

Second Annual Conference: The Future Of Financial Regulation

Following the inaugural conference on the Future of Financial Regulation in 2005 (see Review Number 66), the Financial Markets Group of the London School of Economics and Political Science organized the Second Annual Conference on 6-7 April 2006. 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 conference featured contributions from renowned academics, regulators, and

practitioners. The keynote speakers were Dr Randall Kroszner, Governor, Federal Reserve Board and Nick Le Pan, Vice Chairman, Basel Committee on Banking Supervision and Superintendent of Financial Institutions, Canada.

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The Future of Financial Regulation Conference 2006



Second Annual Conference: The Future of Financial Regulation

6-7 April 2006



Randall S Kroszner (Member of the Board of Governors of the Federal Reserve System)

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(Member of the Board of Governors of the Federal Reserve System) contributed to the current debate in the European Union on cross-border integration of the banking industry by drawing conclusions from the US experience with removing inter-state barriers to geographic expansion of banking organisations. He reviewed the benefits that

this process of deregulation has brought in the US and argued that this policy would bring similar benefits in Europe.

Kroszner began by discussing the evolution, during the past century, of the regulation in the US concerning inter-state banking. Restrictions on geographical expansion originated as a strategy of state governments to maximise revenues arising from granting bank charters. There was a gradual removal of these restrictions, especially after the 1970's, a process which culminated in the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 which effectively removed all barriers.

This process of deregulation has had important consequences on the structure of the banking industry, which has observed a transition from a very atomised structure to one which now shows a much higher degree of national integration, much as expected. The number of banking organisations has fallen by more than half since the early 1980's, a process that has taken place mostly through mergers and acquisitions. Furthermore, this increased concentration at the national level has not happened at the cost of decreased competition at the local level, where concentration has remained remarkably stable, partly due to regulatory restrictions limiting local concentration.

The benefits of the removal of the geographic restrictions can be observed not only in the banking industry but in the broader economy as well, as Kroszner pointed out. He identified four main positive effects, for which he provided extensive empirical support. Consolidation has allowed banks to become, on the one hand, more efficient, making possible a reduction in the prices of banking services, and on the other hand more diversified,

resulting in less risky banks. The broader economy has also benefited from this regulatory development, and an extensive empirical literature has documented higher economic and employment growth associated with the process of deregulation. In addition to this, these changes have encouraged more entrepreneurial activity as a result of an improvement in the access to credit for the more bank-dependent sectors of the economy, such as small and medium-sized enterprises. Lastly, Kroszner argued that economic volatility has been reduced, a point which remains controversial in the theoretical academic literature but which recent empirical research seems to show to be the case.



Randall S Kroszner (Member of the Board of Governors of the Federal Reserve System) and Professor Charles Goodhart at the opening of The Future of Financial Regulation Conference 2006

He concluded in arguing that there is reason to believe that Europe could enjoy similar benefits as those the US has experienced by removing the political concerns that currently limit cross-border bank merger activity.

The first session of the conference focused on financial reforms in the context of emerging market economies, and was chaired by **Professor Harald Benink** (Erasmus University Rotterdam and FMG/LSE).

The opening speaker, **Mr Luo Ping** (Deputy Director-General, China Banking Regulatory Commission), focused on the case of China. He addressed the current state of the banking industry and its regulatory structure, and discussed the key challenges for the future. The vast majority of banking assets remain under state ownership in an economy which has only recently allowed entry of foreign banks and which remains very bank dependent, while the resilience of the banking sector is burdened by poor asset quality and a low degree of diversification but is sustained by robust profits and government support. One key challenge for emerging markets is to provide effective regulation and supervision, something which is hindered by weak macroeconomic policies and under-developed institutional frameworks, and this should be taken into account by international financial institutions when assessing regulatory compliance. Mr Ping also identified signs of over-regulation in China and other



Luo Ping (Deputy Director-General, China Banking Regulatory Commission)

Asian markets, and addressed the merits of Basel II while at the same time cautioning on the convenience of implementing it in emerging markets. Finally, he discussed the current state of the policy debate on allowing entry of foreign banks.

Mr David Lubin (Director, Emerging Markets Research, HSBC Bank) analysed the causes and consequences of the large increase in financial foreign direct investments (FDI)

into emerging markets observed in the last 15 years. A simultaneous increase in demand for foreign bank funds by emerging markets and of supply of FDI by foreign banks occurred in the 1990's. Demand increased in countries hit by financial crises in order to replenish capital in distressed banks, and also in transition economies as banks were privatised and foreign buyers were allowed in. The increase in willingness to supply those FDI's arose as a result of bank clients' higher international presence, and of the intermediaries' need for portfolio redistribution. The main effects of this increased flow have been an increased discipline in the operation of banks in EMEs, an increase in competition accompanied by lower prices of banking services, an improvement in the efficient intermediation of savings to productive uses, and a fostering of capital market development. As a result of these developments, the regulatory challenges are to deal with a shortage of skilled human capital to perform supervisory duties, a loss of regulatory control as some decisions are being taken abroad, and the risk of spillover effects.

The development of Latin American stock markets was the topic of discussion introduced by **Dr Martin Grandes** (American University of Paris and Center for Financial Stability, Argentina), who began by documenting the relative underdevelopment of those markets. An econometric analysis of stock returns in those countries reveals the potential factors behind this landscape by showing, on the one hand, a relatively high cost of equity, and, on the other, a low risk-adjusted return, that is below the level of developed markets. These are driven by a low demand for and supply of equity, and a key policy challenge in order to encourage development of capital markets is to decrease systematic volatility.

Dr Silvina Vatnick closed the first session by introducing some main features of financial development in emerging markets, amongst others the changing composition of capital flows into emerging markets, the underdevelopment of non-bank financial intermediation and the large asset concentration in the banking sectors. With regards to Mr Ping's speech, she highlighted the importance of sequencing as key with regards to the third pillar of Basel II and the development of capital markets in China.

The second session, chaired by **Professor David Webb** (Director of the FMG, LSE), focused on financial regulation and financial stability. The panel comprised **Dr John Laker** (Chairman, Australian Prudential Regulation Authority), **Sir Adam Ridley** (Senior Advisor, London Investment Banking Association), **Dr Jon Danielsson** (FMG/LSE) and **Dr Joong-Kyung Choi** (Executive Director for Korea, Australia and New Zealand, The World Bank).

The first speaker, **Dr John Laker** discussed the Australian Prudential Regulation Authority's Basel II approach and raised issues on Pillar 1 and Pillar 2. He analysed advantages and disadvantages of some alternative approaches to Pillar 2. He also highlighted the importance of information sharing and strengthened relationships with other supervisors.

Sir Adam Ridley analysed issues concerning the regulation of securities trading and exchanges. He pointed out three current major confrontations related to trading of equities: concentration of trades on one exchange versus internalization; full pre and post-trade price transparency versus some privileges for market makers; best price versus what clients want. He also offered his view on the future of regulation of securities trading and exchanges.



Dr Jon Danielsson, Financial Markets Group, LSE

Dr Jon Danielsson focused on the role of regulatory banking capital. He started with an analysis of the traditional function of capital. Then he set a number of conditions for effective capital requirements. Giving the example of the problems of the Millennium Bridge, Danielsson stressed that it is important to consider risk as endogenous because crises are amplified if people behave in the same way

and have similar beliefs. He argued that Basel II actually encourages this harmonization because it motivates banks to react in the same way to adverse shocks. The capital buffer and the maintenance of the buffer hence become sources of systemic risk. Finally, he offered some solutions which may improve the efficiency of capital requirements.

Finally, whilst agreeing to many of the points raised by the other speakers, **Dr Joong-Kyung Choi** stressed the importance of market discipline in financial regulation. He concluded that financial regulation should not only rely on official supervisors, but also focus on improving and empowering the private market's ability to monitor and discipline financial institutions.

