

FMG Celebrates 20 Year Anniversary

We welcome the new academic year, one in which the Financial Markets Group celebrates its 20th Anniversary. Established in January 1987, with funding primarily from City institutions, the original directors were **Professor Mervyn King at LSE**, now Governor of the Bank of England, and **Professor Charles Goodhart** who remains an active member of the Group.

The Financial Markets Group enjoyed a ten-year ESRC research centre status and funding since October 1994. This allowed us to develop longer-term research programmes at the forefront of understanding theoretical and empirical problems in financial markets and in the decision-making processes of corporations, banks and regulators. Over the last 20 years, the Group also developed strong links with the user community, in particular investment banks, commercial banks and regulatory bodies, which supported our research.

The Group is proud of its record of seeing over 80 graduate student members obtain their PhDs and establish themselves as members of the economics and finance profession. The range of output produced in corporate finance, financial econometrics, market microstructure and the innovative applications of microeconomics to general finance theory is of great pride to the Financial Markets Group and its faculty. We are also very proud of the over 600 working papers produced and the contributions made by our highly active seminar and conference series. As witnessed in this issue of our Quarterly Review these remain core strengths of the group.

Over the years the Financial Markets Group has grown in size and continues to renew itself through the active participation of new graduate students, research staff and faculty. This year we enthusiastically welcome three new faculty members: **Professor Christopher Polk** who works in empirical asset pricing; **Dr Yves Nosbusch** who works at the interface of asset pricing and macroeconomics and **Dr Stephane Guibaud** who again works on asset pricing problems but with an emphasis on the international dimension. We look forward to working with them.

Professor David C Webb

Director Financial Markets Group



Professor David Webb, Director, Financial Markets Group, LSE

Price Dynamics under Aggregated Decision Making in Financial Markets with Uncertainty and External Constraints

Dr Jon Danielsson, Dr Amil Dasgupta, Professor Hyun Song Shin, Dr Jean-Pierre Zigrand

In September 2006, FMG completed a two-year research project on 'Price Dynamics under Aggregated Decision Making in Financial Markets with Uncertainty and External Constraints' funded by the Engineering and Physical Sciences Research Council (EPSRC)*. The research project was led by **Jon Danielsson, Amil Dasgupta, Hyun Song Shin** and **Jean-Pierre Zigrand** and was launched in July 2004. The project's research communication programme was completed with a successful conference on 'New Directions in Asset Pricing and Risk Management' organised by **Amil Dasgupta** and held in FMG on 15-16 June 2006.

The main objective of this project was to explore the use of economic models in understanding the nature of financial risk and financial crisis. Extant models have been largely backward looking and statistical, therefore explicitly dismissing economic analysis of behaviour under uncertainty. The researchers affiliated with the project consequently set themselves a challenging task and have been successful in meeting the objectives of the project. They have already produced a number of research papers, some of which have already been published and others submitted to journals. A snapshot of the research under the grant is discussed below.

Within the grant, the researchers explored several distinct avenues. Amil Dasgupta, with co-authors, investigated the links between the behaviour of professional money managers and endogenous asset price dynamics, at both theoretical and empirical levels. Among his completed papers, in collaboration with Andrea Prat (LSE), he examined the asset price dynamics generated by the reputational concerns of professional portfolio managers at a theoretical level. In a follow-up paper with Andrea Prat and Michela Verardo (FMG/LSE) they examine the empirical consequences using data on US institutional holdings of corporate equity between 1983 and 2004. Dasgupta's collaborative work in this area has established an important benchmark in linking institutional incentives with perverse asset price dynamics. In financial markets that are progressively dominated by institutions, such linkages are likely to be increasingly relevant to understanding the properties of asset prices, liquidity and volatility.

Jon Danielsson and Jean Pierre Zigrand explored three interrelated approaches. In equilibrium asset pricing with systemic risk, they consider the impact of imposing financial regulations based on risk sensitivity of the type currently mandated by the government. They find that such regulations have, through

two distinct channels, both a considerable potential to increase systemic risk as well as decrease it. On the one hand, increases in systemic risk may arise as risk regulation can reduce liquidity since it prevents risk hungry investors from buying assets in crisis periods. In addition on the other hand in an environment where not all financial institutions are regulated situations may arise where prices need to fall so much as to induce unregulated institutions such as hedge funds to own an incommensurate share of risky assets on borrowed money on the other hand systemic risk may be reduced since provided enough institutions are regulated, those institutions will hold less risky assets and will be less levered if the constraints are binding. In a second paper, already published, in cooperation with Ashley Taylor (FMG/LSE), they explore the policy implications of financial regulations, in particular the question of whether hedge funds should be regulated in the same manner as banks. The trade-off here is between the welfare enhancing allocational and informational efficiency gains provided by hedge fund trades with the systemic aspects studied in the previous paper. Finally, in 'On time-scaling of risk and the square-root-of-time rule,' just published, they explore the technical assumptions behind rules for aggregating risk for regulatory purposes and find that under general conditions assumptions that can lead to a considerable underestimation of systemic risk, even if the measure of risk – here Value-at-Risk – is properly computed as forward looking. This builds on previous work by the authors (with Hyun Shin) where such risk estimation procedures followed the popular Risk Metrics methodology, which is backward looking in nature and thereby induces potentially destabilizing feedback loops. Jean Pierre Zigrand, together with Rohit Rahi (FMG/LSE), has taken a step back and asked the question 'What is liquidity?' The analysis and definition they provide is functional rather than defined symptomatically. This is important since defining liquidity say as market impact or bid-ask spread is not welfare based: is a big market impact socially good or bad? In this paper the authors provide a definition of liquidity as the degree to which gains from trade can be reaped, and link it to welfare as well as to common observed measures of liquidity.

Finally, Hyun Shin has worked on various areas, including the pricing of debt in a financial system where the assets that borrowers hold to meet their obligations include claims against other borrowers. Assessing financial claims in a system context captures features that are missing in a partial equilibrium setting. It is possible for spreads to fall as debts rise, as debt-fuelled increases in asset prices and stronger balance sheets reinforce each other. Conversely, it is possible that de-leveraging leads to increases in spreads, as is often observed during crises.

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New Directions in Asset Pricing and Risk Management

15-16 June 2006

This conference, organised by **Amil Dasgupta** (FMG/LSE) as part of the EPSRC funded project on 'Asset Price Dynamics under Aggregated Decision Making in Financial Markets with Uncertainty and External Constraints', looked at both statistical and theoretical aspects of financial risk and risk management with special focus on asset price dynamics in the face of liquidity risk and agency conflicts.

Session 1

The first session of the conference, chaired by **Ron Anderson** (FMG/LSE), focused on Empirical Risk Analysis. The session began with a presentation by **Alexandra Dias** (Warwick Business School) of her paper on 'Dynamic Copula Models for Multivariate High-Frequency Data in Finance', co-authored with Professor Paul Embrechts (ETH Zurich). Dias presented her dynamic copula modelling approach highlighting the emphasis on the detection of change points in the data. She discussed the main findings of the paper, such as evidence for non-constancy over time of the conditional copula at six difference aggregation frequencies for FX data on the USD/German Mark and USD/JPY exchange rates, and the relation of change points to specific macro-economic events.

