

The Effect of Pro-Cyclical Capital Regulation on Lending_4

Markus Behn • Rainer Haselmann • Paul Wachtel

Regulatory Influence on Market Conditions in the Banking Union_6

Tobias Tröger

Capital Markets Union: The Next Big Step of Financial Integration in Europe_14

Andreas Dombret

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About SAFE

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

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

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

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Editorial



Jan Pieter Krahen

Director, SAFE

As a part of its mission, the Research Center SAFE has aimed from its beginning to provide research results and policy recommendations on all areas relevant for developing a sustainable architecture for finance in Europe. The articles collected in this issue of the SAFE Newsletter give substance to this claim by dealing with highly topical questions such as: Does banking regulation keep its promise to make banks and markets more stable? Are there any adverse effects? Do different regulatory approaches fit in with each other?

Rainer Haselmann, SAFE Professor of Finance, Taxation and Accounting, deals with the question of whether the new capital requirements in the Basel II regulation cause unwanted effects by negatively influencing bank lending in recessions. His paper with Markus Behn (ECB) and Paul Wachtel (NYU), “The Effects of Pro-Cyclical Capital Regulation on Lending” is forthcoming in the *Journal of Finance* (p. 4).

Tobias Tröger, SAFE Professor of Private Law, Trade and Business Law, Jurisprudence, also looks more closely at new tools in banking regulation. In a paper forthcoming in the *European Business Organization Law Review* he asks whether macro-prudential measures introduced in the context of the banking

union, such as the countercyclical buffer, the systemic risk buffer, or the bail-in tool, will influence market conditions and the relationship between banks and their clients (p. 6).

Driven by the observation that banking and insurance regulation are carried out as separate endeavors that do not take their respective recommendations into account, Helmut Gründl, Professor of Insurance and Regulation, and SAFE Research Assistant Tobias Niedrig were wondering whether contingent convertible (CoCo) bank bonds could really be a good investment for insurance companies as was suggested by the Liikanen Commission. In a SAFE policy paper they outline how CoCo bonds should be designed in order to be attractive for life insurers given the capital requirements under Solvency II (p. 10).

In the research interview, Alfons Weichenrieder, Professor of Economics and Public Finance, elaborates on the impact of tax havens on the financial crisis. He presents two recent papers that look into the question of whether the problem with tax havens is not so much the low tax rates they offer but rather the secrecy they provide for firms that are seeking an unregulated place for all kinds of shady business (p. 8).

The guest commentary of this issue comes from Andreas Dombret, Member of the Executive Board of Deutsche Bundesbank, who outlines ways to get to a European capital markets union (p. 14).

Yours sincerely,
Jan Pieter Krahen

The Effect of Pro-Cyclical Capital Regulation on Lending



Markus Behn
European Central Bank

Holding an adequate level of capital is considered to be the most effective tool to ensure the safety and soundness of financial institutions. The existence of guarantees, both implicit and explicit, that may provide banks with an incentive to hold less capital than is socially optimal, is the main rationale for capital regulation. The determination of capital charges, however, is one of the most controversial topics in bank regulation. Regulating capital via a simple capital to asset ratio might incentivize banks to hold portfolios with more risky assets. Linking capital charges to asset risk – as introduced under Basel II with model-based capital regulation – may intensify the pro-cyclicality of bank lending. In this paper, we empirically quantify how changes in model-based capital charges affect the supply of loans to firms.

There has long been a concern that linking capital charges to asset risk may exacerbate the pro-cyclicality of lending (see Danielsson et al., 2001;

Kashyap and Stein, 2014; Repullo and Suarez, 2012). Specifically, if measures of asset risk are responsive to economic conditions, then capital requirements will increase in a downturn; at the same time, bank capital is likely to be eroded by loan write-offs. Capital constrained banks that are unable or unwilling to raise new equity in the downturn will be forced to deleverage by reducing lending, hence exacerbating the downturn.

Although the pro-cyclical features of Basel II have been widely discussed, we still lack a precise understanding of the link between counter-cyclical capital charges and the corresponding adjustment of loans. In this paper, we exploit the institutional setup around the introduction of model-based regulation in Germany in combination with an exogenous real sector shock, to identify the pro-cyclical effects of risk-sensitive capital regulation on banks' lending behavior and firms' overall access to funds.

The effect of the Lehman failure on bank lending

German banks began implementing the Basel II regulations in 2007. They were allowed to choose between the model-based approach (“internal

ratings-based”, or IRB) and the traditional or standard approach (SA) with fixed risk weights. At those banks that opted for model-based regulation (IRB banks), the approach was phased in over time. Thus, in September 2008, IRB banks were using the IRB approach for some of their loan portfolios, while other portfolios were still subject to SA. Since German firms typically have multiple banking relationships, many firms found themselves in the IRB pool of one bank and in the SA pool of another IRB bank.

We examine changes in bank lending in Germany surrounding the credit risk shock that followed the failure of Lehman Brothers in September 2008. Economic conditions changed suddenly and dramatically following the Lehman event, causing a steep and abrupt decline in real sector expectations (see Figure 1). In response to this exogenous increase in credit risk, banks had to adjust their internal risk estimates, implying an increase in capital charges for loans under model-based capital regulation. In contrast, capital charges for loans under the traditional approach were unaffected by the credit risk shock, as they do not depend on economic conditions.



Rainer Haselmann
Goethe University & SAFE



Paul Wachtel
Stern School of Business,
NYU

The fact that only loans under model-based regulation were affected by the exogenous increase in capital charges following the Lehman failure allows us to identify its effects on bank lending behavior. For this purpose, we use data from the German credit register, including detailed information on the regulatory approach and the bank's internal risk estimate for each loan. The institutional setup allows us to control for heterogeneous effects of the credit risk shock on individual firms' loan demand or on individual banks' loan supply.

