CENTER OF EXCELLENCE
SAFE
Sustainable Architecture for Finance in Europe

Newsletter

AT THE HOUSE OF FINANCE

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Spillover Effects among Financial Institutions: How important are Hedge Funds in a Crisis?_4

Zeno Adams, Roland Füss, Reint Gropp

The Path Towards Civil Liability of Credit Rating Agencies in Europe under CRA3_10

Brigitte Haar

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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.

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Editorial

Wolfgang König
Executive Board
Center of Excellence SAFE
Executive Director
House of Finance

We are looking back on some exciting months, which saw all of the institutions at the House of Finance kept very busy and always "on go". The reason, though positive, also represents a challenge: as we reported in the Q3/2012 issue, the Center for Financial Studies and Goethe University have been successful with their joint venture under the Hessian excellence initiative LOEWE (Landes-Offensive zur Entwicklung wissenschaftlich-ökonomischer Exzellenz). They have won EUR 13 million in funding – which covers the first three years of a six-year period – for the establishment of a new research center within the House of Finance: the Center of Excellence SAFE which is short for "Sustainable Architecture for Finance in Europe".

SAFE opened its doors in January 2013 and not only embraces a good number of House of Finance researchers and staff, but also extends its reach far beyond its base by drawing on scholars and disciplines from other parts of Goethe University as well as from fellow research institutions. In other words: our family is growing, which makes us all happy, proud, and, of course, rather busy.

SAFE can build on the reputation that the House of Finance has successfully acquired since its opening in May 2008. With the LOEWE funding, we are now able to make a great leap forward in terms of our overall goal: to become a leading European research center on all areas relevant to the development of a sustainable financial architecture, which includes a dynamic interaction with policy makers and society.

Reflecting the new set-up, the House of Finance Newsletter will now be transformed into the SAFE Newsletter. Please be assured that we will not relax in our efforts to provide you with highly informative pages on our current research findings and policy output. Needless to say, we will also keep you posted on the latest developments within the House of Finance.

Thank you for your continuous interest. We very much hope that you will enjoy reading the first issue of the SAFE Newsletter!

Yours sincerely,
Wolfgang König

Spillover Effects among Financial Institutions: How important are Hedge Funds in a Crisis?

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"Continued focus on counterparty risk management is likely the best course for addressing systemic concerns related to hedge funds." Ben S. Bernanke (2006)

One of the important lessons from the 2007-09 financial crisis is that systemic risk and spillover effects are significantly underestimated in most widely used risk measures and that standard risk measurement instruments, such as value-at-risk (VaR), need to be adjusted to adequately reflect overall risk. In this paper, we propose a state-dependent sensitivity (SDS) VaR for quantifying risk spillovers among sets of different financial institutions. We estimate a system of quantile regressions for four sets of financial institutions (commercial banks, investment banks, hedge funds and insurance companies), in which each type of financial institution is represented by an index of several firms. In addition, our empirical model explicitly accounts for the effects of different market states (tranquil, normal and volatile) on the magnitude of risk spillovers.

We trace out the time path of how shocks move through the system using impulse response functions. The SDSVaR model explicitly reveals the magnitude of risk spillovers at a certain point in time. Moreover, in contrast to dynamic correlations, we are able to obtain the direction of spillovers from one set of institutions to another. Hence, the approach permits a delineation of spillover effects from shocks affecting the financial sector as a whole.

Hedge funds and systemic risk

As opaque and highly leveraged investment partnerships, hedge funds have recently received attention as a potential source of contagion, a transmission channel of risk between diffe-rent asset classes and as a potential amplifier of systemic risk in financial markets. If highly leveraged hedge funds are forced to liquidate large position at fire-sale prices, counterparties sustain heavy losses. This may lead to further defaults or threaten systemically important institutions, not only directly as counterparties or creditors but also indirectly through asset price adjustments (Bernanke, 2006).

While most observers tend to agree that hedge funds have some systemic importance, little evidence exists on the magnitude of potential spillover effects. In this paper, we provide the first empirical estimates of the size of intra-month spillover effects from hedge funds to other financial institutions.

A new approach to measuring spillover effects

Recently, Adrian and Brunnermeier (2010) proposed CoVaR as a measure for systemic risk. This conditional VaR measure incorporates the additional risk in financial institution i caused by institution j being in distress. A substantial difference between institution j's CoVaR and its VaR measure then indicates a significant contribution of this institution to general systemic risk. Adrian and Brunnermeier argue that a higher contribution to systemic risk should result in higher capital surcharges for this institution. In this paper, we show that the intensity of the contribution of a given set of institutions to systemic risk strongly depends on whether the economy is in a vulnerable or resilient state ex ante.

In contrast to the CoVaR model of Adrian and Brunnermeier (2010), which relies on quantile regression to model the distribution of returns, the SDSVaR proposed in this paper models the distribution of the value-at-risk. After calculating the VaR for each set of institutions, we regress these VaRs over the whole range of quantiles on each other, i. e. we regress the VaR of investment banks on the VaR of commercial banks, hedge funds and insurance companies. The important point is that movements in the VaR change with the financial health of an institution. During tranquil market times, i. e. high quantiles of the VaR distribution, when institutions have plenty of cushion to absorb shocks, risk spillovers between financial institutions are likely to be marginal. When the financial crisis hit in 2007, the behavior of the VaR changed dramatically. The higher risk faced in the market not only turned the VaR strongly negative, i. e. low quantiles of VaR distribution, but also caused the VaR to become more volatile. During this period, dormant linkages that were building up during tranquil periods suddenly became visible and led to high spillovers.