The second talk of the session was delivered by **Helyette Geman** (Birkbeck College and ESSEC Business School), who presented her research on the properties of energy commodity prices. Entitled 'Energy Commodity Prices: Is Mean-Reversion Dead?' her presentation focused on the modelling of price processes for various energy commodities, including oil and natural gas. Geman's findings are that, [a popular modelling assumption in the 1990s], mean reversion although appears to have lost significance in energy commodity prices in the recent years. In the light of her findings she proposed non-mean-reverting modelling approaches for such processes including geometric Brownian motion models coupled with the inclusion of jump components.

Jon Danielsson (FMG/LSE) concluded the first session with the presentation of his paper on 'Market Tranquillity and Turbulence'. Danielsson laid out a new modelling dimension for asset price dynamics in the context of endogenous coordination risk and financial crises. He presented his approach as an empirical model with structural components that build on the theory of 'Global Games' and speculative attacks by Morris and Shin (1998, 1999)*. Danielsson elaborated on the mechanics of the Markov

* Morris, S and Shin, H (1999), A Theory of the Onset of Currency Attacks in The Asian Financial Crisis by P-R Ageron, M Miller, D Vines and A Weber (eds), Cambridge University Press.

Morris, S and Shin, H (1998), Unique Equilibrium in a Model of Self-Fulfilling Currency Attacks, American Economic Review, 88, 587-597

Chain Monte Carlo (MCMC) procedure used in the estimation and showed that the model is capable of reproducing real-life scenarios in financial markets that more conventional models like ARMA-GARCH miss out on. Such situations include for example the 'up-by-the-escalator, down-by-the-elevator' pattern or extreme volatility regimes.

Session 2

The second and third sessions, co-chaired by **John Hardman Moore** (LSE, University of Edinburgh), **Dimitri Vayanos** (FMG/LSE) and **David Webb** (FMG/LSE), focused on agency conflicts, liquidity and asset prices. **Hyun Song Shin** (Princeton University and FMG, LSE) presented the first paper of the second session entitled 'Risk and Liquidity in a System Context'. The paper explores the pricing of debt and aims to explain some puzzling features of leverage observed in the data. The author shows that an inverse relationship between spreads and debt levels can occur in the context of a financial system where the obligations of some financial institution are another party's assets. The key result is that changes in asset prices affect the balance sheets of other members in the system, which in turn affect asset prices thereby amplifying the initial shock to the system. The discussant, **Tanju Yorulmazer** (Bank of England) emphasised that financial regulation should be based on an overall system analysis rather than isolated case-by-case studies as efforts made to remove one imperfection might in fact be counterproductive by amplifying or creating other imperfections elsewhere leading to greater inefficiency overall.

'Vish' Viswanathan (Duke University) presented his paper on 'Collateral and Market Liquidity', which is joint work with Ravi Anshuman (Indian Institute of Management Bangalore). The authors present a market microstructure model of collateral and market making that analyses the effects of the strategic interaction between several agents on asset prices and liquidity. The main research question of the paper is how market liquidity vanishes around market downturns. The key agents are investors, who buy on margin; brokers, who lend on margin; nondiscretionary traders, who trade for exogenous reasons; and market makers, who supply liquidity, and repurchase agreement market participants, who provide capital to market makers. Their main finding is that a negative shock to the asset value leads to margin calls to protect the broker and will induce selling by some margin traders. As market makers have a fixed capacity for buying up assets, the selling pressure will affect market prices and liquidity. The discussant, **Roman Inderst** (FMG/LSE) emphasised the ambitious nature of the project as the model goes beyond the standard set-up in the market microstructure literature in terms of the multiplicity of agents and endogenous variables used. He noted however that a firmer empirical grounding would benefit the paper to justify the extra layers of complexity.

Conference

Dimitri Vayanos (FMG/LSE) concluded the session with the presentation of his paper 'Flight to Liquidity, Flight to Quality, and the Pricing of Risk.' His paper proposes a theory of time-varying liquidity premia along with its effects for asset prices. The author models investors as fund managers whose survival is at risk if large withdrawals occur in times of poor fund performance. This reduces the manager's willingness to hold illiquid assets, thus raising the liquidity premium. The model also generates liquidity premia that are increasing with volatility, which can explain flight-to-quality effects in times of high volatility. A consequence of this finding is that an unconditional CAPM can understate the risk of illiquid assets because these assets become riskier precisely at times when investors are the most risk averse.

Session 3

The first paper of the third session entitled 'Intermediation, Capital Immobility, and Asset Prices' was presented by **Arvind Krishnamurthy** (Northwestern University), co-authored with Zhiguo He (Northwestern University). The authors ask why intermediation matters and study the effects of capital-constrained intermediaries on asset prices. Capital effects arise because, on the one hand, households need to rely on intermediaries, whose actions determine asset prices, to make complex investment decisions on their behalf. This, however, only arises as long as intermediaries contribute enough of their own capital towards the joint investment. The authors find that their model can help explain the behaviour of asset markets during aggregate liquidity events. In particular, they show that low intermediary capital can increase risk premia, Sharpe ratios, volatility and co-movement among intermediated assets. Reductions in intermediary capital lead to flight-to-quality effects, where capital is withdrawn from risky intermediated investments and reallocated to riskless assets. The discussant **Andrea Prat** (LSE) suggested a more robust empirical analysis of the model by calibrating the key model parameter to the data.

Albert 'Pete' Kyle (Duke University, Fuqua Business School) delivered the second talk of the session in which he presented his paper 'Dynamic Strategic Informed Trading With Risk-Averse Market Makers', co-authored with Ming Guo (Citadel Investment Group). Professor Kyle outlined an infinite horizon continuous time asset-pricing model in which risk-averse market makers set prices competitively, risk-averse traders incur trade-size related costs and liquidity traders over- or underreact to dividend announcements. He then continued by explaining the main predictions from such a model, including the build-up of short-term positive and long run negative autocorrelation of returns (momentum and reversal) as well as a short-term positive and long-term negative post-earnings drift.

The third presentation of this session was given by **Massimo Massa** (INSEAD), who spoke about 'Compensation and Managerial Herding: Evidence from the Mutual Fund Industry', which is joint work with Rajdeep

Patgiri (INSEAD). The paper tests the corporate finance theory of managerial herding based on reputation and career concerns using data of the US mutual fund industry in the period 1994-2003. The authors test to what extent the tendency of fund managers to herd and to take risk is affected by managerial compensation schemes arguing that reputation and career concerns induce managers to herd while monetary incentives offset this tendency. Their findings are that high incentives can be efficient in that they reduce managerial herding, encourage higher risk taking and induce managers to take performance-enhancing unobserved actions.

Amil Dasgupta (FMG/LSE) concluded the session with the presentation of his paper titled 'Asset Price Dynamics When Traders Care About Reputation', co-authored with Andrea Prat (LSE). Dasgupta first laid out the mechanics of his approach, consisting of a modified standard sequential trading model that is designed to capture a financial market in which traders' career concerns impact their actions. He showed that such a market cannot be informationally efficient in the sense that there exists no equilibrium in which prices converge to a 'true' value. In such a market, each asset then carries an endogenous reputational benefit or cost, possibly leading to systematic mispricing if asset supply is not infinitely elastic.

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Regional Comparative Advantage and Knowledge-Based Entrepreneurship

RICAPE2 First Conference 5-6 October 2006

The first RICAPE2 conference (fourth in the RICAPE series) was held on 5 and 6 October 2006 at the Financial Markets Group. The conference attracted some of the top venture capital researchers from both US and Europe.