Lending behavior and ability to borrow are significantly affected

Our main finding is that the counter-cyclicality of capital charges based on individual asset risk has a significant pro-cyclical effect on the lending behavior of banks as well as a considerable effect on firms' aggregate ability to borrow. IRB banks reduce loans by 2.1 to 3.9 percent more when they use internal ratings (IRB) to determine capital charges for a given firm than when they use fixed risk weights (SA). The effect is even stron-

ger on the aggregate firm level: firms that had only IRB loans prior to the event experienced a reduction in total loans that was about 5 to 10 percent larger than the reduction for firms that had only SA loans. Thus, the pro-cyclical design of capital regulation was an important factor contributing to the decline in credits in Germany.

Motivation for a counter-cyclical capital buffer?

Our findings have important policy implications for the design of bank capital regulation. They illustrate that changes in capital charges can have sizeable real effects and point to potential conflicts between micro-prudential regulation and macro-prudential policy objectives. The model-based approach gives banks an extra incentive to cut back lending when credit conditions deteriorate, which might enhance the safety of the individual bank and could have a payoff in terms of the long-term solvency of the banking system (Repullo and Suarez, 2012). However, when all banks simultaneously restrain their lending, firms' access to funds becomes restricted, which is undesirable from a macro-prudential point of view.

The new Basel III framework includes measures that are meant to address the problem of pro-cyclicality. Most importantly, Basel III introduces a counter-cyclical capital buffer that requires banks to build up additional capital reserves in times of excessive credit growth, which can be used to satisfy capital requirements when eco-

nomical conditions deteriorate. Our findings could be interpreted as justification for such a measure. However, counter-cyclical capital buffers reduce pro-cyclicality only if the supervisor has sufficient foresight about future economic conditions. Unexpected shocks to credit risks (e.g., shocks that originate abroad) cannot be anticipated and, therefore, regulators cannot always pre-empt such shocks by setting buffer rates accordingly.

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The paper "Pro-Cyclical Capital Regulation and Lending" is forthcoming in The Journal of Finance and available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2305514

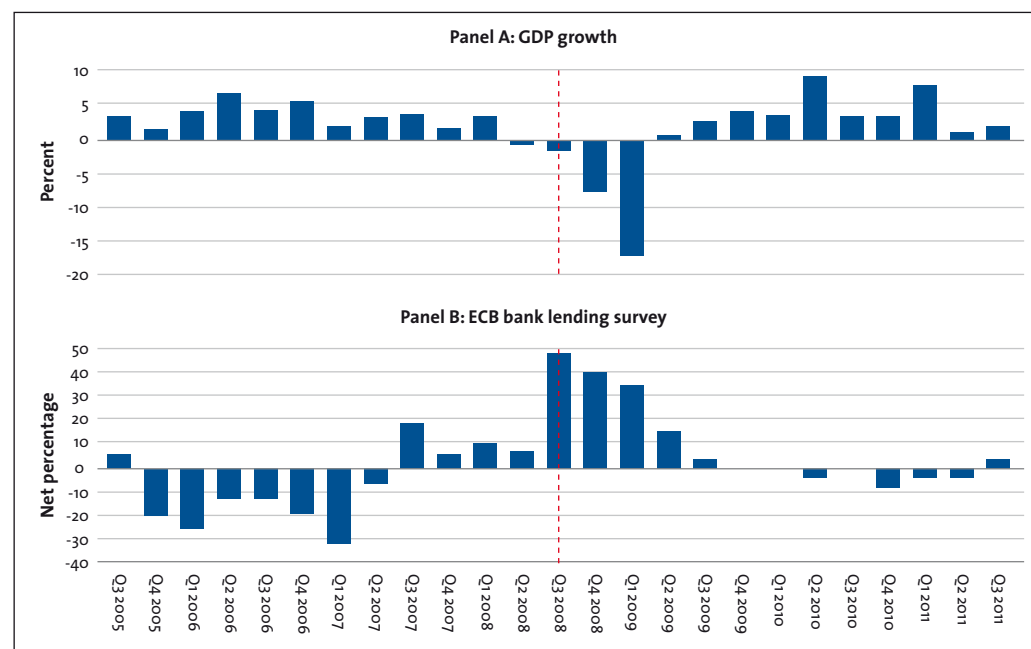


Figure 1: The credit risk shock and the German economy. Panel A shows the quarterly change in real GDP at an annual rate (calendar and seasonally adjusted). Panel B shows the answers of German banks to the following question from the ECB's bank lending survey: "Please indicate how you expect your bank's credit standards to change over the next three months." The values displayed are the proportion of respondents that expect a tightening minus the proportion that expect an easing of credit standards.

Regulatory Influence on Market Conditions in the Banking Union



Tobias Tröger
Goethe University & SAFE

The European banking union will influence (future) bank client relationships through macro-prudential instruments and the bail-in tool. In order to achieve their stability objectives, policy makers may rely on regulatory instruments that affect banks' refinancing needs and/or conditions. This influences these institutions' investment decisions and, thus, determines scope and price of services offered to future clients.

Macro-prudential instruments and real-estate lending

Macro-prudential tools seek to dampen activity levels on those lending markets that are seen to be exaggerating by setting the price and quantity of risk-taking for banks. As mortgage lending markets have been critical in the emergence of many modern financial crises, a litmus test for the new European supervisory architecture can be seen in its suitability to cool down overheated real-estate markets by dampening mortgage lending. Thus, those macro-pruden-

tial tools that target excessive credit growth in the relevant sector deserve attention.

With respect to the division of supervisory competences, it is quite important to notice that the diverse legal bases for these macro-prudential tools are rooted in both supranational and national banking regulation. On the supranational level, relevant tools are the countercyclical capital buffer (CCB) and the systemic risk buffer (SRB) which aim to enhance banks' loss absorption capacities in times of excessive credit growth and to increase funding costs to slow down credit growth. Moreover, the competent supervisor may impose additional capital requirements as well as higher own funds requirements under the Capital Requirements Regulation (CRR). Also, sectoral measures for specific exposures can be implemented (e.g. increased risk weights and higher minimum loss given default (LGD) values). Finally, limits on lending activities like maximum loan-to-value (LTV), loan-to-income (LTI), or debt-service-to-income (DSTI) ratios can serve as direct measures to curb leveraged growth in asset markets. The latter measures are still provided for only in national law. The same is true with regard to

leverage ratios that can be understood as a fail-safe for risk-based capital buffers in countering cyclical or structural systemic risks.

