

Household Debt and Social Interactions _4

Dimitris Georgarakos • Michael Haliassos • Giacomo Pasini

Global Financial Turmoil: Does Connectedness Matter? _6

Loriana Pelizzon

Radical Regulatory Action Would Do More Harm Than Good _14

Douglas J. Elliott

IMPRINT

Publisher:

Prof. Dr. Wolfgang König • Executive Board
Center of Excellence SAFE
House of Finance • Goethe University
Grüneburgplatz 1
60323 Frankfurt am Main • Germany

Editors:

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

Contact:

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

Design:

Novensis Communication GmbH
Bad Homburg

1st Edition

Copyright © by Center of Excellence SAFE,
Frankfurt am Main

Printed in Germany

About SAFE

The Center of Excellence 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

Household Debt and Social Interactions_4

Dimitris Georgarakos • Michael Haliassos •
Giacomo Pasini

Global Financial Turmoil: Does Connectedness Matter?_6

Loriana Pelizzon

Safety Traps_8

Kenza Benhima • Baptiste Massenet

Frankfurt Conference on Financial Market Policy 2013_10

Guest Commentary: Radical Regulatory Action Would Do More Harm Than Good_14

Douglas J. Elliott

News_12

Selected Publications_13

Events_15

Editorial



Alfons Weichenrieder

Center of Excellence SAFE

Many European countries feel haunted by “excess austerity”. Will consolidation in response to market pressures and the demands of European Union institutions and the International Monetary Fund lead to extended spells of low growth plus excessive unemployment? Important far-reaching questions arise with regard to the nature of this link.

For example, to what extent is there a tradeoff between austerity and long-run growth? Are expenditure cuts really better than tax increases? Do adherence to strict austerity measures and the subsequent recession have permanent effects on a nation’s ability to ascend a long-run growth path? Should all Eurozone countries adopt austerity programs simultaneously? There are no easy answers to these questions; a predicament exacerbated by the fact that certain aspects of the prevailing economic and financial crisis are unique. Nonetheless, it is the responsibility of academia and politics to develop new, custom-tailored strategies.

Against this background, the Center of Excellence SAFE 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. An international selection committee consisting of Costas Azariadis (Washington University), Roel Beetsma (Universiteit van Amsterdam), Henning Bohn (University of California at Santa Barbara), Athanasios Orphanides (MIT Sloan School of Management) and myself looked through the almost 50 project proposals submitted in response to this call.

We identified five projects that were particularly worthy of SAFE funding. Their authors, including Alberto Alesina, Harris Dellas, Gernot Müller, Alan M. Taylor and Linda Tesar, all coming from European and U.S. universities, will present their work at a SAFE conference that will be held in Frankfurt on 14 June 2014. Each project should result in a new academic paper published under the SAFE Working Paper Series and to be submitted to a major international journal. It is also envisaged that the findings of these projects will be communicated via a special policy publication from the SAFE Policy Center.

A list of the projects selected is available at <http://safe-frankfurt.de/research/further-projects.html>. If you are interested in attending the conference, please send us an e-mail (info@safe-frankfurt.de).

Yours sincerely,
Alfons Weichenrieder

Household Debt and Social Interactions



Dimitris Georgarakos
Goethe University &
University of Leicester



Michael Haliassos
Goethe University & SAFE



Giacomo Pasini
Ca' Foscari University of
Venice & Netspar

The role of relative standing in relation to peers in influencing household economic behavior has been explored in many contexts, including with regard to consumption and labor supply. But less attention has been paid to how “catching up” or “keeping up” with peers (the so-called “Joneses”) is financed. In particular, almost no attention has been paid to whether perceptions of relative standing contribute to borrowing and to the potential for financial distress. Are people who perceive themselves as being poorer than their social circle more likely to borrow and, if so, to borrow more than what is typically associated with their own resources and characteristics? Does such socially induced borrowing contribute to a worsening of indicators of potential financial distress, such as the debt-to-income and loan-to-value ratios?

The question of social influences on debt is distinct from that relating to consumption; concern with relative standing may lead to greater con-

sumption, but it need not lead to a greater tendency to borrow or to run into financial distress for at least three reasons. First, households can increase labor supply, leaving room for an increase in both consumption and saving. (For example, Neumark and Postlewaite (1998) find that married women in the United States are 16% to 25% more likely to work outside the home if their sisters’ husbands earn more than their own.) Second, households may choose to reduce saving but may not be willing or able to raise borrowing in response to status concerns. Third, even if borrowing is undertaken, it may not significantly increase the potential for financial distress.

Investigating the influence of social interactions on debt behavior presents at least two major challenges. First, many households are willing to display their assets and consumption but prefer to leave any debts undisclosed. Thus, it makes sense to look for evidence that households adjust their debt behavior not to the debts of their peers per se but to their perception of relevant peer characteristics, like income. Using Manski’s (1993) terminology, instead of “endogenous effects”, one needs to focus on “exogenous (or contextual)

effects”. A second challenge has to do with the scarcity of location information in household finance data. Due to privacy laws dictating anonymity of information, data collectors typically remove location details, but this step makes it impossible to identify a circle of “neighbors” or “colleagues”.

Pioneering papers that study the asset side focus on a special population group, a financial asset observed by peers, or on sociability as a factor facilitating the collection of asset-relevant information. Duflo and Saez (2002) demonstrate that the participation of individual librarians in retirement investment plans is influenced by the participation choices of colleagues at the same library. Hong, Kubik, and Stein (2004) show that more sociable individuals are more likely to own stocks.

Influence of social interactions on borrowing behavior

To the best of our knowledge, our paper is the first to investigate the influence of social interactions and comparison effects on borrowing behavior. We exploit a unique feature of population-wide representative data from the Netherlands (the

Dutch National Bank Household Survey), namely, that the respondents report on various characteristics of their peers, such as income, as they actually perceive them. Thus, we can focus on those whom the respondents consider as peers and study their perceptions regarding their own financial position relative to these peers.

