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GAM Gilbert de Botton Award Lecture

International Monetary Stability – Can the IMF Make a Difference?

Rachel Lomax, Deputy Governor, Bank of England

1 November 2006

The GAM Gilbert de Botton Award ceremony took place at Somerset House in London on 1 November 2006. The welcome speech was delivered by **David Webb** (FMG/LSE), who highlighted the importance of the annual GAM Award in fostering research in finance at the LSE and reviewed the career development of previous recipients of this prestigious award.

The main lecture of the evening, which was introduced by **Charles Goodhart** (FMG/LSE), was delivered by **Rachel Lomax** (Deputy Governor for Monetary Policy, Bank of England) under the title 'International Monetary Stability: Can the IMF make a Difference?'. The talk focused on the role the International Monetary Fund (IMF) should play in a new era characterised by an ongoing process of globalisation and the emergence of new economic powers, and on the necessary steps in the direction of implementing that new role.

Ms Lomax argued that the increasing integration of the world economy calls for the IMF's surveillance duties to focus more on the linkages between different economies rather than on domestic issues with small effects outside an individual country's borders, which as she argued, is the current emphasis of many of the Fund's activities. The analysis of countries' policies should be refocused to identify possible spillovers that may compromise external stability and to identify inconsistencies between different countries' policy frameworks. This shift in the focus of the IMF's surveillance has been widely endorsed by member countries, but the extent to which the Fund can have any real influence over countries' policy decisions remains an open question, especially with respect to those countries whose policies have the greatest impact on the world economy. Surveillance, unlike reform programmes linked to financial assistance packages, does not rely on any strong mechanism that can provide leverage to exert influence on countries. So, ultimately, Ms Lomax concluded, the success of the IMF as an institution that promotes international monetary stability will depend to a large extent on the confidence and trust its members are willing to put in it, and this in turn will also be importantly affected by the reform of the Fund's governance which is currently under debate.



Rachel Lomax, Deputy Governor for Monetary Policy, Bank of England



Charles Goodhart, Research Programme Director, Regulation and Financial Stability

GAM Gilbert de Botton Award Lecture



From left to right: **Jeremy Smouha**, **Anisha Ghosh**, **David Webb**, **Janet de Botton**, **Charles Goodhart**, **Sridhar Arcot**, **Ander Perez**

The winners of the GAM Gilbert de Botton Award in Finance Research 2006 were:

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 **Evangelia Vourvachaki** – Equity mis-pricing and R&D growth

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

The lecture was followed by the presentation of the winners of the GAM de Botton Award in Finance Research 2006 by **Jeremy Smouha** and **Mrs Janet de Botton**.



Jeremy Smouha, Director, GAM



Janet de Botton presenting award to **Ander Perez**

GAM

The GAM Gilbert de Botton Award in Finance Research was established in 2002 with the generous support of GAM and is awarded annually by GAM and the London School of Economics. The Award is given to outstanding students pursuing a PhD at the LSE's internationally renowned Financial Markets Group on the basis of a research paper competition. 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 & Portfolio Management, GAM).

The Financial Markets Group at LSE would like to thank GAM for their generous support that 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/>).

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



1 November 2006

On 9 November the FMG hosted a conference which brought together academics and practitioners to discuss recent advances in enhancing the understanding of the interaction between pension fund deficits and the sponsoring company's investment policies. **David Webb** (FMG/LSE) and **Ian Tonks** (University of Exeter) organised this event as part of the UBS Pensions Research Programme.

Pension Plan Funding and the Stock Market

The first session of the conference, chaired by **David Webb**, focused on the relationship between pension plan funding and the stock market. The session began with a presentation by **Francesco Franzoni** (HEC) of his paper on 'Pension Plan Funding and Stock Market Efficiency', co-authored with Jose M Marin (Universitat Pompeu Fabra and CREA). Franzoni explained how the market significantly overvalues companies with severely under-funded pension plans. These firms earn lower stock returns than corporations with healthier pension plans for at least 5 years after the first emergence of the under funding. The main findings of the paper are that the low returns are not explained by risk, price momentum, earnings momentum, or accruals. He also showed that empirical evidence suggests that investors do not anticipate the impact of the pension liability on future earnings, and are surprised when the negative implications of under funding ultimately materialise. The discussant, **Ian Tonks**, emphasised the difference in patterns for UK firms. He showed that there is no evidence of under-performance of most under-funded pension plans when using UK data.

