



Financial Markets Group

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FMG Business Forum

On 30 January, the FMG hosted the inaugural Business Forum. Chaired by Professor Ron Anderson, its purpose is to offer a service to the financial sector, namely a neutral meeting ground for the discussion of fundamental industry issues. The first Forum met to discuss the question: 'Financial Research: What is the New Business Model?'

Professor Ron Anderson opened proceedings by referencing traditional academic issues relating to the business model of financial research: the creation and dissemination of information through prices, the Grossman-Stiglitz paradox and the need for frictions to generate an incentive to undertake research.

The panel to consider the new business model was composed of Gary Baker (Director of Research at Merrill Lynch), Bunt Ghosh (Director of Fixed Income Research at CSFB), Alastair Ross Goobey (Hermes Pension Management) and Christina Sinclair (Financial Services Authority).

In the first session Gary Baker presented the view of financial research from the perspective of an equity analyst. He suggested that the role of research would not change, in that its principal aim will still be to generate ideas for clients. How the new regulatory issues needed to be addressed, however, would vary across industries. Organisation and remuneration of equity analyst teams, for example, needed to mirror the corresponding organisation on the fund management/buy side, ie, scale consolidation on the one hand combined with a certain amount of fragmentation, in the shape of hedge funds, on the other. In other words, the question was not how research should be organised, but rather how the entire industry would be organised.

At present, equity analysis tends to resemble corporate bond analysis, with focus on macro themes, rather than emphasis on individual stocks. Baker noted that there was a greater need to distinguish between the separate demands of retail and institutional customers and that there were increasing economies of scale both in the general and the bespoke forms of research. However the latter was now regarded as the more valuable type. Overall, market economics had transformed the research function over the past 12 months more so than regulation.

Bunt Ghosh pointed out that the fixed income markets are bigger than equities but do not capture the regulators' imagination to the same extent and suggested that fixed income was being inappropriately dragged into equity-based regulatory structures. Whereas equities were an agency business, fixed income was a (substantially OTC) principals' business, as evidenced by the fact that CSFB devoted six times as much of its capital to fixed income as to equities.



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FMG Business Forum

Thus a fixed income analyst's remuneration depended on working internally with the traders, not on external fund manager voting schemes. Current US regulatory ideas (aimed at equities) reduced the amount of research that would be publicly available. Rather than dealing with the 'hassle' of adapting to a range of regulatory regimes, one would operate to the tightest. As a fixed income manager, he had relatively little interest in doing public research, partly because the benefit of research would be greater when working internally and also because FSA regulations would not prohibit unpublished verbal interaction between the analyst and the client.

Alastair Ross Goobey argued that the current research model was unsustainable. The institutional client did not trust equity research recommendations, with there being too much valueless research on the back of corporate earnings announcements. The truly valuable research tended to be highly strategic, did not entail a specific trade, and built long-term business via relationships with clients. Public research now focused on a smaller number of stocks and there was room for research co-sponsored by investment funds. In fixed income, this might be provided by the rating agencies; but there was a question mark over whether such research could be sufficiently forward-looking.

Goobey also asked the question of how the cost of increased regulatory overheads should be covered. The fund managers would not pay hard cash (because their business model, too, had recently deteriorated), so ultimately the client would have to pay. However, clients might be equally unwilling and the usual free rider problem also existed in relation to paying for research. Mergers and Acquisitions (M&A) departments had previously paid for some of the sell side's equity research but were also increasingly inclined not to do this and to favour proprietary research instead. In summary, the business model for both equity and fixed income research was now less attractive, with greater focus on higher quality research and less frequent trading.

Christina Sinclair stressed the FSA's emphasis on consumer protection. US changes had been brought about by much-publicised problems, which did not exist to the same extent in the UK. She pointed out that the impact of investment banking relationships on equity research was evident in the fact that buy recommendations were more than twice as likely as sell recommendations. Such conflicts of interest with the broking function existed in a number of areas including underwriting and position taking. On this subject, Sinclair mentioned that last year an FSA discussion paper had analysed the causes of such problems and the short-term incentives, which might interfere with analyst priorities.

In the US, the SEC had devised prescriptive rules on disclosures and the relationships between analysts and other areas within investment banks. They had also provided increased scope for litigation, and suggested that there should be more independent research. In the EU, the European Parliament's Cesar Group was working on these issues and the FSA would soon be publishing a consultation paper. Though at the time, the contents of the latter were confidential, the FSA chairman had made public that: (i) the FSA was not planning to impose hard cash payment for research, (ii) the actual problem was seen as lying with conflicts of interest within banks (ie, it was not helpful if an analyst's remuneration was linked to one client but s/he was also servicing another), (iii) that records of trade recommendations should be made public.