Results

As an example of the results we obtain, Figure 1 presents the effects from changes in the aggregate hedge fund VaR on the VaR of investment banks. As a reference point, the solid blue line represents the spillover coefficient implied by the CoVaR model of Adrian and Brunnermeier (2010).

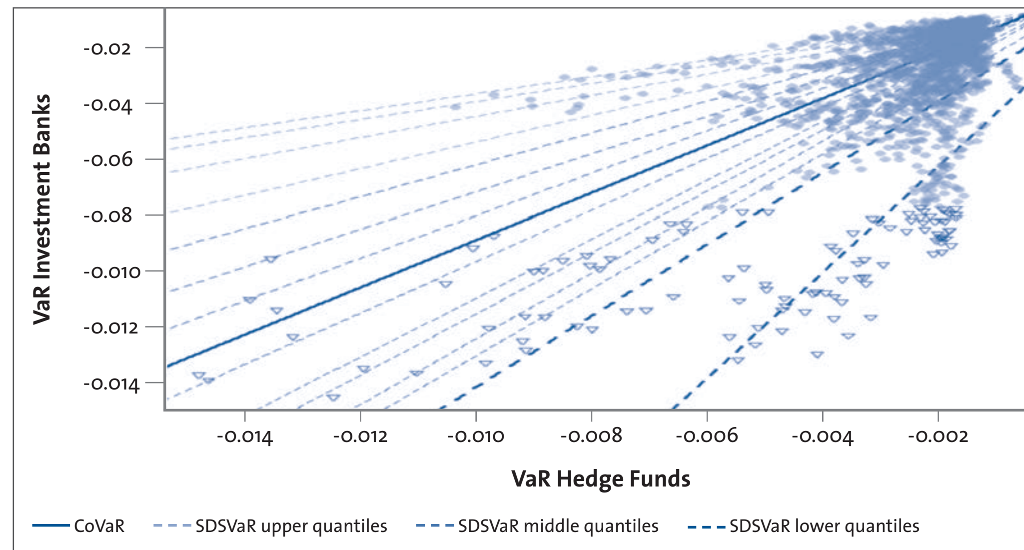

Figure 1: Value-at-risk scatter plots and quantile effects for selected financial institutions

This line represents the average spillover effects emerging from the model. Slopes are estimated to be much flatter during tranquil market periods (i. e. less spillover effects) and much steeper (i. e. more spillover effects) during volatile market phases.

Specifically, during normal market times, a one percentage point increase in the VaR of hedge funds is estimated to increase the VaR of investment banks by 0.09 percentage points. The same shock, however, increases the VaR of the investment bank industry by 0.71 percentage points during times of financial distress. Similarly, during normal times, a one percent increase in the value-at-risk of commercial banks leads to a 0.01 percentage point increase in the VaR of investment banks. In times of financial distress, the spillovers from commercial banks to investment banks increases to 0.05 percentage points. We obtain similar magnitudes for spillovers from investment banks to other financial institutions, while insurance companies tend to exhibit few spillover effects, even in crisis times. Hence, while spillover effects increase overall, hedge fund spillovers to other financial institutions increase by much more and are of a much higher economic significance.

The findings support initiatives such as that of Andrew W. Lo (2008), who in his testimony for the U.S. House of Representatives emphasized that hedge funds should be required to provide more information on a confidential basis to regulators in order to enable them to more accurately assess the risks in the financial sector. They also suggest that limiting supervision and regulation to depository institutions may be misguided.

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The full article will be published as "Spillover Effects among Financial Institutions: A state dependent sensitivity value at risk (SDSVaR) Approach" in the Journal of Financial and Quantitative Analysis and is available at: http://depts.washington.edu/jfqa/forthcoming.html

Organizational Choices of Banks and the Effective Supervision of Transnational Financial Institutions

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Both the financial crisis and the sovereign debt crisis have exposed shortcomings in the legal framework governing the prudential supervision of cross-border banking groups. This article identifies the current division of competences between a transnational bank's home and host supervisory authorities and the required cooperation among these watchdogs as a critical aspect. In particular, it finds tying authorities' competences to banks' organizational choices, i. e. the option to conduct foreign operations through an independently incorporated subsidiary or a legally dependent branch, to be particularly problematic.

Centralization, apart from constituting a realistic option only under particular circumstances like those prevailing at the moment in the European Union (EU), cannot solve all the problems. As an alternative, this article proposes a framework that is neither based on the legal form of a bank's cross-border operations nor relies on unrealistic assumptions of transnational cooperation. Instead, the recommended proposal pays close attention to the economics of public administration and international relations in allocating competences among national and supranational supervisory bodies.

Banks' organizational choices

Recent intra-group restructurings, both in the United States and in Europe, have been criticized by the business press as attempts at regulatory arbitrage in the face of tightened prudential regulation in the financial sector. In fact, the regulatory initiatives taken as reactions to both the global financial and the European sovereign debt crisis affirm that enhanced prudential oversight on a consolidated basis, with robust own-funds requirements, liquidity buffers etc., is regarded as a pivotal element in the prevention of future crises. By looking into some of the assailed transactions that have involved the conversion of independently incorporated subsidiaries into legally dependent branches, the article finds no convincing corroboration of the alleged escape from rigid regulation.

In order to arrive at a more informed idea of which determinants apart from a perceived appetite for regulatory arbitrage drive banks' organizational choices, the article scrutinizes the merits and demerits of either a branch – or a subsidiary – structure in the cross-border business of financial institutions. In doing so, it also considers the policy makers' perspective. The analysis shows that no one-size-fits-all organizational structure is available and concludes that banks' choices should generally not be second-guessed, particularly because they are subject to (some) market discipline.

