

Financial Regulation Conference

The Financial Markets Group held a two-day conference on The Future of Banking Regulation on 7 and 8 April 2005, organised by Jon Danielsson, Harald Benink and Charles Goodhart. The event was sponsored by ABN AMRO Bank, the Financial Services Authority and the World Bank. This keynote conference attracted a large audience of policy-makers, practitioners and academics. The keynote speech was delivered by **Jaime Caruana**, Chairman, Basel Committee on Banking Supervision and Governor, Bank of

Spain. The Basel II Capital Accord represents the most significant development in international banking regulation since the original 1988 Accord. Not only is greater risk-sensitivity to be introduced to the minimum capital requirements but also new measures aimed at enhancing supervisory review and market discipline are introduced. The expected economic and policy implications of these reforms framed the debate on The Future of Banking Regulation.

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Jaime Caruana, Governor, Bank of Spain

Public Pensions Programme

Peter A Diamond (MIT, Department of Economics) gave a Public Lecture on 'Reforming Public Pensions in the US and the UK' on 18 May 2005, under the auspices of the UBS Pensions Research Programme at LSE. Professor Diamond described the expected future financing problems of the US Social Security (public pension) system, discussed the reform of the system proposed by the US government, and drew comparisons to the UK system.



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Peter A Diamond, MIT, Department of Economics

New research in Corporate Governance

In Letter but not in Spirit: An Analysis of Corporate Governance in the UK, is the title of a new project launched by the FMG Corporate Finance and Governance Research Programme which sheds new light in the 'comply or explain' approach to corporate governance.

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The Future of Banking Regulation

7 – 8 April 2005

The first session of the conference was organised around a panel discussion on the implications of Basel II. The panel comprised of **Ms Ingrid Bonde** (Director-General, Swedish Financial Services Authority), **Mr John Mooney** (Global Head of Institutional and Corporate Credits, Deutsche Bank AG), **Professor Christian de Boissieu** (University of Paris-I Panthéon-Sorbonne and President, Conseil d'Analyse Economique) and **Professor Richard Herring** (University of Pennsylvania).



Professor Richard Herring (University of Pennsylvania), **Professor Christian de Boissieu** (University of Paris-I Panthéon-Sorbonne and President, Conseil d'Analyse Economique) and **Ms Ingrid Bonde** (Director-General, Swedish Financial Services Authority)

The first speaker, Ms Ingrid Bonde, highlighted that Basel II attempts to go much further than its first version. It introduces greater sensitivity in the capital requirements, without increasing the level of capital in the economy, and enlisting the forces of market discipline in support of the supervisory effort through pillar III. She highlighted the main problems to be faced: the cross-border arrangements for supervision, and the various deposit insurance schemes that are in place.

John Mooney concurred with Ingrid Bonde that the home-host issue was still to be defined more clearly. In his opinion, the home regulator should be the point of reference for the banks and for the host regulators. He showed some concern for the possible increase in the procyclicality of the system that the greater sensitivity of the capital requirements might cause. In order to mitigate it, he would welcome regular reviews, and a spirit of flexibility, to adapt the Basel II framework to ensure smooth functioning of the banking system across the cycle.

Christian de Boissieu, in contrast, suggested that to mitigate the potential increase in the procyclicality banks should be forced to do dynamic provisioning such as is being done in Spain. He also brought to the fore, given the decentralization process that Basel II represents, that it needed a greater level of international coordination and transparency of the regulatory bodies to avoid favouritisms. Finally, Richard Herring, having reviewed the objectives of Basel II, focused on the compliance costs to the banks, supervisors and economic stability, which, in his opinion are likely to be heavier than intended.

The second session analysed the special problems that the implementation of Basel II may cause in emerging markets (EMC). The panel comprised of **Dr Gerard Caprio** (Director Financial Sector Operations and Policy Department, World Bank), **Dr Gerd Häusler** (Counsellor and Director, International Capital Markets Department, IMF), **Dr Jon Danielsson** (FMG/LSE), and **Dr Liliana Rojas-Suárez** (Center for Global Development and Former Chief Economist, Latin America, Deutsche Bank).

The opening speaker, Gerard Caprio, emphasized the view that while private monitoring boosts bank development, official supervisory power lowers it in EMC. Hence, emphasis of the new regulation should be placed on pillar III, and supervisors would still have a crucial role: support market discipline, not supplant it (even in countries like Nigeria!). In contrast, Gerd Häusler put the emphasis on the process that EMC should follow in adopting Basel II. From his point of view, bank supervisors should be guided by the status of their own systems and set a timetable accordingly, without following the pressure of the market to adopt Basel II until they are ready to do so. He reminded the audience that the IMF places more importance on improving supervision and regulation overall (BCP) than on the choice of any particular capital regime, and stands ready to provide technical assistance to lay the foundation for Basel II.

Jon Danielsson highlighted the fact that foreign currency dependent economies would see an increase in procyclicality with the new Regulation. He argued that the amplified procyclicality could be partly reversed by requiring capital charges arising from foreign currency lending to be denominated in foreign currency. Thus, the capital charges would become countercyclical. Finally, in summing up the session Liliana Rojas-Suárez, whilst agreeing to many of the points raised by the other speakers, preferred to concentrate on those that might make the application of Basel II special for EMC. From her point of view, in EMC the capital requirements

need to reflect the 'true risk' of emerging market bank's portfolio, and this might be extremely difficult since there are no deep capital markets that validate the quality of reported capital. As a striking example, she strongly criticized the fact that government paper is treated as a risk free asset in EMC.



Howard Davies (Director, LSE)

Sir Andrew Crockett (President, JP Morgan Chase International and former General Manager, Bank for International Settlements). At the outset Sir Andrew noted that it was a mistake to over-exaggerate the impact of the regulatory changes on large financial institutions. He then discussed various aspects through which Basel II might affect the efficient allocation of resources in the real economy issues highlighted included the potential for, greater consolidation in the banking industry; the impact on risk-taking by banks (and lending to small and medium-sized enterprises and emerging markets); the debate on procyclicality; and, the role of banking versus capital markets. Sir Andrew then moved on to a discussion of the world post-Basel II and how regulation might respond to the increased complexity of financial markets.

