

Third Annual Risk Capital and the Financing of European Innovative Firms (RICAPE) Conference

Turin, 18-19 November 2005

The Third Annual RICAPE Conference was held at Fondazione Collegio Carlo Alberto, Moncalieri near Turin between 18 and 19 November 2005. With participants from both sides of the Atlantic, the conference attracted high quality papers relating to various aspects of venture capital (VC). The conference programme was spread across four thematic sessions: entrepreneurship; venture capital contracting; the effects of venture capital financing, and; entrepreneurial firms going public.

The first session, chaired by **Alessandro Sembenelli** (University of Turin), focused on entrepreneurship. **Frédéric Palomino** (HEC Paris) presented the first paper in the session, 'Risk Aversion and Entrepreneurship' (joint work with Eloiç-Anil Peyrache, HEC Paris). The paper is based on the observation that, in an attempt to simplify the study of entrepreneurship, most research explicitly distances itself from studying the impact of the entrepreneur's risk aversion. Risk aversion however has a first-order effect

on the decision to become an entrepreneur. Therefore, in a base model the authors discuss the effect of such an assumption relative to that of risk neutrality and show that indeed under the former fewer entrepreneurs leave their current jobs to become an entrepreneur. In a second step the authors discuss 'job-back guarantees', a wide-spread instrument that allows entrepreneurs to return to their old job in case their venture turns out to be unsuccessful. The authors then investigate when such an instrument increases the likelihood that an entrepreneur will found his own firm and when employers are willing to grant such an option. The discussant, **Carsten Bienz** (FMG-LSE and CFS, Frankfurt), pointed out that such guarantees might not only be related to risk aversion but also to adverse selection in the job market.

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Regulation and Financial Stability Programme

As part of the FMG's ongoing commitment to communicate research activity, we focus in this issue on the ongoing Regulation And Financial Stability Programme. The Programme members are Professors Charles Goodhart and Hyun Shin (co-directors), and Drs' Jon Danielsson,

Amil Dasgupta, Ellen Meade and Jean-Pierre Zigrand. Professor Hyun Shin will be taking up an appointment at Princeton University in the US this coming January, but will continue to play an active role in the Programme.

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The second paper in this session, titled 'What are Firms? Evolution from Birth to Public Companies', was presented by **Per Strömberg** (Stockholm Institute of Financial Research), and is joint work with Steve Kaplan (University of Chicago) and Bengt Sersoy (University of Chicago). In this work the authors ask the question of how young, entrepreneurial firms develop and transform themselves into mature, listed firms using a proprietary data set of 49 venture capital-financed firms. Relying on three successive observations on each firm, they show that although firms undergo tremendous transformations in terms of growth and sales, the firms' original fields of business remain remarkably stable, while the composition of the management teams sees quite dramatic changes. This underlines the importance of the firm's alienable assets, while it indicates that the importance of firm specific human capital declines over time. The authors conclude that the important factor for VC financed firms seems to be a coherent business strategy while the management team seems to be interchangeable. The discussant **Bruno Cassiman** (IESE Business School) pointed out that this may not necessarily be the case. Indeed, human capital may be more valuable in early stages of firm development than in later stages.

The third paper in this session was 'Mixing Family with Business: A Study of Thai Business Groups and the Families Behind Them' and was presented by **Antoinette Schoar** (MIT). This paper is joint with Marianne Bertrand (University of Chicago), Simon Johnson (MIT) and Krislert Samphantharak (University of California, San Diego). Most papers in the literature treat families as monolithic entities whereas this paper explores how family dynamics affect the organisation, governance and performance of business groups. To perform this analysis the authors create a unique dataset that contains the family trees of about 100 of the largest business groups in Thailand. They then compile detailed balance sheet information of companies controlled by these groups. The paper finds that sons play a central role in ownership and control and substantially increase their role in ownership once the founder is gone. The governance of the group is also affected by family structure. The authors then analyse the implications of family structure on performance and find that families with more sons are associated with lower performance once the founder is gone. The discussant **Marco Pagano** (Università di Napoli Federico II) suggested that the authors should fully exploit the time dimension of their data and use various other controls. He also suggested the use of a model to fix ideas.

The second session of the conference dealt with venture capital contracting and was chaired by **Frédéric Palomino** (HEC Paris). **Stefan Arping** (University of Amsterdam) presented the first paper of the session titled 'The Ownership and Implementation of Ideas'. The paper develops a model where success in a project depends on entrepreneurial effort. The business partner (or VC) who provides complementary inputs to the project can potentially expropriate the entrepreneur's ideas and deploy them elsewhere. On the one hand, the threat of ex-ante expropriation leads to rent extraction (by the VC) and reduces the effort exerted by the entrepreneur. The author also pointed out that, on the other hand, the threat of ex-post appropriation might be beneficial. This is because it commits the entrepreneur to exert effort so that it is less worthwhile for the VC to destroy project value by expropriation. One of the implications of the model is that transfer of intellectual property rights to the VC can serve as a pre-commitment device for entrepreneurs to execute their ideas. The discussant **Gerard Llobet** (CEMFI) pointed out that the introduction of private information into the model might change its implications. If contracts were incomplete the issue of renegotiation naturally arises which eliminates most of the commitment advantages of the off-equilibrium threat of ex-post appropriation.