The effectiveness of these macro-prudential tools varies in the context of real estate lending. For example, capital buffers as such are not very effective in highly collateralized real estate markets. Given the specifics of these markets, it is quite plausible that indirect measures such as a significant increase in risk weights, outright caps on lending activities (LTV, LTI, DSTI) and a leverage ratio are more effective.

Division of competences within the banking union

In order to assess a potential impact of the banking union on future bank-client relationships, a closer look at the allocation of competences between national and supranational supervisory bodies within the Single Supervisory Mechanism (SSM) is necessary (see Figure 1). The momentum of the new institutional framework depends critically on the ECB's position via-à-vis both the European Systemic Risk Board (ESRB) and national competent authorities (NCAs).

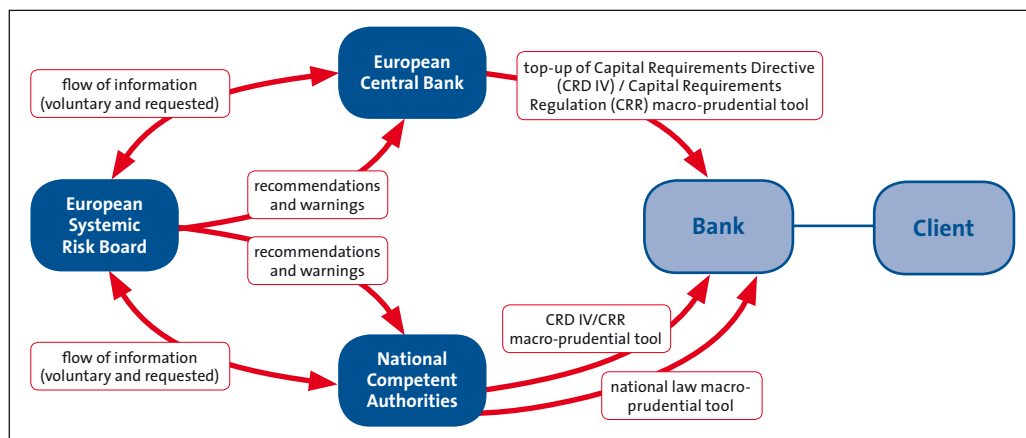


Figure 1: Macro-prudential supervision in the banking union

At the outset, it is important to observe that the ESRB assumes the role of the paramount supra-national macro-prudential player in the EU (see Ferran and Babis, 2013). Thus, the ECB does not enjoy full autonomy in the implementation of macro-prudential policy in the banking union.

The legal framework ensures an adequate flow of information gathered in supervisory practice to the ESRB in order to facilitate the fulfillment of its tasks. The ECB (SSM) can voluntarily disclose information to the ESRB, and the ESRB can request relevant information from the ECB (SSM). Even more importantly, the ESRB can direct recommendations and warnings not only to NCAs within the SSM but also to the supervisory branch of the ECB.

The key power of the ECB is to top-up national

macro-prudential policies which includes the capacity to require macro-prudential tools to be implemented for the first time if NCAs remain inert. Hence, the ECB can push through inconvenient banking policies that (captured) NCAs may shun (see Tröger, 2014). However, the ECB is limited to the macro-prudential tool-kit provided by supra-national law. It has no competence to initiate or modify macro-prudential measures. The only promising tools through which the ECB can implement more rigid macro-prudential policies are those that indirectly reinforce (sectoral) capital requirements by augmented risk weights or LGD values.

Regaining market discipline through bail-in

Another supervisory tool that will potentially influence future bank client-relationships indirectly, yet momentarily, is the bail-in instru-

ment. The tool seeks to address the problem of implicit government guarantees for bank capital from which some banks benefit that are deemed “too big / important / interconnected to fail”. These banks enjoy lower risk premiums and can thus raise capital from rational investors at lower prices that are insensitive to their risk-taking behavior. This leads to excessive risk-taking and inefficient investment decisions. The objective of the bail-in instrument is to credibly ensure loss participation of the private sector in a bank’s failure and thus end excessive risk-taking.

An effective bail-in tool needs to define a clear-cut trigger event, to identify bail-inable capital instruments and must allow to predict the particular consequences of the implementation of the tool (see Krahen and Moretti, 2015). In order to prevent knock-on effects, these instruments have to be held outside the banking sector by investors with sufficient loss-bearing capacity (e.g. insurance companies, pension funds).

The key problem of the European bail-in tool follows from the persistence of a political element in private sector loss participation under the Bank Recovery and Resolution Directive (BRRD) / Single Resolution Mechanism Regulation. For example, the forecasting nature of the trigger event allows competent authorities to delay reorganization and resolution. Hence, in this regard the impact of the banking union

will depend on the stance the ECB (SSM) or – ultimately – the Single Resolution Board will take vis-à-vis shaky banks. The ECB may face incentives to camouflage supervisory failures by postponing reorganization. Moreover, if supra-national funds do not suffice to cover reorganization costs, disproportionately affected Member States may heavily pressure the Single Resolution Board not to initiate the procedure.

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- The full article will be published in the European Business Organization Law Review, Vol. 16, and is available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2613802*

Interview:

“Tax Information Agreements Reduce the Shady Parts of Tax Havens’ Business”



Alfons Weichenrieder
Goethe University & SAFE

Alfons Weichenrieder is Professor of Economics and Public Finance at Goethe University, Principal Investigator in SAFE and a Member of the SAFE Policy Center Core Team. His research interests comprise fiscal policy in Europe, sovereign debt and taxation. Before joining Goethe University in 2002, he held academic positions at the University of Vienna, the LMU Munich and Princeton University. Weichenrieder is a Member of the Scientific Research Council of the German Federal Ministry of Finance.