Mr Mark Tilden (Director, LECG Consultants) provided details of a recent survey commissioned by the FSA of members of the UK financial services sector on the implementation of the capital requirements directive. The survey covered the operations of individual firms and the wider market implications of the directive. Risk managements and monitoring systems were perceived by larger banks (but not smaller) to be at almost at the required levels already. However, IT systems and databases appeared to be furthest from required levels. Interestingly, whilst respondents considered the directive likely to have an impact on regulatory capital levels (up to a 20 per cent reduction for larger banks with slight increases for small banks) they considered that there would be little impact on market prices, volumes or market shares. Tilden thought that this might reflect the fact that many larger banks are already employing the more advanced credit risk methods and that reductions in capital have relatively small impacts on banks' costs.

The third session of the conference, chaired by **Dr Silvina Vatnick** (Lead Financial Economist, Financial Sector Vice-Presidency, World Bank) and discussed by **Professor Clas Wihlborg** (Copenhagen Business School), focused on the economic consequences of Basel II.

The first presentation was made by

Professor Hyun Shin (FMG/LSE) focused on a related regulatory reform, namely the move to greater market-to-market. He argued that this practice can potentially introduce artificial volatility as market prices both reflect fundamentals and influence actions themselves. Using the results of a global games model, this distortion appears to be greater the more illiquid, senior and long-lived the asset. The discussion, developed on this theme, highlighting the linkages between marking-to-market and the Basel II reforms.



Professor Charles Goodhart (FMG/LSE) and **Jaime Caruana** (Governor, Bank of Spain)

The political economy of the Basel II process was the topic of the fourth session, chaired by Dr Jon Danielsson. **Mr Tom de Swaan** (CFO, ABN AMRO Bank and former Chairman, Basel Committee on Banking Supervision) outlined his views on the key principles for the sound implementation of the Basel II framework – a focus on the quality of legislation, convergence in implementation and a principles-based approach. He noted that one of the main implementation issues for international banks was the tension between the local responsibilities of host regulators and the group-wide responsibilities of the home regulator. He concluded that the implementation should be done consistently across EU regulators to avoid distorting the competitive playing field against the EU banking industry. **Professor Charles Goodhart** (FMG/LSE), picked up on this point and questioned whether it meant that Pillar II of the Basel framework (on the supervisory review process) was 'dead on arrival' and could not be used to address procyclicality as some have argued.

Mr Karel Lannoo (Chief Executive Officer, Centre for European Policy Studies) provided a detailed analysis of the European implementation process of Basel II through the European Parliament, Commission and EU Council. He also returned to the complexity of the home/host issue raised by Tom de Swaan and discussed the questions of supervisory convergence within the EU. **Professor George Benston** (Emory University), based on a paper with Professor Harald Benink (Erasmus University Rotterdam and FMG/LSE), took a different angle – he had come 'not to praise Basel II

but to bury it'. Professor Benston discussed the objectives in regulating banks and the reasons for bank failures. He then argued that Basel II could exaggerate distortions between the incentives for CEOs of banks and for portfolio managers that might increase the risk-taking behaviour of the latter. As an alternative he proposed a 15 per cent capital requirement and then discussed how this could be implemented. The relative merits of this proposal were then debated vigorously between the session discussant, Charles Goodhart, and the authors.



Jaime Caruana (Governor, Bank of Spain)

Governor Jaime Caruana (Governor of Bank of Spain and Chairman of the Basel Committee on Banking Supervision) reviewed the status of Basel II and the critical issues that will determine its future success. Caruana noted that Basel II represents a significant step towards achieving a more comprehensive and risk sensitive supervisory approach, which will

enhance banks' safety and soundness, thereby strengthening the stability of the financial system as a whole. That, in turn, will improve the ability of the financial sector to serve as a source of sustainable growth for the broader economy. He noted that Basel II is about much more than just setting better quantitative minimum capital requirements. It is about establishing an incentive-based approach to risk management and capital adequacy, within a framework of three mutually supporting pillars. Basel II represents an unparalleled opportunity for banks to improve their capital strategies and risk management systems. It provides supervisors with an opportunity to improve their ability to identify banking risks and to enhance the dialogue with the industry and among banking supervisors.

Caruana emphasised that the implementation of the Accord will be key in its final effects on banking stability and competitiveness. Since the Accord gives national supervisors plenty of discretion in the implementation, their future job is very important for the success of Basel II. The accord is a dynamic process, which will have to be adapted to any new issues arising during its implementation process.

Caruana reviewed some of the topics that were addressed in previous sessions: procyclicality, the implementation of Basel II in emerging markets and home/host issues. On procyclicality, he noted that banking variables are by their nature correlated with the business cycle which makes the banking business is procyclical. The main question is whether Basel II will exacerbate such procyclicality. The Basel Committee has introduced a number of changes in the framework in order to mitigate its procyclical effects. Basel II appropriately addresses the main contributors to procyclicality: inadequate shock-absorbers (provisions and capital), poor risk management (lack of understanding and proper controls) and weak financial supervision. In his opinion Pillar I, which is blamed for the Accord procyclical impact, has received too much attention while too little attention has been devoted on the effects of higher transparency of risk profiles and better risk management driven by incentives. He proposed these as the main channels through which the positive effects of Basel II will be felt.

The improvement of risk management is a fundamental challenge in Basel II. Risk management is not just about quantitative models, but also about qualitative issues, ie promoting a risk culture. Improved and more formalized risk management will bring more awareness and better assessment (and quantification) of risks and, as a consequence, fewer surprises, early detection of problems and scope for prompt reaction. To the extent that Basel II leads to better risk management, it will bring better macroeconomic performance of the aggregate banking system. Governor Caruana expressed his hope that other areas of regulation, such as provisioning, will receive as much attention, because those are areas where significant improvements could be obtained.

Regarding the implementation of Basel II, Caruana mentioned three issues that should be taken into account in order to guarantee the success of the Accord: calibration, validation and home/host issues. On the last issue he noted that cross border issues are not new. With or without Basel II there is a need to enhance cooperation in a world that moves towards larger scale cross-border activities and a greater presence of systemic foreign banks in domestic economies. One of the goals of both Basel I and Basel II is to foster a more level playing field for internationally active competitors.

In conclusion, Governor Caruana stressed that the publication of the revised framework was only the beginning of a new important phase: implementation.

A panel discussion closed the conference. The discussants offered their views about the future performance of Basel II.