During the first session's floor discussion, Giles Keating suggested that research should be made more proprietary; noting that hedge funds required only a small amount of highly focused proprietary research. Ghosh pointed out that equity research was around eight times more expensive, in terms of people and budget, than fixed income research and this used to be financed by fixed (new issue) commissions. Equity research, Ghosh suggested, might look more like fixed income research in future, with increased emphasis on secondary market trading.

Baker stressed the absence of a requirement on corporations to treat all equity analysts equally

regardless of their recommendations. In order to be rated by institutional clients, an analyst might need to be 'nice' to the company s/he wished to cover. Goobey emphasized the issue of compensation based on transaction volume rather than client esteem, while Baker pointed out that, even though 'regular reporting' may constitute lower-value research, it in effect forms part of the duties of an analyst wishing to follow a particular stock.

A participant from Standard and Poors reported the challenge facing independent research houses without income from corporate finance or trading. He described a consultation process whereby clients proved very interested in helping to shape the research product but less willing to pay for it. Independent research houses benefited from having to spend fewer resources on marketing and maintenance. Two possible business models were either 'proprietary' research, ie, a small number of customers paying 'top dollar'; or independent research subsidised by a regulatory tax, the Spitzer idea. He pointed out that it was almost impossible for big investment banks to treat diverse clients with differing needs equally.

A second panel discussed the new practitioner-academic interface and was composed of Jamil Baz (Director of Fixed Income Research at Deutsche Bank), Victor Haghani (JWM Partners), and Prafulla Nabar, (European Fixed Income Research Department at Lehman Brothers).

The second panel session began with **Jamil Baz**, who described the difference between academic and practitioner research in terms of 'the five S's':

1. Scope. Academics were interested in precise answers to 'uninteresting' questions (for example particular closed-form solutions), practitioners in imprecise answers to more market relevant questions (for example the price behaviour of equities versus bonds). Academia had much to offer in the areas of microstructure, corporate finance, asset pricing and regulation and offered aesthetic answers to fashionable questions (such as the CIR model as an example of reverse engineering). On the other side of the interface, the market asks the question and the answer is always inelegant.

2. Substance. Good financial practitioner research was never generalisable but made money.

3. Style. Academia externalised knowledge. Practitioner research needed to be elegantly and confidently presented. The analyst needed to take a view and to internalise knowledge.

4. Signal. When considering the quality of research, one was faced with a low signal-to-noise ratio on the academic side of the interface and a high signal-to-noise ratio on the practitioner side. It had been shown that an unrealistically long period of time would have to pass before one could say with confidence that an analyst's out performance was due to skill. A good research manager needed to weed out analysts that systematically tended to issue recommendations that were likely to be successful but entailed great downside risk.

5. Sincerity. Practitioners essentially only care about their salaries and bonuses. This raised important questions about how one might segregate the bonus pool to take away existing incentives toward systematic bias, and the costs that this might create.

During the subsequent discussion, Professor Greg Connor asked whether it was time to broaden the scope of academic research 'away from maths and game theory and towards the social psychology of finance'. Behavioural finance has had some impact in asset pricing, but not in the study of institutions and of financial regulation. The classical model was missing a lot of the social mechanisms, eg., the group dynamics of pension fund sponsors and their willingness to pay for a public good. Looking back at his own experience of risk modelling, he noted that the study of management psychology might have offered higher marginal benefit than further fine-tuning of the statistical models.

Victor Haghani then spoke about the benefits to the practitioner of the existing research interface, namely the flow of ideas, and the tools and frameworks in areas including portfolio theory, efficient markets theory, capital structure, derivatives and the theory of exchanges. Academic research, in turn, tended to be led by

the actual commercial transactions observed in the market. Meanwhile, he observed a wide spectrum of financial market research, which was largely alive and healthy. Institutions regarded the removal of research bias as being in their own interest. The main current problem existed in traditional equity research and was due to incentive problems relating to advisory work.

Referring to Shiller's work which 'blew the whistle on market irrationalities', he saw an increased role for academia following the 'humbling' market experience of the last several years. Returning to the fundamental question, namely: 'If markets are rational, how can research be valuable? If research is valuable, how can it be available to everyone?'. He explained that all active managers must do their own research, even if this meant no more than simply processing material they received.

