in *Management Science*, the authors examine whether presenting investors with information about return distribution in a specific way can be used as a tool to facilitate better investment decisions. Theoretically, investors can achieve an optimal portfolio by diversifying their assets in order to reduce the idiosyncratic risk inherent in every single investment. Ideally, this involves the evaluation of correlations between different assets.

However, the extant literature has established that, due to correlation neglect, investors have difficulty achieving the benefits of diversification from their asset allocation decisions: i.e. they frequently fail to give more weight to those assets which promise higher returns.

Against the backdrop of these findings, the authors posit that presenting investors with information about return distribution in a specific way could improve their financial decisions. Specifically, they expect that investors will be better equipped to incorporate correlations into their asset allocation decisions if they experience a return distribution with the help of a simulation of possible returns, as opposed to receiving a simple description of joint returns. This expectation is based on previous findings that personal experiences affect investors' predilection to risk.

Choosing an experimental design, the researchers are able to sustain their hypothesis: in comparison with the subset of respondents who received descriptive information about possible returns, experimental subjects who experienced the joint return distribution with the help of sampling exhibited less vulnerability to correlation neglect; accordingly, they diversified more when the correlations between two assets were lower and diversification benefits were higher.

As a result, the authors provide important insights for, among others, regulators, financial institutions, investment advisors, and FinTech firms on how to communicate information to best support investors in their financial decisions.

[Find the research paper here]

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Review
Since the Global Financial Crisis of 2007, financial markets have grown, as have global debt levels. A SAFE-IBF-CFS-HoF Policy Discussion with SAFE researchers Loriana Pelizzon and Kaspar Zimmermann as well as Moritz Schularick (University of Bonn), Daniel Dieckelmannn and Isabel Vansteenkiste (both from the European Central Bank), and Lena Tonzer (Vrije Universiteit Amsterdam and Leibniz Institute for Economic Research in Halle) looked at the causes – and at possible countermeasures. Read

the follow-up report and listen to a recording of the session here.

Outlook
Together with the Center for Advanced Studies on the Foundations of Law and Finance, SAFE will host an interdisciplinary workshop on "The Quest for Sustainability: A Law & Finance Dialogue" on 16 and 17 January 2023 online. The program of the workshop features international scholars from law and financial economics who will present and discuss academic work on carbon taxation, technical progress in the climate crisis, and the making and meaning of ESG, as well as various other topics. Find the full program and the Zoom link to participate here.

Handpicked

Oliver Hinz, SAFE Bridge Professor and Coordinator of the Digital Finance Network at SAFE, recommends the book *Chip War* by Chris Miller, Associate Professor of International History at the Fletcher School at Tufts University:

"Practitioners and researchers from different disciplines pay a lot of their attention to software and platforms, often taking the hardware for granted and forgetting that microchips constitute the foundation of every software stack. Now, the scarcity of microchips over the last two years has once again made clear the importance of this technology for many industries ranging from automotive to the energy sector, revealing the strong interplay between this technology, politics, and the economy. In his book *Chip War*, Chris Miller describes the rise of the microchip industry and the outsize geopolitical implications of its ascendancy, moving on to examine its current state and impact on the economy before giving an outlook for the near future. *Chip War* emphasizes how microchips are behind tensions between autocracy and democracy: Taiwan is currently the unlikely epicenter of technology, global economics, and China's high-stakes rivalry with the West. Overall, the book provides a fascinating overview and shows how political decisions, technological developments, and economic necessities shape the world we live in."

[Find the book here]

News & Latest

- **News:** Fewer returns in

online shopping due to Smart Green Nudge – the environment and companies benefit

- **Video:** New Scientific Director at SAFE: Florian Heider to follow Jan Pieter Krahnen

- **SAFE Finance Blog:** The future of the banking union between dreams and reality (by Jan Pieter Krahnen and Tobias Tröger)

- All upcoming events and SAFE publications

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