John Mooney (Deutsche Bank AG) and **Professor Charles Goodhart** (FMG/LSE)

Mr Oliver Page (FSA) argued that the main potential for procyclicality in Basel II comes from credit risk capital requirements. A possible solution could be to measure default probabilities with a longer-term view and to make sure losses, given default, are above their long run average. However he realized that problems of data availability limit the scope of these proposals. In his opinion, Basel II has a lot to say to banks and supervisors on governance, risk management and controls. Page noted that emerging countries should not rush to implement Basel II advanced approaches; they must first improve risk management techniques. In the short term, emerging markets should focus more on pillars two and three.

Mr John Hawke (Former Comptroller of the Currency), addressed the procyclicality problem and warned that trying to combat procyclicality by reducing capital standards is a recipe for disaster in view of past experiences. Hawke asked how Basel II will be able to keep total capital in the banking system while promising banks that adopt advanced approaches to experience capital reductions. He argued that we do not know yet the impact of Basel II on the banking system total capital.

Addressing the issue about the decision of the US of not to apply Basel II to small banks, he stressed that those banks are highly capitalized and that there is no need of Basel II for them. Regarding home/host issues, Hawke argued that the real problem is not an economic but a political one. Host countries, in his opinion, will not accept foreign banks being not supervised by their own supervisors.

Professor George Kaufman (Loyola University) compared Basel II with the FDIC Improvement Act (FDICIA) in the United States. He criticized Basel II for not introducing any principles to supervisors about what to do when banks become undercapitalized, which, in contrast, is one of the key elements of FDICIA. In addition, Basel II does not incorporate a closure rule and Pillar three is more about disclosure than about market discipline. For disclosure to enhance market discipline Basel II should increase banks subordinate debt or reduce the deposit insurance coverage. Overall, Kaufman considers Basel II to be inferior to FDICIA and that, as a consequence, future revisions of Basel II should take note of FDICIA and its least costly resolution closure rule. He concluded on some positive aspects of Basel II, recognizing that it has increased the understanding of banks and supervisors about risk management.

Finally, **Ms Patricia Jackson** (Former special adviser on financial stability at the Bank of England), stressed the positive impact of Basel II through the data collection requirements imposed upon banks. She conjectured that it would increase banks' knowledge about risks in their books, leading to more accurate pricing of their credits. Jackson agreed with Oliver Page in that Basel II could have a positive effect on dampening procyclicality if banks use longer periods of data to calibrate default probabilities and losses given default. ■



The Future of Banking Regulation Conference

Reforming Public Pensions in the US and the UK

Peter A Diamond (MIT)

18 May 2005

Chaired by Professor Timothy Besley (Director, STICERD)



Peter A Diamond, MIT, Department of Economics

Professor Peter Diamond started his talk by presenting the expenditure and revenue projections of the Office of the Actuary for the US Social Security defined benefit system. Revenues are generated from a 12.4 per cent payroll tax on earnings (up to a cap indexed to average earnings) shared by employers and employees plus the income taxation of

benefits. Expenditures are benefit payments indexed to average earnings to ensure that the replacement rates remain roughly constant over cohorts. While the system has been running a surplus, which was used to accumulate trust funds, the increase in life expectancy and the retirement of the baby boom cohort will lead to a cost increase which is expected to exhaust the trust funds by 2041. Accordingly, actual benefits will fall short of promised benefits by 26 per cent in 2041 and will remain too low afterwards unless the system is changed. Commenting on the impact of the accumulated trust funds on national savings, Diamond rejected the view that the trust funds were offset by an increased deficit in the US.

Turning to incentives of the Social Security System to delay the start of benefit payments by some time after retirement (where eligibility for benefits requires a minimum age of 62 in the US), Diamond pointed out that both the US and the UK systems, where a one year delay increases benefits by 10.4 per cent in the UK, are not appropriately designed to

provide increasing percentage increases in benefits with increasing delay as demanded by mortality rates, which raise with increasing age. Sweden could serve as an example for an appropriately designed system, where benefits are adjusted automatically in an actuarially fair way with every update of mortality tables.

Describing the replacement rates in terms of benefits over life-time average wage-indexed earnings generated by the US Social Security system, Diamond emphasised the progressive benefit formula as an alternative approach to achieving the same end by a two-pension program, one giving a flat benefit, while the other provides earnings related benefits. As is the UK, the US system guarantees a minimum income for the elderly. Nevertheless in particular widows frequently fall under the poverty line. Diamond expressed his view that both the prevention of poverty and the provision of appropriate earnings replacement are worthy social goals and opposed the view that Social Security should exclusively focus on poverty prevention.

Similar to the UK, occupational pension schemes play an important role in the provision of pension benefits in the US. Like in the UK, there has been a strong trend away from Defined Benefit (DB) plans towards Defined Contribution (DC) plans, a trend, which is welcomed by Diamond because of the problems many DB schemes face to provide the promised benefits. These problems are indicated by the increasing deficit of the Pension Benefit Guarantee Corporation, the US counterpart of the Pension Protection Fund in the UK.

Turning to the Social Security reform proposal of the Bush administration, Diamond explained the concept of the proposed voluntary carve-out accounts which are similar to the contracting out option in the UK state second pension system in the sense of being financed by existing payroll

tax revenue. The part of the payroll tax diverted into personal accounts would be treated as a loan for which Social Security charges interest. At retirement a worker would repay the accumulated debt through a corresponding reduction of monthly benefits depending on his average life expectancy at that time. The proposed interest rate for the calculation of the debt and the reduction in annuities is three per cent real, the projected rate of return on long-term Treasury bonds held by the Social Security trust fund. Eventually, it would be possible to carve-out a fraction of up to four percentage points of the payroll tax. At retirement, annuitisation of the assets accumulated in the individual accounts would be mandatory to the extent that poverty is prevented taken into account remaining traditional benefits. Since Social Security provides annuities the overall level of annuitisation would decrease after an introduction of individual account, a result seen as a problem by the speaker because of the insurance value of real annuities.

Diamond pointed out that with an indexation of the charged interest rate to Treasury rates the proposed carve-out option is equivalent to selling Government bonds in order to purchase stocks or corporate bonds. The individual accounts were generating higher risk for higher return potentials. As such they were of little or no value for workers who already hold well-diversified portfolios outside Social Security. For workers not already holding external diversified portfolios the new accounts could lead to a more efficient asset allocation provided these workers have a good understanding of portfolio choice. The latter is questioned by empirical evidence for the US.