The second talk of the session was delivered by **Garry Young** (Bank of England), who presented his paper co-authored with Kamakshya Trivedi (Bank of England), under the title 'Corporate Cross-Holdings of Equity, Leverage and Pensions: Simulation and Empirical Evidence from the UK'. He explained the role of defined-benefit company pensions in amplifying the effect of common shocks to companies' stock market valuations. The authors confirm empirically (with weekly stock market data for a sample of FTSE 350 UK companies) the significance of two channels of amplification: cross-holdings of equities in pension scheme assets and leverage induced by pension liabilities. In the discussion, **Edmund Cannon** (University of Bristol) focused on the importance of testing the model at different frequencies in the data. He also pointed out the possibility of considering international holdings of equity in addition to other assets.

Pension Plan Funding and Corporate Finance

The second session, chaired by **Ian Tonks**, focused on pension plan funding and corporate finance. **Paolo Volpin** (London Business School) presented the first paper entitled 'The Corporate Governance of Defined benefit Pension'. The paper, co-authored with Joao Cocco (London Business School), explores the governance of defined-benefit pension plans in the UK. In this the authors



Paolo Volpin, London Business School

construct a governance measure equal to the proportion of trustees of the pension plan who are also executive directors of the sponsoring firm. Their empirical findings indicate that pension plans of indebted companies with a higher proportion of insider-trustees invest a higher proportion of the pension plan assets into equities, contribute less into the pension plan, and have a larger dividend payout ratio. The discussant, **Antoine Faure-Grimaud** (FMG/LSE), questioned whether insider trustees really have an incentive to take risks. He pointed out the importance of clarifying the extent to which companies benefit from risk-shifting. He also emphasised the role of bond investment in pension plans in the presence of the mentioned insider trustees.

The second paper in the session 'Capital Structure Decisions and Corporate Pension Plans' was presented by **Irina Stefanescu** (Kelley School of Business, Indiana University). It examines the capital structure puzzle that many firms appear to be under-levered from a tax savings perspective. More specifically, this paper explores the capital structure implications of sponsoring corporate pension plans and finds that firms are significantly less under-levered once off-balance sheet pension obligations are taken into account. The author treats corporate pension plans as fully-owned subsidiaries and she finds that sponsoring companies are 35 per cent more levered on consolidated accounts. The author also calculates marginal tax

UBS Pensions Research Programme Conference

rates by explicitly accounting for the effect of pension contributions on taxable income and finds that the tax benefits of debt-like deductions are 47 per cent larger once pension debt is included as a long-term liability. The discussant, **Ron Anderson** (FMG/LSE), praised the paper for providing a convincing case that in the US capital structure decisions, especially of mature 'old economy firms', need to take pension assets and liabilities into account. He also pointed out that the paper produces some evidence of anomalous results, which raise questions about the static trade-off specification and about the full equivalence of debt and pensions liabilities. With respect to these questions the discussant noted the reasons why dynamic trade-off models tend to predict lower levels of leverage than equivalent static models. Moreover, from the empirical results pension debt should not be considered a perfect substitute for balance sheet debt.

Pension Plan Funding and Asset Allocation

The first paper in the third session was presented by **Joshua Rauh** (University of Chicago Graduate School of Business). In 'Risk Shifting versus Risk Management: Investment Policy in Corporate Pension Plans' the author examines the conflicting incentives with respect to the management of cash flow risks, that firms financed with debt face. Risk reduction can benefit liquidity-constrained firms, but increased risk-taking can increase the value of shareholders' equity through asset substitution when firms are close to default. These conflicting motivations are particularly strong in the case of investments of defined benefit pension plans sponsored by US companies. Empirically, the author demonstrates that firms with poorly-funded pension plans allocate a greater share of pension fund assets to safer securities such as government debt and cash, whereas well-funded plans invest more heavily in volatile asset classes such as equity. Among large public firms, those with better credit ratings allocate greater shares of pension fund assets to equity and smaller shares to government debt and cash. The higher the probability of bankruptcy, the safer the observed pension fund asset allocation. The author concludes that the incentive to limit the cash flow risk from pensions plays a considerably larger role than risk shifting in explaining pension fund investment policy among US firms. The discussant **Seán Finucane** (University of Exeter) suggested some alternative measurements. More precisely he asked why the author chose to use equity vs. fixed income volatility and also suggested that the author could look at very skewed asset class allocations (e.g. venture capital) or very stable cash flow classes (eg, real estate) for risk shifting vs. risk management.