Prafulla Nabar described himself as an academic turned market analyst. Relating to his early experience in the market, and his early apprehension about the requirement that research must make money, he noted that the market needed time to understand incoming data, and that during this process of assimilation, as the market moved from one equilibrium to another, there was an opportunity for the desk to make money. Practitioner research needed to be very timely and involved not just receiving and interpreting information but also observing market responses and the behavioural patterns of certain classes of market participants. In other words, research was able to learn from the flows.

Nabar explained why practitioner research could never be rigorous and that the nature of the commitment to the external and internal client base was such that one could never afford 'not to have an opinion'. Rather, the skill lay in getting direction right more often than not and having an idea about how long the process of price incorporation of a piece of information took. These were areas in which academic research was found to be lacking.

During the second session's floor discussion, Professor Ron Anderson took up the Spitzer idea of substantial funding for independent research and made the case that, subject to style change and being able to get flow data, no-one would be better placed to carry out such research than academia. Bill Shadwick disagreed and made the distinction between 'research' and 'R&D'. The two professions followed fundamentally different goals. Academics needed to increase the body of knowledge, practitioners needed to increase return to shareholders. Another participant described the difference as that between the journalist and the novelist, where the journalist produced imperfect work subject to the daily discipline of tight deadlines.

It was argued that, in a world without research analysts, traders and fund managers would have to start doing their own research. Victor Haghani said that there was nothing wrong with practitioner research, one just needed to be honest about its function – eg., that traditional equity research existed to gather information and was relatively unlikely to make you rich. Kevin James from the Bank of England expressed surprise that there was not a much greater divide between academics and the industry. After all, academics had proved instances of collusion and price fixing, showed that average fund manager performance is low, etc. Also, investment banks profited from inefficiency whereas academics and regulators worked to make markets more efficient. Other participants disagreed and described these cases in the context of a relationship between academic and practitioner research, which was, overall, profitable.

Professor David Webb thanked the speakers and pointed out that the Department at the LSE annually taught 700 undergraduates and 200 postgraduates, most of whom went on to work in the industry. Also, those young academics frequently made presentations in the City and that this helped them to get a feel for the relevance of the work that they were doing. In other words, that the research interface benefited both sides.



Workshop on Pensions Green Paper

Workshop on Pensions Green Paper

'more should have been done regarding topics such as the asset allocation and management style of pension funds and the financial advice provided through the workplace.'

The Government published its Pensions Green Paper in December 2002 entitled 'Simplicity, Security and Choice: Working and Saving for Retirement'. The Green Paper is a response to concerns that demographic changes make the current arrangements for UK pension provision unsustainable. As part of the ongoing UBS Pensions Research Programme at the LSE, on Tuesday 4th March 2003 the FMG held an evening workshop to examine the issues raised in the Green paper, and assess the extent to which the proposed solutions are likely to be effective.

The event was chaired by **Professor Ian Tonks** (CMPO, University of Bristol/UBS Pensions Research Program, FMG, LSE). In his introductory speech, Tonks noted that the Green Paper essentially builds upon two premises. The first is that demographic problems are expected to be less acute in the UK than in other European countries, so that the consequences for pay-as-you-go state pensions can be overcome with a more flexible approach to the retirement age. The second is that a significant number of people under-save with regard to their retirement income needs and should thus be provided with the means and incentives to fill this savings gap.

Carl Emmerson (IFS) commented on Chapter 3 of the Green Paper, entitled 'Informed Choice in Pensions'. This Chapter suggests three reforms aimed at easing the decision-making process for individuals with respect to saving, through reducing the complexity of such decisions. Key measures are a radical simplification of the tax regime, greater encouragement to a phased retirement and the provision of more information on savings options and pensions forecasts. Emmerson pointed out that, while these measures

are desirable per se, they may have, at most, a marginal impact on any under saving problem.

Professor David Blake (Birkbeck College/UBS Pensions Research Program, FMG, LSE) addressed Chapter 4, 'Pensions and the Workplace'. This Chapter outlines proposals to encourage workplace savings. Simplified administration of occupational schemes as well as more flexible rules for scheme funding and contracting out are meant to increase employers' involvement. On top of this, a higher seniority of pension related claims and a new regulator are proposed to restore employees' confidence. Blake first pointed out that these two sets of measures have competing effects. He also stressed that the very significant underfunding of existing defined benefits occupational schemes had not been tackled and that only greater compulsion is likely to fill the under savings gap.