While a contracting out option is very unlikely to affect individual overall contributions to national savings, current US budget rule would treat the individual accounts as expenditures, thereby increasing reported unified deficits. Diamond questions any impact this might have on budget considerations and expects a change in the budget rules which prevents an increase in reported deficits. Diamond was sceptical about the virtues of replacing public with private pension provision when there is little reason to believe that national savings will increase while costs very likely will increase.

To illustrate these costs, Diamond reviewed the organisation of individual accounts introduced in Chile and Sweden towards the end of his lecture. In the Chilean system workers can choose between a small number of highly regulated mutual funds. Workers deal directly with the mutual funds.

In contrast, in Sweden workers can choose between a very large number of mutual funds which, however, are addressed by government agencies who aggregate the individual choices. Both systems charge roughly 75 basis points of annual balances for operation. Diamond emphasised that this number, which appears small on first sight, accumulates to a reduction of roughly 15 percent of final balances because deposits stay in personal accounts for an average of 20 years. He welcomed the proposal put forward by the President, which combines the limited choice feature of the Chilean system with the government intermediation role of the Swedish system and thereby circumvents the cost increasing features of both systems. This is reflected in the management fees: the proposed US system is expected to run at roughly 30 basis points per year. ■

This lecture was part of the UBS Pensions Research Programme: Public Lecture Series.

Previous lectures include:

8 March 2005

Adair Turner, Chairman of the Pensions Commission

'Pensions: Political Choices and Macro-economic Consequences'

7 February 2005

Professor Axel Böersch Supan, University of Mannheim

'Mind The Gap: The Effectiveness Of Incentives To Boost Retirement Saving In Europe'

10 June 2004

Professor Zvi Bodie, Boston University School of Management

'Life-Cycle Investing in Theory and Practice'

25 November 2002

Professor Axel Böersch Supan, University of Mannheim

'Aging and International Capital Flows'

15 May 2002

Professor Jim Poterba, MIT

'Risk and Participant Investment Decisions in Defined Contribution Pensions: the US Experience'



Corporate Finance and Governance Research Programme

The Corporate Finance and Governance Research Programme at the Financial Markets Group has completed 10 years of research since its launch in 1994. Professor Antoine Faure-Grimaud who took over the programme directorship in 2002, has recently reshaped the Programme's research profile. The research focus over this period spanned from issues in corporate financial policy, including internal and external sources of finance, IPOs and mergers and acquisitions to the financing of small and medium enterprises and research on executive compensation.

One of the main areas of research endeavours has been the issue of financing young, small and innovative firms. Though they face the toughest constraints for accessing financial markets, they constitute an important engine for growth in developed countries. Several of our researchers have investigated various aspects of venture capital finance including the links between the

growth of venture capital industry and the development of an appropriate stock market for young firms, as well as the quality of the 'match' between venture capitalists and entrepreneurs.

In the context of this research FMG has also secured funding from the European Commission for a dedicated project on Risk Capital and the Financing of European Innovative Firms (RICAFe). The project was completed in April 2005 and a closing conference to discuss the results will take place in autumn (see Conference Announcements page 12). The final report offers interesting insights on the questions of how the availability of risk capital contributes to the innovativeness of European firms and how current developments in the European models of provision of risk capital affect economic growth and shape policy options and priorities. This in-depth empirical and conceptual assessment of the working of the markets for risk capital in

Europe will help develop a blueprint for effective policies to foster the growth of innovative, entrepreneurial firms. The report will be published later this year. For more information please visit the RICAFe website (www.lse.ac.uk/ricafe).

Another area of research focuses on the general issue of financial disclosure. A group of FMG researchers is carrying out work into the workings of rating agencies. The objective of this project is to cover both the role of credit ratings, and in particular how competition in this market for reputation is likely to develop, but it also examines the market for corporate governance ratings. Some of our researchers will also look into the impact of financial disclosure for risk management. This is also a very topical issue, as the new banking regulation for instance now requires financial intermediaries to use market values when accounting for their financial assets.

Corporate Governance

In Letter but not in Spirit: An Analysis of Corporate Governance in the UK

While pursuing its line of enquires in corporate finance, FMG has recently launched a new project focusing on **Corporate Governance**. Following the Enron and other scandals, which resulted in an unprecedented wave of regulation on both sides of the Atlantic, corporate governance issues became very topical. This has led to the development of new markets and

products for investors like, for instance, corporate governance ratings. FMG has taken advantage of both its location and contacts in the City of London to tailor a series of research projects that will tackle the most important issues. The first step in this direction was the completion of a new research paper by Sridhar Arcot and Valentina Bruno, under the supervision of

Professor Antoine Faure-Grimaud, which sheds new light in the 'comply or explain' approach to corporate governance, which is dominant in the UK.

The debate about how best to regulate corporate governance is currently raging both in the academic as well as the corporate world. The legislative route in the US makes it compulsory for companies to obey the new rules contained in the Sarbanes-Oxley Act. Companies complain about the excessive cost of this regulation (research by Ivy Xiyang Zhang put it at \$1.4 trillion – The Economist, 19 May 2005). The practitioners' community often invokes the British experience of a voluntary code of best practices, as the way forward. Countries like Austria have followed the UK and there are ongoing discussions at the European level to extend the UK approach (see consultation on the 'Final Report of the High Level Group of Company Law Experts' of the European Commission, 2002, by Professor J Winter). It is therefore a key concern, to evaluate how well this mode of regulation is performing which is precisely the objective of the work of Arcot and Bruno:

The UK's approach to governance failures (for eg Maxwell, Polly Peck and BCCI) did not assume the prescriptive and legislative tones recently embodied in the Sarbanes-Oxley Act of 2002, but led the way to a new form of regulation viz the 'comply or explain' approach. The innovative aspect of this reform was the introduction of a voluntary code of best practice characterised by shareholder pressure for adoption and allowing time for implementation. In particular, it is mandatory for companies to state in their annual reports whether they comply with the Code and give reasons for any areas of non-compliance. According to Sir Adrian Cadbury, author of the pioneering Cadbury Code, the 'comply or explain' approach is preferable to statutory measures because it does not commit companies in a 'one size fits all' approach, and it diminishes the risk of complying with the letter, rather than with the spirit, of the provisions.