The second paper of the session was 'The Design of Syndicates in Venture Capital' presented by **Lucy White** (Harvard Business School) joint with Giacinta Cestone (University of Salerno) and Josh Lerner (Harvard Business School). The paper seeks to better understand the design of venture capital syndicates across two dimensions. Firstly who chooses to syndicate with whom and secondly the financial claims used in syndication to mitigate incentive and information problems. Using a theoretical model the paper shows that VCs might not want to choose a more experienced partner since they might have to give away too much rent in exchange for a better quality signal. In late stages of the start-up inexperienced VCs are more likely to syndicate with an experienced VC. Finally, the financial claims which a syndicating VC uses depends on their relative experience and the stage of the venture. The discussant of the paper was **Eloïc-Anil Peyrache** (HEC, Paris) suggested that changing the assumptions pertaining to the information structure could further enrich the model.

The last paper in the second session, titled 'The Dynamics of Venture Capital Contracts', was presented by **Carsten Bienz** (FMG and CFS, Frankfurt) and is joint work with Julia Hirsch (Goethe University Frankfurt and CFS, Frankfurt). The authors analyse the degree of contract

completeness with respect to staging of venture capital investments using a hand-collected German data set of contract data from 464 rounds into 290 entrepreneurial firms. The authors first show that the behaviour of VC's is not fundamentally different to that reported in previous studies of the US. In an additional step they consider how VCs and entrepreneurs choose different forms of staging and show that the exact form depends upon the need to have more or less complete contracts. The need for completeness is determined by the entrepreneur's relative bargaining position and by the extent to which the development process of the firm is predictable or not. The discussant, **Mario Pagliero** (University of Turin), pointed out the richness of the sample and suggested that the authors should exploit the data to model the VC's characteristics more closely.

The third session focused on the effects of venture capital financing and was chaired by Professor **Uwe Walz** (CFS, Frankfurt). **Merih Sevilir** (University of North Carolina) presented the first paper in this session titled 'Size and Focus of a Venture Capitalist's Portfolio', joint work with Paolo Fulghieri (University of North Carolina). Merih presented a theoretical model to address a number of questions. What determines the size and scope of a VC's portfolio and how does size affect performance? Given the scarcity of VC human capital is it better to concentrate all resources on a single start-up or spread resources over many? Based on their analysis the paper identifies three main effects of portfolio size on entrepreneurial and VC incentives. The first is the value dilution effect – a large portfolio requires the VC to spread his effort across many start-ups leading to a negative effect on both the entrepreneur's and VC's incentives. The second effect is the rent extraction effect – given a large portfolio the VC can threaten to reallocate his resources to another start-up, which results in stronger incentives for the VC and weaker incentives for the entrepreneur. Finally the third effect is the resource allocation effect by which the VC can diversify his portfolio leading to stronger incentives for both the VC and entrepreneur. The interaction between the above three effects then produces several implications for the way the VCs form their portfolio.

David Webb (FMG/LSE) was the discussant of the paper and pointed out that the entrepreneur had a limited role to play in the model. He suggested that strengthening the role of the entrepreneur would make the analysis richer.

The second paper of the session was 'Whom you know matters: Venture Capital Networks and Investment Performance' presented by **Yael Hochberg** (Northwestern University) and is joint work with Alexander Ljungqvist (New York University) and Yang Lu (New York University). Networks feature prominently in the VC industry and this paper empirically investigates the performance consequences of the organisational choice by VCs especially in syndication networks. The paper uses graph theory to arrive at measures of networking. Yael noted that indeed funds raised by better-networked VCs show better performance. Start-ups funded by networked VCs are more likely to survive and get to subsequent rounds of funding and successfully exit either through an IPO or trade sale. The discussant of the paper, **Marina Di Giacomo** (University of Turin), pointed out that the use of

network analysis is new to the literature, however she felt that endogeneity issues were not carefully addressed. She also suggested the use of human capital variables of VCs to explore the evolution of networks.

Marco Da Rin (Università di Torino) presented the last paper of the session titled 'Endogenous Matching and the Performance of Venture Capital Backed Companies'. This is joint work with Marina Di Giacomo (Università di Torino) and Alessandro Sembenelli (Università di Torino). The paper empirically tries to answer the question as to which venture capital firms make companies in their portfolio grow faster? They use a novel framework by accounting for the endogenous matching between a VC and the entrepreneur and in the process make an important methodological contribution to the literature. The paper uses a sample of European venture deals in 1999 and follows them through to the end of 2003. To deal with endogeneity problems, the paper uses market characteristics as instruments and obtains estimates of the causal effect of VCs. Marco then presented preliminary evidence showing that investor characteristics do indeed matter for investment outcomes after correcting for matching. In commenting on the paper **Maristella Botticini** (Università di Torino) suggested that the authors could try to use VC fixed effects instead of firm fixed effects as their instrument.