Which research questions are you currently focusing on?

An important topic at the moment is whether we need new fiscal institutions in Europe given that we have a monetary union without a fiscal union. There are many related research questions that are of interest to me. Another longstanding research interest of mine is international taxation, in particular of multinational firms. Here, tax havens have attracted much attention since the financial crisis. Low regulations in tax havens may have contributed to the crisis by offering an unregulated place for all kinds of special vehicles. A related issue, more on the public finance side, is the question to what extent tax havens make it more difficult for high tax countries to secure their tax revenues.

In a recent paper (Braun/Weichenrieder, 2015), you look at the question of how multinational firms use tax havens.

There is a lot of research and public talk on the aspect of private bank accounts in tax haven countries. Research shows that exchange of tax information reduces the willingness of investors to shift money into a “cooperative” tax

haven. I was wondering whether similar behavior can be observed for multinational firms. There were two hypotheses: first, as it is more difficult for firms, as compared to individuals, to hide funds, information exchanges could have rather little impact on multinationals’ use of tax havens. On the other hand, we know from anecdotal evidence that firms sometimes do shady things, e.g. they give bribes to get procurement projects in corrupt countries or they set up tax saving arrangements and do not want tax authorities to figure out how they do it. So, I was interested in whether all these factors lead to a

situation where tax information exchange agreements would change the interest of firms to have an affiliate in tax haven countries.

And what are your findings?

We used Bundesbank data for German parent firms to detect whether a given parent has an operation going on in a particular tax haven country in a given year. Germany has tax information exchange agreements with some tax havens but not with all, which allowed us to examine how many affiliates cooperative tax havens have lost, as compared to those that were

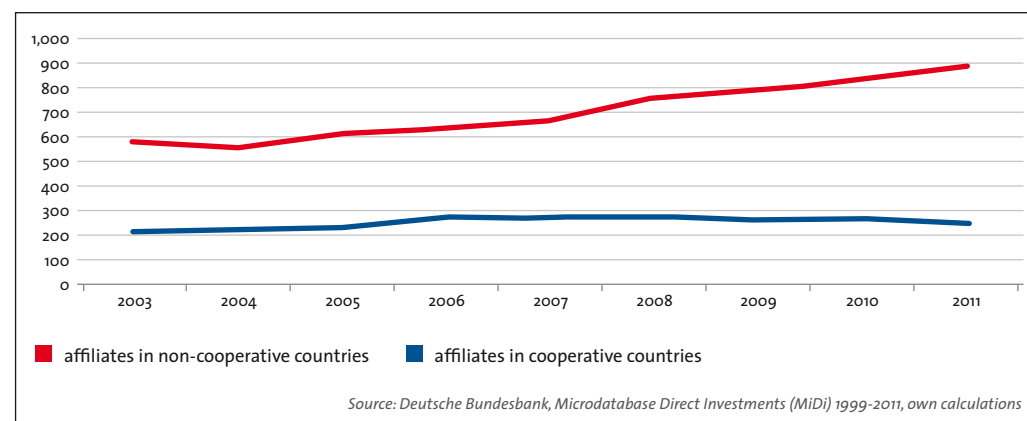


Figure 1: Number of affiliates in cooperative and non-cooperative countries

not cooperative. What we find is that German parent firms indeed seem to have a preference for tax havens that have not signed a tax information exchange agreement with Germany: the number of affiliates in countries that became cooperative slightly went down whereas the number of affiliates in non-cooperative tax havens went up quite steeply (see Figure 1). In sum, affiliates in cooperative tax havens decreased by 46% compared to the control group. So, it is not only a demand for tax advantages that leads to firms' investments in tax havens but also a demand for secrecy. However, it may be that only a part of the activities has been given up completely whereas a considerable amount may have been shifted towards the remaining non-cooperative tax havens.

Do your results also provide information about the activities of shadow banks?

Unfortunately, the number of banks in our data base was too small to concentrate on banks. So, we had to merge all kinds of businesses. But when you look at the most complicated ownership structures of affiliates that use several countries, you will mainly find banks. This may be telling.

In a second paper (Weichenrieder/Xu, 2015), you evaluate the consequences of tax havens for higher tax countries. One would expect these to be negative, right?

Interestingly, this is not clear. A couple of North

American scholars in public finance tend to hold the seemingly paradoxical view that tax havens have positive effects on high tax countries. The explanation is that countries can benefit from the fact that immobile domestic firms have to pay the higher national corporate tax rate, while highly mobile international firms can make use of tax havens without having to leave the country. The underlying assumption is that an outright differentiation of corporate tax rates is not possible in most countries. Therefore, according to this view, tax havens provide an indirect service to high tax countries by allowing international firms to reduce their tax rates. This way, high tax countries lose tax income but they do not lose the mobile firms altogether with all the valuable jobs they provide.

In our paper, we suggest that rather the opposite is plausible: tax-haven secrecy makes it harder to differentiate between domestic and foreign firms. An example is China which, indeed, in the past had a split corporate tax and imposed 15% on foreign owned firms, which by definition are mobile, and 25% on domestic firms. When you now look at the main investor countries in China you surprisingly find that the largest investor – behind Hong Kong – is not Japan or the U.S. but the British Virgin Islands. Same picture in India where the biggest foreign investor is Mauritius. The explanation is that the intransparency

offered by tax havens allows firms to circumvent their home country's legislation and, thus, to get advantages in tax rates and other policy areas by pretending to be foreign. These results are quite contrary to what some proponents of tax havens want to make us believe.

So, both of your papers suggest that tax information agreements could be an efficient policy tool to avoid undesired behavior of multinational firms.

This is true. Tax information agreements would probably also reduce this inefficient roundtripping. So, altogether, these agreements are a good move forward. An OECD initiative has already resulted in 61 countries signing a multilateral treaty. The shady parts of tax havens'

business may be reduced by this. On the other hand, with every agreement the remaining uncooperative tax havens are gaining more and more profits which will make it increasingly difficult to persuade them to cooperate.