Arcot and Bruno (both of the FMG, LSE) perform an empirical investigation aimed at assessing the effectiveness of UK's corporate governance in terms of actual rather than formal implementation of the Code, ie have the companies embraced the genuine spirit of the Code or do they simply follow the letter of its recommendations? To address this question, Arcot and Bruno analyse 245 non-financial UK companies, listed on the London Stock Exchange and belonging to the FTSE 350 index, from the years 1998 to 2004. The period 1998 to 2004 is chosen because the Combined Code (created by combining the Cadbury, Greenbury and Hampel committee recommendations) was in force during this time. They construct a unique dataset by hand-collected information from the corporate governance and directors' remuneration reports included in the annual reports. Amongst others, the authors collect details of each company's compliance with provisions of the code and the explanation provided in case of non-compliance.

As regards compliance their analysis shows that it is monotonically increasing from a low of 10 per cent in 1998-99 to 56 per cent in 2003-04 but differs

significantly among groups of companies. Companies that are widely-held (as opposed to family owned), members of the FTSE100 membership or companies cross-listed in other exchanges (mainly in the US) tend to have a higher percentages of compliance.

The crucial aspect of the 'comply or explain' approach is the explanation given for non-compliance. Companies that do not comply with a provision of the code are expected to explain the reasons for not doing so. It was the original intention of the code-setters that the explanation should justify the unique circumstances of a company. It was thus envisaged that investors and shareholders would then use such information to assess the companies' governance practices.

Arcot and Bruno then investigate the quality of explanations provided by companies. They rank the explanations from the least to the most informative, based on the level of detail given by a company. Their analysis highlights two surprising and unexpected results. Firstly, for an average of 17 per cent of non-compliances over the entire period, no explanations are provided. In such cases, there is neither compliance nor explanation. Since the whole governance system relies on the twin pillars of 'comply' and 'explain', the simultaneous lack of both is worrying. Secondly, even among those that provide explanations the authors find frequent use of standard and uninformative statements when explaining the departure from best practice. In fact, such explanations account for over half (51 per cent) of the total non-compliances. On the other hand in only 8 per cent of the cases companies provide a genuine and informative description of their unique circumstances, which shows that most companies do not pay much attention to the quality of the explanations. The widespread propensity to give general explanations is further amplified where agency problems are likely to be more serious viz family-owned companies; companies are not part of the FTSE100 or those that are not cross-listed.

Finally, using a 'transitional matrix' of changes in explanation from one year to the next, the authors find that companies either stick to their original explanations even when it is not informative or comply. The 'pressure' to comply is greatest for those where the explanation is missing or where a poor quality explanation is provided.

This evidence confirms a widespread feeling of a mechanical 'tick boxes' response, especially among practitioners, to the Combined Code while paying too little attention to the circumstances of the individual company. In conclusion, Arcot and Bruno's analysis shows that the Combined Code and its 'comply or explain' approach does not differ much from a prescriptive law. This highlights a common conformity with the letter but not the spirit of the regulation.

Future research will investigate the market and shareholders reaction to both compliance and the level of information provided in the explanations. ■

The Corporate Governance Forthcoming Seminar

The corporate governance seminar series is our latest initiative to stimulate research in Corporate Finance, in which we are bringing together a series of high profile scholars from around the School to study issues surrounding Corporate Governance. Organised jointly with the LSE Institute of Management, this interdisciplinary group with backgrounds in Finance, Law, Economics, and Management, actively seeks a dialogue with practitioners and policy makers in order to maximise the research impact on policy making and the implementation of best corporate governance practices by firms.

Corporate Governance has improved considerably over the last decade. This is due partly to improved laws and more stringent listing rules, and partly to a wider understanding of the importance of good corporate governance for the welfare of the firm and society. However, there are still many unresolved issues. Looking to the US, recent problems have stemmed in particular from board level monitoring failures, the undervaluation and overpayment of options and the inability of corporate governance institutions to deal with weaknesses in the auditing process. Europe has faced different problems.

Short-term earnings manipulation and excessive stock option awards have been much less important than in the US. The main issues, especially in Continental Europe, relate to the protection of minority shareholders, the independence and fiduciary responsibilities of boards, and the failure to develop an active market for corporate control. A big question for the future is how far these problems should be tackled by legislation or regulation, and whether at the national or European Union level.

The seminar series was launched on 22 June this year with a presentation by Tarun Khanna (Jorge Paulo Lemann Professor, Harvard Business School). We are currently in the process of finalising the seminar schedule for the Michaelmas term 2005. These seminars are specifically designed to facilitate interaction with practitioners and policy makers. Please check our website for the detailed seminar listing (<http://fmg.lse.ac.uk/>). The same group of researchers will also produce a book on the state of research in Corporate Governance in early November (Geoffrey Owen, Tom Kirchmaier and Jeremy Grant, forthcoming 2005, Palgrave)



Fourth Corporate Finance Workshop

6 May 2005

FMG is a partner in the organisation of the Intercollegiate Corporate Finance Workshop which was launched in 2002, and organised by Antoine Faure-Grimaud (FMG) and Denis Gromb (LBS). The workshop has been established as a regular forum for researchers interested in corporate finance. The fourth Corporate finance workshop held at the LSE on Friday May 4th attracted a large number of participants including many postgraduate researchers.

The first paper presented, 'Managerial legacy and entrenchment' by **Alexander Guembel** (University of Oxford) and **Catherine Casamatta** (Université de Toulouse) offers an explanation for the fact that managers often get their stock options schemes re-set after poor performance and frequently get generous 'golden handshakes' when fired. These phenomena seem to point to poor corporate governance as it suggests that managers are not paid in line with performance. However, if investment projects are long term, newly hired managers might be 'stuck' with the choices of the predecessors and therefore it may be difficult to offer the appropriate incentives. The authors suggest that it may be optimal to provide fresh incentives to existing managers even after poor performance. The discussion underlined the interesting intuition delivered by this paper and suggested that the definition of 'entrenchment' used by the authors is perhaps non standard.