The morning session on Friday was chaired by **Sir Howard Davies** and began with the keynote address by **Mr Nick Le Pan** (Vice Chairman, Basel Committee on Banking Supervision and Superintendent of Financial Institutions, Canada). Mr Le Pan began by recalling the objectives of

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Dr Silvana Vatnick (Lead Financial Economist, Financial Sector Vice-Presidency, World Bank)

Basel II. According to him, Basel II was designed to better relate capital to risk, which is achieved by the three-pillar approach: risk based minimum capital requirements (Pillar 1); support for more risk-based supervision, and banks themselves better relating the level of their actual capital related to risk (Pillar 2); improved disclosure (Pillar 3).

However, he then pointed out the following realities which

must be considered when assessing Basel II against its objectives. First, there is a large difference between the complexities of major, internationally active banking organizations and those of smaller or mid-size banks. Second, there is a large difference in the starting point of individual banks and supervisors within and outside of the G-10. Third, there is an increasing difference between how major banks manage themselves and the legal entity structures that supervisors have to deal with because of the national basis of law and depositor compensation arrangements.

He noted that the criticism of Basel II for its impact and complexity was, in some measure, justified. In part this reflected the difficulties in moving a rules system towards being more tailored to circumstances (ie risks) and knowing where to be on the 'detailed rules versus principles' continuum (Basel has both). In addition, he pointed out that there is a symbiotic relationship between banks and supervisors that leads to more complexity than is probably necessary in some areas.

The next part of the talk highlighted some of the biggest challenges for implementation of the revised accord, including home-host implementation the role of judgement in banking and supervision. The former issue is particularly relevant at the banking group level. Host countries need to rely on home countries, as more analytics and risk management are done centrally, and home countries need to rely more on hosts to assess the validity of the local application of Basel II analytics and data. He felt that trust and reliance cannot be mandated but have to be built. On the issue of the role of judgement he commented that Basel II is not simply about arithmetic and higher mathematics but more importantly about the sharing information among supervisors to reduce the chance of large unintended consequences in the exercise of judgement.

Finally **Mr Le Pan** gave his thoughts on the prospects for Basel II and beyond. As regards, the chances of achieving the risk measurement and management objectives of Basel II, he felt that some such as improvements in data and analytics are clearly achievable. In addition he felt that

supervisory communication, trust and reliance will rise post implementation of Basel II. On the question of how Basel II might work to reduce the chance of serious financial stability problems or operate in a problem bank situation, he thought that partly the benefits will be preventative and will depend on the risk implications. In terms of the future, he first raised the practical question of whether anyone would be willing to take on a project of this magnitude for the foreseeable future? He then discussed on the one hand the requirements in moving towards more principle-based regulation, for example the need for information-sharing mechanisms to have a reasonable evenness of implementation, and on the other hand the likelihood of a further rules agenda. The keynote address concluded with discussion and questions from the audience.

The second session was chaired by **Dr Cesare Calari** (Vice President for the Financial Sector, World Bank) and was titled 'Governance of the Regulatory Decision Making Process'. The first presentation of the session was by **Mr Brian Quinn** (former Director of Banking Supervision, Bank of England). He discussed how regulatory decisions are taken and implemented, both at the national and international level. The first prerequisite for a proper regulatory system is independence. The regulatory and supervisory authorities should be kept free from political and commercial interference. A regulator who is weak, or susceptible to interference, is likely to cause huge damage to the economy. The presentation then turned to the issue of regulatory capture. In general, the more developed financial markets and the more diversified the participants, the less likely it is that powerful institutions will exercise undue influence on the regulatory and supervisory process. However, the speaker felt that it would be a mistake to underestimate the quality of supervision in developing countries and their ability to adapt accords like Basle for their local markets. He also felt that crisis management by regulatory authorities had improved substantially in the past few years. Regulators are better prepared but it is vital that trust is build up through both informal and regular contacts. The presentation concluded by acknowledging the role of the Basel Committee that produced principles and guidelines rather than imposing a method of operation for supervisors.

The second presentation by **Mr Oliver Baete** (McKinsey and Company) suggested that Basel II triggers a range of operational and strategic challenges for the entire industry. Most of the attention Basel II receives is around regulatory compliance – however, a number of interacting developments are influencing banks' operational and strategic choices affecting both the level and composition of systemic risk. Operational opportunities arise mainly out of process optimization as well as better capital and treasury management by banks. Based on McKinsey's study, it was felt that there was likely to be increased cyclicity in rating capital requirements, regulatory arbitrage resulting from inconsistent treatment of assets and further consolidation in the retail sector arising out of increasing importance of economies of scale. All the above potentially would have a profound impact on systemic risk landscape.



Professor Richard Herring (Wharton, University of Pennsylvania)

The final presentation of the session by **Professor Richard Herring** (Wharton, University of Pennsylvania) focused on the structure and organisation of cross-sector financial supervision. The talk presented an overview of the regulatory and supervisory functions. It analysed in depth the traditional organisational structure, the factors leading to adoption of the integrated model, the role of the central bank, the issue of

independence and international considerations. In conclusion the speaker felt that many alternative models appears to work in normal times and the organisation of supervision matters less than having clear policies and procedures and adequate resources for the supervisor. Finally, preserving a role for the central bank matters most if it affects these factors, particularly for emerging markets.

In his discussion of the session **Professor Rafael Repullo** (CEMFI) suggested that profitability in retail banking need not decrease. He also did not agree with the proposition that Basel II will lead to consolidation in the retail banking sector. He felt that smaller banks will survive by specializing in certain types of relationship lending. He also questioned if there was an optimal structure of supervision and concluded that it probably depends on how different objectives are traded off. He agreed that more research was needed on the subject to move the system in the 'right' direction. Finally, he recommended that the general guiding principle of 'if it ain't broken don't fix it' has served us well so far and should continue to do so in future.

The last session, chaired by **Dr Andrew Hilton** (Director of the Centre for the Study of Financial Innovation), focused on financial regulation. The panel comprised **Dr Raghuram Rajan** (Economic Counsellor and Director, Research Department, IMF), **Mr David Schraa** (Director, Regulatory Affairs Department, Institute of International Finance), **Professor Christian de Boissieu** (University of Paris-I, Pantheon-Sorbonne, and President, Conseil d'Analyse Economique), **Dr Erlend Nier** (Financial Stability Division, Bank of England) and **Mr Ian Michael** (Financial Services Authority).

The first speaker, **Dr Raghuram Rajan**, highlighted that after an era of extremely regulated financial markets, and consequently an era of poor risk management, market participants nowadays, were in an increasingly competitive market. The main concern expressed by the speaker was that the change in the competitive environment in the market may have moved the incentives towards excessive risk taking. In his opinion the penalties that the market can implement are limited and existing regulation is not fully addressing the issue. On the one hand, increases in disclosure, although being

useful, will never be definitive for large and complex financial institutions since they are continuously changing their positions and future strategies. On the other hand, although capital regulation is moving in the right direction, it is just halfway there. From his point of view, we need simpler and smarter regulation to address the potential excessive risk-taking problem.

Mr David Schraa commented on the US experience and reminded the audience the importance of small banks in the process of designing and implementing optimally the banking regulation. He expressed worries that Basel II may end up being too rule based. Finally, and opposite to the previous speakers' opinion, he emphasized the likely large and positive impact of Pillar III, especially in the G10 economies. Nonetheless, he accepted that increases in transparency are not automatically translated into enhanced financial and risk management.

Professor Christian de Boissieu also expressed the concerns on Basel II which have been previously discussed. Additionally, he called attention to the importance of international cooperation and coordination for the large and complex financial intermediaries. From his point of view, the only effective coordination exercise is going through the Basel Club, which therefore, needs to be enlarged.

Dr Erlend Nier made use of two empirical papers carried out recently by himself and colleagues in the Bank of England to analyse the effects of the current banking regulation. First he showed that there is feedback from loan losses to loan supply and hence potentially to the macro-economy. He concluded however, that it is not yet clear if this going to get worse under Basel II. Then, proceeded to show the benefits of transparency and market discipline, which he used to argue that macro-systemic risk may be reduced through a careful implementation of Pillar 3.

Finally, whilst sharing most of the views already expressed by the other members of the panel, **Ian Michael** underlined the important effects that accounting standards have on bankers incentives. He argued that by reinforcing them, it may help to enhance the effectiveness of prudential regulation.