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- Weichenrieder, A., Xu, F.** (2015) "Are Tax Havens Good? Implications of the Crackdown on Secrecy", SAFE Working Paper No. 111.

Selected Publications by Alfons Weichenrieder

Bursian, D., Weichenrieder, A., Zimmer, J. (2015) "Trust in government and fiscal adjustments", International Tax and Public Finance, DOI 10.1007/s10797-015-9363-2.

Lipatov, V., Weichenrieder, A. (2015) "Welfare and labor supply implications of tax competition for mobile labor", Social Choice and Welfare, DOI 10.1007/s00355-015-0898-z.

Weichenrieder, A., Zimmer, J. (2013) "Euro membership and fiscal reaction functions", International Tax and Public Finance, Vol. 21, Issue 4, pp. 598-613.

Ruf, M., Weichenrieder, A. (2012) "The taxation of passive foreign investment: Lessons from German experience", Canadian Journal of Economics, Vol. 45, Issue 4, pp. 1504 – 1528.

The Effects of Contingent Convertible (CoCo) Bonds on Insurers' Capital Requirements under Solvency II



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The Liikanen Group proposes contingent convertible (CoCo) bonds as instruments to enhance financial stability in the banking industry. Especially life insurance companies could serve as CoCo bond holders. There is a rising awareness of these hybrid securities among life insurers, as they are increasingly looking for higher-yielding investments during the current low interest rate period. Our contribution provides an insight for life insurance companies to understand the effects of holding CoCo bonds as implied by the Solvency II standards that will come into power by 2016.

The Liikanen Group strongly recommends contingent convertible debt issuance by banks as a potential mechanism to reduce the risk shifting towards tax payers created by governments' safety nets. This form of long term debt, with a fixed coupon rate, automatically converts to equity when a bank approaches insolvency, i.e. when a predetermined trigger is met. Upon conversion, a bank immediately replenishes its

equity capital base, while at the same time reducing its interest payment obligations.

To maximize the stabilizing effect on the financial system, CoCo bond holders may not hedge themselves in the banking sector and should not experience refinancing difficulties when suffering losses on their investments. Diversified financial institutions with long term maturities on their funding side and restrictive termination rights, such as life insurance companies, seem to fit this profile. In fact, life insurers are already the largest purchasers of bank bonds in Europe, owning around 11% of European bank debt.

CoCo bonds under Solvency II

In a recent study, we calculate the effects of holding CoCo bonds on life insurers' risk-based solvency capital requirements under the upcoming European Solvency II standards. We develop a stylized model with a direct financial connection between banking and insurance (see Figure 1). The bank provides loans that are financed by equity capital, deposits and additional bank debt (either non-convertible or contingent convertible). The financial connection between

banking and insurance stems from the insurer's investment into the bank's bonds.

We study a variety of CoCo bond designs and allow for partial conversion which has important implications for investors: as CoCos convert to equity, bond holders become shareholders and thus share any costs or benefits that accrue to shareholders from subsequent conversions. To assess the effect of the conversion on insurers' capital requirements, besides using the Solvency II standard model, we develop an internal model that ex-ante anticipates possible future bank share holdings. From the resulting capital requirements for insurers, we study the sensitivity with respect to the CoCo bond design (trigger value, conversion ratio, holding time of bank shares) and the bank's risk appetite.

Capital requirements for different CoCo bond types

We calculate the capital requirements for three contingent convertible bond types: write-down bonds (bond value is written down upon conversion rather than being converted to equity), contingent convertible bonds SAC (sold at con-

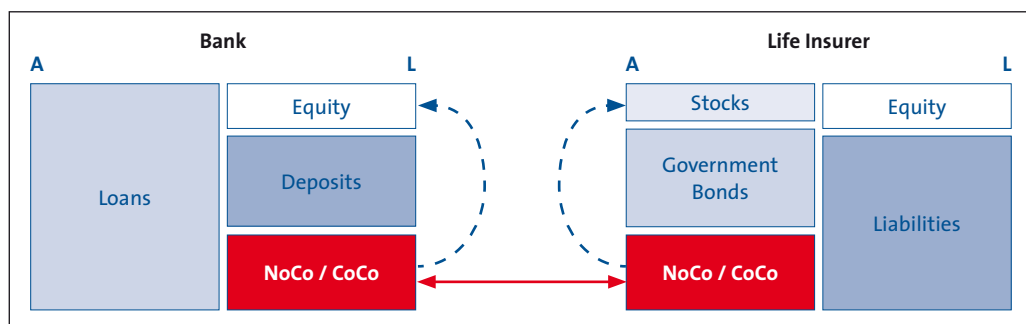


Figure 1: Financial connection between bank and insurance company

version) and contingent convertible bonds HTM (held to maturity). As a benchmark, we use the treatment of non-convertible bank bonds.

Since the current standardized assessment of market risk depends on relatively crude risk weights, the Solvency II standard model is not able to reflect the entire risk profile of a CoCo bond. In contrast, an internal model can recognize the full risk return profile through dynamic modeling techniques and therefore evaluate the actual risk situation of the company. By varying the CoCo bond's trigger value and the conversion ratio as well as the bank's risk appetite, we find that the standard model can mislead CoCo

investors and produce economically unsound incentives. For example, by increasing the trigger value, capital requirements under the Solvency II standard model wrongfully decrease, while they increase under the internal model.

From the internal model, we learn that capital requirements for CoCo bonds increase with increasing trigger value, decreasing conversion ratio as well as increasing bank risk. In addition, CoCos lead to higher capital charges than non-convertible bonds if bank risk is low, and to lower capital requirements if bank risk is high. For high bank risk, insurers clearly benefit from buying CoCos due to lower capital charges and a higher

coupon rate. In this case, holding a CoCo clearly dominates holding a non-convertible bond.

Policy implications

Our results show which design makes CoCo bonds an attractive investment category for life insurers. The current set-up and calibration of the Solvency II standard formula for market risk are inadequate with respect to the treatment of contingent convertible bonds. By highlighting

these weaknesses of the market risk module, our results provide an indication for improving it.