The conference was opened by **David Webb** (FMG/LSE) who also chaired the first session. The morning session on Thursday (5 October) included four paper presentations. The first paper of the session was titled 'Motivating Innovation' and was presented by **Gustavo Manso** (MIT Sloan School of Management). The main point of the paper is that the standard pay-for-performance incentive schemes are not suitable for motivating innovation. This was shown theoretically by embedding a bandit problem into a principal-agent framework. In this framework, innovation is the result of learning through the exploration of untested approaches that are likely to fail. Thus the key ingredients to motivate innovation are tolerance for early failure, rewards for long-term success, inefficient continuation and timely feedback on performance. The author then presented applications of this framework to a variety of situations: executive compensation and corporate governance, bankruptcy in start-ups and management of creative workers. The discussant of the paper was **Antoine Faure-Grimaud** (FMG/LSE). He felt that the framework was novel in exploring the dynamics of contracting, but wondered about the robustness of dynamics, specifically whether the results would hold in an infinite horizon setting.

The second paper of the session presented by **David Hsu** (Wharton School) titled 'The Impact of Intellectual Property Rights on the Market for Ideas: Evidence from Patent Grant Delays' (joint work with Professor Joshua Gans, Melbourne Business School and Scott Stern, Northwestern). The paper dealt with the question of how uncertainty over patent scope impacts upon the timing of cooperation between start-up and more established firms. Most prior research treats the timing of invention and granting of patents as the same, whereas in this paper patent grant delays allow the authors to statistically identify the role of patent grants in the market for ideas. The paper first presents a simple theoretical model and then uses detailed data of 200 licenses involving

start-ups and more established firms to test its hypothesis. The paper reported that patent grant is associated with a doubling in the probability of technology licensing. The hazard of licensing is increased when technology cycle times are short and alternate reputation mechanisms which mitigate the risk of expropriation exist. The discussant of the paper was **Uwe Walz** (CFS, Frankfurt). He felt that the model presented in the paper was very stylised and a more general model would have been appropriate. He also questioned the empirical strategy used to arrive at the results.



Marco Da Rin, (Tilburg and Turin University)

The third paper of the session was presented by **Marco Da Rin** (Tilburg and Turin University) on 'The Importance of Trust for Investment: Evidence from Venture Capital' (joint work with Laura Bottazzi, Bocconi University, Milan and Thomas Hellmann, University of British Columbia). The paper empirically studies the effect of trust in micro-data (venture capital investments) and poses two main questions

– does trust affect investment and does contracting attenuate the effects of trust? These questions are answered by analysing 1,300 deals of 109 European VCs and the Eurobarometer Trust measure undertaken by the EU. Based on the analysis, the authors found that trust plays an important in VC investing and that sophisticated contracting cannot (fully) substitute for lack of trust. The discussant, **Ulrich Hege** (HEC, Paris) commented that it is the investors rather than companies that are much more exposed and therefore suggested that the paper should use a different econometric

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model than the structural equation used. Further, the paper needs to robustly demonstrate that it is indeed trust rather than some other variable which is driving the relationship.

The final presentation of the session was by **Yael Hochberg** (Kellogg School, Northwestern) on 'Networking as a Barrier to Entry and the Competitive Supply of Venture Capital' (joint with Professor Alexander Ljungqvist and Mr Yang Lu, both New York University). The paper argues that networking features prominently in the VC industry and the traditional benefits of networking are numerous including better screening, access to deal flow, ability to draw on other VCs expertise etc. However, one other reason for networking could be the ability to reduce competition by deterring entry. Incumbent VCs could potentially deter entry of new VCs by controlling access to deal flow, refusing to syndicate and other externalities. The paper uses graph theory to map networks amongst US VCs involved in all venture investments between 1975 and 2003 to study the link between networking and entry. Based on the sample the paper then empirically demonstrates that networks do indeed deter entry and entrepreneurs get lower valuations as a result. The discussant, **Per Strömberg** (Swedish Institute of Financial Research, Stockholm), questioned the economic relationship between network measure and competition/entry. He felt that there could potentially be other interpretations of the network measure, for example, the attractiveness of investment opportunities in the market. Therefore more intuition is needed to justify the interpretation of the network measure.

The second session, which consisted of three papers dealing with different aspects of the design of venture capital contracts, was chaired by **Giovanna Nicodano** (University of Torino). The opening speaker, **Zsuzsanna Fluck** (Michigan State and The William Davidson Institute), presented joint work with Kedran Garrison (MIT) and Stewart Myers (MIT and NBER) on 'Venture Capital Contracting: Staged Financing and Syndication of Later-Stage Investments'. The authors study how venture capital contract provisions introduced to deal with certain financial imperfections may at the same time be aggravating (or introducing) others, and what the optimal design of contracts in the face of multiple imperfections is. They focus in particular on the effort provision and hold-up problems, and start by showing how an efficient contract term to deal with the first imperfection is staged financing. This, though may introduce a hold-up problem as the original provider of finance achieves significant bargaining power in later financing stages. To solve this, the authors illustrate how introducing syndication of later-stage investments manages to solve the hold-up problem without compromising effort provision incentives. The discussant, **Lucy White** (Harvard Business School), praised the use of numerical methods to study optimal contracting in the face of multiple agency problems. She questioned whether what was identified as a hold-up problem could be better understood as a ratchet effect, and elaborated on the analysis of the robustness of the results to the introduction of other mechanisms such as commitment on the part of the venture capitalist.

Roman Inderst (FMG/LSE) presented the second paper of this session, a theoretical analysis into 'Venture Capital Financing and Firm Growth in

New Industries', co-authored with Holger Müller (New York University). The observations that motivate their work are that (1) the growth profile of new industry start-up firms is much steeper in the US than in Europe, and that (2) practically all of the cases of high-technology firms which grow very fast from start-up into major international enterprises take place in the US. They rationalise the first observation by introducing a simple model of monopolistic competition in the product market where venture capital investors are characterised by their level of involvement in the project; more hands-on US investors obtain informative signals about the true worth of the venture earlier and will thus promote (terminate) a profitable (unprofitable) project earlier than a European financier would. The second observation is explained by the authors in an extension of the basic model that introduces competition and strategic interaction in the product market. Start-ups with a first mover advantage may want to strategically over-invest early on to pre-empt competitors, and in general only those financed by hands-on investors will be in a position to do so. **Gerard Llobet's** (CEMFI, Madrid) discussion of this paper was mainly focused on highlighting how the main friction driving the results of the model is more general than the paper suggests and not exclusive to venture capital financing. He also questioned the relevance of comparing a setting of monopoly with a competitive environment.

The last seminar of the second session was given by **Carsten Bienz** (FMG/LSE), who presented joint empirical work with **Uwe Walz** (CFS, Frankfurt) on the evolution of decision and control rights in venture capital contracts. Based on a unique data set that the authors have compiled, they study how decision and control rights evolve by financing rounds, through time (especially focusing on what happened before, during and after the late nineties stock market expansion) and relative to time-to-exit. They find that there is a shift from debt to more equity over time, and that, contrary to what other authors have found, the amount of decision and control rights does not decrease over time, but rather its composition changes (operational rights decrease in favour of exit rights). The discussion by **Armin Schwenbacher** (University of Amsterdam) started by questioning why other explanations of why the use of these rights increased over time are discarded by the authors in favour of the learning rationale. He also questioned why the study did not analyse the trade-off between control rights and other rights such as cash flow rights more carefully.