Allocation of competences under the Basel Core Principles and EU legislation

In light of these findings, the question becomes how can competences regarding the prudential supervision of banks be distributed so that effective oversight is provided for without impeding banks' organizational choices. The analy-

sis describes and evaluates how competences in prudential supervision were allocated among national and supranational supervisory authorities during the recent crises. It finds that both the "Core Principles for Effective Banking Supervision" of the Basel Committee on Banking Supervision and the EU's Directive 2006/48/EC on banking required extensive information-sharing and cooperation between supervisors in different jurisdictions without providing for a powerful arbitrator in case of refusal or dissent. Moreover, the competences of host supervisors vis-à-vis the home/consolidating supervisor varied, largely depending on whether the bank had opted for a subsidiary – or a branch – structure for conducting its cross-border business, with the divergence being particularly strong in the EU (see Figure 1).

In order to assess the legal analysis, the article employs insights gained from the economics of public administration and international relations. It argues that the supervisory architecture should pay closer attention to and be more aligned with bureaucrats' incentives. Hence, inefficient requirements for cooperation and information-sharing should be reduced. Contrary to a widespread perception, even where this option is available – like currently in the EU – shifting responsibilities to a supranational authority cannot solve all of the problems identified and creates problems of its own. Moreover, with regard to global systemically important financial institutions (G-SIFIs), it remains indispensable to develop a regime that facilitates effective supervision by vesting local authorities with exercisable powers.

	Home Member State	Host Member State
Subsidiary structure	• Authorization and supervision of parent • Consolidated supervision of group	• Authorization and supervision of legally independent subsidiaries in cooperation with consolidating supervisor (home Member State authority) • Participation in consolidating supervision
Branch structure	• Authorization and supervision of bank, foreign activities included (on-site investigations, etc.)	• No authorization (EU passport) • Supervision of liquidity endowment in cooperation with home Member State authority

Figure 1: Allocation of competences under the EU Directive 2006/48/EC on banking

Proposed regime of mutual recognition

Resting on these foundations, the article finally sketches a solution that contemplates far-reaching mutual recognition of national supervisory regimes and allocates competences in line with supervisors' incentives and the risk inherent in cross-border banking groups. It argues that competences should be assigned following the current EU solution for branch structures, i. e. the prudential architecture should always provide for a strong home supervisor (national or supranational), regardless of the legal structure of the transnational banking group. As an exception, discrete competences should be given to host supervisors where the banking group's activities are deemed significant from the perspective of the foreign economy.

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The full article will be published in The Texas International Law Journal, Vol. 48, Issue 2 (2013) and is available at:
http://ssrn.com/abstract=2111979

Optimal Portfolio Choice with Annuities and Life Insurance for Retired Couples

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Couples in retirement face the challenge to derive consumption and investment policies that will maximize their joint lifetime utility, subject to pre-existing retirement income and the savings accumulated during the course of the working life. They invest their wealth in capital market instruments, typically stocks and bonds, or insurance products, such as term life insurance or life annuity contracts. Today, it is an open question how retired couples should optimally combine these products in their retirement portfolio.

We present a portfolio choice model for a re-tired couple with an intentional bequest motive, the desire to leave some wealth to the next generation, and uncertainty about their joint lifetimes. In the classical single agent model (see Cocco et al., 2005), the uncertain lifetime leads to the risk of the household outliving its assets. Explicitly modeling a couple and a surviving spouse, our model adds another aspect to this risk: the early death of one spouse may result in an income drop for the surviving partner that substantially exceeds the corresponding reduction in consumption needs. We analyze how private annuities and life insurance can help mitigate this risk.

Previous papers (see Inkmann and Michaelides, 2012) argue that the empirically observed life insurance demand of households indicates the existence of a pure bequest motive. In contrast to these papers, by modeling both spouses, we are able to disentangle this pure bequest motive from a provision motive, the desire that, after one's death, the surviving spouse is financially secure.

Our main results are that private annuities are mainly purchased to achieve a symmetrical distribution of annuitized income between both spouses. High life insurance holdings are predominantly caused by the provision motive and only to a very small extent by a pure bequest motive. In an empirical analysis of the Health and Retirement Study (HRS), we find strong support for our model predictions.

Model description

We model the couple and surviving spouses as a Markov chain, whereas the transitions to widowhood are given by the survival probabilities. Compared to a widow or a widower, a couple has higher consumption needs. Empirical studies (see Lazear and Michael, 1980) have found that with economies of scale, this is considerably less than twice as high. As a consequence, a surviving widow needs to consume only slightly less than before with her partner.

They may buy single annuities as well as joint annuities, which pay till the last spouse dies. This combination allows to endogenously determine the optimal survivor benefit factor

of annuity income. Each partner can purchase one-year term life insurance. Besides these purchases, the couple also decides on how much to consume and how to invest the remaining liquid wealth in risky stocks and riskless bonds.

Model predictions

To present the results of our theoretical model, we distinguish two cases. First, the couple's annual income of $30,000 is symmetrically distributed. Whichever partner dies first, any surviving spouse receives two-thirds of the initial income. This resembles the US social security retirement system with its spousal and widow benefits. Second, the same annual income is asymmetrically distributed, resulting in only a small income reduction for a widower (-17%), but leaving a widow with only one-third of initial income. This can be seen as a combination of social security and a private pension for the husband without any widow benefits. In both cases, the couple also has liquid assets worth $240,000.