We find that, once we control for demographics, resources, region, time fixed effects, region-specific time trends and other factors that typically determine borrowing needs, a higher average income in the social circle, as perceived by a household, increases a household's tendency to borrow. The estimated effects are sizeable for both collateral loans and consumer debt: a EUR 1,000 increase in the perceived monthly average household income of peers (corresponding to 0.85 of one standard deviation of peer income) is estimated to raise the unconditional likelihood of having collateral and unsecured loans by 10% and 7% respectively. Not only is this influence significant among those who perceive their income as being below average for their social circle, it also extends to the likelihood of future financial distress, indicated by the debt service ratio and the loan-to-value ratio.

We verify the robustness of these results using several approaches, including instrumental variable estimation and placebo tests. Our aim is to rule out uninteresting alternative explanations of the peer income-own borrowing relation and to address the potential for reverse causality or a

spurious correlation between the two. The former could arise, for example, if people who borrow are more likely to think of their peers as earning more than themselves. The latter could be induced by similarities in unobserved characteristics with those of peers, which tend to induce both higher peer incomes and a greater tendency to borrow without any direct causal link between the two.

| | Pr(collateral loans>0) | | | Pr(consumer loans>0) | | |
|--------------------------------------|------------------------|-------|-----|----------------------|-------|-----|
| | Probit | | | Probit | | |
| | M.E. | SE | | M.E. | SE | |
| IHS (average peer income) | 0,040 | 0,009 | *** | 0,016 | 0,006 | *** |
| Age | -0,001 | 0,001 | | -0,002 | 0,001 | *** |
| Male | 0,002 | 0,025 | | 0,009 | 0,015 | |
| Couple | 0,179 | 0,028 | *** | 0,055 | 0,016 | *** |
| No. of children | 0,014 | 0,012 | | 0,001 | 0,007 | |
| High school education | 0,018 | 0,030 | | 0,023 | 0,019 | |
| College degree | 0,061 | 0,030 | ** | 0,019 | 0,019 | |
| Other education | 0,029 | 0,143 | | 0,116 | 0,092 | |
| Employed | 0,081 | 0,032 | ** | 0,019 | 0,020 | |
| Self-employed | 0,086 | 0,056 | | 0,034 | 0,034 | |
| Retired | 0,029 | 0,039 | | 0,001 | 0,027 | |
| Unemployed | 0,018 | 0,069 | | 0,059 | 0,053 | |
| Last year inc.: unusually low | -0,098 | 0,035 | *** | 0,070 | 0,030 | ** |
| Health poor/ fair | -0,011 | 0,021 | | 0,022 | 0,015 | |
| IHS (net household income) | 0,014 | 0,004 | *** | 0,004 | 0,003 | |
| IHS (net financial wealth) | 0,004 | 0,007 | | -0,197 | 0,004 | *** |
| IHS (net real wealth) | 0,073 | 0,009 | *** | 0,001 | 0,005 | |
| Ability to borrow from social circle | 0,005 | 0,020 | | -0,010 | 0,013 | |
| Get advice from social circle | -0,031 | 0,021 | | -0,026 | 0,013 | ** |
| Average peer education | 0,016 | 0,022 | | -0,006 | 0,014 | |
| Province dummies | yes | | | yes | | |
| Year dummies | yes | | | yes | | |
| Province x year dummies | yes | | | yes | | |

The table reports the marginal effects and associated standard errors from a non-linear probability model estimated via probit. The left (right) panel refers to the likelihood of having collateral (consumer) loans. The reported marginal effects for peer income refer to the increase in the participation probability resulting from a EUR 12,000 annual increase in perceived average peer income. Standard errors are corrected for heteroscedasticity and clustered at the household level. Meanwhile, ***, **, and * denote significance at the 1%, 5%, and 10% levels, respectively.

Figure 1: Marginal effects for the participation probabilities in collateral and consumer loans

Although our analysis does not rule out that much of this socially induced additional borrowing is repayable, at least ex ante, our finding that it tends to worsen indicators of potential financial distress suggests that repayment problems may still occur ex post, especially if borrowers and lenders fail to take proper account of all relevant risk factors. This paper provides a powerful additional rationale for promoting debt literacy

on the part of households and scrutiny on the part of lenders: a potential for financial distress is not only generated by the objective borrowing needs of households, but can also be influenced by how they perceive themselves relative to their social circle. Moreover, this happens regardless of their income class or the accuracy of the perceptions of relative standing.

References

- Duflo, E., Saez, E.** (2002)
 “Participation and investment decisions in a retirement plan: the influence of colleagues’ choices”,
Journal of Public Economics, Vol. 85, pp. 121-148.
- Hong, H., Kubik, J., Stein, J.** (2004)
 “Social interaction and stock-market participation”,
Journal of Finance, Vol. 59, pp. 137-163.
- Manski, C.** (1993)
 “Identification of Endogenous Social Effects: The Reflection Problem”,
Review of Economic Studies, Vol. 60, pp. 531-542.
- Neumark, D., Postlewaite, A.** (1998)
 “Relative income concerns and the rise in married women’s employment”,
Journal of Public Economics, Vol. 70, pp. 157-183.

The full article is forthcoming in Review of Financial Studies and available here: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2208516

Global Financial Turmoil: Does Connectedness Matter?



Lorian Pelizzon
Goethe University & SAFE

Recent crises put the spotlight on systemic risk. Despite the absence of a widely accepted definition of this term and despite most regulators and policy makers being convinced that systemic events can be only identified after the fact, we believe that measuring the degree of connectedness among financial institutions and monitoring its evolution can provide meaningful information on where systemic risk is coming from and when a crisis is approaching.

During the last few decades, the global market has faced a series of major financial crises: the 1997 Asian crisis, the 2008/09 financial crisis and the recent European banking and sovereign debt crisis. These heterogeneous crises all have something in common: they originated in specific countries and specific financial sectors, spreading over to other geographical areas and financial markets, and affecting the real economy through a severe spillover effect. According to these characteristics, the crises mentioned can be defined as “systemic”. Hence, we question

whether the connectedness of institutions operating in the financial markets played a role and whether the evolution of such connectedness could be an indicator of an approaching crisis.