Jos Van Bommel (Saïd Business School) presented 'An empirical enquiry into the speed of information aggregation: the case of IPOs' co-authored with Jay Dahya. It investigates the speed at which new information is incorporated into prices. The authors use data from 2531 US IPOs over the period 1993-2000 and study the volatility process of prices after shocks. The authors show that it takes about 3-4 days for information to be aggregated in prices. They also investigate the behaviour of trading volume and Bid-Ask spreads attempting to identify the determinants of the speed of aggregation. They find interesting behaviour of Bid-Ask spreads: contrary to the evidence provided in Ellul and Pagano, investigating the British market, they find that bid ask spreads are lower in the American market. The proposed explanation is that the American market is more liquid due to the presence of more uninformed traders.

Arup Daripa (Birkbeck College) and **Gyöngyi Lóránth** (Cambridge University) present a theoretical model of the role of banks as financiers of new projects in the presence of a market. Their model examines the monitoring role of banks with heterogeneous types. The authors show that the incentive to monitor can completely erode without the presence of a 'third-party' market. The authors present a 'voting by feet' mechanism and a 'market discipline' mechanism to show how the presence of markets can solve the bank's monitoring problem. The model, while controversial, received a great deal of constructive feedback from the conference participants.

Sudipto Bhattacharya (LSE) and **Sergei Guriev** (New Economic School) presented a theory model of the trade of new product ideas from a research unit to development units. The authors model the choice of licensing between an open sale with patenting or a closed sale in which the research unit continues to hold a stake in the future revenues of the research asset. The authors are interested in the implications for information leakage and its effect on the choice of sale mode.

Finally, **Enrico Perotti** (University of Amsterdam) presented 'The political economy of financial fragility', co-authored with Erik Feijen. The authors present a model to explain financial liberalization under a weak regulation. They show that weak regulation might be the rational outcome of lobbying on part of cash rich entrepreneurs. These entrepreneurs can restrict entry into product markets by increasing the difficulty by which cash constraint entrepreneurs acquire financing. The authors provide empirical evidence on this phenomenon using firm level data provided by the United Nations statistics division. The discussion pointed to the fact that the authors are modelling investor protection legislation rather than 'financial fragility'. The model captures an interesting mechanism behind political lobbying.

For more information on FMG's Corporate Finance and Governance Programme please email FMG@lse.ac.uk or call +44 (0)20 7955 7891

Winner of the GAM Gilbert de Botton Award in Finance Research 2005 announced

Peter Kondor, a research student at the Financial Markets Group, London School of Economics and Political Science (LSE), has been awarded the 2005 GAM Gilbert de Botton Award in Finance Research 2005. He was awarded the prize of £10,000 for his paper *Risky Arbitrage, Liquidity and Delegation*.

The GAM Gilbert de Botton Award, given in recognition of outstanding research in finance, was established with the support of GAM and is awarded annually by the Financial Markets Group at LSE and GAM. The award was created in honour of the late Gilbert de Botton, founder of GAM.

A team of experts from the academic and the business community evaluated the research papers submitted and selected six papers for the shortlist. **Xuewen Liu** and **Alexander Bleck** were awarded the first runner-up prize of £5,000 for their paper on *Market Transparency and the Accounting Regime* and second runner-up prize of £2,500 goes to **Enrico Sette** for *Competition in Information Transmission*.

The Award Jury shortlisted six papers of very high quality:

- **Sridhar Arcot**
Participating Convertible Securities in Venture Capital Exits
- **Mohammed Fawaz**
Optimal Threshold in Filter-based Contrarian and Momentum Strategies
- **Michael Kollo**
Underwriter Competition and Gross Spreads in the Eurobond Market

Information about the GAM award competition 2006 will be posted in the FMG website in December 2005 (<http://fmg.lse.ac.uk/>).

The GAM Gilbert de Botton Award is given in recognition of outstanding research in finance. The Financial Markets Group at LSE would like to thank GAM for their generous support that will enable us to continue our efforts to promote top quality research by talented young people in financial market behaviour and practice. Previous winners included Hassan Naqvi in 2003 who is now an Assistant Professor of Finance at National University of Singapore, and Miguel Segoviano in 2004 who has also successfully completed his PhD this year and moved to the IMF.

The Award was created in honour of the late Gilbert de Botton, founder of GAM. Gilbert de Botton founded GAM in 1983. A man of wide-ranging intellectual interests, he is widely acknowledged as the pioneer of the 'open architecture' model of asset management. GAM manages more than billion of clients' assets from

ten offices around the world and has been owned by UBS AG since 1999. It continues to have distinctive style and culture.

A team of experts from the academic and the business community evaluated the research papers submitted. The 2005 Award's Jury included Professor David Webb (director, Financial Markets Group, LSE) as chairman of the panel, Professor Charles Goodhart (research programme director, Financial Markets Group, LSE), Dr Ross Altman (governor, LSE), Dr Shusil Wadwhani (Wadwhani Asset Management LLP) Dr Michael Kuczynski (Pembroke College, Cambridge) Dr Burkhard Poschadel (vice chairman, GAM), Mr Jeremy Smouha (director, GAM) Mr David M Solo, (group chief executive officer, GAM) and Mr Graham Wainer (group head of clients and portfolio management, GAM).

Finance Student of Year Award

Michael Kollo, from the London School of Economic, is winner of the IFA's Finance Student of the Year Award. Organised by the Institute of Financial Accountants (IFA) in association with City Jobs the Finance Student of the Year Award 2005 is open to all finance students, currently studying at a higher education or further education establishment in the UK and Northern Ireland. The Award aims to encourage excellence by rewarding students and tutors who are true ambassadors of the finance industry.



Garry Richardson (Sports Anchor on Radio 4's Today Programme), **Gary Butler** (Sponsor, Jobsite UK Ltd), **Michael Kollo** (FMG) and **Michael O'Brien** (Chairman of Council, IFA and IAB)

FMG Job Market Placements

In this current academic year the following students have found job placements:



Max Bruche

Max will join CEMFI as an assistant professor
m.e.bruche@lse.ac.uk



Miguel Segoviano

Miguel has accepted a position at the International Monetary Fund, Washington DC
msegoviano@imf.org



Ryan Love

Ryan has accepted a quantitative portfolio analyst position for a hedge fund – Oxford Asset Management
r.e.love@lse.ac.uk



Paolo Colla

Paolo will be joining Bocconi University, Milan as an Assistant Professor
colla@core.ucl.ac.be



Beatriz Mariano

Beatriz will be joining the Carlos III University of Madrid
b.j.mariano@lse.ac.uk



Joachim Inkmann

Joachim will be starting an Assistant Professorship at Tilburg University, The Netherlands
j.inkmann@lse.ac.uk

Further details can be found in the FMG website at <http://fmg.lse.ac.uk>

Third RICAFE Conference

Entrepreneurship, Risk Capital and the Financing of Innovative Firms

Real Collegio Carlo Alberto

Moncalieri, Torino

18-19 November 2005

The research network 'Risk Capital and the Financing of European Innovative Firms' (RICAFE), formed by the London School of Economics (FMG), the Department of Economics and Finance of Turin University, the Center for Financial Studies (Frankfurt), and HEC School of Management (Paris), will hold its Third Conference on 18-19 November at the Real Collegio Carlo Alberto in Moncalieri (Torino).