In the symmetric case, the couple has a very low annuity demand and buys only small amounts of joint annuities. In the asymmetric case, however, the couple buys large amounts of single annuities for the wife to reduce income asymmetry. But even the substantial liquid assets are insufficient to remove the asymmetry completely. Consequently, the husband holds significant amounts of life insurance (see Figure 1). The initial life insurance face values (payout to the widow upon husband's death) in the asymmetric case are multiple times higher than in the symmetric case ($171,000 compared to $27,000). These face values decrease with age as the expected remaining lifetime of the widow becomes smaller. For the wife, we find negligible life insurance demands. A pure bequest motive, on the other hand, only affects life insurance demand for households with very few liquid assets. This is proof that the life insurance demand is mainly caused by the provision motive, which is considerably higher in the case with asymmetric income and decreases with expected lifetime.

Empirical support

An analysis of the life insurance holdings of elderly US households in the HRS backs our model's findings. As a measure of income asymmetry, we use the husband's share of the household's private pension income, which usually has lower widow benefits than social security. A probit regression shows that an increase in this pension income share results in a significant increase in the probability of the husband holding life insurance. In an OLS regression, we find that the pension income share also has a significant positive effect on the life insurance face values. Even though our empirical analysis cannot strictly rule out a pure bequest motive, the number of children has only insignificant effects on life insurance holdings.

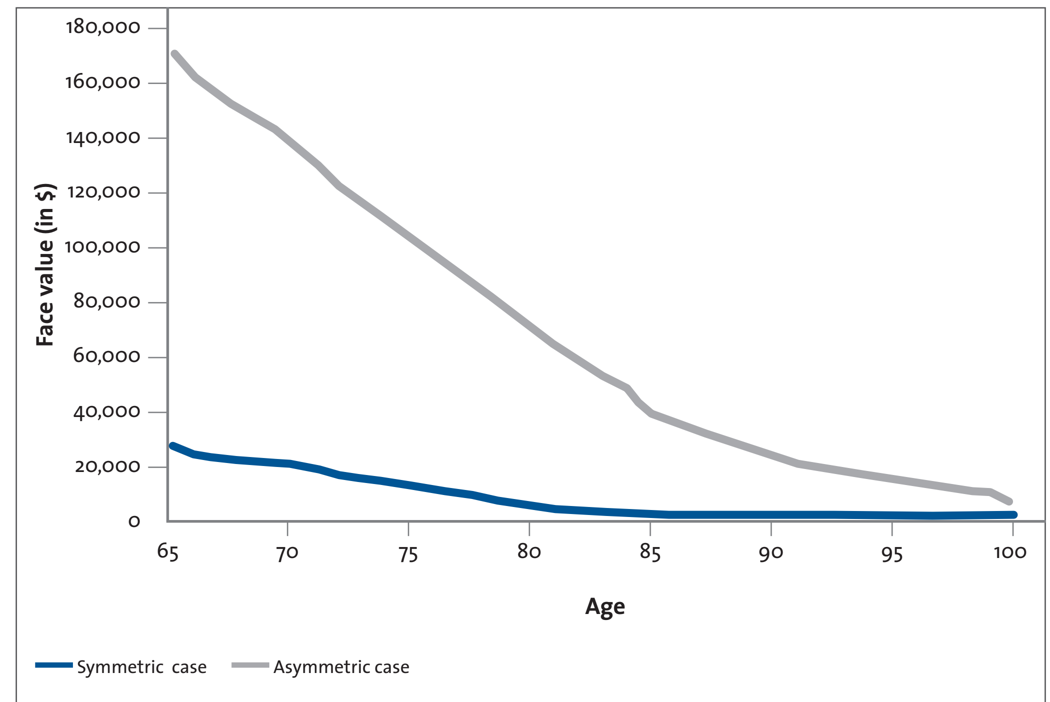

Figure 1: Face values of a husband's life insurance

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The full article is forthcoming in the Review of Finance and is available at
http://rof.oxfordjournals.org/content/early/2013/01/31/rof.rfs046.short

The Path Towards Civil Liability of Credit Rating Agencies in Europe under CRA3

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Credit rating agencies are moving to the center of the debate in the current sovereign debt crisis and the repercussions of wrong downgrades are becoming greater. Consequently, the civil liability of credit rating agencies is subject to an unprecedentedly intense regulatory debate in the rating industry. Only recently the European Commission has put forward a proposal for a regulation (CRA3) to amend and strengthen the 2009 version of the EU Rating Regulation, among other things imposing civil liability on the agencies. Art. 35a of the Commission's Draft Proposal introducing a mandatory civil liability of credit rating agencies has been one of the most controversial changes of this proposal, which has partially found its way into the legislative resolution of the European Parliament of January 16, 2013.

To evaluate the European Commission's CRA3 proposal, it is worthwhile to look at existing rules on civil liability of rating agencies. In the European member states there is no specific legislation governing contracts between issuers and credit rating agencies, so that the general rules of contract law apply.

Under German law the debate on contractual liability of rating agencies centers on the potential existence of an implicit agreement between the issuer and the rating agency in favor of investors as third parties. Basing investor claims on an implicit agreement seems problematic, however, as the interests of investors and issuers are not aligned. Whereas the issuer is interested in the highest possible rating, the investor may prefer a lower rating in the interest of a cheaper entry-level price. Another concern is that in the case of issuer insolvency there is a danger that the insolvency risk is shifted to the rating agency if now the rating agency can be held liable by investors.

Finally, a quasi-contractual liability between rating agencies and investors could arguably be established, arising as a precontractual liability because of the trust placed in rating agencies in reliance on their expertise, thus favorably influencing contract negotiations or the conclusion of a contract. In the typical rating scenario, these requirements for quasi-contractual liabi-lity are not met for lack of immediate contact between the party held liable and the claimant. However, the liability for misstatements in a prospectus based on general German civil law may offer room to argue by analogy to arrive at some kind of gatekeeper/expert liability of rating agencies.