To answer this question, my coauthors and I focused on different players in the financial markets, applying several econometric measures with two common denominators: Granger causality tests and the usage of market data instead of accounting data. Our research allowed us to infer a substantial robust relationship between the degree of connectedness and the market situation. This would suggest that connectedness measures based on a Granger causality test are potentially good indicators for detecting systemically relevant institutions and for providing an early warning of systemic crises.

“On a new approach for analyzing and managing macrofinancial risks”

With the growing connectedness of global markets that has taken place over time, analyzing and managing macrofinancial risk has also increased in importance. Thus, the interactions between the household, corporate, financial and government

sectors, as well as the corresponding risks, must also be understood, measured and monitored.

In our paper (Merton et al., 2013), we use the Granger causality test in order to model and measure the degree of connectedness deriving from the feedback loops of explicit and implicit guarantees set between sovereigns, banks and insurers. Risks are evaluated through credit default swap (CDS) market data and a version of the Merton Model (based on Contingent Claims Analysis or CCA). The sample encompassed 17 sovereigns, 63 banks and 39 insurance companies.

An analysis of the number of connections points to a much greater connectedness among financial institutions during and after the crisis periods with regard to all areas covered. The data suggest that the degree of connectedness across different types of entities changes over time, indicating that models capable of capturing these dynamics are needed in order to monitor the system.

“Econometric measures of connectedness and systemic risk in the financial and insurance sectors”

In this article (Billio et al., 2012), my coauthors and

I targeted our research on banks, insurers, hedge funds and brokers operating in the U.S. market. We proposed several econometric measures of connectedness based on principal component analysis and Granger causality networks applied to the monthly returns of the target institutions. The aim of our research was to capture the network of causal relationships between the largest financial institutions across the four types of institutions mentioned. Moreover, we tried to understand whether these measures of connectedness are meaningful indicators of the condition of the financial markets and to discover, in the light of the last financial crisis, which are the key banks, insurers, hedge funds and brokers as far as systemic risk is concerned.

The empirical analysis conducted shows that the degree of connectedness increases before and during crises, and the pattern of the last financial crisis suggests that banks are more central to systemic risk than the so-called “shadow banking system”. Moreover, the proposed measures are able to reflect periods of market dislocation and distress with promising out-of-sample characteristics.

“Sovereign, bank and insurance credit spreads: connectedness and system networks”

As banking and insurance system risk has become an important element in the determination of sovereign risk and vice-versa, in this article (Billio et al.,

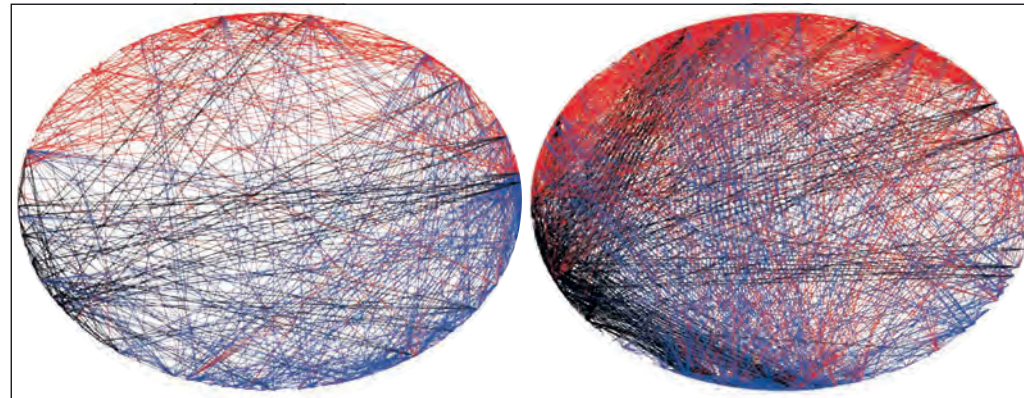


Figure 1: Network diagrams of linear Granger-causality relationships that are statistically significant at the 1% level between banks (red), insurers (black), and sovereigns (blue) – from July 2004 to June 2007 (left) and from April 2009 to March 2012 (right)

2013) we focused on the relationship between the private financial sector and sovereign risk, aiming to highlight the connectedness among financial institutions and sovereigns. To that extent, we applied several econometric measures of connectedness based on Granger causality networks to changes in the sovereign risk of European countries and the credit risk of major European, U.S. and Japanese banks, broker-dealers and insurers. Financial institution and sovereign risk is measured using Expected Loss Ratio (ELR) data from the Moody’s KMV database. This uses equity, equity volatility and the default barrier (from accounting information) to get the “distance-to-distress” which it then maps to a default probability using a pool of 30 years of default information.

The application of the Granger causality test to ELR data allowed us to ascertain the evolution of connectedness. An empirical analysis showed that the system of banks, insurers and sovereigns included in our sample is highly connected in a very dynamic way. These interconnections are not symmetric. An analysis of the number of connections points to a much greater connectedness among financial institutions after the crisis than before (see Figure 1). Moreover, time series showed that banks, insurers and sovereigns were much more connected during and after the global financial crisis than before. In conclusion, the proposed financial network measures can be utilized as early warning indicators and to assess the complexity of the financial system. This framework can also be employed for the

analysis of shocks, spillovers and tradeoffs with regard to different policy alternatives.

References

- Billio, M., Getmansky, M., Gray, D., Lo, A. W., Merton, R. C., Pelizzon, R.** (2013) “Sovereign, Bank and Insurance Credit Spreads: Connectedness and System Networks”, MIT Working Paper.
- Billio, M., Getmansky, M., Gray, D., Lo, A. W., Pelizzon, R.** (2012) “Econometric measures of connectedness and systemic risk in the financial and insurance sectors”, *Journal of Financial Economics*, Vol. 104, Issue 3, pp. 535-559.
- De Bandt, O., Hartmann, P.** (2000) “Systemic Risk: A Survey”, *European Central Bank Working Paper Series*, No. 35.
- Merton, R. C., Billio, M., Getmansky, M., Gray, D., Lo, A. W., Pelizzon, R.** (2013) “On a New Approach for Analyzing and Managing Macrofinancial Risks”, *Financial Analysts Journal*, Vol. 69, Issue 2.
- Merton, R. C.** (1974) “On the Pricing of Corporate Debt: The Risk Structure of Interest Rates”, *Journal of Finance*, Vol. 29, pp. 449-470.