This conference was organised by

Professor Charles Goodhart, Director, Regulation and Financial Stability Research Programme, FMG/LSE

Dr Jon Danielsson, FMG/LSE

Professor Harald Benink, Erasmus University Rotterdam and FMG/ LSE

The conference presentations are available to download from the FMG website: <http://fmg.lse.ac.uk>

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Regulation and Financial Stability Conferences

As part of the ESRC funded series of Regulation and Financial Stability Conferences (**Award Reference Number: RES – 451-25-4005**) the FMG has organised the initial two conferences of the programme:

27 – 28 April 2006 The Legal Foundations of International Monetary Stability

18 – 19 May 2006 Financial Stability: Theory and Applications

The conferences build on the established FMG London Financial Regulation seminar, which has run since 1999. The ultimate purpose of the programme 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 workshop series leader is Professor Charles Goodhart of FMG and the organisational committee has an intercollegiate and interdisciplinary profile involving Professor Philip Davis (Brunel University), Dr Rosa Maria Lastra (Queen Mary, University of London), Dr Alistair Milne (Cass Business School), Mr Andrew Winckler (Ernst and Young) and Professor Geoffrey Wood (City University Business School). The workshops will target the academic, policymaking and professional communities and will encourage and support the participation of young researchers and research students.

The Legal Foundations of International Monetary Stability

27 – 28 April 2006

The Legal Foundations of International Monetary Stability conference (based on Dr Lastra's forthcoming book to be published by Oxford University Press in June 2006) focused at the area of monetary law and financial regulation. The programme aimed to bring an interdisciplinary debate to developments at the national, European and international level.

The first session of the conference focused on monetary and financial stability. The opening speaker, and chair of the session, **Mr Thomas Baxter** (Federal Reserve of New York) discussed central bank independence. He highlighted that the difference between control and influence in the definition of independence is one of degree and defined central bank independence as freedom from control of another; not freedom from influence of another. Mr Baxter reviewed the role of funding, structure and culture as sources of control or influence.

Professor Geoffrey P Miller (New York University School of Law) analysed why politicians, often self-interested, would be willing to give up power over price stability and create independent central banks. He argued that the independent central bank is a relatively reliable pre-commitment mechanism not to give in to temptation when it appears. However, politicians tend not to undertake this kind of pre-commitment in other

areas. Professor Miller noted that central bank independence serves the self-interest of politicians for reasons other than blaming someone when things go poorly. He concluded that it maximizes the politicians' ability to extract campaign contributions in the short run and hence they may find it advantageous to give away control over prices levels.

The foundations of international monetary laws were discussed by **Dr Rosa Maria Lastra** (Centre for Commercial Law Studies, Queen Mary, University of London). She highlighted the importance of national, European and international developments in the pursuit of monetary and financial stability and the key role of the central bank at the national level, the European Central Bank within Europe and the International Monetary Fund at the international stage. Dr Lastra emphasised the multi-layered structure and the overlapping jurisdictions that currently characterise monetary law and accentuate the challenge of cross-border resolution of crises.

Professor Charles Goodhart (Financial Markets Group, London School of Economics and Political Science) concurred with Dr Lastra that, given the ongoing integration of European financial markets, there is a need in the future for European arrangements for financial supervision and stability. He focused on burden sharing in cross-border banking crises and expressed his



concern about whether home countries would be prepared to pay for the rescue of a bank's presence and depositors in other EU countries. Goodhart argued that, ex-post, it would not be possible to bargain internationally over burden sharing and hence it would be necessary to agree on the ex-ante rules of cross-border recapitalisation. He presented two ex-ante mechanisms of fiscal burden sharing in a banking crisis. The first one could be a general fund to shoulder the burden of recapitalisation financed from the seigniorage of the ECB (and of central banks from non-euro area countries). In his opinion, although the costs of recapitalisation are smoothed over countries (and over time), this approach runs into problems of causing cross-border fiscal transfers, and adverse selection, moral hazard and free-rider concerns. The second is a specific burden sharing mechanism: only countries in which the problem bank is conducting business contribute to the burden sharing. Cross-border transfers are then largely avoided, but this scheme is still subject to the free-rider problem.

The session concluded with a panel discussion on the independence of central banks, private and public law, political theory of central banks, burden sharing in banking crises in Europe and central bank governance. The panel comprised **Professor Gaspar Ariño** (Universidad Autónoma de Madrid), **Professor Lars Gorton** (University of Lund), **Professor Donato Masciandaro** (Bocconi University), **Mr Mark Jewett** (Bank of Canada) and **Dr Gavin Bingham** (Bank of International Settlements).

The topic for the second session was current developments in the European financial system, and how these have affected the financial supervisors' ability to ensure the existence of a sound financial system. The banking markets of the European Union have throughout the past decade been characterised by cross-border banking, which has occurred through the acquisition of subsidiaries and the establishment of foreign branches in local markets. This has been accompanied by a centralization of the international banks' risk management such that one branch maintains the risk management decisions of all subsidiaries. This has led to an increased divergence between the legal and operational structure of banking groups. The current state of the supervisory authority framework is one of home country control with mutual recognition of the requirements of other member states. Subsidiaries are separate legal entities, and are supervised by the authority in the country of incorporation. This setup combined with the divergence between the legal and operational structure of the banking group presents an interesting dilemma: actions of the supervisory authority in the country in which the 'risk managing branch' is incorporated affects the financial stability of this branch, but hereby also financial stability of potential subsidiaries domiciled in other countries. This creates an externality since the authority is only accountable for the implications of its actions on its domestic financial markets. Against this backdrop, the discussion was on the viability and potential enhancements of the current European regulatory framework. The session followed with comments from **Mr Antonio Sainz De Vicuna** (European Central Bank) on the 'Institutional Theory of Money'. Mr Vicuna argued that the financial developments of the 20th century have rendered the 'State Theory of

Money' and the 'Society Theory of Money' obsolete. In the current financial system, money is no longer limited to a physical token with an intrinsic value. Today the financial system is based on electronic money and a transfer of claims on financial institutions. The value of money, as defined by the purchasing power of scriptural money, is determined by the market and is therefore outside state control. The 'Institutional Theory of Money' acknowledges this development in the financial system, and argues that the value of money can only be maintained if the market retains its faith in scriptural money. This requires a legal framework where financial institutions are granted the freedom and tools to manage and preserve the global trust in scriptural money.

Professor Rene Smits (Universiteit von Amsterdam) followed up with a discussion of the asymmetries in the European economic and monetary union. The union's objective was outlined as one of stable prices, sound public finances, sound monetary conditions and a sustainable balance of payments in all of its member states. In spirit the union is an open market economy with free competition. In order to ensure that the objective is achieved, a set of prohibitions and provisions have been implemented. The goal of these is to ensure that local governments do not interfere with the allocation of credit by local banks, and that local governments adhere to sound macroeconomic policies. This includes limitations on local government budget deficits. The speaker discussed the instances where local governments have violated the budget deficit guidelines. On most occasions the Economic Council have had difficulties in implementing any of available sanctions, since the Council is composed of the very people which may be subject to the sanctions. This has opened up a more lax reading of the guidelines with scope for a distinct local interpretation. He argued that this will lead to larger asymmetries amongst the members of the economic union and, if anything, this path will make it harder for the union to achieve its economic objectives. In addition, he noted that currently the union appears to have created a series of segregated free markets rather than one integrated market. The speaker suggested that better integration could be achieved through a higher degree of harmonization of local laws, particularly concerning labour mobility and education and those pertaining to markets for energy and financial services.

The question of the integration of the financial markets in the economic union was discussed further by **Mr Karel Lannoo** (Centre for European Policy Studies). He argued that the current supervisory structure is influenced by unhealthy asymmetries, which amongst other things are rooted in the separation of the body that regulates from the body that might be accountable if international banks fail (as described above). Lannoo further argued in favour of a consolidation and enhancement of the current system rather than the introduction of a new European financial architecture. A suggested enhancement of the current system was the creation of a central registry for supervisory information. This would ensure that supervisory information could be provided consistently and in a timely fashion. In turn this would ease the cooperation of local supervisory authorities. Further steps towards



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enhancing the cooperation between local supervisory authorities could be achieved through the creation of common reporting standards. Finally, he argued that convergence across supervisory authorities should take the form of convergence of objectives rather than convergence of procedures, which further strengthens the requirement to alleviate asymmetries.