Liability in the EU Commission's draft proposal

In light of the serious flaws in the Big Three's ratings and their contribution to the financial crisis as well as their involvement in the sove-reign debt crisis, the CRA3 Draft Proposal presented by the European Commission included a very strict liability rule in Art. 35a. Its strictness resulted from the procedural facilitation in Art. 35a paras. 2-4 of the Draft Proposal, leading to a shift in the burden of proof, so that it would be sufficient for the investor to establish "...facts from which it may be inferred that a credit rating agency has committed any of the infringements...". Therefore the burden would have been on the credit rating

agency to prove that it had not committed that infringement or that that infringement did not have an impact on the issued credit rating. At the bottom line, under this provision, rating agencies would have had to provide proof of the flawlessness of their ratings, eventually putting them under pressure to disclose their methods and modeling inputs.

This was very much at odds with the limits of disclosure duties as stated in the EU Rating Regulation of 2009, which should not jeopardize trade secrets nor impede innovation. Such a disclosure might eliminate competition for the best rating methods, thus thwarting the desired goal of the European Commission to strengthen competition. What is even more detrimental to competition, is its potentially deterring effect on market entry of new competitors, who will shy away from these high liability risks. In addition, far-reaching liability will have a chilling effect on capital markets because rating agencies may be reluctant to rate some financial instruments at all, as has become apparent from the example of the consequences of the newly introduced expert liability of rating agencies in the Dodd-Frank Act in the USA.

Amendments by EU Council and Parliament

Against this background of incisive criticism against the stringent liability rule, the European Council has voted for a removal of the reversal of the burden of proof and the European Parliament and the Legal Affairs Committee have favored the inclusion of common civil liability rules for deliberate and negligent infringements of the rules of the EU rating regulation.

Despite the wide range of proposals to amend the Draft Proposal of the EU Commission, negotiations in the European Parliament and the Council reached an agreement on the accountability of rating agencies on November 27, 2012. The polished legislative text finally adopted on January 16, 2013 requires investors, in order to establish liability of rating agencies, to demonstrate "that he has reasonably relied..." and "...to present accurate and detailed information indicating that the credit rating agency has committed an infringement..., and that that infringement had an impact on the credit rating issued." Interestingly, the determination of compliance with this standard is left to the respective member state's legal system, so that potential shortcomings of the traditional national liability provisions remain unresolved. What is more, the additional issue of an open market for capital in the European Union under uniform standards may be raised.

The full article "Civil Liability of Credit Rating Agencies – Regulatory All-or-Nothing Approaches Between Immunity and Over-Deterrence" is available for download at:
http://safe-frankfurt.de/policy-publications/

Selected Policy Center Publications

Hackethal, A., Krahnen, J. P. (2013)
„Kommentierung des Entwurf eines Gesetzes zur Abschirmung von Risiken und zur Planung der Sanierung and Abwicklung von Kreditinstituten und Finanzgruppen",
Policy Letter No. 3/2013, Policy Center, Center of Excellence SAFE

Gründl, H. (2013)
„Beteiligung der Versicherungsnehmer an den Bewertungsreserven in der Lebensversicherung",
Policy Letter No. 2/2013, Policy Center, Center of Excellence SAFE

Haliassos, M. (2013)
"Salary Cuts and Competitiveness",
Policy Letter No. 1/2013, Policy Center, Center of Excellence SAFE

Krahnen, J. P. (2012)
„Europataugliche Einlagensicherung: Vorschlag für eine dreistufige Einlagensicherung mit begrenzter europäischer Haftung",
Policy Letter No. 16/2012, Policy Platform at the House of Finance, Goethe University Frankfurt

Siekmann, H. (2012)
„Missachtung rechtlicher Vorgaben des AEUV durch die Mitgliedstaaten und die EZB in der Schuldenkrise",
White Paper, No. 15/2012, Policy Platform at the House of Finance, Goethe University Frankfurt

Siekmann, H. (2012)
„Stellungnahme zum Entwurf eines Dritten Gesetzes zur Umsetzung eines Maßnahmenpakets zur Stabilisierung des Finanzmarktes",
White Paper, No. 14/2012, Policy Platform at the House of Finance, Goethe University Frankfurt

Minister hands over LOEWE Certificates

On 6 February 2013, a ceremony was held in Goethe University's casino building to celebrate the start of the University's new "LOEWE" (Landes-Offensive zur Entwicklung wissenschaftlich-ökonomischer Exzellenz) entities. Eva Kühne-Hörmann, Hessian Minister of Higher Education, Research and the Arts, handed over a letter of approval to Jan Pieter Krahnen (standing on the right), the representative of the Center of Excellence SAFE. SAFE has been granted a first tranche of EUR 13 million under the State of Hessen's LOEWE excellence initiative as first part of a projected six-year funding period.

Deutsche Bank Prize awarded to Raghuram G. Rajan

The Center for Financial Studies (CFS) has awarded the 5th Deutsche Bank Prize in Financial Economics 2013 to Raghuram G. Rajan for his highly influential contributions in a broad range of areas in financial economics most important to the development of economies worldwide. These include the impact of financial development on growth, banking and financial crises, and corporate finance and governance. His work develops novel empirical and theoretical approaches with significant policy implications. The academic prize is sponsored by the Deutsche Bank Donation Fund and carries an endowment of EUR 50,000. It honors internationally renowned economic researchers whose work has a marked influence on research concerning questions of financial economics and macroeconomics, and has led to fundamental advances in economic theory and practice. The CFS awards the prize on a biannual basis in partnership with Goethe University Frankfurt. The prize will be presented to Rajan during an academic CFS symposium that will be held at Goethe University Frankfurt on 26 September 2013.