The morning session on the 6th of October was chaired by **Vyacheslav Dombrovsky** (BICEPS, Latvia) and included presentation of three papers. The first presenter was **Rich Mathews** (Duke University, Fuqua School of Business) who presented the paper 'Market Structure, Internal Capital Markets, and the Boundaries of the Firm', joint with David Robinson (Duke University, Fuqua School of Business). The paper contains a theoretical analysis of the importance of internal capital markets for the organisational structure of the firm. The analysis is cast in a framework with uncertainty regarding the potential size of the product market. Consequently, firms with different organisational structures have different abilities to commit capital to product market competition. The authors illustrate how internal capital



markets, as represented by the ability to redeploy capital from one market to another gives the integrated firm flexibility. The flip side of the flexibility is that it creates a commitment problem for the firm vis-à-vis maintaining its engagement in the product market competition. Contrary to the integrated firm, the stand alone entity has no flexibility to redeploy capital from one market to another, but also has no competition commitment problems. The authors find that the integrated firms' resource flexibility can deter entry, when the size of the product market is uncertain. On the contrary, when there is low uncertainty regarding the size of the product market, the ability to commit capital can deter entry by predatory capital raising by the stand alone entity. Finally, the authors analyse how strategic alliances can dominate both the stand alone and the integrated structure by allowing capital redeployability whilst maintaining the firms' ability to commit to competition. The discussant on the paper was **Giovanna Nicodano** (Torino), who pointed out that given the latitude in strategic alliances, a deeper analysis of the firms' ownership structure was required prior to addressing the benefits to from these alliances. The discussant liked the model's simple structure, but pointed out that a higher level of detail might benefit the theoretical modelling.

The session's second paper was titled 'Knowing Who You are Matters: A Theory of Young Firms versus Mature Firms'. The paper was presented by **Masako Ueda** (School of Business, University of Wisconsin) and was joint work with Kyriakos Frantzeskakis (School of Business, University of Wisconsin). The paper analyses the difference in the project selection process between young and established firms. The analysis is performed



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in a framework where firm types and project types need to be matched in order for the production process to be successful. Firms are unaware of their types, and can only learn these types through undertaking various projects, and observe whether the production process is successful. As a consequence, mature firms have learned their types, and can therefore rapidly tell whether a new project will fit

well within their competences or not. Conversely, young firms have to learn their types, and will therefore venture further into the product development process before terminating the project. This set-up leads to an equilibrium where mature firms reject nonperforming projects rapidly, whereas young firms spend significant resources on developing projects that can lead to failures. The discussant on the paper was **Merih Sevilir** (University of North Carolina) who raised the point that firms are aware of their types prior to

selecting projects. In addition, the discussant pointed out that contrary to the model's main conclusion, young firms are strapped for cash, and therefore need to be careful on their capital commitment, whereas mature firms are starved for growth opportunities, and therefore have a high rate of investment and disinvestment in new projects.

The last paper of the session was presented by **Rebecca Zarutskie** (Duke University, Fuqua School of Business), and was titled 'Do Venture Capitalists Affect Investment Performance? Evidence from First-time funds'. The paper attempts to shed light on the importance of the identity of venture capital fund managers, as measured by their academic and professional history, for the performance of the venture capital fund. In order to better ensure that the performance is driven by the educational characteristics of the fund manager, the author limits the analysis to first time funds. The econometric analysis is based on 318 US based funds founded between 1980 and 1998. Of these funds, 45 per cent were engaged in seed, or early stage financing. The author finds a significant positive correlation between the performance of seed stage funds and prior venture capital experience by the manager. However, this relationship turns out to be significant only when the venture fund also has a manager with start-up experience. For later stage funds, the author finds that the most important indicator of performance is whether the fund manager holds an MBA from an ivy league university. In addition, the data indicate that the venture capitalist characteristics appear to be persistent in follow-on funds. The discussant of the paper was **Sridhar Arcot** (FMG/LSE), who raised the question of whether characterising the funds as first time funds was correct, given that the manager had prior experience within the venture capital industry. Further, the discussant would like to have seen some interaction of the various explanatory variables, but pointed out that the size of the dataset made this kind of analysis difficult.

The afternoon session on Friday 6 October was chaired by **Harry Yuklea** (Technion) and consisted of three presentations. The whole session was oriented towards explanation of the relationship between the venture capital industry and human capital. The first paper of the session was titled 'Human Capital Investment, Entrepreneurship and New Firm Creation' and was presented by **Merih Sevilir** (The University of North Carolina at Chapel Hill). She develops a model which rationalises why established firms encourage entrepreneurship of their own employees. Who may – if they are successful in their innovative activity – leave the firm and start their own business. The existence of two equilibria with varying degrees of entrepreneur and venture capital creation is analysed. In the first equilibrium, established firms' investment in their employees' human capital leads to the creation of entrepreneurs, which in turn drives the creation of venture capital industry. Similarly, the availability of venture capital increases the willingness of established firms to invest in employee human capital, which drives the emergence of entrepreneurs from established firms. Hence the creation of entrepreneurs and venture capital firms is determined endogenously in equilibrium. On the contrary, in the second equilibrium, established firms do not invest in employees' human capital, there is little innovation

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creation activity and no new entrepreneurs emerge. As a consequence, the venture capital industry remains underdeveloped, which does not create incentives for established firms to invest in employee human capital in the first place. The model predicts that there will be a variation in the amount of entrepreneurship activity and venture capital financing across regions, as well as regional clustering of entrepreneurial established firms, entrepreneurial new firms and venture capitalists. The discussant of the paper was **Sudipto Bhattacharya** (LSE). He commented that the framework was interesting in exploring the role of venture capitalists in the process of promoting start-up activity. However, he questioned whether the regional clustering of established firms, new firms and venture capitalists is indeed the prediction of the model or is driven by characteristics of the region (eg, the degree of interactions with universities) which were outside the model.

The second paper of the session was presented by **Manju Puri** (Duke University and NBER) titled 'Who are Entrepreneurs and Why Do They Behave That Way?' (joint work with David Robinson, also Duke University). The paper sheds light on who entrepreneurs are as it explains some puzzling facts about their choices found in past research. In particular, why are entrepreneurs poorly diversified, bear excessive risk and accept lower median life-time earnings than wage-earners? The paper comprehensively explores three potential explanations: high non-pecuniary benefits associated with being self-employed and having one's own private business, different attitudes toward risk, and optimism as a special behavioural characteristic of an entrepreneur. The paper finds that entrepreneurs who start/buy businesses are optimistic but less likely to be extreme optimists. At the same time they have high risk tolerance and never want to retire. On the other hand, entrepreneurs who inherit businesses show no difference in optimism than the general population, are risk-averse, and the economic significance of 'never stop working' is low. The presented results suggest that entrepreneurs differ from non-entrepreneurs in terms of attitudes of optimism and risk taking and how they view their work. The discussant of the paper was **Daniel Ferreira** (FMG/LSE). He recognised many interesting findings of the paper and proposed some alternative explanations. He pointed out the possible reverse causality endogeneity as being an entrepreneur could be considered as a success and successful people are in general likely to become more optimistic over time.

The conference concluded with the presentation by **April Franco** (University of Iowa) of a paper on 'Covenants not to Compete, Labour Mobility and Industry Dynamics' (joint with Matthew Mitchell, University of Iowa). The paper models the evolution of innovative firms as some employees spin-out and create new companies. In particular, the analysis



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focuses on how contractual restrictions on employee mobility can lead to a difference in creation of start-up firms and evolution of the new industries. The analysis is well motivated by the opposing legal climates of California and Massachusetts which are believed have resulted in different evolution of the respective electronics industries. It is shown that if employees have private information, the region that enforces non-compete clauses initially dominates but the region that does not enforce covenants not to compete eventually overtakes. This happens when the competition between spin-outs and their parent firm becomes tough compared to competition between unrelated firms. The discussant, **Francesca Cornelli** (LBS), questioned the assumption that if an employee innovates and remains in the firm instead of creating a spin-out, the profits of the incumbent firm do not increase. She also pointed out that the paper does not fully model the industry life cycle as we should observe in the reality. This is because the model allows for emergence of new competition only through spin-outs and leaves out the possibility that entirely new firms can enter.