Safety Traps



Kenza Benhima
University of Lausanne

Fear of risk is an oft-mentioned factor behind protracted economic downturns, such as Japan's "lost decade" or the recent financial crisis, because it makes investors seek safer and less profitable investments, thereby prolonging the recession. We show in our paper that risk aversion may indeed have played an important role during the economic slowdown faced by Japan in the 1990s.



Baptiste Massenet
Goethe University & SAFE

Fear of risk matters

First, anecdotal evidence suggests that the lost decade made the Japanese more anxious about the future. This fact is best illustrated by the following excerpt from an article in The New York Times ("When Consumers Cut Back: An Object Lesson from Japan" by Hiroko Tabuchi, 21 February 2009):

"Today, years after the recovery, even well-off Japanese households use old bath water to do laundry, a popular way to save on utility bills. Sales of whiskey, the favorite drink among moneyed Tokyoites in the booming '80s, have

fallen to a fifth of their peak. And the nation is losing interest in cars; sales have fallen by half since 1990. (...) Although the (Takigasaki) family has a comfortable nest egg, Hiroko Takigasaki carefully rations her vegetables. (...) 'You can make almost anything with some cabbage, and perhaps some potato', says Mrs. Takigasaki, 49, who works part time at a home for people with disabilities. Her husband has a well-paying job

with the electronics giant Fujitsu, but 'I don't know when the ax will drop,' she says. 'Really, we need to save much, much more'."

Second, Japanese households started investing less and less in risky assets from the beginning of the lost decade in 1990, even though their total assets kept increasing (see Figure 1).

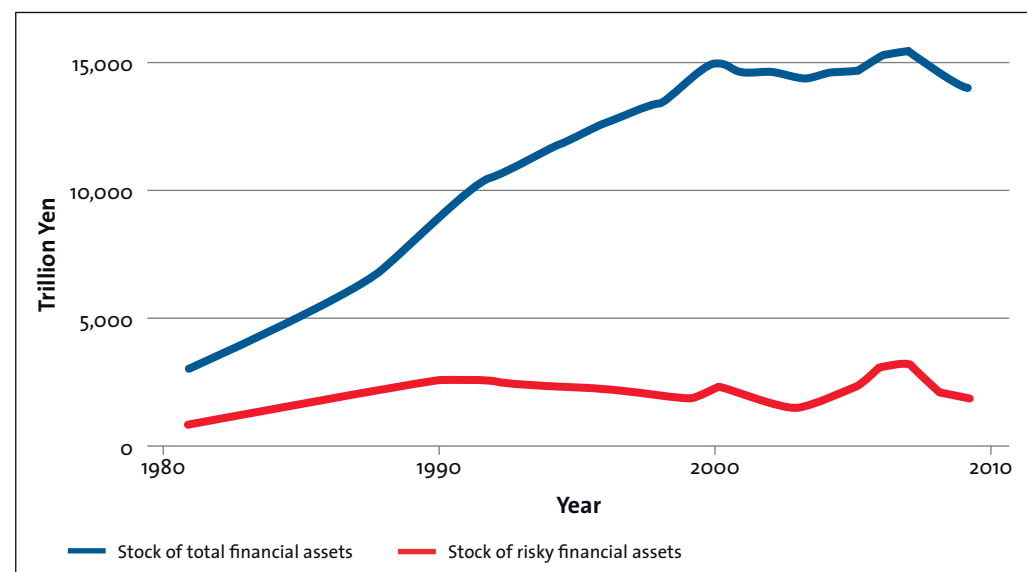


Figure 1: Financial assets of Japanese households

The two equilibria

To account for this evidence, we assume that investors have decreasing relative risk aversion; meaning that they compare their consumption to a reference level and become more risk averse as their consumption gets closer to this level. With such preferences, investors become less risk averse when they become wealthier. This is consistent with the fact that wealthier investors hold riskier portfolios.

We introduce decreasing relative risk aversion in a business cycle model and let investors allocate their wealth between more or less risky assets. In addition to a standard equilibrium, our model can have a “safe” equilibrium with higher risk aversion and a lower interest rate. This equilibrium is characterized by investment in safer assets, which implies a greater misallocation of capital and thus weaker production. It arises because of a feedback effect from risk aversion to the interest rate. On the one hand, with high risk aversion, investors invest more in safe assets, which decreases the interest rate. On the other, a low interest rate makes agents more risk averse because it decreases their safe revenues.

The two equilibria have opposite predictions: the comovement between risky investment and wealth is positive in the standard equilibrium and negative in the safe equilibrium. When they become wealthier, investors want to keep a balanced portfolio by increasing their demand for both safe and risky assets. In the standard equilibrium, the stock of both asset classes increases. However, in the safe equilibrium, the return to safe assets decreases so much that it makes investors more risk averse and they end up holding a safer portfolio even though their wealth has increased. As a consequence, when the economy switches from the standard to the safe equilibrium, its dynamics are characterized by a declining stock of risky assets and rising wealth; a situation which we refer to as a “safety trap”. In the remainder of the paper, we show that the empirical evidence is consistent with interpreting Japan’s lost decade as a safety trap. We also find that several alternative hypotheses fail to explain the same evidence.

Some final thoughts on Japan’s lost decade

We show that the government can crowd out the safe equilibrium by increasing the supply of

bonds or by making transfers to investors. These two policies can reduce the adverse effect of the interest rate on risk aversion. A larger supply of bonds increases the interest rate and thus reduces risk aversion. Transfers to investors help them secure their reference level of consumption and thus make them less risk averse.