Professor Dirch Schoenmacher (Dutch Ministry of Finance) suggested a revision of the current European financial architecture in order to deal with the changing financial landscape. The main challenges for a revised financial architecture are to be able to cope with the consolidation of financial groups, and to accommodate cross-border externalities arising from the failure of EU-wide operating financial groups. The suggestion is to amend the current system such that a lead supervising authority is introduced to deal with international financial groups. Small to medium size local groups are still to be supervised by the local authority. The lead supervisor's objective is to regulate the entire consolidated entity, and it would as such also be given the direct responsibility of foreign domiciled subsidiaries and branches. Furthermore, the current system should be expanded by a European level central agency for prudential supervision of cross-border financial groups. This central agency would be responsible for the design of cross-border banking policy design, and for key cross-border banking supervisory decisions. The board of the central agency should consist of representatives from all 25 national supervisory teams. The speaker argued that this system could eliminate costly double supervision and would insure that the externalities of local supervisory decisions of international banks could be appropriately addressed.

The third session raised the question of which legal arrangements can be implemented to deal with crises workouts and insure financial stability. The opening speaker and chair of the session **Professor William Blair** (QC, Verulam Buildings) argued that regulation is at the core of recent international developments and recognised the role of law and institutions in promoting international financial stability.

The first presentation by **Mr Lee Buchheit** (Cleary Gottlieb Steen and Hamilton) dealt with the legal techniques used to restructure sovereign debt. These approaches have largely evolved over the last quarter of the century. One possibility is to consider the existing contractual provisions in sovereign bonds to explore how far these may be enlisted to further the goal of orderly sovereign debt arrangements. This communication has especially focused on the case of the Grenada islands debt restructuring in 2004. From the speaker's point of view, this debt restructuring is very important in the sense that it represents the first indenture reflecting a convergence between English and New York documentation practices for sovereign bonds. Indeed, the exchange offer took advantage of an omission of a reference to individual bondholder enforcement rights in the Grenada US dollar bonds, as is the case under the English-style bonds.

Such a convergence in sovereign debt documentation represents one example of a deeper trend toward more harmonization of the rules of international

finance. The second presentation precisely dealt with this issue. **Professor Hal Scott** (Harvard Law School) presented an overview of the field of international finance from the perspective of law and regulation and mainly concentrated on the analysis of which rule (that of the home or host country or an international one) applies in particular cases of regulation and especially in the context of sovereign debt problems. The positive conclusion was that there is an inexorable trend toward the harmonization of the rules of international finance and an increasing delegation to international organizations to formulate and enforce such rules. The reason is that the rules created and supervised by supranational authorities in the field of international finance aim to minimize global financial instability and maximize efficiency.

Assessing the benefits and losses from harmonization of the rules of international finance on global financial stability requires a precise definition of the latter concept. Following the East Asian crisis, there has been a great deal of thought devoted to defining international financial stability. The question addressed by the third presentation of the session by **Professors Geoffrey Wood** (City University Business School) and **Forrest Capie** (Bank of England) was whether it is possible and would be useful to define the concept of international financial stability. The main thesis of the authors is that pursuing international financial stability is pursuing a chimera, therefore rendering the concept of international financial stability of no use. The reasoning was based on an analogy with domestic financial stability. Domestic financial stability requires the existence of a lender of last resort, bankruptcy laws and structural regulation of banking. However these necessary conditions at the national level do not exist and cannot be obtained at the international level.

Against this rather pessimistic view is the pragmatic approach of the international financial institutions in seeking to achieve international financial stability. Indeed, **Mr Thomas Laryea** (International Monetary Fund) presented the role of the International Monetary Fund in promoting financial stability. While the initial IMF mandate was to provide surveillance, financing and technical assistance, its role in terms of international financial stability has largely been extended. In this respect, capital account liberalization has been one of the main concerns. It has also concentrated on the definition of Standards and Codes to strengthen the financial architecture at the international and domestic levels, in order to detect financial system weaknesses and to develop policy responses. In an effort to improve arrangements for resolving financial crises, some tools for sovereign debt restructuring have been designed – such as the proposition for a Sovereign Debt Restructuring Mechanism, the encouragement of the adoption of Collective Action Clauses by domestic countries and the application of the lending into arrears policy.

The session concluded with an panel discussion on international developments of monetary stability. The panel comprised of **Dr Rosa María Lastra** (Centre for Commercial Law Studies, Queen Mary, University of London), **Mr Daniel Lefort** (Bank for International Settlements), **Ms Janet Dine** (Centre for Commercial Law Studies), **Mr Jorge Guira** (Warwick University) and **Dr Dalvinder Singh** (Oxford Brookes University).



Financial Stability: Theory and Applications

18-19 May 2006

This conference explored various issues related to the theory and application of financial stability. The first session focused on the relationship between bankruptcy law and macroeconomic fluctuations and on the effect of competition on bank risk taking was chaired by **Dimitrios Tsomocos** (University of Oxford) and discussed by **Charles Goodhart** (FMG/LSE).

The opening speaker, **Javier Suarez** (CEMFI and CEPR), presented joint work with **Oren Sussman** (Said Business School, University of Oxford) in which the authors study the relative success of different policy alternatives in mitigating the negative effect of financial distress. The authors employ a dynamic general equilibrium analysis of the interrelations between cyclical movements in financial distress and various policy measures, amongst them bankruptcy law. They find that, when comparing bail-outs and active interest-rate policies with the softening of bankruptcy laws, the latter measure may be unsuccessful at reducing cyclical fluctuations (indeed, it may increase their amplitude in the long-run), as opposed to the two first measures, which may have positive stabilizing effects. The discussion by **Charles Goodhart** started by questioning the assumptions that drive the agency problem in the model, namely the assumption that output is observable but not verifiable. He also highlighted some of the questionable distributional effects of some of the policies which Suarez and Sussman identified as most successful at stabilizing output.

Gianni De Nicolò (International Monetary Fund) presented a theoretical and empirical analysis into the relationship between the degree of banking competition and banking stability co-authored with John Boyd (University of Minnesota) and Abu Al Jalal (University of Minnesota). The common wisdom that banking stability decreases with the degree of competition in bank markets was questioned in previous work by the authors, in which, by assuming that competition is allowed in loan markets as well as in deposit markets, the consensus results were overturned. The authors summarize the two competing views of the literature and extend them to incorporate bond holdings in order to study the causal relationship from market structure to asset portfolio allocation. The 'charter value hypothesis', where the loan market is not modelled, predicts a negative relationship between concentration and bank's probability of failure, while the alternative specification with both loans and deposits predicts the opposite relationship. The authors find that the data rejects the relationship predicted by the 'charter value hypothesis'. The discussion by **Charles Goodhart** focused on the empirical exercise, and he expressed surprise at the results, which he found contrary to his intuition. He questioned some aspects of the data sets, such as the problems with relying on data from only one period, the treatment of publicly-owned banks in the international data set, and how the presence of foreign banks was accounted for.

Session 2 focused on the cases of two Latin American economies.

Professor Charles Calomiris (Graduate School of Business, Columbia) presented his paper on 'Devaluation with Debt and Concession Contract Redenomination as a Macroeconomic Policy in Argentina'. He argued that there is a trade-off between a fair, exactly right adjudication process about debt contracts and general contract redenomination. He argued that the latter might bring more rewards in extreme episodes of financial instability, featuring a number of adverse ingredients, such as a highly dollarized economy and a low ratio of export to GDP. Despite its unequal effects, redenomination would have lower social costs and contribute to a faster economic recovery. This view is upheld by the empirical analysis of the Argentine case in 2001, not only at the macroeconomic level, but also at the industry level. Analyses of non-tradable versus tradable industries, as well as those with high dollar debt, suggest that redenomination alleviated negative (financial distress) effects, namely of the most vulnerable sectors. The discussant, **Mario Blejer** (Director of the Centre for Central Banking Studies at the Bank of England), addressed broader aspects of the Argentine redenomination experience, benefiting from his experience as Deputy Governor of the Central Bank of Argentina. He stressed the political economy aspects of crisis episodes and how these eventually influence the formulation and implementation of policies. He also emphasized the asymmetric nature of redenomination (eg by giving in relative terms far greater rewards to the exporting sector). Although agreeing with Calomiris' view that in extreme and infrequent cases, as in Argentina in 2001, redenomination could be a better option than alternative approaches, he did not believe that there is yet ground for sufficiently general policy recommendations in the field.