Programme Committee

Catherine Casamatta (University of Toulouse), Vyacheslav Dombrovsky (BICEPS, Latvia), Antoine Faure-Grimaud (LSE), 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)

RICAFE2 research network

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 (Latvia), University of Lugano, Indian School of Business, Technion (Israel).

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

RICAFE2 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

Corporate Governance at LSE

Research Debates

The remuneration committee process – a study of boardroom decision-making

Professor Brian Main (University of Edinburgh)

12 October 2006

The Corporate Governance at LSE programme this academic year kicked off with a research debate on 'The remuneration committee process – a study of boardroom decision-making' by **Brian Main** (University of Edinburgh's School of Management and Economics). Professor Main presented joint work with Calvin Jackson (Watson Wyatt), John Pymm (Watson Wyatt) and Vicky Wright (Watson Wyatt). There has been an increased focus on the role of remuneration committees ('remcos'), partly in response to institutional influences and the regulatory environment. The role of remuneration committees has increased in importance from 1990 to the present. Professor Main described the main functions of these committees, which include choosing a remuneration package, calibrating it, confirming periodically that the package is working fine and finally communicating the same effectively to the shareholders. While remuneration levels in the UK are nowhere near those of the US there are still issues in the functioning of UK remcos. In their research based on interviews with members of nearly 30 remcos, they found that remcos make choices with an eye to



Paul Munn, Hermes Pension Management Ltd

conforming. The main concern of remcos is to avoid 'over-payment' rather than on exact pay-performance metrics. Remcos seem to be concerned more with fairness of the process rather than outcomes. There was also a desire expressed for one-voice from institutions. The presentation concluded with a thought that the remuneration committee is a latter day Gulliver which has not realised its potential.

The discussant, **Paul Munn** (Hermes Pension Management Ltd) began by contrasting the UK and US situations and said that he was a lot more comfortable with the remuneration practices in the UK. He made three points on what is expected of remcos: 1) there was a need for the remco to be aware of corporate strategy and use that as a basis for setting remuneration, 2) remcos should consult widely but ultimately use their discretion and 3) it was impractical to expect one voice from the institutions, since they had different objectives. The presentation was followed by an interesting discussion on the various facets of the committee.

This event was sponsored by
Watson Wyatt



The next Corporate Governance at LSE Research Debate will take place on 13 November. The presentation will be given by **Gerhard Cromme** (Chairman of the Government Commission on the German Corporate Governance Code and Chairman of the Supervisory Board of ThyssenKrupp AG) who will speak on 'Recent Developments in German Corporate Governance'.

Attendance at the Research debates is by invitation only. Further information is available on the FMG website: <http://fmglse.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

New Research Grant

Home Ownership, Housing Collateral and Aggregate Fluctuations

Dr Alex Michaelides

The 'Home Ownership, Housing Collateral and Aggregate Fluctuations' research project at FMG is funded by the **Economic and Social Research Council (ESRC)*** in the context of the Phase 2 of the Council's World Economy and Finance Research Programme. This three-year research grant is led by **Alex Michaelides** and was launched in September 2006.

Research Programme Summary

The World Economy has undergone a remarkable transformation over the past two decades. Inflation has fallen and is now very low and stable, while aggregate output and consumption volatility have declined across the developed world (except in Japan). These changes have been accompanied by large shifts in financial prices. Real estate prices have risen relative to household incomes. Despite substantial share price volatility, it appears that the equity risk premium may have fallen too.

At the same time, aggregate household debt has risen sharply, especially in the US and UK. This has led to concern amongst a number of policy institutions such as the IMF and the Bank of England that the high levels of household debt and housing prices will make economies more vulnerable to shocks, endangering the macro-economic stability that has prevailed since the early 1990s. As household debt grows across the developed world, households, may, as a result, become more vulnerable to monetary policy or other macroeconomic shocks.

Japan's economic experience since the 1980s illustrates the potential dangers. Despite a stable inflation rate, Japan experienced a spectacular increase in stock and real estate prices. This was followed by the 1990s crash and a prolonged recession causing substantial damage to the financial system. Japan's recent experience raises the question of whether such events were unique to Japan or whether they may materialise in other developed economies as well.

An alternative, more benign view has stressed other reasons for the changes in house prices and household debt levels,

which do not necessarily have undesirable implications for macroeconomic stability. For instance, greater macroeconomic and financial stability reduces the risks faced by households and allows them to sustain higher levels of debt to income ratios. The resulting increase in housing prices is therefore a sign of economic success rather than a cause for concern.

Our project involves a theoretical and empirical investigation of these competing conjectures. We plan to develop a structural model of the 'household as a small business', in which agents derive utility from non-durables and housing. Crucially, we will assume imperfect contract enforcement, which implies that debtors will repay their debts only if these debts are secured. And because housing is the only durable asset in our model, it is the natural source of collateral. Our focus on housing collateral is in line with substantial micro level evidence in the UK and the US which suggests that dwellings are an important source of collateral for households.

The importance of secured borrowing means that the choice between renting and home ownership becomes a non-trivial one. We believe that this choice has significant implications for consumer behaviour at both the micro and macro level. We plan to model the home-ownership decision explicitly within our framework in order to explore these implications in detail.

House prices play a crucial role in determining consumer behaviour in a limited contract enforcement world. Fluctuations in the market value of housing collateral directly affect households' ability to borrow and spend. This endogeneity of borrowing limits leads to two-way interactions between asset prices and real quantities. Household expenditure and house prices are jointly determined in equilibrium, generating a powerful transmission mechanism for real and monetary shocks.

* ESRC Research Grant No: RES –165-25-0024



UBS Pensions Research Programme Conference

Pension Plan Funding, the Stock Market, Asset Allocation and Corporate Finance

9 November 2006

The conference on Pension Plan Funding, the Stock Market, Asset Allocation and Corporate Finance will examine the stock market and regulatory responses to the existence of substantial pension fund deficits in corporate accounts. For example a recent PwC Report for the Pensions Regulator suggested that by December 2004 pension fund deficits of FTSE350 companies totalled £70 billion. This conference will examine a number of issues surrounding deficits in corporate pension schemes, including: the extent to which the stock market recognises and capitalises the deficit in the company valuation; the incentives for risk-taking by companies with such deficits; the trade-offs between pension fund deficits and corporate debt; and the effect of accounting regulations on pension fund deficits.