Professor Phil Davis (Brunel University) dealt with Chapter 5, 'Financial Services: Building Trust', which examines the role of the financial services industry. He acknowledged the action undertaken to clear up pensions mis-selling and the introduction of new products such as stakeholder pensions. He proposed that more should have been done regarding topics such as the asset allocation and management style of pension funds and the financial advice provided through the workplace. He also deplored the fact that key issues had been ignored, such as the introduction of compulsory funded pensions, the survival of defined benefit schemes and financial education of future consumers in schools. Finally, Davis mentioned that collective arrangements set up in other countries, such as American 401 (k) plans, seemed more likely to address issues

related to personal defined contributions plans, and could be a source of inspiration for the UK.

Dr Jonathan Wadsworth (Centre for Economic Performance, LSE), provided comments on Chapter 6, 'Extending Opportunities for Older Workers'. Wadsworth described two sets of measures proposed to enable people to work longer. The first one consists of making the unreduced pension payable from age 65 rather than 60 for public pensions schemes, and an increase in the State Pension Age for women between 2010 and 2020 to match State Pension Age for men. The second one is meant to decrease the inactivity rate for people over 50 by addressing the tax, pensions or incapacity benefits rules, which distort incentives to work after 50. Wadsworth emphasized that three million people between 50 and the State Pension Age were still out of the labour market in spite of a general rise in the activity rate during the 90s. He also pointed out that roughly 70 per cent of them suffered from long illness or disability, so that introducing incentives for workers to remain in work after 65, was unlikely to be effective.

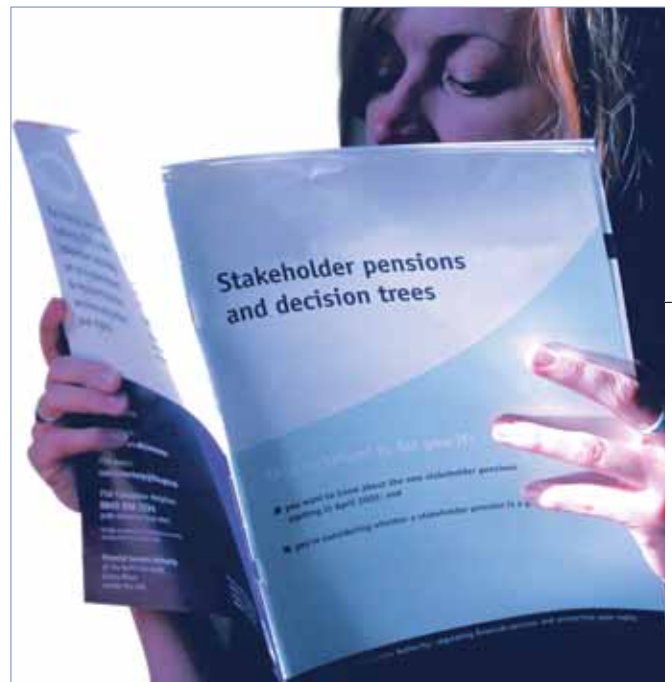
He concluded by suggesting that suspect even if it was possible to get these people back into work there is no guarantee that they would be saving for (later) retirement which seemed to be the implied thrust of the Green paper argument.

Finally, Dr Jay Ginn (Sociology Department, Surrey University and Netherlands Institute for Advanced Studies) analysed Chapter 7, 'Women, Work and Pensions'. She pointed out that reforms designed to help mothers maintain employment, such as improved maternity and paternity provisions and Child Tax Credit, would only affect women below 40. As a result, the over-representation of women among pensioners

with a low income will continue for several decades. The Green Paper, while acknowledging this, does nothing to remedy the situation.

Dr Jay Ginn (Surrey University and Netherlands Institute for Advanced Studies) analysed Chapter 7, 'Women, Work and Pensions'. Ginn acknowledged some improvements regarding women's labour market positions, extra support for families and changes to maternity and paternity provisions. However, she emphasized that these measures target mainly women below 40, so that they should have an impact on women's pensions only in the long run.

As a result, the overrepresentation of women in low-income pensioners groups will continue for several decades, and the Green Paper, while acknowledging this point, does not suggest much to tackle it.