The conference will include empirical and theoretical papers on venture capital, private equity, entrepreneurship, the decision to go public, and intellectual property rights. The conference will address topics such as:

- The choice between alternative sources of financing for innovative firms and their impact on strategic decision in entrepreneurial firms;
- Venture capital, its contribution to entrepreneurship, and the determinants of its performance;

- The economics of intellectual property rights, their interaction with the legal and institutional framework, and with entrepreneurial risk-taking;
- The role and design of financial contracts and of the choice of organizational form in fostering innovation;
- The links between entrepreneurship and the stock market;
- The economics of the going public process for entrepreneurial firms;
- Public incentives for venture capital and the financing of innovation.

Local organizing committee:

Marco Da Rin, Marina Di Giacomo, Giovanna Nicodano, Alessandro Sembenelli.

Programme Committee:

Marco Da Rin (Turin University), Ulrich Hege (HEC Paris), Augustin Landier (Stern School, NYU), Gerard Llobet (CEMFI), Antoinette Schoar (Sloan School, MIT), Uwe Walz (Center for Financial Studies), David C Webb (FMG, the London School of Economics and Political Science).

The Conference is made possible by a generous grant from Fondazione Collegio Carlo Alberto (www.collegiocarloalberto.it).

For registration and programme information please visit the RICAFE website (www.lse.ac.uk/ricafe).

Final Conference of the RTN project on Financing Retirement in Europe: Public Sector Reform and Financial Market Development

15-16 September 2005

The London School of Economics and
Political Science, Financial Markets Group

Organizing Committee:

Ron Anderson, Pierre Pestieau, Ian Tonks, and David Webb

Final networking and dissemination event of the four-year Research Training Network on 'Financing Retirement in Europe: Public Sector Reform and

Financial Market Development' funded by the European Commission. (www.cepr.org/research/Networks/FINRET/).

The conference will deal with the reform of social security systems, the portfolio management of private pension funds, their regulation and the effects of their activities on the development of financial markets. In addition to recent research, the conference will involve the presentation of some of the main findings of the RTN and a high-level policy roundtable discussion.

For more information on the conference programme and registration details please visit the FMG events website. (<http://fmg/events/conference>)

Discussion papers



DP 516

A GARCH Model of the Implied Volatility of the Swiss Market Index from Options Prices

Michael Sabbatini and Oliver Linton

This paper estimates the implied stochastic process of the volatility of the Swiss market index (SMI) from the prices of options written on it. A GARCH(1,1) model is shown to be a good parameterization of the process. Then, using the GARCH option pricing model of Duan (1991), the implied volatility process is estimated by a simulation minimization method from option price data. We find the persistence of volatility shocks implied by options on the SMI to be very close to that estimated from historical data on the index itself. Comparing the performances of the implied GARCH option pricing model to that of the Black and Scholes model it appears that the overall pricing performance of the former is superior. However, the large sample standard deviations of the out-of-sample pricing errors suggest that this result should be taken with caution.

DP 517

A Time Series Analysis of Financial Fragility in the UK Banking System

Charles Goodhart, Dimitrios Tsomocos and Ponjanart Sunirand

This paper extends the model proposed by Goodhart, Sunirand, and Tsomocos (2003, 2004a, b) to an infinite horizon setting. Thus, we are able to assess how the model conforms with the time series data of the UK banking system. We conclude that, since the model performs satisfactorily, it can be readily used to assess financial fragility given its flexibility, computability, and the presence of multiple contagion channels and heterogeneous banks and investors.

the financial system. But, even the remote possibility of a systemic crisis weighs against no regulation. If reform is delayed until after a crisis it is likely to be politically influenced and sub-optimal. We argue that any reform should involve both the promotion of measures to reduce the likelihood of failure of a major hedge fund and crisis management procedures to address any fallout if this occurs.

DP 519 (UBS Pensions series 028)

Portfolio Choice and Wealth Accumulation with Taxable and Tax-Deferred Accounts

Francisco Gomes, Alex Michaelides and Valery Polkovnichenko

We calibrate a life-cycle model with uninsurable labor income risk and borrowing constraints to match portfolio allocation and wealth accumulation profiles of direct and indirect stockholders in both taxable and tax-deferred accounts. Tax-deferred accounts generate an increase in wealth accumulation that is larger for wealthier households. Furthermore, while the cost of following a fixed contribution rate over the life cycle is small, the optimal rate can differ substantially across households, and the welfare losses from choosing the wrong one can be substantial. Finally, the welfare gain from having access to a tax-deferred account ranges from less than 0.1 per cent to 11.5 per cent, depending on the preference parameters.

DP 518 (IAM Series No 004)

Highwaymen or Heroes: Should Hedge Funds be Regulated?

Jean-Pierre Zigrand, Jon Danielsson and Ashley Taylor

The exponential growth of hedge funds, their role in financial crises in the 1990s, and examples of fraudulent behaviour have precipitated a heated debate over their regulatory status. The existing approaches of greater disclosure and activity restrictions appear too blunt to be effective and may stifle the benefits hedge funds can bring to

DP 520

Strategic Financial Innovation in Segmented Markets

Rohit Rahi and Jean Pierre Zigrand

We study an equilibrium model with restricted investor participation in which strategic arbitrageurs reap profits by exploiting mispricings across different trading locations. We endogenize the asset structure as the outcome of the security design game played by the arbitrageurs. The equilibrium asset structure depends realistically upon consideration such as depth, liquidity and gains from trade. It is not socially optimal in general; the degree of inefficiency depends upon the heterogeneity of investors. Finally we use this framework to formally analyse Shiller's conjecture of the optimality 'macro markets'.