Conference Programme

Session 1 Pension Plan Funding and the Stock Market

9am Pension Plan Funding and Stock Market Efficiency
Francesco Franzoni (HEC)
Discussant: **Ian Tonks** (University of Exeter)

10am Corporate cross-holdings of equity, leverage and pensions: simulation and empirical evidence from the UK
Garry Young (Bank of England)
Discussant: **Edmund Cannon** (Bristol)

Session 2 Pension Plan Funding and Corporate Finance

11.20am Capital structure decisions and corporate pension plans
Irina Stefanescu (Indiana University)
Discussant: **Ron Anderson** (FMG/LSE)

12.20pm The Corporate Governance of Defined Benefit Pension
Paolo Volpin (London Business School)
Discussant: **Antoine Faure-Grimaud** (FMG/LSE)

Session 3 Pension Plan Funding and Asset Allocation
2.20pm Risk Shifting versus Risk Management: Investment Policy in Corporate Pension Plans
Joshua Rauh (University of Chicago Business School)
Discussant: **Sean Finucane** (Exeter)

3.40pm The Influence of PBGC Insurance on Pension Fund Finances
Julia Coronado (Barclays Capital) joint with **Nellie Liang** (Federal Reserve Board)
Discussant: **David McCarthy** (Imperial College)

Session 4 Market and Regulatory Responses to Pension Plan Funding

4.40pm Overview and Discussion
Steve Sharpe (Federal Reserve Board of Governors) and **David Webb** (FMG/LSE)



Financial Regulation Workshops

Prompt Corrective Action and Cross-Border Supervisory Issues in Europe

20 November 2006

This conference is the fourth and final in a series of events dedicated in the area of Regulation and Financial stability that have been organised with the support of the Economic and Social Research Council*. The series of conferences builds on the established FMG London Financial Regulation seminar, which has run since 1999. 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 workshop series included the following one-day conferences:

27 – 28 April 2006

The Legal Foundations of International Monetary Stability
Organisers: Dr Rosa M Lastra (Queen Mary, University of London) and Professor Charles Goodhart (FMG/LSE)

18 – 19 May 2006

Financial Stability: Theory and Applications
Organisers: C A E Goodhart and D P Tsomocos

28 September 2006

Workshop on Financial Regulation and Payments Systems,
Organisers: Professor Charles Goodhart (FMG/LSE), Dr Alistair Milne (Cass Business School)

Conference Programme

10am Opening and Welcome Remarks
Charles Goodhart (FMG/LSE)

Session 1: Prompt Corrective Action in Europe

Chair: **Harald Benink** (Erasmus University Rotterdam and FMG/LSE)

10.15am International Press Conference of the European Shadow Financial Regulatory Committee (ESFRC)
The Scope for Prompt Corrective Action and a Leverage Ratio in Europe
ESFRC Members

11.15am The need for PCA rules in Europe
María Nieto (Bank of Spain) and **Larry Wall** (Federal Reserve Bank of Atlanta)

Session 2: Cross-Border Supervisory Issues

Chair: **Charles Goodhart** (FMG/LSE)

1.20pm Resolving Cross-Border Banking Crises
Rosa Lastra (CCLS, Queen Mary, University of London) and **Clas Wihlborg** (Copenhagen Business School)

1.55pm Challenges for Deposit Insurance and Financial Stability in Europe
Robert Eisenbeis (Federal Reserve Bank of Atlanta) and **George Kaufman** (Loyola University Chicago)

2.40pm Dealing with Distress in Financial Conglomerates
Thomas Huertas (Financial Services Authority)

Panel Discussion

Chair: **Charles Goodhart** (FMG/LSE)

Panellists: **Christian de Boissieu** (University of Paris-I (Panthéon-Sorbonne)

Franco Bruni (Bocconi University), **Gillian Garcia** (formerly International Monetary Fund)

* 'Regulation and Financial Stability Workshop Series', ESRC Grant No: RES-451-25- 4005

The London-Oxford Financial Econometrics Study Group

24 November 2006

The study group is convened by **Professor Nour Meddahi** (Imperial College), **Dr Andrew Patton** (FMG/LSE) and **Professor Neil Shephard** (Oxford) in order to stimulate research in financial econometrics in our research groups and beyond. The Group will hold two workshops per year (in London and in Oxford) and will draw primarily on the large number of financial econometricians now working in the UK. The goal of these workshops is to stimulate research in financial econometrics and provide a forum for research discussion and debate.

The first workshop will be held on Friday 24 November 2006 and is partly funded by the **Leverhulme Trust** research grant on 'The Evaluation and Comparison of Risk Forecasts using High Frequency Data' held by Andrew Patton at the Financial Markets Group at LSE. *

The second workshop is scheduled for early Spring 2007. More details will be published on the FMG website:
<http://fmg.lse.ac.uk>

Roel Oomen (University of Warwick)
Covariance Measurement in the Presence of Non-Synchronous Trading and Market Microstructure Noise (joint with Jim Griffin)

Discussant: **Kevin Sheppard** (University of Oxford)

Antonio Mele (FMG/LSE)
Macroeconomics Strikes Back: Real Determinants of Volatility Risk-Premia (joint with Valentina Corradi and Walter Distaso)
Discussant: **Christian Julliard** (FMG/LSE)

Neil Shephard (University of Oxford)
Subsampling realised kernels (joint with Ole E Barndorff-Nielsen, Peter Hansen and Asger Lunde)
Discussant: **Oliver Linton** (FMG/LSE)

For more will be available soon on the FMG website:
<http://fmg.lse.ac.uk>

* The Leverhulme Trust, Research Grant Reference No: F/07 004/AF

Conference Programme

11am-5.30pm

Keynote speaker: **Stephen Taylor** (Lancaster University)
A multi-horizon comparison of density forecasts for the S&P 500 using index returns and option prices (joint with Mark Shackleton and Peng Yu)
Discussant: **Andrew Patton** (FMG/LSE)

Karim Abadir (Imperial College, London)
Distilling co-movements from persistent macro and financial series (joint with Gabriel Talmain)
Discussant: **Valentina Corradi** (University of Warwick)

Marcelo Fernandes (Queen Mary)
International market links and realized volatility transmission (joint with Walter Distaso and Valentina Corradi)
Discussant: **Nour Meddahi** (Imperial College, London)



GAM Gilbert de Botton Award in Finance Research 2006

The Financial Markets Group at LSE is pleased to announce **Valentina Bruno** and **Sridhar Arcot** as the winners of the GAM Gilbert de Botton Award in Finance Research 2006, for their paper on Corporate Governance. The Award is made annually in recognition of outstanding research in finance. Competition was extremely high this year, with both a dramatic increase in the number of entries and in standard and academic rigour.

A team of experts from the academic and the business community evaluated the research papers. The 2006 Award's Jury included **Professor David Webb** (Director, Financial Markets Group, LSE) as Chairman of the panel, **Professor Charles Goodhart** (Research Programme Director, Financial Markets Group, LSE), **Dr Shusil Wadwhani** (Wadwhani Asset Management LLP) **Dr Michael Kuczynski** (Pembroke College, Cambridge), **Mr Jeremy Smouha** (Director, GAM) **Mr David M Solo**, (Group Chief Executive Officer, GAM) and **Mr Graham Wainer** (Group Head of Clients and Portfolio Management, GAM).

The results of this year's competition are:

Winner: **Valentina Bruno** and **Sridhar Arcot** – 'One Size does not fit all, after all: Evidence from Corporate Governance'

First Runner-up: **Ander Perez** – 'Endogenous Market Incompleteness, Entrepreneurial Risk and the Business Cycle'

Second Runner-up: **Anisha Ghosh** – 'Realized Beta and the Conditional CAPM: A Time-Series Test When Risk Premia Are Time-Varying'

The Award Jury also short-listed three additional papers of very high quality: **Oriol Aspachs** – 'Real Business and Banking Cycle'

Katrin Tinn and **E Vourvachaki** – 'Equity mis-pricing and R&D growth'

Michael Kollo – 'Specialists, Reputation and the Rise of US Banks in the International Debt Markets'

Valentina Bruno and **Sridhar Arcot** were presented with the joint winner's prize of £10,000. The 1st Runner-up received £5,000 while the Second Runner-up received £2,500. The award ceremony this year took place on 1 November 2006 and was combined with a lecture by **Rachel Lomax** (Deputy Governor, Bank of England) entitled 'International monetary stability – can the IMF make a difference?'.