Discussion Papers

Discussion papers



DP 407

Consistent Testing for Stochastic Dominance: A Subsampling Approach

Oliver Linton, Esfandiar Maasoumi and Yoon-Jae Whang

In economics and finance, utility functions are frequently employed to order different outcomes/prospects, the preferred one being that with the highest utility. Examples are investment strategies, welfare outcomes and program evaluation exercises. One question, however, is whether economic agents have the means and willingness to select an actual utility function to describe their preferences. And even if they do, the researcher still faces the problem of uncovering this function. In this situation uniform order relations may be preferable where an ordering is set up without selecting a specific utility function, the most popular order relations being the Stochastic Dominance (SD) relations.

Linton, Maasoumi and Whang investigate how to implement the SD relations in a semi/non-parametric setting given a sample of prospects while allowing for a high degree of flexibility. The main objective of the paper is to set up a consistent test for a class of prospects being stochastically maximal; that is, no prospect dominates the others.

The test statistics employed are the same as those in Klecan, McFadden and McFadden (1991). But in contrast to that paper, the authors here make use of the so-called 'subsampling' procedure (see eg., Politis, Romano and Wolf (1999)) to estimate the critical values of the test statistics. This procedure is related to the bootstrap and jackknife procedures but is much more robust allowing for almost any

model and/or dependence structure. The benefits from applying the subsampling procedure to the test for stochastic maximality are twofold: (i) One obtains a better finite-sample performance of the test statistics while (ii) allowing for general dependence structures between the sampled prospects. The main result of the paper offers conditions under which the proposed tests for stochastic maximality are consistent.

The performance of the test statistics is demonstrated in a simulation study and with an application to the daily returns of the Dow Jones Industrial and the S&P500 stock returns.

DP 408

Coordination Failure and the Lender of Last Resort: Was Bagehot Right After All?

Jean-Charles Rochet and Xavier Vives

In the presence of deposit insurance schemes, the only potentially unstable source of short term financing for banks is the interbank market. Several authors have argued that Bagehot's doctrine of the Lender of Last Resort (LLR), according to which it is desirable to provide liquidity assistance to solvent but illiquid banks, is now outdated since this market, involving sophisticated agents, is sufficiently informationally efficient to separate out liquidity and solvency problems.

Rochet and Vives develop a model of banks' financial structure where a solvent bank can be illiquid because of coordination failure among rational and well informed participants in the

interbank market. In contrast to the existing literature on bank runs, the model has a unique equilibrium. This enables them to carry out a normative analysis of the complex interplay between illiquidity and insolvency and derive some regulatory implications.

Their first result is that prudential regulation (solvency and liquidity ratios) can protect solvent banks from being illiquid. The minimal liquidity ratio that achieves this aim is a decreasing function of the bank's solvency ratio: both rules are complementary. However, prudential requirements may dramatically reduce both the banks' abilities to lend and their profitability.

The model also predicts that combining prudential regulation with ex post intervention of a LLR protects solvent banks from illiquidity at a lower cost, provided the LLR adopts 'normal' lending conditions, namely the ones that would prevail in the market absent any coordination failure.

In addition, the model yields predictions regarding the regulator's optimal disclosure policy. An overly transparent disclosure policy may hurt illiquid but solvent banks, even though they have good fundamentals, by further destabilizing the interbank market. This finding rationalizes why regulators or Central Bankers tend to make oblique public statements.

Finally, Rochet and Vives develop an extension of the model where this coordination problem in the interbank market emerges endogenously as an optimal (second best) disciplining device for bank managers, incentivised by the threat of early closure. In this case, they show that the action of a LLR has to be complemented by further regulatory actions (prompt corrective action or orderly resolution of failures), so as to make the disciplining role of the interbank market fully efficient.

DP 409

Platform Competition in Two-Sided Markets

Jean-Charles Rochet and Jean Tirole

Many, if not most markets with network externalities (eg., TV networks, software, payment systems) are characterised by the presence of two distinct sides whose ultimate benefit stems from interaction through a common platform. Unlike in the multiproduct literature (eg., razors and razor blades, inkjet printers and ink cartridges), the externalities created by the strong complementarities between the two sides are not internalised by end users.

The authors present detailed descriptions of several of these markets and observe that the problem of 'getting both sides on board' is central to the choice of business plan and the pricing structure chosen by the platform operators.

The paper then presents an analysis that takes these particular features into consideration and studies how the price allocation between the two sides of the market is affected by issues such as platform governance (for-profit vs. not-for-profit), end users' cost of multihoming, platform differentiation, the platforms' ability to use volume-based pricing, the presence of same-side externalities and platform compatibility. Finally, the authors compare the outcomes with those under an integrated monopolist and a Ramsey planner.

high volatility to generate spreads of a reasonable size.