The full research paper is available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2593035

A longer version of this summary was first published in The Geneva Association's Insurance & Finance Newsletter, August 2015.

Selected Policy Center Publications

Brühl, V., Gründl, H., Hackethal, A., Kotz, H.-H., Krahen, J. and Tröger, T. (2015) "Comments on the EU Commission's Capital Markets Union Project", White Paper 27, SAFE Policy Center.

Krahen, J. (2015) "Three Theses on the Greek Crisis", Policy Letter 42, SAFE Policy Center.

European Shadow Financial Regulatory Committee (ESFRC) (2015) "Escalating Crisis in the Eurozone: The Case for Conditional Debt Relief for Greece", Policy Letter 43, SAFE Policy Center.

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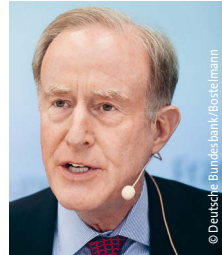
Tackling Three 'Intractable' Challenges Facing the World

On 9 June 2015, the President of the World Bank, Jim Yong Kim, gave a speech at Goethe University Frankfurt. The lecture was jointly organized by the SAFE Policy Center, the Center for Financial Studies, and Deutsche Bundesbank. The welcome address was held by Bundesbank President Jens Weidmann and Kim was introduced by CFS President Otmar Issing. In his speech, Kim pointed out that the world faces three 'intractable' challenges: ending extreme poverty in just 15 years, preparing for the next pandemic that could be much more deadly than any that has been experienced in recent years, and battling climate change so that the planet can be preserved for future generations. Kim argued that for each of these problems finance is a key factor for success.



Long-Term Fiscal Sustainability

On 8 July 2015, Alan J. Auerbach, Robert D. Burch Professor of Economics and Law and Director of the Burch Center for Tax Policy and Public Finance, gave a SAFE Policy Center Lecture on "Long-Term Fiscal Sustainability in Advanced Economies". He argued that fiscal pressures do not only result from higher debt-to-GDP ratios, but also from demographic change and the rising costs of age-related social insurance. The focus on how to manage the short-term debt burden may help to avoid crises like the one being played out in Greece at the moment. However, attention and policy actions must eventually turn to longer-term fiscal problems. Long-term projections show that especially countries with low birth rates and high life expectancies, such as Japan, will face increasing fiscal problems over the next decades. High immigration rates, such as in the U.S., can defuse the problem. However, due to their massive health care costs, the U.S. will also face huge fiscal gaps.



Debt – Economic, Political, and Moral Consequences

On 24 June 2015, a symposium on "Debt – Economic, Political, and Moral Consequences" was held in honor of Benjamin M. Friedman, Harvard University, first holder of the Endowed Chair of Financial History at Goethe University (photo). The event was jointly organized by Deutsche Bundesbank, the Institut für bankhistorische Forschung, and the Research Center SAFE (Hans-Helmut Kotz). In the keynote lecture, Charles Wyplosz, Graduate Institute of International and Development Studies in Geneva, pleaded for a less moralistic concept of debt and debt forgiveness and encouraged Europe to focus more on the underlying financial instruments. The conference was organized in three panels that dealt with the topics "Too much debt: inability or unwillingness to pay?", "Over-indebtedness and societal consequences", and "Debt pathologies – political and moral consequences". In the first panel, Lucas Papademos, University of Athens, elaborated on the importance of credibility for debt sustainability and argued for debt relief in combination with essential reforms in Greece. The second panel discussed the need for solidarity and the question of which institutions are necessary to stabilize Europe. The third panel focused on the dilemma of choosing between debt reduction with slower recovery and stimulating the economy with more short term debt. Benjamin Friedman emphasized that Europe was increasingly at risk to repeat many of the mistakes made between the two world wars. He pointed to the eagerness to protect lenders – even reckless ones – from borrowers.



Cultural Change in Banking

On 10 June, the SAFE Policy Center organized a panel discussion with anthropologist and Guardian journalist Joris Luyendijk to discuss problems in bank culture and possibilities to change it. Luyendijk recently published a book on bank culture ("This Can't Be True") based on more than 200 interviews with London bankers. He was joined on the panel by Daniel Mikkelsen, Director at McKinsey & Company, and Thomas Mosk, SAFE Assistant Professor. The discussion was moderated by Hans-Helmut Kotz, Program Director of the SAFE Policy Center.

Luyendijk stressed that the issue at the heart of problematic bank culture is not that bankers are amoral. Rather, institutional structures, as for instance the fact that bankers have almost no job security, lead to behavior which is focused too much on short-term profits. Individual employees have no reason to place much importance on the long-term effects of their actions or to identify with the future reputation of their bank when they can expect to be let go at a moment's notice. Luyendijk criticized that bankers are not made liable for the risks they take on. Losses are borne by clients, shareholders or – in case of severe unbalances – taxpayers. He therefore demanded a new banking structure where bankers are responsible for the risks they take as well as for the long-term outcomes of their investments. This would incentivize them to avoid too high risks and keep them from investing in products they do not fully understand.

SAFE Researchers Receive Large Grants

An international team of researchers headed by Loriana Pelizzon, SAFE Professor of Law and Finance, has received a large research grant from the Volkswagen Foundation for a research project on "Quantitative Easing and Financial (In)Stability". Apart from Loriana, the contributing researchers are: Jan Pieter Krahen, Christian Schlag, Matthias Thiemann (all Goethe University and SAFE), Sascha Steffen (ESMT), Jun Uno (Waseda University Japan), Marti Subrahmanyam and Viral Acharya (New York University), Marcel Bluhm and Linlin Niu (Xiamen University, China), and Co-Pierre Georg (University of Cape Town, South Africa). The funded project aims to analyze the potential effects of Quantitative Easing on (i) the pricing of financial assets, (ii) risk taking by banks, and (iii) the spillover effects to emerging markets.