According to Hayashi and Prescott (2002), the lost decade is mostly the result of lower productivity. Our mechanism is consistent with this finding. The safety trap implies lower productivity, as investors increasingly invest in safer and less productive assets. Another explanation for the lost decade which is also consistent with a lower productivity level is the one proposed by Caballero, Hoshi and Kashyap (2008). They argue that banks kept on lending to unproductive firms – so-called “zombies” – during the lost decade. This prevented more productive firms from entering the market and decreased aggregate productivity.

Our framework is also consistent with the liquidity trap perspective on Japan’s lost decade put forward by Krugman (1998). Although our mod-

el is a real model and thus has no room for monetary policy, it provides a possible explanation for low interest rate situations that lead to liquidity traps.

References

- Caballero, R. J., Hoshi, T., Kashyap, A. K.** (2006) “Zombie Lending and Depressed Restructuring in Japan”, NBER Working Paper No. 12129.
- Hayashi, F., Prescott, E. C.** (2002) “The 1990s in Japan: A Lost Decade”, Review of Economic Dynamics, Vol. 5, Issue 1, pp. 206-235.
- Krugman, P. R.** (1998) “It’s Baaack: Japan’s Slump and the Return of the Liquidity Trap”, Brookings Papers on Economic Activity 1998, Vol. 29, Issue 2, pp. 137-206.

The full paper was published in American Economic Journal: Macroeconomics (2013) and is available at: <https://sites.google.com/site/bmassenot/>

Frankfurt Conference on Financial Market Policy 2013

On 29 November 2013, the first Frankfurt Conference on Financial Market Policy took place. High-level regulators and industry representatives discussed the challenges their institutions currently face in implementing recent reform proposals that can be subsumed under the term Banking Union. The one-day event was organized by the SAFE Policy Center. It will be established as a yearly event. Over 250 participants from more than 15 countries, among them high-level researchers and decision-makers from central banks, supervisory institutions and the financial industry, attended the event held at Goethe University in Frankfurt and seized the opportunity to address the speakers with their own insights and questions.

The audience was welcomed by Rainer Klump, Vice President of Goethe University, and Jan Pieter Krahn, Director of SAFE. In the following keynote address, Yves Mersch, Member of the Executive Board of the European Central Bank (ECB), stressed the main pitfalls the current

attempts to reform the financial system are facing: First, the competitiveness differentials between member states of the European Union; second, the high public and private debt levels; and finally, the institutional barriers to reform. Mersch stressed that economic recovery will depend on overcoming these obstacles.

The first of three ensuing panel sessions dealt with *“One market, one supervisor? Underwriting safety and soundness of EMU banks”*. The session was chaired by Hans-Helmut Kotz, Program Director of the SAFE Policy Center. Ignazio Angeloni, Director General Financial Stability of the



Yves Mersch, Member of the Executive Board of the European Central Bank (ECB)

ECB presented the design of the ECB's comprehensive balance sheet assessment. According to Angeloni, the goal of the assessment is foremost to increase the level of transparency and thereby re-install confidence in the financial system. In his view, the assessment will serve as a testing ground for the Single Supervisory Mechanism (SSM), which it is preparing. John Berrigan, Director for Financial Stability, Economic and Financial Affairs in DG ECFIN of the European Commission, underlined that the SSM alone will not suffice to sever the link between bank risk and sovereign risk. He argued that the SSM needs to be complemented by a resolution framework that is based on a common rulebook and has access to a single resolution fund.

Vitor Gaspar from the Banco de Portugal added that the elements of the Banking Union are not only important for stabilizing the financial markets but also essential for overcoming financial fragmentation and thereby enabling the transmission of monetary policy. Charles Goodhart, Director of the Financial Regulation Research Program at the London School of Economics, warned that current micro-prudential measures



lead to banks tightening their balance sheets. From a macro perspective, a deleveraging is problematic as investments are badly needed. Adam Posen, President of the Peterson Institute for International Economics in Washington, underlined the need to have a strong centralized body for supervision, resolution and also deposit insurance in the euro area. In his view, it is due to a lack of proper instruments for fiscal transfers in Europe that the recapitalization of banks is not working. A lively debate ensued around the question of whether the reform measures now being implemented correspond to the conceptual ideas originally laid out for the banking union.

The details of the common resolution framework were discussed in the second panel, entitled

“Making banks failable” and chaired by Jürgen Schaaf, Counselor to the Executive Board of the ECB. The panelists addressed the need to differentiate between financial institutions which are “going-concern” and those which are “gone-concern”. In the context of a bank recovery, for instance, the bail-in bond could take on the form of a contingent convertible (coco-) bond. Andreas Dombret, member of the board of Deutsche Bundesbank, stressed the importance of agreements between home- and host-authorities in the resolution of cross-border banks. Philipp Härle, Director at McKinsey & Company, praised the fact that “living wills” have forced contingency planning by banks.

Jan Krahnen made the point that bail-in has not been used in notable bank resolution cases because the authorities fear contagion effects. Krahnen asked for enhancing the resolution regulation by establishing that the holders of subordinate bank debt cannot be other banks. In his view, it could be a task for the new central supervisory institution to monitor the bail-in-ability of subordinate bank debt. Maria Nieto, Associate to the Director General Banking Regulation and Financial Stability at Bank of Spain, underlined the view that for the bail-in tool to be effective, visible market signals are necessary. She therefore considers it paramount that the resolution framework be transparent regarding triggers for bail-in. Adrian van Rixtel, Senior Economist in the

Bank for International Settlements, broadened the discussion by reminding the panel and the audience that there still remains an open question as to the core business of banks. The legislation on banking separation has proceeded in several member states and a European answer is still outstanding.