The second paper in this session was presented by **Julia Coronado** (Barclays Capital) and **Nellie Liang** (Federal Reserve Board). The paper, 'Moral Hazard from Government Pension Insurance: Evidence from US and UK Firm Finances', represents joint work with Michael Orszag (Watson Wyatt Worldwide). It analyses the degree to which lower contributions and greater under-funding of defined benefit plans increases the size of the claims of the Pension Benefit Guaranty Corporation. The authors use a large sample of defined benefit plans of US corporate sponsors, among the



Conference participants

Fortune 1000 from 1999 to 2004. This panel dataset allows them to estimate not only behaviour across firms with different levels of risk but also behaviour as a firm's risk changes over time. Their findings suggest the behavioral channel is quite important. The authors find that riskier firms in

the US tend to make lower cash contributions to their defined benefit plans and have lower funding ratios, even after controlling for excess cash flow. The authors do not find that UK firms exhibit the same behaviour. They also find only limited evidence that US firms closer to bankruptcy invest more of their defined benefit assets into equities, consistent with moral hazard, but the increment is small. The discussant, **David McCarthy** (Imperial College), suggested that the authors could explore in more detail possible alternative explanations for the observed differences in the UK and the US, for example differences in governance or in bankruptcy codes.

Market Regulatory Responses to Pension Plan Funding

In the last session, **Steven Sharpe** (Federal Reserve Board of Governors) presented an overview of joint work with Julia Coronado (Barclays Capital), Olivia Mitchell (University of Pennsylvania) and Blake Nesbitt (University of Pennsylvania). The authors investigate whether the increased public attention on the fact that financial markets have difficulty in pricing the risks and rewards associated with maintaining a corporate defined benefit pension plan, in conjunction with the huge swings in financial health of such plans, induced US equity market investors to price their assets and liabilities more accurately. Their empirical findings show how equity market investors value firms based on their income statement, and how the valuation that the market places on pension-related accruals is at least as high as, if not higher than, the value it places on core earnings. Therefore, these results have substantial implications for current proposals intended to make pension accounting more transparent.

David Webb summarised the conference by giving an overview of the main issues raised during the day and noted the significant contributions made to the general understanding of the interaction between pension plan surpluses/deficits and the sponsoring company's investment policies. However, he also drew the audience's attention to the observed lack of empirical regularities between the US and the UK. The differences in the two countries' experiences and what can be learned from it makes this topic an open question and sets the grounds for further research.

Corporate Governance at LSE

Research Debates

Recent Developments in German Corporate Governance

Dr Gerhard Cromme, Chairman, Thyssenkrupp

13 November 2006

In his speech, **Gerhard Cromme** (Chairman, Thyssenkrupp) focused on corporate governance in Europe viewed from the German perspective. He argued that there exist considerable differences between corporate governance systems in Europe and highlighted that even the meaning of essential words, like 'board' or 'chairman', varies across countries. These differences are driven by distinct business traditions across European countries, variations in the national legal systems, or differences in the structure of the banking sector. On reflection of this situation, the European commission in early 2000 decided not to implement a single regulation across the whole EU but has instead put forward 10 key principles (eg, independence and transparency) that every national corporate governance code has to respect.

Dr Cromme briefly reviewed the history of corporate governance regulation in Germany. Before and during 1980s there was no demand for corporate governance regulation in continental Europe. One reason was that many firms were family-owned or had significant government stakes. Another reason was that most firms were financed by banks or from retained earnings. This environment started to change in the beginning of 1990s and Germany started to implement corporate governance regulation inspired by the UK example. The objective of the German corporate governance code is to achieve public confidence in the management of public corporations. The German code is flexible and principle-based. It is up to companies and the public to find the most appropriate way to implement the code. Dr Cromme discussed in detail the issues of independence and compensation in unitary versus two-tier boards. He pointed out that in the two-tier board system there is by law a separation between executive

management and members of a supervisory board. Similarly, in the two-tier board system the general assembly decides the compensation of the supervisory board members who then decide the compensation of the executive board members.

In the ensuing discussion, **Sir Christopher Hogg** (Chairman of the Financial Reporting Council) noted that corporate governance issues were of interest in the UK even before a code was in place but he thinks that companies are better-off under the current system. **Sir Adrian Cadbury** stressed that corporate governance rules should be considered as guidelines and a reasonable level of personal judgement is equally important, with the UK comply or explain approach serving well this purpose.

The next Corporate Governance at LSE Research Debate will take place on 8 February 2007. The presentation will be given by **Jonathan Rickford** (LSE) who will speak on 'Shareholder Democracy and the case for 'One share: One vote'. The discussant will be **Peter Montagon** (Association of British Insurers, ABI).