Dairo Estrada and **Agustin Saade** (Director and Analyst at Banco de la República de Colombia) presented their joint work on the application of an equilibrium approach to financial stability analysis. They addressed the challenges in calibrating models of financial stability to Colombia, in particular in their ability to forecast the recession in the period 1997 to 1999 and the subsequent recovery from 1999 to 2002. The models perform relatively well in the prediction of short-run trends, but tend to overestimate several trends over longer terms. By examining alternative specifications, they suggested possible lines of improvement of the empirical fit, via econometric calibration, to deal with overestimation of GDP, and inclusion of idiosyncratic features of the Colombian financial system. Discussant **Kevin James** (Bank of England) welcomed quantitative exercises of the sort of Estrada and Saade. He argued that these exercises are useful for the monitoring of financial stability of a specific country and key to further refine the modeling of financial stability. His discussion concentrated on

Regulation and Financial Stability

possible ways to improve the fit of the model to Colombia, taking into account features such as dollarization and the degree of informality of the economy, as well as its vulnerability to external shocks.

The third session began with a presentation by Paul Kupiec (Federal Deposit Insurance Corporation) on 'Capital Allocation for Portfolio Credit Risk'.

The paper focuses on the appropriateness of the calculation of credit risk capital allocations under the Basel II Advanced Internal Rating Based (IRB) approach and by market participants' risk models. The starting point of the paper was the development of capital allocation rules using a structural Black-Scholes-Merton equilibrium framework. The capital allocations under this model were shown to be substantially higher than those implied under Basel II A-IRB, similar industry models (Gaussian Credit Loss Models GCLM) or under hybrid Gaussian Credit Return Models (GCRM) models which mimic the full structural approach but are more easily applicable. Part of the underallocation of the GCLM approach reflects the definition of loss given default (LGD) used. This excludes expected loss from the capital allocation. Even using an appropriate measure of LGD which encapsulates future losses, GCLM models such as Basel II A-IRB were shown to understate true capital requirements by a multiplier of around 1.3 (depending on the acceptable default probability and pricing model employed). This stark conclusion (along potential problems on specific and concentration risks) are problems for the Basel II A-IRB approach beyond the familiar estimation concerns over its key parameters. In his discussion, **Sudipto Bhattacharya** (LSE) highlighted a need to reconcile the high variations in economic capital between GCLM and GCRM rules with the still notable variation across vendor models quoted in a recent survey. In the general discussion the fact that regulatory capital rules generally do not bind for developed country banks was noted as an offsetting factor to the paper's conclusion on the capital underprovision under the Basel II proposals.

The second paper in the session on 'Commitment to Overinvest and Price Informativeness' was presented by **James Dow** (London Business School) and is joint work with Itay Goldstein (Wharton School, University of Pennsylvania). The focus of the paper is on how stock market prices both reflect firm value, i.e. produce information about the firm, and affect firm value, i.e. how the information in stock prices also affects the allocation of resources. In the model, an outside speculator can acquire superior information regarding future investment returns at a cost. This information is noisily aggregated in prices due to the presence of stochastic liquidity traders. If the investment policy is such that investments are only undertaken if the ex ante NPV of investment is positive, then investments are cancelled too often following negative information in stock prices. Securities become less sensitive about investment fundamentals and as a result will not produce information. A key implication is that more information is collected during booms than busts and this amplifies shocks to fundamentals. A solution to this problem is a commitment to overinvest by the firm, i.e. they invest even if projects have slightly negative

NPVs conditional on price. A number of potential methods to achieve overinvestment were suggested, for example cancellation fees or via financial slack. In his comments Sudipto Bhattacharya suggested that there could be more discussion of the empirical implications of, and supportive evidence for, the theory and also it would be interesting to consider in more detail the potential commitment devices.

The fourth session analysed the vulnerability of the banking system and a central bank's reactions to financial stability concerns. The panel comprised **Daniel Osorio R** (Analyst, Financial Stability Department, Banco de la República de Colombia), **Kjersti-Gro Lindquist** (Norges Bank, Norway) and **Roman Inderst** (FMG/LSE).

The first speaker, **Daniel R Osorio**, emphasized the possibility of financial crises occurring in the absence of bank runs and inter-bank financial linkages. Even if the banking sector as a whole does not face withdrawals of the deposits, some individual banks can face withdrawals, while others receive more deposits. Banks hold a part of their assets in non-tradable long-term loans; therefore the banks facing a negative liquidity shock want to sell their tradable assets to meet the demand of depositors. However, the potential buyers of these assets (the liquid banks), may give a priority to expanding in loans, because of a higher loan interest rate. As a result, some of the banks will be unable get enough funds from the market and go bankrupt. Therefore, a financial crisis can occur despite the banking sector being liquid as a whole. The risk of such mechanism occurring is higher, the higher is the loan demand in the economy. This analysis was conducted jointly with **Dairo Estrada** (Director, Financial Stability Department, Banco de la República de Colombia). The discussion by **Roman Inderst** questioned the magnitude of such reallocation of deposits in the absence of bank runs. He also commented that the possibility of inter-bank borrowing could be a mechanism to overcome the possibility of financial crisis through a mechanism that implies a lack of market clearing.

The second speaker, **Kjersti-Gro Lindquist** (Norges Bank, Norway), provided an analysis of a central banks' monetary policy choices when using financial stability as an explicit policy target. She emphasized the central banks' often claimed mandate to promote financial stability and argued that a policy following a pure Taylor-type inflation targeting rule may not react adequately to the financial stability concerns. The different targets may result in a conflict between the policy objectives. Her joint research with Farooq Q Akram (Norges Bank, Norway) and Gunnar Bårdsen (NTNU, Department of Economics, Trondheim, Norway) compares the implications of monetary policy with both inflation and explicit financial stability targets with pure inflation targeting in a small open economy. They measure financial stability as related to the bankruptcy ratio and household debt and consider the differences under the different policy rules in the reaction of the economy to shocks to house prices and credit. Simulations based on the Norwegian economy suggest that a financial stability target implies longer policy horizon and therefore more interest rate smoothing than otherwise.