The third panel turned to the question: *“What’s up for banks – and their clients”*. This panel, chaired by Andreas Hackethal, Professor of Personal Finance at Goethe University, brought up controversial arguments regarding the responsibility of banks for the financial crisis. Lutz Diederichs, Member of the Management Board of Hypo Vereinsbank – UniCredit Bank AG, protested against the high and contradicting expectations regulators and consumers have of banks. Joachim Nagel from the Executive Board of the Deutsche Bundesbank criticized the self-pity displayed by banks and stressed that the reasons for why regulation is being intensified are the risks that accumulated in bank products and activities before the crisis. Sylvie Matherat, Deputy Director General of the Banque de France, added that the current regulatory efforts are not about “punishment” for the crisis but about getting the regulation right. Thierry Philipponnat from Finance Watch in Brussels quoted the Liikanen Report in saying that only 28 percent of the bank assets are dedicated to lending to the non-financial sector and households, prompting the

question whether the financial system is foremost about serving the economy and society. The panel was completed by Karl-Peter Schackmann-Fallis, Executive Member of the Board of the German Savings Banks Association, and Michael Hüther, Director of the Cologne Institute for Economic Research (IW Köln).

In his concluding remarks, Ignazio Visco, Governor of the Bank of Italy, distinguished between the 2007 crisis in the financial industry, caused by a lack of proper regulation, and the euro area government crisis. In his view, single countries



Ignazio Visco, Governor of the Bank of Italy

need to implement the required structural reforms in order to “put their house in order”. The ECB meanwhile has intervened a number of times to repair the transmission mechanism of monetary policy. He argued that the banking union will improve the situation, and supported the idea of a single supervisory authority.

Selected Policy Center Publications

Böcking, H.-J., Gros, M., Worret, D. (2013)
[“Commentary on ESMA Guidelines on enforcement of financial information”](#),
 Policy Letter No. 15, SAFE Policy Center

Faia, E. (2014)
[“Surveillance of peer to peer payment systems and peer to peer lending platforms”](#),
 Policy Letter No. 18, SAFE Policy Center

Gomber, P., Haferkorn, M., Zimmermann, K. (2014)
[“Securities Transaction Tax in France: Impact on Market Quality and Inter-Market Price Coordination”](#),
 White Paper No. 11, SAFE Policy Center

Krahnen, J. P. (2013)
[“A Big Bang for Banking in Europe”](#),
 Policy Letter No. 16, SAFE Policy Center

Krahnen, J. P. (2013)
[“Rescue by Regulation? Key Points of the Liikanen Report”](#),
 White Paper No. 9, SAFE Policy Center

Krahnen, J. P., Rocholl, J. (2013)
[“Designing the funding side of the Single Resolution Mechanism \(SRM\): A proposal for a layered scheme with limited joint liability”](#),
 White Paper No. 10, SAFE Policy Center

Krahnen sees Barnier Proposal as a Step in the Right Direction



SAFE Director Jan Pieter Krahnen considers the legislative proposal on structural reforms of the EU banking sector recently presented by Michel Barnier, the European Commissioner for Internal Markets and Services, as a step in the right direction. According to Krahnen,

who was a member of the Liikanen Commission, this will help provide a coherent framework for several regulatory innovations, like Basel III or the banking union.

Writing in the German daily “Frankfurter Allgemeine Zeitung” on 30 January, Krahnen argued: “At first glance, the present proposal seems restrained. With regard to scope (only proprietary trading is affected), it falls short of the recommendations made by the Liikanen Commission. Nevertheless, we see that the proposal could definitely be effective. It depends on the implementation by the supervisory authority to which the responsibility for preventing systemic risk from proprietary trading has been delegated”.

Krahnen expects that supervisors and affected banks will have a strong interest in transparent binding requirements for risk assessment by the supervisory authority. He assumes that “the changes in the operations of trading divisions implemented by banks will prove close to a de facto separation – even if a separation order is not made”. Against this background, a corresponding law could prove appropriate for stimulating changes in bank business models and organizational structures.

Thomas Wieser Delivers Lecture on EU Financial Architecture

Thomas Wieser, President of the Economic and Financial Committee and Chairman of the Euro Working Group at the European Commission, delivered a lecture at the SAFE Policy Center on 11 February, where he explained how Europe is enhancing its financial architecture and why the banking union will play a key role. Wieser said that the banking union would not only advance the internal market for financial services, but also help break the vicious circle between bank and sovereign debt.

It is important to recognize that the design of the financial architecture is an internal market issue of concern to all 28 Member States and not just those participating in the monetary union, Wieser noted.

With regard to the banking union, the single supervisory mechanism will play a key role, as it will rapidly enhance the convergence of supervisory practices. The link between bank debt and sovereign debt will also be further weakened by the bail-in of creditors foreseen under the Bank Recovery and Resolution Directive. In addition, the planned Single Resolution Fund will help finance the bank resolution process and thus serve as an effective backstop.

Wieser conceded that shared fiscal responsibility is required in order to fully complete the banking union; something which is not yet in sight. But, given constitutional limitations, the banking union is the best solution within reach and the current



efforts will go a long way to strengthening financial stability in Europe, he added.

Peter Gomber Reelected a Member of Exchange Council



Peter Gomber, Chair of e-Finance at Goethe University and Co-chair of the E-Finance Lab, has been reelected a member of the Exchange Council of the Frankfurt Stock Exchange. Gomber, who acts as Investor Representative, will remain in this position for a further

three years. The Council has 18 members in total and serves as the highest controlling and supervisory body of the stock exchange: the Management Board requires its approval on all matters of fundamental significance. In particular, the Exchange Council is responsible for the appointment, dismissal and supervision of the Management Board, as well as for issuing Exchange regulations, the fee scale and the conditions for exchange transactions.

SAFE Scholars Win External Funding

- The Europlace Institute of Finance has awarded a research grant to a team of researchers, headed by Peter Gomber (Goethe University) and Erik Theissen (University of Mannheim), for their research on the “Impact of Dark Trading on Market Quality”. The project, which also involves the participation of Satchit Sagade, Moritz Christian Weber and Christian Westheide, analyzes the impact of dark trading on market quality in respect of the European equity markets on a cross-sectional and time series basis. Both Gomber and Theissen are principal investigators at SAFE, conducting extensive work on the determinants of over-the-counter (OTC) trading volumes; an issue related to this project grant.
- Helmut Gründl’s project assessing the impact of interest and mortality risks on the solvency position of life insurance companies has secured financial support from the Deutscher Verein für

Versicherungswissenschaften e.V. for a two-year period. Against the current environment of very low interest rates and longer life expectancy, life insurance companies are particularly vulnerable to both types of risk. Gründl, Managing Director of the International Center for Insurance Regulation at the House of Finance, is a principal investigator at SAFE whose work focuses on the risks and side-effects of Basel III and Solvency II.