The problem of co-ordination failure is akin to the problem faced by depositors of a bank that is vulnerable to a run. Even if it is not efficient to foreclose, eg, when the debtor is fundamentally viable but possibly prone to liquidity problems, fear that other creditors may grab assets can lead to pre-emptive action, and can cause a liquidity crisis which can force the borrower into restructuring. Although the prevention of co-ordination failures is one of the key aims of all bankruptcy codes, whether or not co-ordination failures arise in practice depends on the effectiveness of the legal provisions in bringing structure to formal and informal renegotiation. Deviations from principles laid down in bankruptcy codes, such as, for example, deviations from absolute priority rules are well documented.

DP 410 derives a continuous time Merton-type model of bond prices with the simplest possible assumptions, integrating co-ordination failure. The resulting model is essentially a Merton model with a default barrier. It shows that models of this kind can produce reasonable spreads. A preliminary empirical calculation indicates that co-ordination failure can possibly explain some of the empirical difficulties of the Merton model.

power, since the latter does not have to search as hard to find a suitable entrepreneur.

Bargaining and contractual form matter in this setting because the project's expected returns are affected by both the venture capitalist's and entrepreneur's effort choice. The optimal incentive contract would seek to balance the incentives of both agents through the allocation of risky claims. Ultimately, however, this allocation is governed by respective bargaining powers. As a result, when capital supply is high or low, bargaining powers are strongly asymmetric and incentive contracts deviate from the second best. Consequently, net value created (as well as gross value and success probability, provided that efforts are complements) is a hump-shaped function of capital supply. This deviation from second-best allocations also creates a role for public policy measures.

The authors then examine the impact of a change in entry costs and find that entry by venture capitalists entails a contracting externality since the individual investor does not take into account the effect of his entry on the overall level of capital supply. Finally, the authors also study the role of capital market transparency and screening. Transparency is shown to reduce search frictions and to amplify the impact of capital market competition on the bargaining outcome while venture capitalists are found to screen more if the level of capital market competition is low.

DP 410

A Structural Model of Corporate Bond Pricing with Co-ordination Failure

Max Bruche

It has been suggested (Morris and Shin 2001) that co-ordination failure between holders of debt could produce an effect that would explain the systematic mispricing of corporate debt produced by the Merton (1974) framework – the Merton model seems to rely on unreasonably

DP 411

Venture Capital Contracts and Market Structure

Roman Inderst and Holger Mueller

Empirical evidence suggests that the venture capital market is highly cyclical and that value created in new ventures as well as the features of contracts written between venture capitalists and entrepreneurs depend on market structure and their respective market power. To capture this dependency, the authors present a model in which the bilateral bargaining game between venture capitalists and entrepreneurs is embedded in a search theoretic framework. A rise in the number of entrepreneurs, for example, translates into an increase in the venture capitalist's bargaining

SP 136

Securities and Banking: Bridges and Walls

Tommaso Padoa-Schioppa

In this paper the author considers the relationship between banking and securities activities in light of a number of market developments, with particular emphasis on the EU financial system, where the importance of securities markets has significantly increased.

Discussion Papers

The author observes the emergence of several strong bridges between banking and securities activities, considering for example: Securitisation, institutionalisation of investment, emergence of complex financial instruments, conglomeration, and consolidation. Securitisation refers to the shift in the financial system away from the dominance of non-marketable instruments (bank loans and deposits) to marketable securities. Institutionalisation of investment refers to the increased purchase of securities via collective investment vehicles, such as mutual funds, pension funds and life insurance. All in all, securities have become more important for many banks, either directly or via their subsidiaries, thereby establishing a strong bridge between banking and securities activities. The third structural change is the rapid growth in complex financial instruments designed to unbundle, trade and transfer risks. This implies that banks are losing their monopoly position over instruments involving credit risk, as credit risk can be traded and re-allocated to other financial institutions. Conglomeration can be defined as conducting within one financial institution or group at least two of the three traditionally distinct activities of banking, securities and insurance. Consolidation consists of the establishment of large and complex financial institutions with sizeable market position. The author mentions that all these five changes represent major bridges between banking and securities activities but also suggested the possibility of both increased risk and new types of risks to individual financial institutions arising from securities activities. He took the view, however, that this should not lead to the belief that non-bank financial firms have become sources of systemic risk in their own right, as long as the banking system itself is not disrupted. The author points out that indeed, the special role of banks in liquidity provision remains a basic distinction between banking and securities businesses. For these reasons, stepping up the micro and macro prudential monitoring of risks emerging from securities activities should be a clear priority. This entails strengthening co-operation among sectoral supervisors in the

micro-prudential field, and between them and central banks in the macro-prudential field.