DP 521

Conglomerate Entrenchment under Optimal Financial Contracting

Antoine Faure-Grimaud and Roman Inderst

We provide a formal analysis of the notion that conglomerates are more 'entrenched' as they have 'deeper pockets'. Using the financial contracting model of Bolton and Scharfstein (1990), we can isolate two effects that confirm this conjecture: the pooling of cash flows, which allows to smooth out repayments, and the ability to obtain better credit terms. For less profitable business segments, the internal capital market operated in a conglomerate may, however, work in the opposite direction, increasing the sensitivity of operations to own cash flows and increasing the likelihood of exit.

DP 522 (IAM Series No 005)

Are 'Market Neutral' Hedge Funds Really Market Neutral?

Andrew Patton

One can consider the concept of market neutrality for hedge funds as having breadth and depth: breadth reflects the number of market risks to which a fund is neutral, while depth reflects the completeness of the neutrality of the fund to market risks. We focus on market neutrality depth, and propose five different neutrality concepts. Mean neutrality nests the standard correlation-based definition of neutrality. Variance neutrality, Value-at-Risk neutrality and tail neutrality all relate to the neutrality of the risk of the hedge fund to market risks. Finally, complete neutrality corresponds to independence of the fund to market risks. We suggest statistical tests for each neutrality concept, and apply the tests to a combined database of monthly market neutral hedge fund returns from the HFR and TASS hedge fund databases. We find that around one-quarter of these funds exhibit some significant exposure to market risk.

DP 523 (UBS Pensions series 029)

Barriers to Pensions Scheme Participation in Small and Medium Sized Enterprises

Alistair Byrne, Debbie Harrison and David Blake

Large sections of the UK population are failing to make adequate provision for their retirement, and one area where provision is notably poor is amongst people working for small and medium

sized businesses. We use information gathered from interviews with individuals from a wide range of organisations active in the pensions market for these companies to shed light on the particular barriers to pension scheme participation in this sector in which over 40 per cent of the working population is employed. We find that many finance directors are sceptical of the benefits of providing pensions for their employees and deliberately structure their pension schemes to avoid high participation rates. We also find that financial advisers and pension providers are reluctant to promote pensions in companies where they perceive the management to be unsupportive and where there is no clear profit margin. We suggest one way in which management could be motivated to encourage pension scheme participation amongst their employees.

DP 524

Basel and Procyclicality: A comparison of the Standardised and IRB Approaches to an Improved Credit Risk Method

Charles Goodhart and Miguel Segoviano

The regulation of bank capital in the form of capital adequacy requirements is itself inherently procyclical; it bites in downturns, but fails to restrain in booms. The more risk-sensitive the regulation, the greater the scope for pro-cyclicality to become a problem, particularly in view of the changing nature of macroeconomic cycles. The simulation exercises performed in this paper suggest that the new Basel II accord, which deliberately aimed at significantly increasing the risk sensitiveness of

capital requirements, may in fact considerably accentuate the procyclicality of the regulatory system. Since the experience in the past, also discussed in this paper, suggests that a required hoisting of capital ratios in downturns may be brought about by cutting back lending rather than raising capital, the new capital accord may therefore lead to an amplification of business cycle fluctuations, especially in downturns.

DP 525 (UBS Pensions series 030)

Credible Pensions

Timothy Besley and Andrea Prat

One of the main problems in pension policy is to develop an institutional framework that guarantees that public and private pensions promises are kept. This paper discusses how the governance of public and private pensions is key to making such promises credible. It argues that credibility concerns undermine the case for earnings-related pensions run by the state and private defined benefit plans.

Special papers

SP 159

How Do We Achieve Regulatory Convergence In Practice?

Callum McCarthy

Callum McCarthy joined the FSA in September 2003 from the Office of Gas and Electricity Markets where he was Chairman and Chief Executive. He had previously held senior positions in Barclays Bank, BZW and Kleinwort Benson, as well Department for Trade and Industry. He is an economist and graduate of the School of Business at Stanford University, where he was a Sloan Fellow. The lecture was given as part of a full-day conference hosted by the Financial Markets Group, LSE and held in honour of Tommaso Padoa-Schioppa on 8 December 2004.



Forthcoming Discussion and Special Papers

Discussion Papers

DP 526 (UBS Pensions series 031)

'Immigration or bust? Options for securing the future viability of the UK state pension system'

David Blake and Les Mayhew

DP 527 (UBS Pensions series 032)

'Pension Plan Funding Risk Sharing and Technology Choice'

David Webb

DP 528 (UBS Pensions series 033)

'Can the retirement-consumption puzzle be resolved? Evidence from the British Household Panel Survey'

Sarah Smith

DP 529

'A Model of Corporate Liquidity'

Ron Anderson and Andrew Carverhill

DP 530 (UBS Pensions series 034)

'Mortality Insurance, Healthcare and Bequests'

David C Webb

DP 531

'Spot Market Power and Future Market Trading'

Alexander Muermann and Stephen Shore

DP 532

'The more we know, the less we agree: public announcements and higher-order expectations'

Peter Kondor

DP 533

'Rational Trader Risk'

Peter Kondor

Special Papers

SP 160

'Defining and Achieving Financial Stability'

William A Allen and Geoffrey Wood

Visitors to the FMG

May – July 2005

Federico Bandi (Chicago GSB)
Suleyman Basak (LBS)
Jan Bena (CERGE-EI)
Li – Ting Chiu (Centre for Education Policy Development)
Camille Cornand (GATE CNRS)
John Cotter (University College Dublin)
Andrew Ellul (Kelley School of Business)
Zsuzsanna Fluck (Michigan State University)
Vicky Henderson (Princeton)
Soosung Hwang (CASS)
Charles Jones (Columbia Business School)
Shachar Kariv (UC Berkeley)
Paul Kofman (University of Melbourne)
Jeremy Large (Oxford)
Gyongyi Loranth (Judge Institute, Cambridge)
Tobias Moskowitz (Chicago GSB)
Guillaume Plantin (Carnegie Mellon)
Jean-Charles Rochet (University of Toulouse)
Maria Grazia Romano (University of Salerno)
Brunello Rosa (University of Siena)
Tano Santos (Columbia Business School)
Jakub Steiner (CERGE-EI)
Sheridan Titman (University of Texas at Austin)
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