- Nathanael Vellekoop, Assistant Professor at SAFE, has been awarded a grant from Data without Boundaries (DwB) for his project on “Bonus Income and Household Saving”. DwB is an EU-funded body which aims to support equal and easy access to official microdata for individual Member States (see <http://www.dwbproject.org>). With this grant, Vellekoop can now install a remote access facility at SAFE for obtaining detailed microdata from the Netherlands.

Selected Publications

Adams, Z., Füss, R., Gropp, R. (2014)

“Spillover Effects among Financial Institutions: A State-Dependent Sensitivity Value-at-Risk Approach”,
forthcoming in Journal of Financial and Quantitative Analysis.

Billio, M., Frattarolo, L., Pelizzon, L. (2014)

“A Time Varying Performance Evaluation of Hedge Fund Strategies Through Aggregation”,
Bankers, Markets & Investors, Vol. 129, pp. 38-56.

Branger, N., Kraft, H., Meinerding, C. (2014)

“Partial Information about Contagion Risk, Self-Exciting Processes and Portfolio Optimization”,
Journal of Economic Dynamics and Control, Vol. 39, pp. 18-36.

Gal, J., Wandt, M. (2014)

“Grenzbereiche der Befugnisse von EIOPA”,
Dreher, M., Wandt, M. (Eds.), Solvency II in der Rechtsanwendung, pp. 147-179.

Gaul, J., Theissen, E. (2014)

“A Partially Linear Approach to Modelling the Dynamics of Spot and Futures Prices”,
forthcoming in Journal of Futures Markets.

Haar, B. (2014)

“Investor Protection Through Model Case Procedures? Implementing Collective Goals and Individual Rights Under the 2012 Amendment to the German Capital Markets Model Case Act (KapMuG)”,
CFS Working Paper No. 442, forthcoming in European Business Organization Law Review.

Langenbucher, K. (2013)

“Zum Begriff der Insiderinformation nach dem Entwurf für eine Marktmissbrauchsverordnung”,
Neue Zeitschrift für Gesellschaftsrecht, pp. 1401-1406.

Post, T., Gründl, H., Schmitt, J. T., Zimmer, A. (2014)

“The Impact of Investment Behaviour for Individual Welfare”,
Economica, Vol. 81, Pages 1-33.

Tröger, T. (2013)

“Der Einheitliche Aufsichtsmechanismus (SSM) – Allheilmittel oder quacksalberische Bankenregulierung?”,
Zeitschrift für Bankrecht und Bankwirtschaft (ZBB), Vol. 25, Issue 6, pp. 373-400.

Weichenrieder, A. J., Zimmer, J. (2014)

“Euro Membership and Fiscal Reaction Functions”,
forthcoming in International Tax and Public Finance.

Zimmermann, K. (2014)

“Price Discovery in European Volatility Interruptions”,
forthcoming in 23rd European Financial Management Association (EFMA) Annual Meeting, Rome, Italy.

Recent SAFE Working Papers

- No. 41** Buss, A., Uppal, R., Vilkov, G.
“Asset Prices in General Equilibrium with Recursive Utility and Illiquidity Induced by Transactions Costs”
- No. 40** Kraft, H., Schendel, L. S., Steffensen, M.
“Life Insurance Demand under Health Shock Risk”
- No. 39** Damar, H. E., Gropp, R., Mordel, A.
“Banks’ financial distress, lending supply and consumption expenditure”
- No. 38** Lambert, C., Noth, F., Schüwer, U.
“How do insured deposits affect bank risk? Evidence from the 2008 Emergency Economic Stabilization Act”
- No. 37** Radev, D.
“Systemic Risk and Sovereign Debt in the Euro Area”
- No. 36** Hett, F., Schmidt, A.
“Bank Rescues and Bailout Expectations: The Erosion of Market Discipline During the Financial Crisis”
- No. 35** Gomber, P., Sagade, S., Theissen, E., Weber, M. C., Westheide, C.
“Competition/Fragmentation in Equities Markets: A Literature Survey”
- No. 34** Branger, N., Grüning, P., Kraft, H., Meinerding, C., Schlag, C.
“Asset Pricing Under Uncertainty About Shock Propagation”

Radical Regulatory Action Would Do More Harm Than Good



Douglas J. Elliott
The Brookings Institution

and complex financial system. Further, the pieces of reform have to fit together, which requires a great deal of coordination. All of this takes time. That said, there are certainly turf battles and other bureaucratic and political obstacles that have slowed things down further, but that was always going to be a problem in the real world and it cannot be waved away with a magic wand.

The good news is that much has been accomplished in 2013, including important rules about derivatives markets, mortgage originations and securitizations, and the long-awaited promulgation of the details of the Volcker Rule to largely eliminate proprietary trading. Very good progress has also been made by the Federal Deposit Insurance Corporation (FDIC), in cooperation with other regulators, in designing a solid approach to dealing with banks that run into problems in the future. The FDIC's progress significantly reduces any risks from "Too Big to Fail" financial institutions, although more still needs to be done.

Reform of U.S. financial regulation continued with great intensity in 2013. Progress by the regulators is often portrayed as unpardonably slow, but we must keep in mind the immensity of the task they have been handed and the totally unrealistic set of deadlines imposed by Congress. The fact is that we are dramatically transforming major parts of a very large

The big debate in 2014 is likely to be between two views of progress on financial reform. Most analysts, including me, broadly endorse the existing approach to reform, embodied in Dodd-Frank and Basel III, although everyone has disagreements to a greater or lesser extent with the specifics. However, there is a substantial minority who argue that real financial reform requires radical change. The three most common proposals for such radical action are: to break the big banks up into smaller pieces; to restore some version of Glass-Steagall thereby forcing banks to split between traditional commercial banks and those that focus on securities and derivatives markets; and to require very high levels of capital at the banks.