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, Department of Management, LSE



2006 Fall Meeting of the Corporate Finance Workshop

17 November 2006

Jointly hosted by LBS, LSE and Said Business School



Antoine Faure-Grimaud, FMG, LSE

FMG hosted the 5th meeting of the Corporate Finance Workshop series. These intercollegiate workshops were established in 2002 by **Antoine Faure-Grimaud**, **Denis Gromb** (LBS) and **Oren Sussman** (Said School of Business, Oxford), with the objective to become a regular forum for corporate finance researchers in the UK.

The first paper of the meeting was given by **Vassilis Hajivassiliou** (LSE), who presented a research study testing the existence and impact of financing constraints on the innovation by firms.

The analysis uses an interesting dataset of survey-based measures of financing constraints. The main contribution of the paper is the novel econometric limited dependent variable (LDV) framework allowing for mutual endogeneity in the system of equations. As pointed out by the discussant, **Paolo Volpin** (LBS), the paper advances the finance/real-sector interaction literature by using 'careful econometrics' in dealing with endogeneity issues. The new set of coherency conditions was discussed in detail. These conditions are sufficient for model identification while allowing for more flexibility compared to the restrictions previously used.

The next paper, presented by **Viral Acharya** (LBS), concerns access to finance and the efficiency of investments in state-level sectors in the United States. Efficiency is understood in portfolio theory sense whilst access to finance is associated with the liberalisation of bank branching regulation. The author finds that financial development has important consequences for the real sector investments when both mean and variance-covariance properties of returns are considered.

Bart Lambrecht (Lancaster University Management School) presented a model linking firm investments and capital structure. The paper finds optimal debt policies adopted by

compensation-maximising managers as a function of their personal wealth constraints. **Ron Anderson** (FMG/LSE) provided a thorough discussion of the results. He pointed out that the results rely on security design framework and bankruptcy procedure for which more justification would be welcomed.

Gilles Chelma (Imperial College, CNRS and CEPR) presented his paper titled 'The Dynamic Trade-off Theory with Real Investments'. The central idea of the paper is to incorporate real investments and a time-varying environment in a trade-off theory model. The paper concludes that by accounting for these two factors, and in the presence of output price dynamics and certain tax features, the model can generate well-documented empirical facts that are widely believed to be inconsistent with the trade-off theory (Negative correlation between profitability and leverage, negative correlation between investment and debt, positive correlation between cash flow and investment, mean-reversion in leverage). The discussion was led by **Kostas Koufopoulos** (Warwick Business School, University of Warwick). Koufopoulos' first comment was on the interpretation of the state variable of the price of output. He argued that in an economy with many goods, a change to the firm's output price would change the relative price of other goods. This would render the results inconsistent with utility maximisation. He indicated that treating this state variable as a productivity shock would be a more prudent approach. Koufopoulos also stated that the fact that some of the results are completely driven by the assumption that the output price (or productivity shock as Koufopoulos suggested) is positively autocorrelated was not satisfactory. He recommended that this assumption be replaced by one where investment/debt are a positive function of the firm's cash flow/value.

The next paper was presented by **Flavio Toxvaerd** (University of Cambridge, Hebrew University of Jerusalem and CEPR) on 'Mergers, Diversification and Financial Intermediation'. The paper builds a model of diversification through merger formation within a Holmstrom-Tirole (1997) framework,



Ron Anderson, FMG, LSE

which is extended to include the case of mergers. In this model, poorly capitalised companies are credit constrained (due to moral hazard problems) and may seek to increase debt capacity by either merging or by employing a monitor or a combination of both. The author showed that in this framework, merged firms extended their debt capacity, diversified firms traded at a discount relative to non-diversified firms, and merger activity was pro-cyclical. The discussant of the paper, **Sonia Falconieri** (Brunel University), began by pointing out that the strategy followed to model

diversification is restrictive as it only considers independent investment opportunities. She suggested modelling some degree of correlation amongst investment opportunities and also commented on the fact that the model did not take synergies into account. She wondered whether there could be an important trade off between the existence of synergies and diversification and whether merging could also imply some savings in monitoring costs. Lastly, Falconieri mentioned that the diversification discount seemed to affect the assumption that only firms with similar level of capitalisation are allowed to merge. She argued that in reality poorly capitalised firms could be young promising firms that are bought out by larger ones.