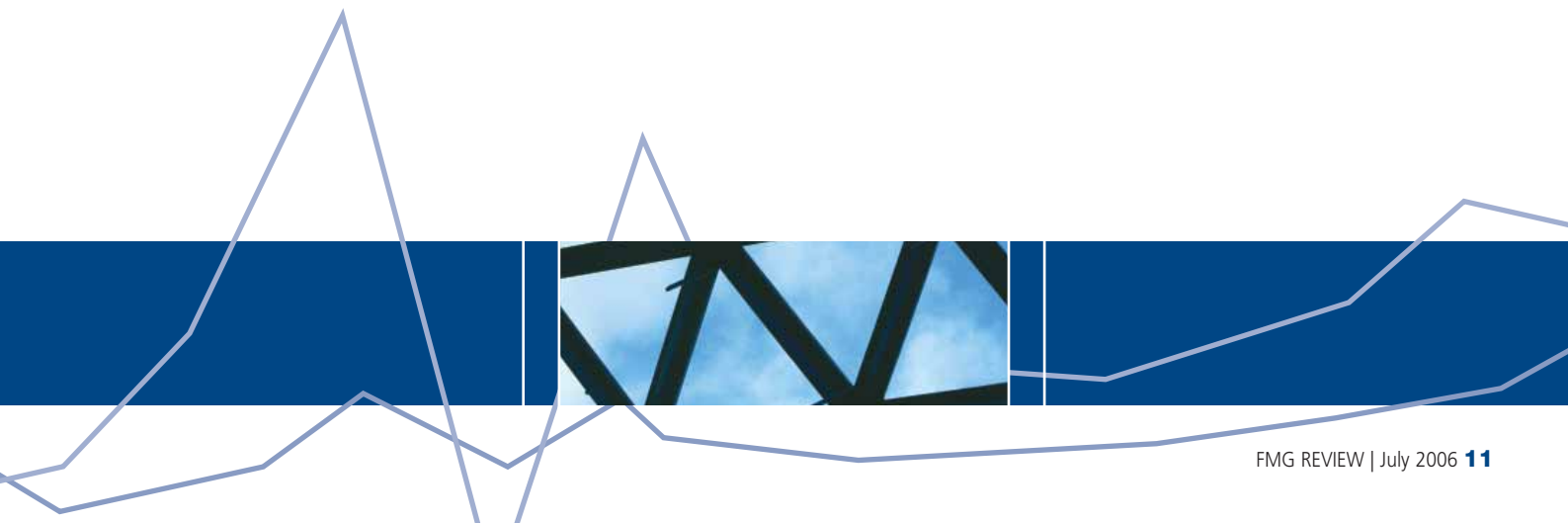


The discussant, **Roman Inderst** (FMG/LSE), pointed out the differences in financial stability measures for avoiding the melt-down of the financial system and gradual interference. Further discussions involved the limitations of economic theory in justifying the policy rule with explicit financial stability targets and the real-life behavior of central banks.

The last session, chaired by **Professor Xavier Freixas** (Universitat Pompeu Fabra), aimed to identify the current sources of financial instability and their evolution over time. The first speaker, **Andrew Haldane** (Bank of England), presented a paper on 'Public Policy in an Era of Super-Systemic Risk' which is joint with Prasanna Gai (Bank of England). In the paper they argue that there are two opposite views of how the recent developments in the financial markets may influence its stability. On the one hand, the 'Greenspanian' or 'Flat Earth' theories argue that the overall systemic risk is falling mainly due to the increase in the level of integration of financial markets and the arrival of a new generation of financial instruments. This combination allows market participants to better diversify their risks and hence be less exposed to idiosyncratic shocks. On the other hand, it can also be argued that the arrival of the new financial instruments allow market participants to take greater risks. At the same time, as the new instruments are more complex, financial markets may eventually become more opaque, making it more difficult to assess the real exposures of it. The response of the speaker to the apparently conflicting theories is that both of them, and neither of them, are true. That is, in his opinion financial crises will be less frequent, but should they occur, the buffers of the system can end up playing against the system and further amplifying initial shocks. That is, crises may be less frequent but much stronger. In this context, the role of the public agencies is key to preventing and softening the scale of crises. The set of potential policies discussed including drawing systemic risk maps, systemic regulatory requirements and using the Central Bank balance sheet as ex-ante policies and effective crises management as the main ex-post policy.

The second speaker, **Lea Zicchino** (Bank of England) presented 'Towards a Measure of Financial Fragility', joint work with Oriol Aspachs (LSE, FMG) Charles Goodhart (LSE, FMG) and Dimitrios Tsomocos (University of Oxford). The aim of their paper is to identify the key factors that drive banking fragility and their impact on welfare with the ultimate objective being the construction of a welfare index that takes into account the effects of financial fragility. The authors calibrate a general equilibrium model with banks and endogenous default as in the earlier analyses by Goodhart et. al. (2004). From the model, they identify the main contributors to welfare as changes the banks' risk taking profile, and hence loan defaults, and banks' profitability. To validate the predictions of the model they bring it to the data by running a series of Panel VARs in which they further show that these factors do have an impact on GDP (the proxy for welfare). From the impulse responses of the VAR they can identify the effect that each variable has on the GDP and hence, they can create an index that summarises the state of financial fragility. The index is constructed for a series of countries that did experience banking crises recently, and it turns out that it is able to identify such episodes.

We would like to thank The **Bank of England** and the **Economic and Social Research Council** (ESRC) for supporting this conference.



Corporate Governance at LSE

Research Debates

Regulatory competition and board insulation: Lessons the UK should not learn from the US

Professor Lucian A Bebchuk (Harvard Law School)

8 May 2006

Professor Bebchuk from Harvard Law School, one of the most prominent corporate governance experts in the US, addressed the Corporate Governance at LSE workshop. Speakers from the US often focus on what other countries can learn from the US. In contrast, Professor Bebchuk discussed the lessons the UK should not learn from the US. His talk was based on two main points: the problem of regulatory competition and the costs of board insulation from shareholders.

On the first aspect, he discussed both demand- and supply-side issues. On the demand-side, decisions where to reincorporate are controlled by management, as reincorporation must be initiated by the board. Therefore, reincorporations will happen only when management prefers them. On the supply side, there is a lack of vigorous competition: although 40 per cent of companies are incorporated outside Delaware, more than 90 per cent of companies are incorporated either in Delaware or in their states of headquarters. Therefore, Delaware is a virtual monopolist. In relation to the second aspect the contrast was drawn that, unlike in the UK, public companies in the US may use a 'poison pill', and all have at least a 'shadow pill'. Furthermore, a further difference was that the board is staggered in about half of US public companies, as two elections are needed to replace a majority of directors. Bebchuk noted his analysis that finds a negative correlation between Tobin's Q and staggered boards.

Professor Paul Davies (Department of Law, LSE) discussed the presentation and highlighted the point that one should be very careful when discussing 'Anglo-American' corporate governance, since UK and US corporate governance differ in many respects. He also noted that there is not much supportive evidence of strong competition and re-incorporation movements within Europe.

The floor discussion of the presentation involved a stimulating debate. In response to a question by Davies, Bebchuk said he believed that the board must be independent from shareholders to work effectively. If the board is independent of shareholders, then the separation CEO/Chairman is irrelevant for the company. Chris Pierce (ICMA) asked about the growing trend for corporate governance ratings. Professor Bebchuk's view was that it is necessary to be very careful about a tick-box approach to corporate governance. Finally Sir Geoffrey Owen (LSE) asked whether corporate governance matters for productivity. Professor Bebchuk pointed out that Germany and Japan in the past, and China now, had higher rates of productivity, which is not necessary related to the level of investors' protection in the country, in particular minority shareholders.



Golden Handshakes: Separation Pay for Retired and Dismissed CEOs

David Yermack (New York University, NYU)

25 May 2006

On 25 May Professor David Yermack from the Stern School of Business, NYU presented his study on separation payments made when CEOs leave their firms. These payments constitute a highly controversial topic, as they include 'golden handshakes', the colloquial name for separation packages awarded to CEOs at retirement or termination.

Critics of severance payments assert that these payments occur at the time that the CEO exits the firm and that these payments do not influence further firm performance. Thus the existence of these payments hints at hidden governance problems at the firm. Proponents of separation-pay argue that these payments may be an important component of a multi-period incentive contract. For example, Professor Yermack asserts that 'for successful CEOs, a separation package could represent the pay-off from an 'ex post settling up' implicit contract (Fama, 1980), under which a board of directors assesses a CEO's achievements at the end of his career and compensates him accordingly'. Similarly he argues that 'for CEOs who fail, severance compensation might be predicted by one or more related bonding theories. In these models, contingent severance pay is promised in advance to managers, providing insurance of their human capital value. CEOs are thereby encouraged to take risk (Almazan and Suarez, 2004) and discouraged from concealing adverse information (Inderst and Mueller, 2005), entrenching themselves in office (Almazan and Suarez, 2004), or shirking when their dismissal appears possible (Berkovitch, Israel, and Spiegel, 2000). Under a separate theory, separation pay may serve as an instrument of damage control when CEOs are ousted, helping the board protect corporate secrets and head off litigation or adverse publicity'.