I believe all three of these extreme approaches are quite flawed and would hurt the economy. America needs at least a few banks that can provide a very wide range of financial products for our big companies and do so on large scale and in many locations around the world. This requires some huge banks, whether we like it or not. Similarly, there are very strong and useful connections between traditional banking prod-

ucts and securities and derivatives transactions. Trying to artificially divide them will create inefficiencies that hurt the economy without adding to safety. Finally, requiring very high levels of capital would have economic costs as well as driving most banking business to less regulated "shadow banking" firms and activities.

Luckily, none of these is likely to be passed in the current political environment. The danger is that one or more major new scandals in the financial industry could quickly change that political environment, causing Congress to seize on one of these proposals as a way to show the public that they are not in the pockets of the banks and are prepared to take bold action.

So, I am keeping my fingers crossed that 2014 will see yet more progress in the step-by-step implementation of sensible financial reforms without interference from radical actions that would do more harm than good.

While visiting the SAFE Policy Center, the author gave a lecture in the Policy Center's lecture series on 23 January 2014.

Events

| March | |
|--|--|
| Wednesday, 5 th | IMFS Distinguished Lecture Speaker: Jaime Caruana, Bank for International Settlements |
| Tuesday, 11 th 2.15 – 3.45 pm | Frankfurt Seminar in Macroeconomics – joint with SAFE Speaker: Victor Rios-Rull, University of Minnesota |
| Wednesday, 12 th 8.30 am – 3.40 pm | CFS / IMFS Conference The ECB and Its Watchers XV |
| March, 14 th 2.00 – 6.00 pm | SAFE Policy Center Roundtable on the Future Structure of Banking |
| Friday, 14 th 9.00 am – 5.00 pm | ILF Conference Interne Ermittlungen – Eine Momentaufnahme |
| Tuesday, 18 th | SAFE Policy Center Lecture Speaker: Vitor Gaspar |
| Tuesday, 18 th 3.30 pm – 8.15 pm | CFS Conference Unternehmensrestrukturierung - Perspektiven 2014 Organization: Volker Brühl, CFS, and Burkard Göpfert, Baker & McKenzie |
| Friday, 21 st 9.30 am – 9.00 pm | ILF Conference Die Deutsche Bundesbank im Eurosystem – Aufgaben, Strategie und Entwicklung |
| Friday, 21 st 12.30 – 2.00 pm | CFS Lecture on the Order of Money Die Ordnung des Geldes bei Eucken, Hayek, Schumpeter und Friedman Speaker: Stephan Balling, Bibliomed Verlag |
| Friday, 21 st 1.00 pm – 6.30 pm | ILF Conference Fachgruppentagung 2014 |

Monday, 31st – April, Friday, 11th

ILF Spring School
Unternehmensrecht in der Beratungspraxis plus Fallstudie

| April | |
|--|--|
| Wednesday, 2 nd 12.30 – 2.00 pm | CFS Lecture on the Order of Money Speaker: Thorsten Polleit, Frankfurt School |
| Thursday, 3 rd – Friday, 4 th 9.00 am – 6.00 pm | CEPS Ideas Lab Does Europe Matter? Organization of the Finance part by SAFE |
| Tuesday, 15 th 4.15 – 5.30 pm | Finance Seminar – joint with SAFE Speaker: Vasso Ioannidou, Tilburg University |
| Tuesday, 29 th 4.15 – 5.30 pm | Finance Seminar – joint with SAFE Speaker: Jean-Pierre Zigrand, London School of Economics and Political Science |

| May | |
|---|---|
| Thursday, 1 st – Friday, 2 nd | IMFS Asia Workshop Economic Reforms in Europe and Asia: Similarities and Differences |
| Monday, 5 th 5.00 – 6.00 pm | EFL Jour Fixe The Impact of Mindful Application of Virtualized Desktops in the Financial Service Industry Speaker: Sabine Dernbecher, E-Finance Lab |
| Tuesday, 6 th 4.15 – 5.30 pm | Finance Seminar – joint with SAFE Speaker: Martin Schmalz, University of Michigan |
| Friday, 9 th 9.00 am – 6.00 pm | SAFE Workshop Interconnectedness of Banking and Insurance Risks |

Tuesday, 13th
4.15 – 5.30 pm

Tuesday, 20th
4.15 – 5.30 pm

Wednesday, 21st
7.00 pm

Finance Seminar – joint with SAFE
Speaker: Clara Vega, Federal Reserve

Finance Seminar – joint with SAFE
Speaker: Philipp Illieditsch, Wharton School

GBS Information Session
Part-Time Master in Finance

| June | |
|---|--|
| Monday, 2 nd 5.00 – 6.00 pm | EFL Jour Fixe Should we look at Response or Uplift in Customer Analytics. Results from a Field Experiment in the German Banking Sector Speaker: Carlo Wix, E-Finance Lab |
| Wednesday, 4 th – Thursday, 5 th 9.00 am – 6.00 pm | SAFE Conference First International Conference on Sovereign Bond Markets In cooperation with: Center for Financial Research at Waseda University, NYU Stern Salomon Center for the Study of Financial Institutions |
| Friday, 6 th – Saturday, 7 th 9.00 am – 6.00 pm | SAFE Workshop Financial Regulation: A Transatlantic Perspective |
| Saturday, 14 th 9.00 am – 6.00 pm | SAFE Conference Austerity and Growth |
| Tuesday, 17 th 4.15 – 5.30 pm | Finance Seminar – joint with SAFE Speaker: Amit Seru, Chicago Booth |
| Tuesday, 17 th 7.00 pm | GBS Information Session Part-Time Master in Finance |

Please note that for some events registration is compulsory.



LOEWE

Exzellente Forschung für
Hessens Zukunft

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