The Financial Markets Group at LSE would like to thank GAM for their generous support that will enable us to continue our efforts to promote top quality research by talented young people in financial market behaviour and

practice. Previous winners included **Hassan Naqvi** in 2003 who is now an Assistant Professor of Finance at National University of Singapore, **Miguel Segoviano** in 2004 who has also successfully completed his PhD this year and moved to the IMF and **Peter Kondor** in 2005 who is now at The University of Chicago Graduate School of Business.

Information about the GAM award competition 2007 will be posted in the FMG website in Lent term 2007 (<http://fmg.lse.ac.uk/>).

The Award was created in honour of the late **Gilbert de Botton**, founder of **GAM**.

GAM

GAM delivers active investment management to private clients, institutions and intermediaries. Its goal is to produce outstanding results for clients by providing access to great investment talent throughout the world. All of GAM's fund managers, whether employed by GAM or contracted to GAM, are unconstrained in their investment management process and decisions. As well as active management within funds, GAM uses active asset allocation to combine funds in managed portfolios that meet clients' diverse needs. GAM's funds and strategies cover a broad range of asset classes, currencies and market conditions. It has long experience of hedge funds and funds of hedge funds. With rigorous attention to detail and client-friendly technology, GAM provides excellent service to its clients. It manages some CHF 76.2 billion of clients' assets from nine offices around the world. Established in 1983 by its visionary founder, Gilbert de Botton, GAM was owned by UBS AG from 1999 until December 2005 when it was acquired by Julius Baer Holding Ltd. GAM continues to have a distinctive style and culture.

Deutsche Bank PhD Fellowship 2006-07

The FMG Deutsche Bank PhD Fellowship continued through its second year with the appointment of one more student fellow: **Sean Lew** of Accounting and Finance Department, and the renewal for a second term of the 2005-06 Deutsche Bank Fellowship PhD Fellows: **Nikolaj Schmidt** and **Aytek Malkhozov**, both of the Accounting and Finance Department of LSE.

The objective of the Deutsche Bank PhD Fellowship Programme is to offer a number of 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 area of risk management or capital management.

In 2005, the programme supported three students who were selected as Deutsche Bank PhD Fellows: **Nikolaj Schmidt**, **Aytek Malkhozov** and **Michael Kollo**.

The Fellowships are 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 students' proposals 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.

Information about the competition for the Deutsche Bank PhD Fellowship 2007 will be posted in the FMG website in the Summer term 2007 (<http://fmg.lse.ac.uk/>).

Young Scientist Award Journal of Applied Econometrics

Cristian Huse (FMG/LSE) has been recently awarded the 'Young Scientist Award' by the Journal of Applied Econometrics for the paper 'Term Structure Modelling with Observable State Variables' he presented during the International Workshop on Spatial Econometrics and Statistics (www.unich.it/conferencerome2006) which took place in Rome, 25-27 May 2006. The award, worth USD500 was used to cover conference registration and part of the travel expenses. This award is the way the Journal of Applied Econometrics aims to support and stimulate the participation of young scholars in international conferences, besides acknowledging high quality research produced by researchers in the early stages (up to three years after the PhD) of their careers. The awarding ceremony was held during the conference dinner, which took place at the LUISS Business School, Rome.

FMG Students Job Market Candidates

Enrico Sette

Research Interests: Applied microeconomics, organisation theory and corporate finance.

Email: e.sette@lse.ac.uk

Katrin Tinn

Research Interests: Macroeconomics, Financial Economics, International Economics and Monetary economics

Email: k.tinn@lse.ac.uk

Sridhar Arcot

Research Interests: Corporate Finance
Job market paper: One size does not fit all, after all: Evidence from Corporate Governance
Email: s.r.arcot@lse.ac.uk

Cristian Huse

Research Interests: Finance and Econometrics
Job market paper: Term Structure Modelling with Observable State Variables
Email: c.huse@lse.ac.uk

Xuewen Liu

Research Interests: Corporate finance, Economics of organization, Economic growth and development, Political economy

Job Market Paper: The Capital Structure of Private Equity-backed Firms

Email: x.liu@lse.ac.uk

Michael Kollo

Research Interests: Banking, Empirical corporate finance, Corporate governance

Job Market Paper: Combine and conquer. Investor relationships, global reputation and underwriter competition

Email: M.G.Kollo@lse.ac.uk

Valentina Bruno

Research Interests: Corporate finance and governance

Email: v.g.bruno@lse.ac.uk



Discussion papers

DP 555

Imperfect Common Knowledge in First Generation Models of Currency Crises

Gara Minguez-Afonso

First generation models assume that the level of reserves of a Central Bank in a fixed exchange rate regime is common knowledge among consumers, and therefore the timing of the attack on the currency, in an economy with persistent deficit, can be correctly anticipated. In these models, the collapse of the peg leads to no discrete change in the exchange rate. We relax the assumption of perfect information and introduce uncertainty about the willingness of a Central Bank to defend the peg. In this new setting, there is a unique equilibrium at which the fixed exchange rate is abandoned. In our model, the lack of common knowledge will lead to a discrete devaluation of the local currency once the peg finally collapses.

DP 556

Rent Extraction by Large Shareholders: Evidence Using Dividend Policy in the Czech Republic

Jan Bena, Jan Hanousek

Using cross-sectional analysis of corporate dividend policy we show that large shareholders extract rents from firms and expropriate minority

shareholders in the weak corporate governance environment of an emerging economy. By comparing dividends paid across varying corporate ownership structures – concentration, type, and domicile of ownership – we quantify these effects and reveal that they are substantial. We find that the target payout ratio for firms with majority ownership is low but that the presence of a significant minority shareholder increases the target payout ratio and hence precludes a majority owner from extracting rent. In contrast to other studies from developed markets, our unique dataset from the Czech Republic for the period 1996-2003 permits us to take account of the endogeneity of ownership.

DP 557

Consistent Information Multivariate Density Optimizing Methodology

Miguel Angel Segoviano Basurto

The estimation of the profit and loss distribution of a loan portfolio requires the modelling of the portfolio's multivariate distribution. This describes the joint likelihood of changes in the credit-riskquality of the loans that make up the portfolio. A significant problem for portfolio credit risk measurement is the greatly restricted data that are available for its modelling. Under these circumstances, convenient parametric assumptions are frequently made in order to represent the nonexistent information. Such assumptions, however, usually do not appropriately describe the behaviour of the assets that are the subject of our interest, loans



granted to small and medium enterprises (SMEs), unlisted and arm's-length firms. This paper proposes the Consistent Information Multivariate Density Optimizing Methodology (CIMDO), based on the cross-entropy approach, as an alternative to generate probability multivariate densities from partial information and without making parametric assumptions. Using the probability integral transformation criterion, we show that the distributions recovered by CIMDO outperform distributions that are used for the measurement of portfolio credit risk of loans granted to SMEs, unlisted and arm's-length firms.