Session four, which was chaired by **David Webb** (FMG/LSE), was concerned with IPOs and the decision to go public. **François Derrien** (University of Toronto) presented joint work with François Degeorge (University of Lugano), Toronto) and Kent Womack (Tuck School of Business, Dartmouth College) titled 'Analyst Hype and Bookbuilding'. In this study of the French stock market from 1993 to 1998 the authors compare two popular methods of determining the price of new issues: auctions and book-building. Motivated by the stylized fact that book-building results in higher underwriter fees than auctions, they embark on a thorough investigation of why book building has proved the more popular method in recent years. The hypotheses the authors pursue are that underwriters control the allocation of shares to interested parties. This allows them to ensure more favourable analyst reports for their underwriters, even from independent analysts. Such behaviour should ultimately result in better performance of the firm going public. Even though the authors find evidence for such behaviour, they do not find differences in the long run performance of firms that choose alternative routes. The discussant **Jörg Rocholl** (University of North Carolina) commented on the care the authors had taken with their analysis. He also questioned the assumption that book building was necessarily more expensive than auctions. By choosing book-building, firms have an option to postpone their IPO in case of negative outside shocks, while this is much harder in the case of an auction.

In the second talk of the session, **Andrew Ellul** (Indiana University), in joint work with Levent Guntay (Indiana University) and Ugur Lel (Board of Governors, Federal Reserve System) presented a talk on 'External Governance and Debt Agency Costs of Family Firms'. The presentation started with the

observation that while the presence of large blockholders in firms may solve conflicts of interests between shareholders and managers, it creates problems of its own. For example, while conflicts between majority and minority shareholders have received previous attention, those between blockholders and bondholders have not. On the other hand, the authors point out that outstanding bonds may have disciplining effects on blockholders. This effect may be less pronounced for firms operating in weaker legal environments. In empirical tests of Fortune 500 firms and firms with American Depositary Receipts (ADRs) the authors test if and to what extent the market believes that there is room for exploitation by block holders. Indeed, the authors find higher yield spreads for firms from weaker legal environments, confirming their conjecture. The discussant **Giovanna Nicodano** (Università di Torino) encouraged the authors also to consider the behaviour of banks in such weak legal environments.

In the final talk of the conference, **Thomas Chemmanur** (Boston College) presented results of joint work with Shan He (Boston College) and Debarshi Nandy (York University) on 'The Going Public Decision and the Product Market'. Exploiting an unprecedented data-set made available by the US Bureau of Census, the authors study firms that go public before and after their entry on the stock market. The authors are especially interested in studying the effects the going public decision has on the firm's product market behaviour. Relying on their data set, the authors are able to show that a firm's productivity peaks in the year of them going public. The discussant, **Yishay Yafeh** (Hebrew University of Jerusalem), pointed out that the authors' very interesting findings were based on well-crafted econometrics but that the economic reasons behind the findings were still left unexplored. ■

RICAFE programme; Risk Capital and the Financing of European Innovative Firms

The RICAPE programme, Risk Capital and the Financing of European Innovative Firms, was successfully completed in April 2005. The programme's final research result are included in the RICAPE final report – available from the programme's website www.lse.ac.uk/collections/RICAPE/. The RICAPE research network is formed by members from the London School of Economics and Political Science (Financial Markets Group), the Centre for Financial Studies in Frankfurt, HEC School of Management Paris and Turin University.

RICAFE 2

In October 2005 the Financial Markets Group successfully completed the first stage of the application to the European Commission for the financing of the second phase of the RICAPE programme and has been invited to enter the contract negotiation process. The second phase of the programme is expected to start in the first quarter of 2006 under the title 'Regional Comparative Advantage and Knowledge-Based Entrepreneurship' – RICAPE 2.

The main objective of the second phase of the research is to develop a comprehensive report on how societal, legal, and economic factors affect the patterns of regional economic growth and how Knowledge-Based Entrepreneurship (KBE) contributes to shifting patterns of regional comparative advantage and to regional growth and social cohesion.

Our research will assess the links between societal, legal, and economic mechanisms and KBE at the micro level, while studying the resulting regional dynamics and growth patterns at macro level. We will employ a cross disciplinary approach to study KBE as a complex, multi-dimensional process. While theoretically grounded, the programme of research is also empirical and will provide a detailed blueprint for the implementation of the Green paper on Entrepreneurship. More details about the RICAPE2 programme will be announced soon at the RICAPE website:

www.lse.ac.uk/collections/RICAPE/.

Regulation and Financial Stability Research Programme

The FMG is one of the pre-eminent academic centres in Europe for the analytical study of financial regulatory issues. The Programme has continued its leading role as a centre of policy advice; research and independent analysis on current regulatory developments internationally and in the UK. On-going work may be divided into three main fields:

Financial Stability Programme

During the last decade, the world has experienced a series of global financial crises. Beginning with Mexico in late 1994, crisis-stricken countries have included Thailand, Korea, Indonesia, Russia, Brazil, and most recently, Argentina. Our work on the analysis of these developments is broad, ranging from microeconomic issues, such as the causes of financial crises, risk in financial markets, and the structure of financial market regulation through to macroeconomic issues, such as exchange rate management, monetary policy, and institutional structure or 'architecture'.

Research grants:

'Price Dynamics under Aggregated Decision Making in Financial Markets with Uncertainty and External Constraints' is an ongoing research project funded by the Engineering and Physical Sciences Research Council (EPSRC) and led by Dr Jon Danielsson, Dr Amil Dasgupta, Professor Hyun Song Shin and Dr Jean-Pierre Zigrand. The objective of the research is to calibrate our structural models to existing data to obtain an operational third generation model that matches properties of observed asset price dynamics with a view to understanding systemic risk, improving upon current second generation models by properly integrating endogenous risk. The research further aims to identify conditions under which stylised market patterns observed in periods of turbulence (eg, 'elevator-escalator' patterns) can be generated. Finally, applications to asset allocation and derivatives pricing will be developed. The project will be completed in June 2006 with a final conference on the theme 'New Directions in Asset Pricing and Risk Management'. The conference will take place in the FMG on 15-16 June. More information will be announced soon on the FMG website.