The strengthening of co-operation should take place both at the national level and on a cross-border basis.

SP 137

Supervising the European Financial System

Karel Lanoo

The EU's financial sector has been undergoing many waves of reform in the past decades. By the end of the nineties, it had become clear that the integration process of the European financial regulation system was still far from complete. The double objective of this paper is to give an overview of the present state of this process in the different industries of the financial sector and highlight the future challenges.

The paper considers the desirability of a single integrated European supervisory authority and suggests that although there are possible advantages of such a framework, the fundamental and political problems imply that the best solution would be to keep certain functions at the national level.

In future, the rules of enforcement must also be strengthened with special attention paid to the new entrant states and at present the role of different European institutions in the systematic risk and crisis management of the Euro area is still not clear. However, the work of the Committee of Wise Men under the Chairmanship of Alexandre Lamfalussy resulted in a detailed reform proposal of the legislation of financial services, the successful implementation of which is still to be seen. Similarly, the results of the Basel II Review must be included in the EU directives and it will certainly be a difficult process considering the extent of the differences between the various interest groups.

SP 138

Sovereign Bonds and the Collective Will

Lee Bucheit and Mitu Gulati

This paper assesses the feasibility of a supranational bankruptcy regime for sovereign borrowers by considering a situation where existing contractual arrangements, applicable to corporate bond issues, could be used as guiding principles for sovereign debt reorganisation.

Analogous to debt workout procedures adopted by corporate bond issuers, intercreditor disputes following default, constitute as big a problem for sovereign borrowers as it is for corporate bond issuers. Bucheit and Gulati acknowledge that several prime concerns of orderly debtor reorganisation are shared in both instances: the control of the 'grab and run' instinct of each bondholder, the binding nature of collective judgement about the terms of a debt workout and the ability to discipline dissident creditors into accepting the preferential buyout of majority claims. Recognising these concerns, the authors explore how existing bankruptcy laws could facilitate sovereign debt workouts. Firstly, they survey the history and legal rationale of existing provisions sovereign bonds (eg., 'majority action clauses', 'amendment clauses', 'acceleration clauses' and 'enforcement restrictions'). Bucheit and Gulati argue that the use of collective decision-making provisions in sovereign bonds could lead to successful outcomes in a similar way to collective decision-making provisions in corporate. Furthermore, the authors discuss the legal aspects that may impede the use of contractual provisions to restructure foreign sovereign debt. When considering the possibility of introducing a 'Chapter 11 procedure for sovereigns', the authors resent what they consider a bashful and ambivalent reaction of capital markets to mechanisms that would ensure that contractual provisions such as majority action clauses would become a standard feature in sovereign bonds. This, they argue, would needlessly aggravate the impact of these measures ensuring majority creditor control in future sovereign debt workouts.

Forthcoming Discussion and Special Papers

Discussion Papers

DP 412

Market Timing and Return Prediction under Model Instability

M Hashem Peseran and Allan Timmermann

DP 413

Dividends and Equity Prices: The Variance Trade Off

Margaret Bray and Giovanni Marseguerra

DP 414

Rational Asset Pricing Implications from Realistic Trading Frictions

Jean-Pierre Zigrand

DP 415

Hedging Housing Risk in London

Francois Ortalo-Magne and Matteo Iacoviello

DP 416

Speculative Attacks and Financial Architecture: Experimental Analysis of Coordination Games with Public and Private Information

Peter Ockenfels, Rosemarie Nagel and Frank Heinmann

DP 417

How deep was the September 2001 Stock Market Crisis? Putting Recent Events on the American and French Markets into Perspective with an Index of Market Shocks

Thierry Michel and Bertrand Maillet

DP 418

You might as Well be Hung for a Sheep as a Lamb: The Loss Function of an Agent

Charles Goodhart and Margaret Bray

Special Papers

SP 139

Banking Regulation and Supervision in Japan

Maximilian J B Hall

SP140

Competition and Stability: What's special about Banking?