Holger Kraft, Professor of Asset Pricing and Principal Investigator in SAFE, is receiving a grant by Deutsche Forschungsgemeinschaft for a research project on "Non-financial life-cycle decisions and their impact on consumption-portfolio choice with unspanned labor income".

A "Freigeist" Fellowship was granted by Volkswagen Foundation to Matthias Goldmann, currently a Senior Research Fellow at the Max Planck Institute for Comparative Public Law and International Law, to join Goethe University and SAFE from January 2016 for 6 years in order to form a research group working on "Stability through Deliberation: Finance and Public Law".

Selected Publications

Bursian, D., Weichenrieder, A. J. (2015)
“Trust in Government and Fiscal Adjustments”,
International Tax and Public Finance, Vol. 22,
Issue 3.

Caporale, G. M., Donadelli, M., Varani, A. (2015)
“International Capital Markets Structure, Preferences and Puzzles: A US-China World”,
Journal of International Financial Markets, Institutions and Money, Vol. 36, pp. 85-99.

Gerlach, P., Maurer, R. (2015)
“Return-Based Classification of Absolute Return Funds”,
Journal of Asset Management, Vol. 16, Issue 2,
pp. 117-130.

Gomber, P., Sagade, S., Theissen, E., Weber, M., Westheide, C. (2015)
“The State of Play in European Over-the-Counter Equities Trading”,
Journal of Trading, Vol. 10, Issue 2, pp. 23-32.

Haar, B. (2015)
“Organizing Regional Systems: The EU Example?”,
in Ferran, E., Moloney, N. and Payne, J. (Eds.),
The Oxford Handbook of Financial Regulation,
Oxford University Press 2015, pp. 157.

Harenberg, D., Ludwig, A. (2015)
“Social security in an analytically tractable overlapping generations model with aggregate and idiosyncratic risks”,
forthcoming in International Tax and Public Finance.

Langenbacher, K. (2015)
“Diversity on corporate boards – why, how?”,
forthcoming in Revue Trimestrielle de Droit Financier/Corporate Finance and Capital Markets Law Review (RTDF).

Niedrig, T. (2015)
“Optimal Asset Allocation for Interconnected Life Insurers in the Low Interest Rate Environment Under Solvency Regulation”,
Journal of Insurance Issues, Vol. 38, Issue 1,
pp. 31-71.

Recent SAFE Working Papers

No. 111 Weichenrieder, A., Xu, F.
“Are Tax Havens Good? Implications of the Crackdown on Secrecy”

No. 110 Krueger, D., Ludwig, A.
“On the Optimal Provision of Social Insurance”

No. 109 Tröger, T.
“Regulatory Influence on Market Conditions in the Banking Union”

No. 108 Baghestanian, S., Gortner, P., Massenot, B.
“Compensation Schemes, Liquidity Provision, and Asset Prices: An Experimental Analysis”

No. 107 Powell, D., Rapp, M. S.
“Non-Mandatory Say on Pay Votes and AGM Participation: Evidence from Germany”

No. 106 Massenot, B., Straub, S.
“Informal Sector and Economic Development: The Credit Supply Channel”

No. 105 Lipatov, V., Weichenrieder, A. J.
“A Decentralization Theorem of Taxation”

No. 104 Baghestanian, S., Massenot, B.
“Predictably Irrational: Gambling for Resurrection in Experimental Asset Markets?”

No. 103 Caporin, M., Pelizzon, L., Ravazzolo, F., Rigobon, R.
“Measuring Sovereign Contagion in Europe”

No. 102 Aldasoro, I., Alves, I.
“Multiplex interbank networks and systemic importance: An application to European data”

No. 101 Grupp, M.
“On the Impact of Leveraged Buyouts on Bank Systemic Risk”

No. 100 Grupp, M.
“Taking the Lead: When Non-Banks Arrange Syndicated Loans”

Capital Markets Union: The Next Big Step of Financial Integration in Europe



Andreas Dombret
Member of the
Executive Board,
Deutsche Bundesbank

The European Commission has announced the objective to create a European capital markets union by 2019. Following monetary union and banking union, this will be the third major step of financial integration in Europe.

The capital markets union has two objectives. The first objective is to increase the share of capital markets in the funding mix of the real economy. The second objective is to integrate capital markets more closely across borders.

The first objective is based on the idea of diversification. A system in which the real economy relies on a single source of funding will most certainly run into trouble when that source dries up. The capital markets union is therefore supposed to supplement bank-based funding with capital markets-based funding. And in Europe above all places there is ample room to do so.

Increasing the share of capital markets will improve access to funding for the real economy. At the same time, it will improve the matching of investors to financial risk, thereby increasing the efficiency of the financial system. As a result, the financial system will be able to better support sustainable economic growth.

The second objective of the European capital markets union is to improve the integration of capital markets in the entire European Union. One of the main arguments is that integrated capital markets can improve private risk sharing.

Empirical studies for the United States show that integrated capital markets cushion around 40%

of the cyclical fluctuations among the US federal states. A share of around 25% is smoothed via the credit markets, while fiscal policy cushions 10-20% of shocks. Altogether, around 80% of a given economic shock is absorbed before it can affect consumption.

In Europe, it is mainly credit markets that cushion economic shocks – and they are not very effective in doing so. Altogether, only around 40% of a given shock is absorbed before it can affect consumption. Integrating capital markets across borders would help improve private risk sharing within Europe.

To sum up: a European capital union would pay a double-dividend. It would contribute to economic growth and it would improve risk-sharing. But how do we get there?

With regard to the objective of increasing the share of capital markets, we should focus on equity markets. Tax treatment, for instance, still favors debt financing over equity financing. Removing this bias in taxation would encourage companies to strengthen their equity base

and thus turn more towards equity markets as a source of funding.

With regard to the objective of integrating capital markets across Europe, there are some areas where standardization could give us some early gains. The market for high-quality securitization is one of these areas. So far, a number of policy initiatives have been launched to restart European securitization markets. Other areas for early action include private placements, crowd-funding or the harmonization of prospectuses. With a view to the long run, it might also be beneficial to harmonize insolvency laws across Europe.