The ESRC funded project on **'Imperfect Common Knowledge, Monetary Stability and Financial Stability'**, led by Professor Hyun Shin, examined the signaling role of monetary policy in the active shaping of expectations when differentially informed agents have access to private information as well as shared, public information. In particular, the research emphasised the potential tension between the effectiveness of this signalling role and the central bank's role as an observer of outcomes – the more effective the former in affecting outcomes the more impaired the information value of outcomes for the latter purpose of inferring the underlying state of the economy. For example, in 'Imperfect Common Knowledge and the Information Value of Prices' Jeffery Amato and Hyun Song Shin analyse these issues in the context of price-setting firms in monopolistically competitive economies operating under differential information. Morris and Shin extend the analysis in 'Central Bank Transparency and the Signal Value of Prices' (presented at the Fall 2005 meeting of the Brookings Panel on Economic Activity). When the central bank has to rely on the outcomes in the economy itself as the inputs in its own forecasting of future outcomes, there is a feedback effect in which the less informative outcomes in turn become the inputs for even less informative forecasts. In 'Beauty Contests and Iterated Expectations in Asset Markets', Franklin Allen, Stephen Morris and Hyun Song Shin consider the analysis of the impact of public information in a financial market setting. This research found that public information (including past prices) had a disproportionately large effect relative to the statistical optimum. Since monetary policy operates through financial markets these results have potentially large significance. This research of the disproportionately large effect of public information has stimulated a debate over the implication that greater precision of information need not always be desirable. This grant resulted in the following papers: 'Imperfect Common Knowledge and the Information Value of Prices' (Amato and Shin) and 'Central Bank Transparency and the Signal Value of Prices' (Morris and Shin).

Liquidity

The regulatory authorities, notably the Basel Committee of Banking Supervision (BCBS), have been concentrating on setting capital ratios (CARs) in the last two decades. Concern about the need for liquidity ratios has subsided into abeyance. Both the BCBS and BoE now realize that this is undesirable. But the theoretical analysis of the rationale for (required) liquidity ratios and their appropriate form and composition are also lacking. Shin (FMG), together with a number of collaborators, has been examining the role of asset market liquidity in the origination and propagation of systemic shocks to a financial system. Existing studies of systemic risk have focused on the balance sheet interlinkages between financial institutions and the 'domino effect' of the failure of one institution cascading down to the others. Liquidity effects generate a more potent channel of contagion. When financial institutions mark their assets to market, a shock to prices may

induce some of them to adjust their asset holdings by selling into the market. These sales will give a further impetus to asset prices, which generate further sales, and so on. Liquidity is a public good, and ex ante liquidity requirements may soften the impact of asset prices on the financial system as a whole.

Modeling Financial Contagion

The main reason for financial regulation is that financial instability is contagious. Hence the failure of any one bank has externalities, which provides grounds for regulation. Yet the transmission process of such contagious crises remains unresolved. The research builds upon expertise in nonlinear dependence and extreme value theory to model contagion as an event where the dependence structure in two markets significantly strengthens when the contagious event occurs.

Regulatory Structure and Incentive-oriented regulation

The work programme on regulatory structure and incentive-oriented regulation reflects the ongoing changes in the regulatory environment. In the near term, there is the implementation of the Basel revised framework for international convergence of capital measurement and capital standards. In the medium-term, regulatory structures will increasingly need to adapt further to the increased globalisation of financial services. These topics have been the subject of certain FMG special and discussion papers as well as the focus of a series of high-profile public lectures and conferences held at the FMG. Starting with the revised Basel accord, the procyclical implications of its more risk-sensitive regulation are analysed in DP 524.

Regulation and Financial Stability

The primary purpose of this Programme is to research the impact of financial regulation on the workings of the banking system and on the functioning of financial markets. The Programme also aims to analyse the evolving structure of financial regulation in Europe and understand the problems facing both regulators and the regulated institutions in the UK, Europe and worldwide in the context of an increasingly global financial system. Some of the main research areas of this Programme are:

- The regulation of banks, including bank capital and solvency.
- The nature, propagation and control of financial crises and the appropriate structure and operation of the international financial architecture.
- Evaluation of the links in the global financial system and the implications for the measurement and management of risk and asset management practices.

Regulation and Financial Stability Programme Events

The Second Annual Future of Financial Regulation Conference

6 and 7 April 2006

Hong Kong Theatre, LSE

Financial regulation is undergoing significant change. As new regulations including Basel II enter force, financial stability has, once again, become an important focal point for discussion on the future of the financial system.

The expected economic and policy implications of regulatory developments frame the debate at *The Future of Financial Regulation*, a conference to be organized by the Financial Markets Group of the London School of Economics in April 2006. The conference features contributions from renowned academics, regulators, and practitioners. Issues to be discussed include:

- **Governance of the regulatory decision making process.**

The Basel II process is determined by the G-10 industrialized countries, and the word 'regulatory capture' has been used to describe the relationship between the Basel Committee and the largest banks. Are these concerns valid? Moreover, do smaller banks, smaller countries and emerging markets countries have sufficient input?