Professor Yermack then presented his study of a sample of 179 exiting Fortune 500 CEOs. More than half received severance pay with the mean separation package worth \$5.4 million. Most severance payments were awarded on a discretionary basis by the board and seemed not to be governed by a previous employment agreement. Although around ten percent of dismissed CEOs received more than \$10 million on leaving the firm, in general the size of the payments constitute less than one year salary for the CEO and on average around 0.06 per cent of the firm's market value.

For dismissed CEOs he argued that separation pay generally seems to conform to theories related to bonding and damage control. Dismissed CEOs seem to receive larger sums than CEOs that leave the firm voluntarily. Also younger CEOs receive higher severance payments upon dismissal. This seems to point towards that payments may be driven by notions of fairness, without any clear evidence for any of the above discussed theories. In terms

of the market response to separation agreements he found that there seem to be negative stock market reactions once separation agreements are disclosed, but only in cases of voluntary CEO turnover. However, the statistical significance of these findings is quite low.

Professor Antoine Faure-Grimaud then discussed the paper, highlighting its importance for our understanding of the determinants of CEO pay. He also noted that in contrast to the UK the US seem to have fallen behind in this aspect of corporate governance. The discretion given to directors in the UK in awarding severance payments is less generous than in the US. In the following lively discussion, participants pointed out that the low payments to CEOs leaving their firm voluntarily may be due to fact that these CEOs may be able to 'plan' their retirement early on, thus being able to extract payments before their actual leaving date.

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Future Corporate Governance at LSE Research Debates include:

12 October **Brian Main** (Edinburgh) on Pay in the UK.

13 November **Gerhard Cromme** (Chairman ThyssenKrupp) on Corporate Governance in Germany.

Attendance at the Research Debates is by invitation only. Further information is available on the FMG website: <http://fmg.lse.ac.uk>

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

Portfolio Risk Forecasting Lectures

Professor Greg Connor, FMG, LSE

April – May 2006

During April and May 2006, the Financial Markets Group hosted a series of joint academic-practitioner workshops on portfolio risk forecasting. The series of lectures was sponsored by Northfield Information Services and UBS Securities. Rupert Goodwin (Northfield) and Alan Scowcroft (UBS) served as co-chairmen and organisers of the workshops.

The series consisted of ten workshops organised around ten chapters of the work-in-progress, *Portfolio Risk Forecasting*, by Professor Gregory Connor (FMG, LSE). Each workshop consisted of a lecture by Professor Connor, followed by a discussion by a research-practitioner, and then audience comments and open discussion.

The first workshop placed the problem of portfolio risk forecasting in the context of portfolio management and security market pricing. There was considerable discussion, and differing opinions, about the feasibility and desirability of separating portfolio risk forecasting from security valuation and alpha-generation in portfolio management. The second workshop explored the problem of risk model measurement error and various methods to mitigate its impact, including the Bayesian shrinkage method, imposing structure on the risk model prior to estimation, and/or placing position limits on portfolio weights. There was a lively discussion about which sources of estimation error are most problematic in risk model design, whether it is in the estimation of risk exposures or risk factors. Jason MacQueen (R-Squared) served as discussant for the first two workshops. There was also a considerable contribution to the discussion from the audience in all the workshops.

The third workshop looked at industry and country risk, with the discussion led by James Sefton (UBS). The perennial controversy arose about the relative magnitude of industry and country risks, and whether globalisation is decreasing the influence of country factors on portfolio risk. The fourth workshop looked at statistical factor models, which attempt to forecast portfolio risk based on returns data alone, without reference to macroeconomic data or data on security characteristics. The discussion was led by Tim Wilding (EMA). One issue that was highlighted was the relative magnitudes of specification error (low in statistical factor models and high in more structured models) and sampling error (high in statistical factor models and low in more structured models). Another topical concern was the value of the new 'hybrid' models, in which statistical factor analysis is combined with structural modelling.

The fifth workshop was on macroeconomic-based portfolio risk forecasting. The discussion was led by Ed Fishwick (Merrill-Lynch). A major theme which emerged from the lecture and discussion was the theoretical centrality of

macroeconomic risks in understanding portfolio management decision-making, and the contrast with their very weak empirical power in explaining asset returns. There were some suggestions that macroeconomic risks might become more powerful at longer horizons: the focus of most empirical research on short-horizon relationships might therefore understate their empirical power. The sixth workshop looked at corporate characteristics and their explanatory power in portfolio risk forecasting. The discussion was led by Ian Paczek (UBS). The contrast with macroeconomic-based models was highlighted: characteristic-based risk models have excellent explanatory power but a weak theoretical foundation in asset pricing theory, exactly the reverse from the situation with macroeconomic-based models. Differences of opinion arose in the open discussion about the amount of 'meaning' that can be associated with characteristic-based factors.

The seventh workshop looked at foreign exchange risk, with the discussion led by David Buckle (Merrill-Lynch). There was some focus on the anomalous behaviour of foreign exchange returns, and particularly the large differences between the near-random movement of short-run exchange rates and the more predictable patterns in long-run exchange rate relationships. The eighth workshop considered integrated global risk models, spanning multiple asset classes and countries. Ely Klepfish (UBS) led the discussion. The discussion highlighted some of the 'new technologies' which can be used to package individual asset class risk models into a consistent overarching risk model.

The ninth workshop looked at risk dynamics, both in individual asset volatilities and in correlations between asset returns. There was considerable interest expressed in mixed-frequency models, for example combining monthly data for covariance estimation with daily data for dynamic volatility adjustments. The discussion was led by Dan Dibartolomeo (Northfield). The tenth and final workshop explored long-horizon risk forecasting. The discussion was led by David Miles (Morgan Stanley). The difficulty in accurately estimating long-run risk patterns, and the importance of regime-switching events, received considerable attention.

The Portfolio Risk Forecasting Lectures are sponsored by Northfield Information Services and UBS Securities



GAM Gilbert de Botton Award in Finance Research 2006

GAM

The GAM Gilbert de Botton Award in Finance Research was established with the generous support of GAM and is awarded annually by GAM and the London School of Economics and Political Science. The Award is given to outstanding PhD or MSc students intending to pursue a PhD at the LSE's internationally renowned Financial Markets Group. This Award from GAM aims to support the effort of first-rate students, lacking the financial resources, to pursue their academic studies at the LSE. The GAM Award provides a stipend to support, research and living expenses.

The Award will be given in September to three outstanding PhD students or graduate students who have demonstrated excellence in an area of finance research including:

- Financial Markets and Instruments
- Corporate Finance
- Financial Regulation
- Finance and Economic Performance and Development

Students will be judged on the basis of research papers submitted to the FMG or published in an academic journal. The Panel will look at evidence of academic rigour and originality that suggests strong potential to complete future high quality research. The Award Review Panel will consider chapters of a PhD, MSc Dissertations (accompanied by a letter of support from the MSc dissertation supervisor), or an extended Essay on the above finance related topics.

The Award Review Panel will announce the first five shortlisted candidates on 14 July 2006 and will invite them to submit a 2,000 word summary of their paper by 21 July.

About Gilbert de Botton and GAM:

GAM delivers active investment management to private clients, institutions and intermediaries.

The goal is to produce outstanding results by providing clients with access to great investment talent throughout the world.

As well as active management within funds, GAM uses active asset allocation in managed portfolios to meet clients' diverse needs. Our funds and strategies cover a broad range of asset classes and currencies to cater for all market conditions.

Established in 1983 by visionary founder, Gilbert de Botton, GAM was owned by UBS AG from 1999 until December 2005, when it was acquired by Julius Baer.

GAM continues to have a distinctive style and culture.





Regional Comparative Advantage and Knowledge-Based Entrepreneurship

RICAPE2 First Conference

5 – 6 October 2006

Financial Markets Group, LSE

The Regional Comparative Advantage and Knowledge-Based Entrepreneurship (RICAPE2) Research programme was launched on 1 March 2006. The new programme builds on the successful RICAPE project, completed in April 2005. The research network includes the London School of Economics and Political Science (FMG), the Department of Economics and Finance of Turin University, the Center for Financial Studies (Frankfurt), HEC School of Management (Paris), University of Amsterdam, University of Tilburg, Baltic International Centre for Economic Policy Studies, University of Lugano, Indian School of Business, Technion (Israel). RICAPE2 is funded by the European Commission, DG-Research, under Priority 7 -Citizens and Governance in a Knowledge-based society- of the 6th Framework Programme. More information about RICAPE2 can be found at www.lse.ac.uk/ricafe

The RICAPE2 First Conference will be held on 5 – 6 October at the London School of Economics and Political Science. Some of the topics to be discussed at the conference are:

- The choice between alternative sources of financing for innovative firms and their impact on strategic decision in entrepreneurial firms;
- The determinants of knowledge-based entrepreneurship;
- Venture capital, its contribution to the knowledge-based economy;
- Economics of intellectual property rights and its implications for knowledge-based entrepreneurship.