New Research Partners in Global Law in Finance Network

The Doctorate/Ph.D. Program in Law and Economics of Money and Finance (LEMF) has joined the newly founded Global Law in Finance Network (GLawFin) supported by the 2012 Max Planck Research Prize awarded to Katharina Pistor (photo), Michael I. Sovern Professor of Law at Columbia Law School, and the Institute for New Economic Thinking. The GRNLF is an interdisciplinary network of scholars located at Columbia University, the University of Oxford and Goethe University Frankfurt. Brigitte Haar will be collaborating with the GRNLF's project leader, Katharina Pistor, and Dan Awrey from Oxford University. As of the academic year 2013/14, the GRNLF will be able to offer one doctoral scholarship annually on a per node basis as well as research stays at Columbia University in New York. The LEMF Program recently had the pleasure to host Katharina Pistor who gave a presentation on "The European Banking Union and Global Finance" – the kick-off event for the new GRNLF. Pistor also held a mini-course on the "Legal Construction of Global Finance", bringing to bear her newly-conceived "Legal Theory of Finance".

Discussion on the Future of Universal Banking

On 25 January 2013, Jan Pieter Krahnen, Co-Director of SAFE and the Center for Financial Studies, and Michael Kemmer, General Manager of the Association of German Banks (Bundesverband deutscher Banken), talked about the future of the universal banking model. This was the second event in the SAFE Policy Center's discussion series on structural reforms in the European banking sector. The series aims to debate the report of the Liikanen Group of which Jan Pieter Krahnen was a member. The Group's report suggests spinning off all of the trading activities of major banks in order to have a distinct separation between retail business and trading business in their financial structures. "In our view, both businesses should be financially independent and take their respective risks by themselves", said Krahnen. Michael Kemmer defended the current universal banking model. He expressed the fear that disbanding traditional structures could throw the whole European banking system off balance. Only a few days after the discussion, the German government came up with a legislative initiative that calls for spinning off only banks' proprietary trading. According to Krahnen, this "Liikanen light" would require a lot of energy, but be of little advantage.

Symposium on "Central Banking: Where are we headed?"

On 7 February 2013, the Institute for Monetary and Financial Stability (IMFS) and the House of Finance honored Stefan Gerlach, Deputy Governor of the Central Bank of Ireland, for his contributions to the IMFS in his former capacityas Managing Director. The celebration was held in the form of a symposium, titled "Central Banking: Where are we headed?"

A key issue was the proposed single supervisory mechanism for the Eurozone to be established at the European Central Bank (ECB). According to Sabine Lautenschläger, Deputy President of the Deutsche Bundesbank, and Benoît Cœuré, Member of the Executive Board of the ECB, a strict separation between monetary policy and banking supervision is essential when assigning the supervision of the Eurozone area banks to the ECB. Patrick Honohan, Governor of the Central Bank of Ireland, asked the fundamental question whether the ECB should be responsible for banking supervision in the long run. Despite these reservations, the central bankers described a common banking supervision as an important step to adapt the institutional framework of the Eurozone in response to the crisis.

In the second part of the symposium, Athanasios Orphanides from the MIT Sloan School of Management (and a former Governor of the Central Bank of Cyprus) compared the ways in which European governments acted in former crises with their response to the current crisis. He described how the European Union's political leadership is in a state of crisis. Michael Burda from the School of Business and Economics at Humboldt Universität in Berlin gave his outlook on what the Eurozone will look like in ten years.

Selected Publications

Angeloni, I., Faia, E. (2013)
"Capital Regulation and Monetary Policy with Fragile Banks",
forthcoming in Journal of Monetary Economics.

Ascheberg, M., Bick, B., Kraft, H. (2013)
"Hedging structured credit products during the credit crisis: A horse race of 10 models",
forthcoming in Journal of Banking and Finance.

Bunting, N. (2012)
"Konzernweite Compliance – Pflicht oder Kür",
Zeitschrift für Wirtschaftsrecht (ZIP), Vol. 32, pp. 1542ff.

Büttner, T., Schreiber, U., Overesch, M., Wamser, G. (2012)
"The Impact of Thin-Capitalization Rules on the Capital Structure of Multinational Firms",
Journal of Public Economics, Vol. 96, pp. 930-938.

Cahn, A., Mertens, H.-J. (2013)
Kommentierung der §§ 95-117 Aktiengesetz und der Mitbestimmungsgesetze,
Kölner Kommentar zum Aktiengesetz, 3rd Edition.

Christelis, D., Georgarakos, D., Haliassos, M. (2013)
"Differences in Portfolios Across Countries: Economic Environment versus Household Characteristics",
forthcoming in The Review of Economics and Statistics, Volume 95, Issue 1.

Gal, J., Sehrbrock, D. (2012)
"Verfahrens- und materiellrechtliche Anforderungen an die vorzeitige Abberufung von Vorstandsmitgliedern der Deutschen Bundesbank",
Archiv des öffentlichen Rechts (AöR), pp. 360–400.

Gomber, P., Schweickert, U., Theissen, E. (2013)
"Liquidity Dynamics in an Electronic Open Limit Order Book: An Event Study Approach",
forthcoming in European Financial Management.

Gregory, R., Beck, R., Keil, M. (2013)
"Control Balancing in Information Systems Development Offshoring Projects. A Longitudinal Case Study of an ISD Offshoring Project in the Financial Services Industry",
forthcoming in Management Information Systems Quarterly (MISQ).