- **How will financial reforms impact upon emerging markets?**

Changes in financial regulations have the potential to level the playing field between emerging markets and industrialized countries, but the raising of the technical bar may also work as a barrier to entry for institutions that are not based in the largest financial centres.

- **Financial regulation and financial stability.** Financial regulations are inherently procyclical and, therefore, simultaneously stabilizing and destabilizing. Quantitative impact studies have shown that the final outcome from changes in regulations is much more uncertain than had been claimed by proponents. Are the benefits from new financial regulations higher than the costs, or not?

The conference is organized by **Harald Benink**, **Jon Danielsson** and **Charles Goodhart**.

We would like to thank McKinsey & Company Inc. and the Bank of England for supporting this conference.

The Legal Foundations of International Monetary Stability

27 and 28 April 2006

Room R405, Lionel Robbins Building, LSE

This conference is the first in a series of events dedicated in the area of Regulation and Financial stability that are organised with the support of the Economics and Social Research Council. The ultimate purpose of these events is to clarify the principles on which financial regulation should be based, and to advance practical proposals for improving the organisation and conduct of such regulation.

The '*Legal Foundations of International Monetary Stability*' conference (based upon Dr Lastra's forthcoming OUP book) will look at the area of monetary law and financial regulation, and aims to bring an inter-disciplinary debate to developments at the national, European and international level.

The conference will address questions such as:

- The future of the euro
- The definition of financial stability
- The liability of financial supervisors
- How to operate an European System of Financial Supervisors?
- Independence and accountability of central
- The role of the IMF in the XXIst century

Contributors include:

Geoffrey Miller (New York University School of Law), **Geoffrey Wood** and **Forrest Capie** (City University Business School and Bank of England), **Charles Goodhart** (Financial Markets Group) **Rene Smits** (University of Amsterdam and Dutch Competition Authority), **Karel Lannoo** (Centre for European Policy Studies), **Dirk Schoenmaker** (Dutch Ministry of Finance), **Takis Tridimas** (Centre for Commercial Law Studies) **Lee Buchheit** (Cleary, Gottlieb, Steen and Hamilton), **Rosa Lastra** (Centre for Commercial Law Studies, Queen Mary, University of London), **Hal Scott** (Harvard Law School), **Thomas Baxter** (Federal Reserve Bank of New York), **Antonio Sainz de Vicuña** (European Central Bank).

Conference Organisers:

Dr Rosa M Lastra and **Professor Charles Goodhart**

This Conference is sponsored by the Economic and Social Research Council (ESRC).

More details about the events and registration will be announced soon at <http://fmg.lse.ac.uk>

Corporate Governance at LSE

Launch event



Professor Antoine Faure-Grimaud, LSE

On 1 December 2005, we successfully launched the *Corporate Governance at LSE* programme with our first in a series on research debates, which attracted a lot of interest from distinguished members of the professional and academic community.

As part of the first research debate, Antoine Faure-Grimaud was talking on 'Corporate Governance in the UK: Is the 'Comply or Explain' approach working?', a paper he has jointly written with Sridhar Arcot and Valentina Bruno of the

Financial Markets Group. The event was

introduced and chaired by LSE's Director, Sir Howard Davies, and the paper was discussed by Peter Montagnon from the Association of British Insurers. The mixture of academics and practitioners attending the debate gave rise to a stimulating discussion highlighting the views of the different stakeholders in the corporate governance issues. The seminar was followed by a lively discussion over dinner in the LSE Senior Common Room. The aim of our 'Corporate Governance' research debates is to create a platform on which practitioners, policymakers and academics can discuss current issues in corporate governance, underpinned by the latest research evidence. For this, we

brought together a series of high profile scholars from around the LSE to study issues surrounding Corporate Governance. The main objective of this new Programme is to promote high quality research across the various disciplines – economics, finance, law and management – which have a link to corporate governance, and to do so in a way that is of interest and practical value to directors of companies, investors, regulators and policy-makers. The Programme includes publications, conferences (the first of these conferences will focus on the European Takeover Directive – see right page), targeted research projects, debates and other activities.

The 'Corporate Governance at LSE' initiative is led by:

Professor Paul Davies, Department of Law, LSE

Professor Antoine Faure-Grimaud,
Financial Markets Group, LSE

Dr Thomas Kirchmaier, MBS and
Financial Markets Group, LSE

Sir Geoffrey Owen, Interdisciplinary Institute of
Management, LSE

For more information please visit the FMG website
<http://fmg.lse.ac.uk>

Other future events in the 'Corporate Governance at LSE' Programme include:

2 February 2006 'The Company Law Reform Bill: What is New?'
Paul Davies, Department of Law, LSE

23 March 2006 'Changing Role of the Chairman: The Impact of Corporate Governance Reform in the UK.'
Geoffrey Owen and **Thomas Kirchmaier**, LSE

Corporate Governance at LSE Conference

European M&A and FMG Conference

The European Takeover Directive

12 January 2006

Financial Markets Group, LSE, Room R405, 4th Floor, Lionel Robbins Building, 10 Portugal Street, London WC2A 2HD

This conference is organized as part of the Corporate Governance at LSE Programme. The conference will look at the introduction of the European Takeover Directive, and its impact on financial markets, particularly the market for corporate control in Europe.