DP 558

Conditional Probability of Default Methodology

Miguel Angel Segoviano Basurto

This paper presents the Conditional Probability of Default (CoPoD) methodology for modelling the probabilities of loan defaults (PoDs) by small and medium size enterprises (SMEs) and unlisted firms as functions of identifiable macroeconomic and financial variables. The process of modelling PoDs represents a challenging task, since the time series of PoDs usually contain few observations, thus making ordinary least squares (OLS) estimation imprecise or unfeasible. CoPoD improves the measurement of the impact of macroeconomic variables on PoDs and consequently the measurement of loans' credit risk through time, thereby making a twofold contribution. First, econometrically, it recovers estimators that show greater robustness than OLS estimators in finite sample settings under the Mean Square Error criterion. Second, economically, on the basis of

economic theory and empirical evidence, CoPoD can incorporate a procedure to select a relevant set of macroeconomic explanatory variables that have an impact on the PoDs. We implement CoPoD with information from Norway and Mexico.

DP 559

The Dark Side of 'Good' Corporate Governance: Compliance-Fuelled Book-Cooking Activities

Tom Kirchmaier, Mariano Selvaggi

We argue on theoretical grounds that obligatory compliance with stricter Financial reporting rules (eg, the US Sarbanes-Oxley Act) may entail important unintended consequences. Paradoxically, the amount of misreporting may increase because corporate boards spend more valuable resources fulfilling statutory mandates rather than involving themselves in forward-looking strategy setting. As these surveillance devices are substitute methods of gauging management quality, when boards focus on the firm's internal control and accounting system they become semi-detached from strategy – their business acumen falters. Top executives are then judged primarily on the basis of financial metrics as opposed to long-term fit. Since the balance sheet review carries more weight in the board's decision-making process, the return to managerial book-cooking (a purely 'influence' activity) and the risk of endorsing flawed business plans swell. This confirms a burgeoning sentiment among business leaders and scholars that boards should perhaps pay less rather than more heed to codified, verifiable 'good' governance principles.

DP560

Hedge Funds and Financial Stability: Explaining the Debate at the Financial Stability Forum Special Papers

Paola Robotti

No abstract available

DP 561

Equilibrium Asset Pricing with Systemic Risk

Jon Danielsson, Jean-Pierre Zigrand

We provide an equilibrium multi-asset pricing model with micro-founded systemic risk and heterogeneous investors. Systemic risk arises due to excessive leverage and risk taking induced by free-riding externalities. Global risk-sensitive financial regulations are introduced with a view of tackling systemic risk, with Value-at-Risk a key component. The model suggests that risk sensitive regulation can lower systemic risk in equilibrium, at the expense of poor risk-sharing, an increase in risk premia, higher and asymmetric asset volatility, lower liquidity, more comovement in prices, and the chance that markets may not clear.

DP 562 (UBS Pensions Series 040)

Pensions: Overview of the Issues

Nicholas Barr

Many countries face increasing fiscal problems financing pensions in the face of population aging. There is controversy about the underlying economic theory, about the extent of the problem, and about the best mix of policies to protect old-age security. This paper establishes the areas of debate; gives thumbnail descriptions

of pension arrangements in different countries; discusses the main analytical and empirical issues relevant to thinking about pension design; and assesses a range of policy directions. The main conclusions are that what matters most is effective government and economic growth; that the debate between pay-as-you-go and funding is secondary; that good pension schemes can take many forms; and that there is a problem in financing pensions, but not a crisis.

Special papers

SP 165

Preconditions for a successful implementation of supervisors' Prompt Corrective Action: Is there a case for a banking standard in the EU?

María J Nieto, Larry D Wall

Over the past years, several countries around the world have adopted a system of prudential prompt corrective action (PCA). The European Union countries are being encouraged to adopt PCA by policy analysts who explicitly call for its adoption. To date, most of the discussion on PCA has focused on its overall merits. This paper focuses on the preconditions needed for the adoption of an effective PCA. These preconditions include conceptual elements such as a prudential supervisory focus on minimizing deposit insurance losses and mandating supervisory action as capital declines. These preconditions also include institutional aspects such as greater supervisory independence and authority, more effective resolution mechanisms and better methods of measuring capital.

Forthcoming Discussion and Special Papers

Discussion Papers

DP 563 (UBS Pensions Series 041)

'The Economics Of Pensions'

Nicholas Barr, Peter Diamond

DP 564 (UBS Pensions Series 042)

'Compensating Wage Differentials for Defined Benefit and Defined Contribution Occupational Pension Scheme Benefits'

Nicholas Barr, Peter Diamond

DP 565

'Consistent Measures of Risk'

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

DP 566

'Choice of Corporate Risk Management Tools under Moral Hazard'

Jan Bena

DP 567 (UBS Pensions Series 043)

'The Optimal Design of Funded Pensions'

Luciano G Greco

DP 568

'Are there Monday effects in Stock Returns: A Stochastic Dominance Approach'

Young-Hyun Cho, Oliver Linton, Yoon-Jae Whang

DP 569

'Monetary Policy and its Informative Value'

Romain Baeriswyl, Camille Cornand

DP 570

'Speculative Attacks with Multiple Sources of Public Information'

Camille Cornand, Frank Heinemann

Special Papers

SP 166

'Broad money vs. narrow money: A discussion following the Federal Reserve's decision to discontinue publication of M3 data'

Tim Congdon

SP 167

'Searching for a Metric for Financial Stability'

O Aspachs, C Goodhart, M Segoviano, D Tsomocos,
L Zicchino

Visitors to the FMG

August – October 2006

Carsten Bienz (University of Bergen)

Marco Da Rin (Tilburg and Turin University)

Vyacheslav Dombrovsky (BICEPS, Latvia)

Zsuzsanna Fluck (Michigan State and the William Davidson Institute)

April Franco (University of Iowa)

Ulrich Hege (HEC, Paris)

Yael Hochberg (Kellogg School of Management)

David Hsu (Wharton School, University of Pennsylvania)

Gerard Llobet (CEMFI, Madrid)

Brian Main (University of Edinburgh)

Rich Mathews (Duke University)

Gustavo Manso (MIT Sloan School of Management)

Giovanna Nicodano (University of Torino)

Manju Puri (Duke University and NBER)

Armin Schwienbacher (University of Amsterdam)

Merih Sevilir (Kenan-Flagler Business School, University of North Carolina)

Per Strömberg (SIFR, Stockholm)

Masako Ueda (University of Wisconsin and CEPR)

Uwe Walz (CFS, Frankfurt)

Lucy White (Harvard Business School)





Financial Markets Group

The Financial Markets Group Research Centre at LSE is one of the leading centres in Europe for academic research into financial markets. [more about FMG](#)



Events this week @ FMG

Wednesday, 1st November 2006 - 13.00pm - 14.00pm

[Lunchtime Workshop](#) | [Competing Influence](#) | [Enrico Sette \(LSE\)](#)
location: R407, 4th Floor, Lionel Robbins Building, LSE

Wednesday, 1st November 2006 - 5.00pm

[Capital Markets Workshop](#) | [Risk Aversion and Clientele Effects](#) | [Will Goetzmann \(Yale University\)](#)
location: R405, 4th Floor, Lionel Robbins Building, LSE

In the news

[GAM Gilbert de Botton Award in Finance Research 2006 Results](#) **29 Oct 2006**

The Financial Markets at LSE is pleased to announce Valentina Bruno & Sridhar Arcot as the winne

[Launch of the new internal Corporate Governance at LSE research seminars](#) **24 Oct 2006**

FMG would like to announce the launch of a new series of informal research seminars in the area of C

[announce Valentina Bruno & Sridhar Arcot as the winne](#) [Launch of the new internal Corporate Governance at LSE research seminars](#) - FMG w

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