In any case, we should not exclusively focus on the institutional and legal framework. There might also be soft factors at play, such as cultural preferences for certain forms of funding or the level of financial education. We also should address these issues in order to achieve our objective.

Ultimately, the path towards a European capital markets union will be long and arduous. Nevertheless, I consider it a path well worth taking.

Events

September

Monday, 7 th – Friday, 18 th	ILF Summer School Bank- und Kapitalmarktrecht
Tuesday, 8 th – Wednesday, 9 th	4th Conference on Global Insurance Supervision (GIS) Insurance Globally Under Pressure? organized by ICIR and EIOPA
Wednesday, 9 th 11.00 am – 6.00 pm	CFS Conference 1. Konferenz für Finanztechnologie
Thursday, 10 th – Friday, 11 th	SAFE Conference Behavioral Aspects of Macroeconomics and Finance
Friday, 11 th – Saturday, 12 th	SAFE Conference European Conference on Household Finance
Tuesday, 15 th 7.00 pm – 8.30 pm	SAFE Panel Discussion Perspektiven für eine innovative und wachstumsfördernde Bund-Länder-Finanzbeziehung
Thursday, 17 th 5.00 pm – 6.30 pm	CFS Lecture Using Bank Data to Identify Corruption Speaker: Sumit Agarwal, University of Singapore
Monday, 21 st – Wednesday, 23 rd	Lectures on Internal Organization The Economics of Organizations and Human Resources co-funded by SAFE
Wednesday, 23 rd – Thursday, 24 th	SAFE Summer Academy Banks and Markets in Europe's Financial Architecture
Wednesday, 23 rd – Friday, 25 th	GBS Finance Seminar The Basics of Financial Risk Management
Thursday, 24 th – Saturday, 26 th	CFS Conference Frankfurt-Fudan Financial Research Forum
Thursday, 24 th 12.00 pm – 5.45 pm	Deutsche Bank Prize Award Ceremony and CFS Symposium
Monday, 28 th	CFS Lecture Series "Risk & Regulation" Wie gut managen Asset Manager ihre eigenen Risiken? Speaker: Bernd Scherer, First Private Investment Management
Tuesday, 29 th	SAFE Asset Pricing Workshop

October

Monday, 5 th 5.00 pm	EFL Jour Fixe The Impact of IS Security Awareness Management Practices on Individual User Behavior – Insights of a Field Study in a Financial Institution in Germany Speaker: Andreas Eckhardt, E-Finance Lab
Wednesday, 7 th 5.00 pm – 6.30 pm	CFS Lecture Series "Risk & Regulation" Moderne Entscheidungsunterstützungssysteme der Asset Allocation in Zeiten regulatorischen und ökonomischen Drucks Speakers: Carsten Schulze and Jochen Papenbrock, both PPI AG
Thursday, 8 th 5.00 pm – 6.30 pm	CFS Lecture High Frequency Trading Speaker: Mathew Szeto, RBC London
Thursday, 8 th – Friday, 9 th 9.00 am – 6.00 pm	GBS Finance Seminar An Advanced Understanding of Financial Risk Management
Tuesday, 13 th 2.15 pm – 3.45 pm	Frankfurt Seminar in Macroeconomics – joint with SAFE Speaker: Klaus Adam, University of Mannheim
Tuesday, 13 th 4.15 pm – 5.30 pm	Finance Seminar – joint with SAFE Speaker: Anette Vissing-Jorgensen, University of California, Berkeley
Wednesday, 14 th	SAFE Workshop 2015 Frankfurt-Mannheim Macro Workshop
Tuesday, 20 th 4.15 pm – 5.30 pm	Finance Seminar – joint with SAFE Speaker: Mikhail Chernov, UCLA Anderson
Tuesday, 20 th 2.15 pm – 3.45 pm	Frankfurt Seminar in Macroeconomics – joint with SAFE Speaker: Barry Eichengreen, University of California, Berkeley
Tuesday, 20 th 5.30 pm – 7.00 pm	CFS / IbF Lecture Die großen Crashes 1929 und 2008 – Warum sich Geschichte wiederholt Speaker: Barry Eichengreen, University of California, Berkeley

Thursday, 22nd –
Friday, 23rd

Monday, 26th

Tuesday, 27th
2.15 pm – 3.45 pm

Tuesday, 27th
4.15 pm – 5.30 pm

Thursday, 29th
5.30 pm – 7.00 pm

**Karel's Club – Executive Networks
Good Governance: Fiction or Reality?**

**9th ICIR Talk on Insurance and Regulation
Solvency II, Ultralow Interest Rates and
Consumer Protection – Life Insurance Product
Development in Upheaval**
Speaker: Alf Neumann, Allianz Lebensver-
sicherungs-AG

**Frankfurt Seminar in Macroeconomics –
joint with SAFE**
Speaker: Tomohiro Hirano, University of Tokyo

Finance Seminar – joint with SAFE
Speaker: Tarun Ramadorai, Said Business School,
University of Oxford

CFS Presidential Lecture
Speaker: Martin Feldstein, Harvard University

November

Monday, 2nd
5.00 pm

Friday, 6th

Monday, 9th
5.00 pm – 6.30 pm

Monday, 23rd
12.00 pm – 1.00 pm

**EFL Jour Fixe
Performance Control of Cloud-based Services**
Speaker: Melanie Siebenhaar, E-Finance Lab

**Third SAFE Frankfurt Conference on
Financial Market Policy
Digitizing Finance**

**CFS Lecture Series "Risk & Regulation"
Der Einheitliche Abwicklungsmechanismus
(SRM): Anforderungen, Instrumente und
Praxiserfahrungen**
Speakers: Karsten Paetzmann and Ulf Bachmann,
both BDO

IMFS Working Lunch
Speaker: Stavros Gadinis, University of California,
Berkeley

Please note that for some events registration is compulsory.



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