The main issues to be discussed are:

- Implementation of the Directive
- Country Level Effects
- Takeover Strategies and Defences
- Impact on European Financial Markets
- Investor Activism

Conference Programme

9am	Registration
9.30am	Welcome: Sir Howard Davies (Director, LSE) and Sir Geoffrey Owen (Institute of Management, LSE) Keynote Speech: Jaap Winter (De Brauw Blackstone Westbroek; Chairman, High Level Group of Company Law Experts)
10am	Richard Murley (Director General of the UK Takeover Panel)
10.40am	Coffee Break
11am	Jonathan Rickford (UK Representative, High Level Group of Company Law Experts; Visiting Professor LSE), The Takeover Directive: A UK Perspective
11.40am	John Armour (University of Cambridge), Transatlantic Lessons on Takeovers
12.15pm	Lunch

1.30pm	Panel Presentations and Discussion – Takeover Directive: National Effects Cleary Gottlieb Steen and Hamilton LLP, Overview of the Directive (Jan Meyers) – UK (Stuart Banks), France (Valérie Lemaitre), Germany (Klaus Riehmer), Italy (Roberto Bonsignore)
2.30pm	Country Case Studies Banca Antonveneta (Roberto Casati and Giuseppe Scassellati-Sforzolini, Cleary Gottlieb Steen and Hamilton LLP) Endesa/Gas Natural (Alejandro Fernandez de Araoz, Araoz and Rueda) Beiersdorf (Thomas Kirchmaier, Financial Markets Group)
3.15pm	The Takeover Directive and Pan-European Consolidation – The Market Perspective Simon Dingemans (Managing Director, Investment Banking Division, Goldman Sachs International)
3.45pm	Coffee Break
4.15pm	Investor Activism Colin Melvin (Director of Corporate Governance, Hermes Investment Management)
4.45pm	Investor Activism Presentations and Panel Erik Bomans (Managing Partner, Deminor), and speakers from Institutional Investors and Hedge Funds (TBC)
5.45pm	LSE Reception

Organizing Committee

Jeremy Grant, Thomas Kirchmaier and Sir Geoffrey Owen

For information please contact fmg@lse.ac.uk or visit the FMG website at <http://fmg.lse.ac.uk>

Deutsche Bank PhD Fellowship Programme

FMG is pleased to announce the Launch of the Deutsche Bank PhD Fellowship Programme established with the generous support of Deutsche Bank. The objective of the Programme is to offer two Fellowships annually to support outstanding PhD students in pursuing research in the general areas of risk management or capital management at the London School of Economics and Political Science. The Deutsche Bank and the Financial Markets Group at the LSE will offer the Fellowships jointly. The Programme of fellowships is intended to provide research support to PhD-level research students and to enable the LSE to attract, retain and support outstanding PhD students in the above subject areas. Recipients of the Deutsche Bank PhD Fellowship will be provided with an annual stipend of £20,000 to support tuition fees, research and living expenses.

The Fellowships will be awarded annually by a Fellowship Committee consisting of the LSE Deutsche Bank Chair in Finance at LSE, the FMG Director, and two representatives of Deutsche Bank. The awards will be made on the basis of a student's proposal for admission to the LSE PhD programme, and background and achievements, in the case of a first-year student, or on the basis of previous years' performance in the cases of second, third and final year students. The Fellowships will be awarded in July each year and will be advertised via the Financial Markets Group in the summer term. More information and submission details for the Fellowships for 2006-07 will be advertised on the FMG website at the summer term of 2006 (<http://fmg.lse.ac.uk>).

Concordia Research Student Fellowship

The competition for the Concordia Research Student Fellowship 2005-06 was completed in September 2005. The competition attracted a total of 8 applications from students from the LSE Economics and Accounting and Finance departments. The Concordia Research Student Fellowship for the academic year 2005-06 was awarded to Christian Reusch of the Accounting and Finance Department. Christian Reusch has been a PhD student in Finance at the LSE since 2003. He has been a research assistant at the FMG and in the EPSRC-sponsored project 'Price Dynamics under Aggregated Decision Making in Financial Markets with Uncertainty and External Constraint' under the supervision of Dr Jon Danielsson since 2004. His current research in financial econometrics focuses on the formulation and estimation of risk and liquidity models. A graduate of the LSE in economics and finance, Christian worked in investment banking before starting his PhD.

The Concordia Research Student Fellowship is established with the generous support of Concordia Advisors LLP in UK. The Fellowship will be awarded annually by Concordia and the Financial Markets Group at LSE to an outstanding student who has been accepted for a PhD degree in the LSE Economics or Accounting and Finance Departments. This contribution from Concordia is intended to encourage research in the wider area of Asset Pricing and Portfolio Management. The Concordia Fellowship provides a stipend of £15,000 annually to support tuition fees or/and research and living expenses.

The deadline for applications for the Concordia Research Student Fellowship will be announced in the summer term each year. If you wish to apply for the Fellowship for 2006-07 please consult the FMG website during the summer term of 2006 (<http://fmg.lse.ac.uk>).