- The role and design of financial contracts and of the choice of organizational form in fostering knowledge-based entrepreneurship;
- Effects of regulation on venture capital investment;
- Impact of corporate governance mechanisms on the performance of entrepreneurial firm;
- The contribution of knowledge-based entrepreneurship to regional comparative advantage.

Programme Committee: Catherine Casamatta (University of Toulouse), Vyacheslav Dombrovsky (BICEPS, Latvia), Antoine Faure-Grimaud (London School of Economics and Political Science), Ulrich Hege (HEC), Antoinette Schoar (MIT), Armin Schwienbacher (University of Amsterdam), Per Stromberg (SIFR, Stockholm and GSB, Chicago), Javier Suarez (CEMFI) and Lucy White (Harvard Business School)

More information and registration details can be found on the RICAPE website: www.lse.ac.uk/collections/RICAPE/

Discussion papers

DP 547

The Interest Rate Conditioning Assumption

Charles Goodhart

No abstract available

DP 548

On Modelling Endogenous Default

Dimitrios Tsomocos, Lea Zicchino

Not only in the classic Arrow-Debreu model, but also in many mainstream macro models, an implicit assumption is that all agents honour their obligations, and thus there is no possibility of default. This feature leads to well-known problems in providing an essential role for either money or for financial intermediaries. So, in more realistic models, the introduction of minimal financial institutions, for example default and banks, becomes a logical necessity. But if default involved no penalties, everyone would do so. Hence there must be default penalties to allow for an equilibrium with partial default. This paper shows that there is an equivalence between a general equilibrium model with incomplete markets (GEI) and endogenous default, and a model with exogenous probabilities of default (PD). The practical, policy implications are that a key function of regulators (via bankruptcy codes and default legislation), or the markets (through default premia) are broadly substitutable. The balance between these alternatives depends, however, on many institutional details, which are not modeled here, but should be a subject for future research.

DP 549

Subadditivity Re-Examined: the Case for Value-at-Risk

Casper G de Vries, Gennady Samorodnitsky, Bjørn N Jorgensen, Sarma Mandira, Jon Danielsson

This paper explores the potential for violations of VaR subadditivity both theoretically and by simulations, and finds that for most practical applications VaR is subadditive. Hence, there is no reason to choose a more complicated risk measure than VaR, solely for reasons of coherence.

DP 550

Exchange Rate Volatility and Central Bank Interventions

Freyan Panthaki

This paper studies the impact of Swiss National Bank interventions, and news about these interventions, on the intraday volatility of the Swiss franc – US dollar exchange rate. It extends the existing literature by characterising the impact of different aspects of central bank interventions, like direction, size, frequency and time of intervention, on exchange rate volatility. Briefly, the paper finds that the effect of intervention on volatility varies depending on how volatility is defined. Interventions decrease volatility contemporaneously but the effect is reversed in the two hours afterwards. This relationship is symmetric with respect to the direction of the intervention, whether they be buy and sell interventions or with-the-wind and against-the-wind interventions. Analysis of the volatility and intervention size relationship suggests that larger interventions tend to increase volatility relative to small interventions. The frequency of interventions has a small but positive impact on volatility, and this is underscored when



the analysis is done by splitting the sample into low, average and high frequency interventions. The interaction between intervention size and intervention frequency results in a small positive effect on volatility for the squared return measure and the absolute return measure and a negative effect for both the realised volatility measures this effect negative. As before, the effect of the timing of the intervention varies with the volatility measure. The relationship is different for interventions at different times of the day. For the two realised volatility measures 9am interventions reduce volatility while for the other two measures the significant coefficients have an overall positive effect increasing volatility. 2pm interventions decrease volatility for both the squared return measures but increase volatility for both the absolute return measures. Reuters reports of sell interventions have a significant and lagged negative effect on volatility for the squared measure and both the absolute return measures.

DP 551

Comparing Downside Risk Measures for Heavy Tailed Distributions

Casper G de Vries, Bjørn N Jorgensen, Sarma Mandira, Jon Danielsson

Using regular variation to define heavy tailed distributions, we show that prominent downside risk measures produce similar and consistent rankings of heavy tailed risk. Thus regardless of the particular risk measure being used, assets will be ranked in a similar and consistent manner for heavy tailed assets.

Publications

DP 552

The Dynamics of Venture Capital Contracts

Julia Hirsch, Carsten Bienz

We analyze 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. We distinguish three forms of staging (pure milestone financing, pure round financing and mixes). Thereby, contract completeness reduces when going from pure milestone financing via mixes to pure round financing. We show that the decision for a specific form of staging is determined by the expected distribution of bargaining power between the contracting parties when new funding becomes necessary and the predictability of the development process. To be more precise, parties choose the more complete contracts the lower the entrepreneur's expected bargaining power – the maximum level depending on the predictability of the development process.

DP553 (UBS Pensions Series 039)

Rare Events and Annuity Market Participation

Alex Michaelides, Paula Lopes

We investigate whether a rare event (like the default of the annuity provider) can explain the annuity market participation puzzle. High risk aversion is needed to change behaviour in the presence of such a disastrous shock but higher risk aversion also makes annuities more valuable. Therefore, these rare events are unlikely candidates to explain the low take-up of voluntary annuities.

DP 554

Towards a Measure of Financial Fragility

Lea Zicchino, Dimitrios Tsomocos, Charles Goodhart, Oriol Aspachs

This paper proposes a measure of financial fragility that is based on economic welfare in a general model calibrated against UK data. The model comprises a household sector, three active heterogeneous banks, a central bank/regulator, incomplete markets and endogenous default. We address the impact of monetary and regulatory policy, credit and capital shocks in the real and financial sectors and how the response of the economy to shocks relates to our measure of financial fragility. Finally we use panel VAR techniques to investigate the relationships between the factors that characterise financial fragility in our model ie, banks' probabilities of default and banks' profits – to a proxy of welfare

Special Papers

SP 163

China's Banking Reform: Problems and Potential Solutions

Xiaosong Zeng, Charles Goodhart

China's financial system has been undergoing major reforms during the last decade, with the aim of establishing a modern commercial banking system and the development of stock market(s). In recent years there have been large capital injections into ailing state-owned banks, and currently encouragement for them to explore IPOs, as well as bail-outs of bankrupt securities firms by state-owned investment companies.

We acknowledge the considerable progress already made in reforming the banking system, but we feel that there are still questions that

need to be asked. For example, exactly what is the core of the fundamental problem(s) with the banking system in China? What is the best path to take to address such problems?

SP 164

Burden Sharing In A Banking Crisis In Europe

Dirk Schoenmaker, Charles Goodhart

Pan-European banks are starting to emerge, while arrangements for financial supervision and stability are still nationally rooted. This raises the issue who should bear the burden of any proposed recapitalisation should failures occur in large cross-border banks. A recapitalisation is efficient if the social benefits (preserving systemic stability)

exceed the cost of recapitalisation. Using the multi-country model of Freixas (2003), it is shown that ex post negotiations on burden sharing lead to an underprovision of recapitalisations.

We explore different ex ante burden sharing mechanisms. The first is a general scheme financed from the seigniorage of participating central banks (generic burden sharing). The second relates the burden to the location of the assets of the bank to be recapitalised (specific burden sharing). As a country's benefits and that country's contribution to the costs are better aligned in the specific scheme, the latter is better able to overcome the co-ordination failure. Finally, decision-making procedures for administering an ex ante burden sharing mechanism are required.



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