Haar, B. (2013)
"Civil Liability of Credit Rating Agencies – Regulatory All-or-nothing Approaches between Immunity and Overdeterrence",
University of Oslo Faculty of Law Legal Studies Research Paper Series No. 2013-02, forthcoming in European Business Law Review.

Hirsch, J., Walz, U. (2013)
"Do Venture Capitalists select different firms or different contracts?",
Small Business Economics, Volume 40, Issue 3, pp. 511-525.

Kühn, C., Stroh, M. (2013)
"Continuous time trading of a small investor in a limit order market",
forthcoming in Stochastic Processes and their Applications.

Langenbucher, K., Bliesener, D., Spindler, G. (2013)
"Bankrechts-Kommentar",
C.H. Beck, München.

Orphanides, A., Wieland, V. (2013)
"Complexity and Monetary Policy",
International Journal of Central Banking, Vol. 9 (S1), pp. 167-204.

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

Slamka, C., Skiera, B., Spann, M. (2013)
"Prediction Market Performance and Market Liquidity: A Comparison of Automated Market Makers",
IEEE Transactions on Engineering Management, Vol. 60, Issue 1, pp. 169-185.

Wandt, M. (2013)
"Versicherungsverbote im Rahmen von Embargomaßnahmen",
Zeitschrift für Versicherungsrecht, Haftungs- und Schadensrecht (VersR), pp. 257ff.

Recent SAFE Working Papers

No. 7 **Darracq Paries, M., Faia. E., Rodriguez Palenzuela, D.**
"Growth Options and Firm Valuation"

No. 6 **Kraft, H., Schwartz, E. S., Weiss, F.**
"Growth Options and Firm Valuation"

No. 5 **Vilkov, G., Xiao, Y.**
"Option-Implied Information and Predictability of Extreme Returns"

No. 4 **Kaustia, M., Rantapuska, E.**
"Does Mood Affect Trading Behavior?"

No. 3 **Kaustia, M., Lehtoranta, A., Puttonen, V.**
"Does sophistication affect long-term return expectations? Evidence from financial advisers' exam scores"

No. 2 **Kaustia, M., Knüpfer, S., Torstila, S.**
"Stock Ownership and Political Behavior: Evidence from Demutualization"

No. 1 **Georgarakos, D., Haliassos, M., Pasini, G.**
"Household Debt and Social Interactions"

The EU must make a Fresh Attempt for the Uniform Regulation of Financial Markets

Florian Rentsch

Hessian Minister for Economics, Transport, Urban and Regional Development

The 2009 G20 summit in Pittsburgh appears to be forgotten. In face of the crisis, the world's 20 most important economies then made far-reaching decisions on the restructuring of financial markets. A common basic understanding was that a global financial market requires a (as far as possible) global regulatory framework in order to be effective – both in terms of itself and the overall economy. However, as the interval since the financial market crisis increases, the consensus that was achieved then evaporates. This carries the risk of regulatory arbitrage, the renationalization of financial markets and ultimately the weakening of international trade and investment activities.

There is notable divergence and uncertainty: The United States (US) postponed the introduction of "Basel III" for indefinite time. Given the experiences from the still not yet introduced "Basel II" accord, this provides a poor outlook. Also, the separation of investment banking from the rest of a universal bank's activities (i.e. commercial banking) is understood differently in the US than on this side of the Atlantic. In turn, within the European Union (EU), many questions were controversial for a long time, as shown by the contentious discussions on the structure of an EU banking supervision and settlement, the Capital Requirements Directive IV (CRD IV), the Solvency II Directive (Solvency II), the Markets in Financial Instruments Directive II (MiFID II) and the financial transaction tax. Debate on a greater separation between trading and deposit business has only just begun in the EU, and the proposed solutions, for example those of the Liikanen Group, differ significantly from the proposals developed by the Vickers Commission in the United Kingdom. In addition, the regulation of so-called "shadow banking" is still in its infancy.

The delay of these important regulatory plans has led to solo initiatives in the EU. On 1 August 2012, France introduced its own financial transaction tax, whilst Germany's Federal Government is pushing ahead with such a levy together with other Member States. On 14 February 2013, the European Commission adopted a proposal for a Council Directive implementing enhanced cooperation in the area of financial transaction tax. This follows the decision of the Council to authorize enhanced cooperation between 11 Member States and the previous consent of the European Parliament. It can be critically questioned if the adopted provisions and especially the "residence principle" and the newly added "issuance principle" are suitable to prevent financial transaction tax avoidance.

At the same time, Germany's Federal Government is planning a law on high frequency trading – ahead of the EU decision on (MiFID II). However, there are serious objections to this plan – not only because of the isolated nature of the action but also due to issues of substance. For example, for the first time ever, the future classification of high frequency trading as financial or investment services will make proprietary traders subject to a license requirement under the German Banking Act (Kreditwesengesetz, KWG). This, however, is associated with significant costs, as the KWG aims to protect customer deposits. Proprietary traders would bear these costs even though they are not speculating with client money. Thus, an authorization requirement under the German Stock Exchange Act (Börsengesetz) would be more reasonable. Otherwise, there is the fear that the trading participants newly affected by this requirement may withdraw from German stock exchanges.

On 6 February 2013, the German government proposed legal requirements for a separation of proprietary trading and traditional banking business (e.g. lending and deposit business) to stabilize the banking sector. Although the basic concept is coordinated with France, this is the latest example for heterogeneous activities in the EU.

The examples clearly show that isolated initiatives thwart all efforts to unify a single judicial area. The EU and its Member States must therefore make a fresh attempt to provide uniform solutions for pivotal regulatory tasks.