Pensions Public Lectures

UBS Pensions Research Programme

'Responding to the demographic challenge:
deciding the appropriate role of government'

Adair Turner, Chairman, Pensions Commission

1 February 2006

6pm, Hong Kong Theatre, LSE

This event is sponsored by the **UBS Pensions Research Programme at LSE**

In its first report the Pensions Commission concluded that faced with the increasing proportion of the population aged over 65, society and individuals have to choose between pensioners becoming poorer relative to the rest of society, increased taxes, higher savings, and/or later retirement. Speaking recently to the Trade Union Congress, Adair Turner, Chair of the Pensions Commission, promised only one thing: that there are no easy answers to the pensions challenge.

Speaking at the LSE on 1 February 2006, Lord Turner will outline and discuss how the Commission's long-awaited recommendations, due to be published on 30 November 2005, are designed to create a sustainable and equitable future for pensioners in the UK.

Watson Wyatt Public Lecture

'Work Past Retirement'

Alicia H Munnell, Peter F Drucker
Professor of Management Sciences, Boston College

9 February 2006

6pm, FMG Conference Room, Room 405, 4th Floor, Lionel Robbins Building, LSE, 10 Portugal Street, London, WC2A 2HD

Increasing the retirement age is among the most contentious topics in UK pension policy. Alicia Munnell, director of the Center for Retirement Research at Boston College, will provide a broad perspective on these topics in the second Watson Wyatt lecture on 9 February at the London School of Economics and Political Science. Professor Munnell will draw on her recent research on working past retirement in the US and draw on international lessons in commenting on the policy issues associated with raising effective retirement ages.

More information and registration details will be published soon on the FMG website.

Discussion papers

DP 534

Estimating Structural Bond Pricing Models via Simulated Maximum Likelihood

Max Bruche

This paper describes how structural bond pricing models can be estimated using a Simulated Maximum Likelihood procedure developed by Durbin and Koopman (1997). The approach has the advantage that the price dated on any traded claim (such as bonds, equity, and credit default swaps), as well as information about the balance sheet (eg, accounting data) can be used in the estimation, improving efficiency. Monte Carlo evidence as well as a small application to real data indicates that this approach is superior to both traditional estimation methods and recently proposed versions of Maximum Likelihood Estimation (Ericsson, Reneby 2002).

DP 535

IMF Concern For Reputation and Conditional Lending Failure: Theory and Empirics

Silvia Marchesi and Laura Sabani

One possible explanation for the unsatisfactory implementation of IMF conditionality has been attributed to the lack of credibility of the IMF's threat of interrupting financial assistance in case of non compliance with the negotiated conditions. In this paper we suggest that such lack of credibility might be due to the dual role played by the IMF which acts at the same time as a creditor and a monitor of economic reforms. We show that the IMF incentive to hide its surveillance failures, in order to preserve its reputation of being a good monitor, may actually distort its lending decisions towards greater laxity (relative to social optimum) in punishing non-compliance with economic reforms. We have empirically tested such theoretical result by supposing that larger departures from efficiency of the IMF lending rule are associated with a longer relationship between a country and the IMF. The longer this relationship, the stronger the IMF reputation will be affected in case it ultimately decides to stop lending. Specifically, we have empirically investigated whether IMF disbursements are affected by the IMF own share of debt, which is taken as a proxy for the duration of the relationship between the Fund



and a country. Our empirical results show that a higher IMF debt share does increase IMF disbursements.

DP 536

Financial Tunnelling and the Revenge of the Insider System

Jeremy Grant and Thomas Kirchmaier

In this paper, we document how European companies can use financial tunnelling to the disadvantage of minority shareholders, despite improved legislation directed at eliminating such activities. In four case studies, two German and two Italian, we document how newly established corporate governance standards were successfully circumvented by dominant shareholders, major financial institutions, politicians, and in the worst case the regulator. These cases demonstrate that for effective Corporate Governance to work, one not only has to change the law, but even more importantly, one has to ensure the widespread acceptance of new rules. The litmus test of corporate governance reforms in any country is whether the rules are applied objectively in situations where powerful elites perceive they are disadvantaged under the new regulations.

DP 537 (UBS Pensions Series 035)

Asset Pricing with Limited Risk Sharing and Heterogeneous Agents

Francisco Gomes and Alex Michaelides

We solve a model with incomplete markets and heterogeneous agents that generates a large equity premium, while simultaneously matching stock market participation and individual asset holdings. The high risk premium is driven by incomplete risk sharing among stockholders, which results from the combination of borrowing constraints and (realistically) calibrated life-cycle earnings profiles, subject to both aggregate and idiosyncratic shocks. We show that it is challenging to simultaneously match aggregate quantities (asset prices) and individual quantities (asset allocations). Furthermore, limited participation has a negligible impact on the risk premium, contrary to the results of models where it is imposed exogenously.

DP 538 (UBS Pensions Series 036)

Dynamic Portfolio And Mortgage Choice For Homeowners

Otto van Hemert, Joost Driessen and Frank de Jong

We investigate the impact of owner-occupied housing on financial portfolio and mortgage choice under stochastic inflation and real interest rates. To this end we develop a dynamic framework in which investors can invest in stocks and bonds with different maturities. We use a continuous-time model with CRRA preferences and calibrate the model parameters using data on inflation rates and equity, bond, and house prices. For the case of no short-sale constraints, we derive an implicit solution and identify the main channels through which the housing to total

wealth ratio and the horizon affect financial portfolio choice. This solution is used to interpret numerical results that we provide when the investor has short-sale constraints. We also use our framework to investigate optimal mortgage size and type. A moderately risk-averse investor prefers an adjustable-rate mortgage (ARM), while a more risk-averse investor prefers a fixed rate mortgage (FRM). A combination of an ARM and an FRM further improves welfare. Choosing a suboptimal mortgage leads to utility losses up to six per cent.