Philipp Hartmann and Elena Carletti

SP141

Money Laundering:

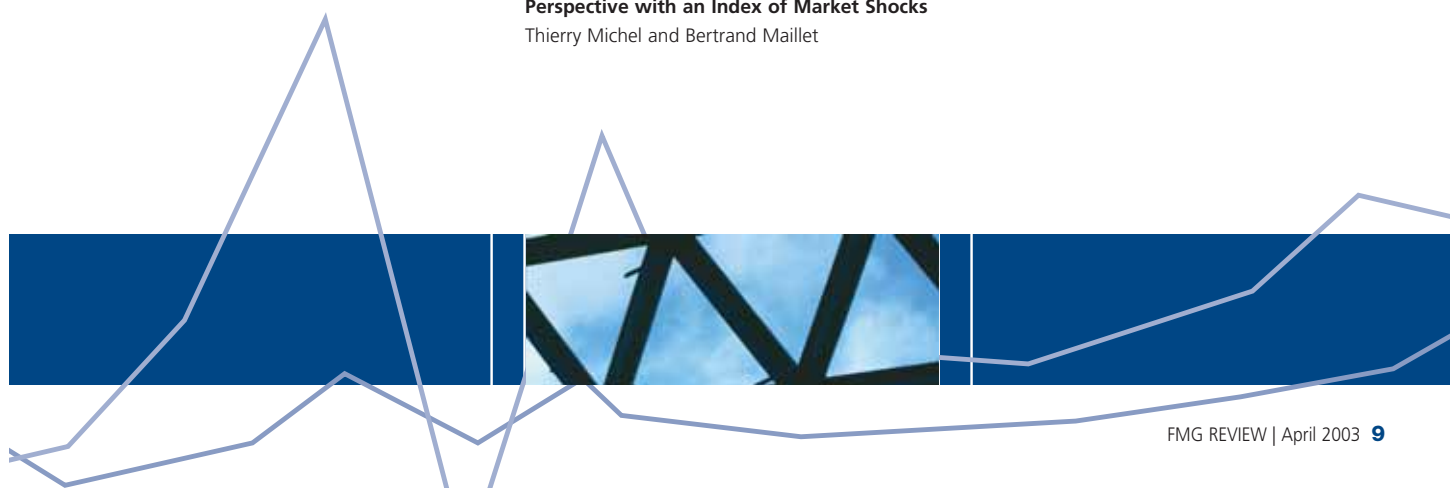
A view from North America

John Moscow

SP142

Self Vs Public Discipline in the Financial Field

Tommaso Padoa-Schioppa



Capital Markets Workshop

Capital Markets Workshop

The Capital Markets
Workshop meets
regularly throughout
the academic year at
5pm on Wednesdays in
room R405, Lionel
Robbins Building, LSE

Summer Term 2003

7 May

Julian Franks (London Business School) joint with Colin Mayer (Said Business School) and Stefano Rossi (London Business School)
'The Origination and Evolution of Ownership and Control'

14 May

Itay Goldstein (Duke University)
'Manipulation, The Allocational Role of Prices and Production Externalities'

21 May

Douglas Gale (NYU) joint with Shachar Kariv (NYU)
'Bayesian Learning in Social Networks'

28 May

Markus Brunnermeier (Princeton) 'Optimal Expectations'

4 June

TBC

11 June

Alman Roy (CSFB) 'Demographics, Pensions & Asset Allocation'

18 June

Steve Zeldes (Columbia)

25 June

Cornelia Holthausen (European Central Bank)
joint with Thomas Ronde (Copenhagen Business School)
'Cooperation in International Banking Supervision:
A Political Economy Approach'

2 July

TBC

DC Webb Revisions to the programme may take place, these will be identified through the website at: <http://fmg.lse.ac.uk>

Job opportunities at FMG

Postdoctoral Research Fellow

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The Financial Markets Group at the London School of Economics and Political Science is looking to recruit a postdoctoral Research Fellow for the academic year beginning in September 2003, to work within the framework

of the European Union funded Research Network on: 'Financing retirement in Europe: Public Sector Reform and Financial Market Development'

The successful candidate will be expected to develop research work in the areas of the research project. For more details on the research project please visit the RTN website at www.lse.ac.uk/ubs/rtn.htm or www.cepr.org/research/networks/FINRET/

Candidates should have completed or be near the completion of a PhD degree.

In addition the European Commission contract specify that applicants must:

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Applicants should send a CV (including details of 2 referees) and a personal research statement, including a specific proposal for research in the pensions area, to:

Maria Komninou
Centre Manager
Financial Markets Group
The London School of Economics and Political Science
Houghton Street
London WC2A 2AE

Or email to: M.Komninou@lse.ac.uk

For more information about the Financial Markets Group please visit our website at <http://fmglse.ac.uk>

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