Events

April

Tuesday, 9th
5.30 – 7.00 pm
CFS Presidential Lecture
Will the Euro destroy the European Union?
Speaker: George Soros, Soros Fund Management LLC

Tuesday, 16th
4.15 – 5.30 pm
Finance Seminar
Speaker: Rüdiger Fahlenbrach, École polytechnique fédérale de Lausanne

Wednesday, 17th
5.15 – 6.30 pm
Applied Microeconomics and Organization Seminar
Speaker: Mikhail Drugov, Universidad Carlos III de Madrid

Thursday, 18th
12.15 – 1.45 pm
Frankfurt Seminar in Macroeconomics
Speaker: John Knowles, University of Southampton

Tuesday, 23rd
4.15 – 5.30 pm
Finance Seminar
Speaker: Alok Kumar, University of Miami

Tuesday, 23rd
5.30 – 7.00 pm
CFS Colloquium
Die BaFin als Teil der europäischen Aufsichts-strukturen
Speaker: Elke König, Federal Financial Supervisory Authority (BaFin)

Wednesday, 24th
5.15 – 6.30 pm
Applied Microeconomics and Organization Seminar
Speaker: Christian Leuz, Chicago Booth

Thursday, 25th
5.15 – 6.45 pm
International Economic Policy Research Seminar
Speaker: Gianmarco Leon, University of California, Berkeley

Tuesday, 30th
4.15 – 5.30 pm
Finance Seminar
Speaker: Lasse Heje Pedersen, Copenhagen Business School

May

Monday, 6th
12.15 – 1.45 pm
Frankfurt Seminar in Macroeconomics
Speaker: Melissa Dell, Harvard University

Monday, 6th
5.00 pm
EFL Jour Fixe
Green IS and Sustainability of Business Processes
Speaker: Stanislav Kreuzer, Goethe University

Tuesday, 7th
4.15 – 5.30 pm
Finance Seminar
Speaker: Søren Hvidkjær, Copenhagen Business School

Wednesday, 8th
5.15 – 6.30 pm
Applied Microeconomics and Organization Seminar
Speaker: Sergei Guriev, New Economic School, Moscow

Tuesday, 14th
4.15 – 5.30 pm
Finance Seminar
Speaker: Engelbert Dockner, Vienna University of Business and Economics

Tuesday, 14th
7.00 pm
GBS Broaden your Horizon
Die Rolle der Ratingagenturen in der Wirtschaft und in der Krise
Speaker: Daniel Kolter, Moody's Germany, Benjamin Sahel, ECB

Thursday, 16th
12.15 – 1.45 pm
Frankfurt Seminar in Macroeconomics
Enrichetta Ravina, Columbia Business School

Tuesday, 21st
4.15 – 5.30 pm
Finance Seminar
Speaker: Evgeny Lyandres, Boston University

Tuesday, 21st
IMFS Distinguished Lecture
Speaker: James Bullard, Federal Reserve Bank of St. Louis

Wednesday, 22nd
7.00 – 9.00 pm
ILF Guest Lecture
Common Banking Supervision in the Eurozone
Speaker: Guido Ferrarini, University of Genoa

Wednesday, 22nd
5.15 –6.30 pm
Applied Microeconomics and Organization Seminar
Speaker: Pauline Grosjean, University of New South Wales

Tuesday, 28th
4.15 – 5.30 pm
Finance Seminar
Speaker: Geoffrey Tate, UNC Kenan-Flagler Business School

Wednesday, 29th
5.15 – 6.30 pm
Applied Microeconomics and Organization Seminar
Entrepreneurial Innovation, Patent Protection and Industry Dynamics
Speaker: Javier Suarez, Centro de Estudios Monetarios y Financieros (CEMFI), Madrid

June

Monday, 3rd
2.15 – 3.45 pm
International Economic Policy Research Seminar
Speaker: Andrei Shleifer, Harvard University

Monday, 3rd
5.00 pm
Joint Micro- and Macroeconomics Seminar
Speaker: Andrei Shleifer, Harvard University

Monday, 3rd
5.00 pm
EFL Jour Fixe
The Development of German Installment Loans: An Age Group Analysis
Speaker: Philipp Blommel, E-Finance Lab

Tuesday, 4th
4.15 – 5.30 pm
Finance Seminar
Speaker: Loriano Mancini, École Polytechnique Fédérale de Lausanne

Thursday, 6th
5.15 – 6.45 pm
International Economic Policy Research Seminar
Speaker: Marianne Saam, ZEW Mannheim

Tuesday, 11th
5.30 – 7.00 pm
CFS Colloquium
Banking in Times of Low Interest Rates: New Strategies for Universal Banks
Speaker: Anshu Jain, Deutsche Bank AG

Wednesday, 12th
5.15 – 6.30 pm
Applied Microeconomics and Organization Seminar
Speaker: Alexander Sebald, University of Copenhagen

Thursday, 13th
5.15 – 6.45 pm
International Economic Policy Research Seminar
Speaker: Jean-Marie Baland, University of Namur

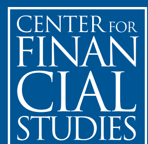
Tuesday, 18th – Wednesday, 19th
9.00 am – 5.00 pm
CFS and NETSPAR Research Conference
International Pension Workshop

Thursday, 20th
12.15 – 1.45 pm
Frankfurt Seminar in Macroeconomics
Speaker: Greg Veramendi, Arizona State University

Wednesday, 26th
5.15 – 6.30 pm
Applied Microeconomics and Organization Seminar
Speaker: Yves Zenou, Stockholm University

Thursday, 27th
12.15 – 1.45 pm
Frankfurt Seminar in Macroeconomics
Speaker: Hans Gersbach, ETH Zurich

Please note that for some events registration is compulsory.



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