DP 539

Simulated Nonparametric Estimation of Dynamic Models with Applications to Finance

Filippo Altissimo and Antonio Mele

This paper introduces a new class of parameter estimators for dynamic models, called Simulated Nonparametric Estimators (SNE). The SNE minimizes appropriate distances between nonparametric joint (or conditional) densities estimated from sample data and nonparametric joint (or conditional) densities estimated from data simulated out of the model of interest. Sample data and model-simulated data are smoothed with the same kernel. This makes the SNE: 1) consistent independently of the amount of smoothing (up to identifiability); and 2) asymptotically root-T normal when the smoothing parameter goes to zero at a reasonably mild rate. Furthermore, the estimator displays the same asymptotic efficiency properties as the maximum-likelihood estimator as soon as the model is Markov in the observable variables. The methods are flexible, simple to implement, and fairly fast; furthermore, they possess finite sample properties that are well approximated by the asymptotic theory. These features are illustrated within the typical estimation problems arising in financial economics.

DP 540

Reputation Effects in Trading on the New York Stock Exchange

Robert Jennings, Andrew Ellul and Robert Battalio

Theory suggests that reputations, developed in repeated face-to-face interactions, allow non-anonymous, floor-based trading venues to attenuate adverse selection in the trading process. We identify instances when stocks listed on the New York Stock Exchange (NYSE) experience a non-trivial relocation on the trading floor for reasons unrelated to execution quality. Although the specialist follows the stock to its new location, most floor brokers do not. We use this natural experiment to determine whether reputation appears to affect trading costs. We find a discernable increase in the cost of liquidity in the days surrounding a stock's relocation. The increase is more pronounced for stocks with higher adverse selection and greater broker turnover. Using NYSE audit-trail data, we find that the floor brokers relocating with the stock obtain lower trading costs than those brokers who do not move and those that begin trading post-move in the days surrounding the move. Together, these results suggest that reputation plays an important role in the liquidity provision process on the floor of the NYSE.

Special papers

SP 161

Politics and the Creation of a European SEC: The Optimal UK Strategy – Constructive Inconsistency

Ruben Lee

This paper analyses the factors influencing whether a European Securities and Exchange Commission (ESEC) will be created and confirms the primary role that politics will play in its establishment. In the face of growing support for an ESEC, the paper recommends a strategy the UK should adopt towards the creation of such an institution. It is proposed that the UK adopt a three-pronged approach. First, the UK must, as it currently does, support the Lamfalussy Process in the hope that it works. Second, the UK must determine what criteria need to be assessed in order to evaluate whether the Lamfalussy Process together with the Financial Services Action Plan are in fact harming UK interests, and then make such an evaluation. Finally, if political support for an ESEC becomes unstoppable, the UK should negotiate for the creation of an appropriately structured ESEC – even though its backing for the Lamfalussy Process should logically preclude its support for any type of ESEC. A key attribute of the recommended strategy is thus that it is inconsistent. This is not, however, thought a problem. On the contrary, given that the creation of an ESEC is the stuff of politics and thus that a political response is called for, and given that other key participants' policies on the creation of an ESEC are themselves inconsistent, the strategy proposed is argued as being not only constructive, but indeed rational.

Forthcoming Discussion and Special Papers

Discussion Papers

DP 541 (UBS Pensions Series 037)

'Optimal intergenerational risk sharing'

Otto van Hemert

DP 542

'Long-term debt and hidden borrowing'

Heski Bar-Isaac and Vincente Cuñat

DP 543 (UBS Pensions Series 038)

'Reforming Public Pensions in the US and the UK'

Peter Diamond

DP 544

'Minority Blocks And Takeover Premia'

Fausto Panunzi, Denis Gromb and Mike Burkart

DP 545

'ART versus reinsurance: the disciplining effect of information insensitivity'

Christian Laux and Silke Brandts

DP 546

'An Essay on the Interactions between the Bank of England's Forecasts, The MPC's Policy Adjustments, and the Eventual Outcome'

Charles Goodhart

Special Papers

SP 162

'The Future of Central Banking'

Charles Goodhart

Visitors to the FMG

November – January 2006

Carsten Bienz, Goethe University Frankfurt

Thomas Chemmanur, Boston College

Joe Chen, University of Southern California

Andrew Ellul, Kelley School of Business, Indiana University

Manuel Klein, INSEAD

Arvind Krishnamurthy, Northwestern University

Ossi Lindstrom, Helsinki School of Economics

Lubos Pastor, Chicago University

Adriano Rampini, Northwestern University

Paola Sapienza, Northwestern University

Antoinette Schoar, MIT

Miguel Segoviano, IMF

Enrique Sentana, CEMFI

Jakub Steiner, Cerge-ei

Felix Treptow, Munich School of Management

Otto van Hemert, Universiteit van Amsterdam, Tinbergen Institute



<http://fmg.lse.ac.uk/>

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