The final paper of the conference was presented by **Silvia Rossetto** (Warwick Business School, University of Warwick) and

entitled 'Corporate Control and Multiple Large Shareholders' (joint work with Amrita Dhillon – University of Warwick). The paper builds a model that endogenously creates incentives for various blockholders to emerge whilst also providing a framework to analyse the pricing implications of having more than one blockholder. In this setting, large blockholders have endogenous conflicts of interests that arise due to the fact that they do not hold well-diversified portfolios. Consequently, with a median-rule voting mechanism, a single blockholder may be able to choose a conservative investment policy that does not favour dispersed shareholders. This would cause the share price to drop. The paper shows that additional blockholders could shift corporate decisions towards higher-return outcomes at the cost of holding a suboptimal portfolio. A second blockholder has the incentives to do this, as the cost of holding a sub-optimal portfolio is offset by the gain of tilting corporate decisions towards higher-return investments. Therefore, the presence of a second-blockholder mitigates conflict of interests, and increases the share price. The discussion was led by **Denis Gromb** (London Business School and CEPR) who discussed the assumption that an entrepreneur could only raise a fixed amount of funds. Without this restriction, the entrepreneur could sell the whole firm to investors leading to no conflict of interests and thus to an efficient project choice. Gromb suggested that the authors might explicitly assume another friction (ie, entrepreneur must exert effort) and solve concurrently the conflict of interest and the second friction problems (ie, equity stake the entrepreneur has to hold to exert high effort).



Prompt Corrective Action and Cross-Border Supervisory Issues in Europe

20 November 2006

Organised by **Harald Benink** (Erasmus University Rotterdam and FMG/LSE), **Charles Goodhart** (FMG/LSE) and Rosa Lastra (CCLS, Queen Mary, University of London), this conference was the fourth and final in a series of events in the field of Regulation and Financial Stability that have been organised with the support of the Economic and Social Research Council.*

The conference began with Harald Benink introducing the latest statement of the European Shadow Financial Regulatory Committee which focuses on the benefit of implementing Prompt Corrective Action (PCA) rules in Europe. **Clas Wihlborg** (Copenhagen Business School) summarised the main contents of the statement of the committee. He underlined that the implementation of the Basel II Capital Accord in Europe increases the need for additional safeguards for the banking system, and some such safeguards could be provided by Prompt Corrective Action procedures. The United States already employ a PCA approach, and though European countries show great heterogeneity, he argued that the general principles can be applicable. Clas Wihlborg also underscored the difficulties inherent with cross border supervision due to potential conflicts of interest between home- and host- country supervisory authorities. He stressed the importance of making procedures predictable: bankruptcy costs have to be predictable, insolvency ratios need to be well defined as well as the different trigger points before insolvency. The latter should aim at reducing the likelihood of insolvency occurring. Providing a well-defined framework of rules will also help in fostering trust and coping with the potential conflict of interests between home and host country supervisory authorities during crisis management.

The floor debate following the statement involved a lively discussion. It was pointed out that it might be difficult in practice to define clear rules, as supervisory authorities prefer to have more discretion in their interventions. It was also stressed that banks in the United States can actually choose among different regulators and this might increase the potential for forbearance through regulatory arbitrage. Other questions included whether regulators should also be the authority responsible for declaring bankruptcy and whether prompt corrective action might be better executed confidentially. The members of the European Shadow Financial Regulatory Committee clarified that while rules should be known and clear ex ante, the actual intervention might well be executed in a confidential way.

In the remainder of the first session, **María Nieto** (Bank of Spain) and **Larry Wall** (Federal Reserve Bank of Atlanta) presented their joint work entitled 'The need for PCA rules in Europe'. In contrast with most previous work in this area which mainly focuses on discussing its overall merits of PCA, the authors focus on studying the preconditions needed for the adoption of an effective PCA. They divide the preconditions into two sets. The first involves conceptual elements such as a prudential supervisory focus on minimising deposit insurance losses and mandating supervisory action as capital declines. The second set of preconditions include institutional aspects such as greater supervisory independence and authority, more effective resolution mechanisms and better methods of measuring capital. In the presentation, they first discussed the domestic implementation of PCA, in particular considering its roots (particularly its origins, rationale and experience in the US). Then they moved on to analyse cross-border implementation in Europe. They considered the major conceptual changes that PCA brought to US bank supervision and the extent to which these would represent changes for European bank supervision. They concluded that an effective PCA for any bank requires acceptance of its conceptual basis and an adequate institutional framework (ie, supervisors be given the same authority to take corrective measures; creation of bridge banks). An effective PCA for cross-border groups in the EU would also require additional coordination measures: enhanced availability of information (supervisors and markets), supervisors' decision-making processes based on a collegial form, and a resolution committee.

The second session was devoted to Cross-Border Supervisory Issues and was chaired by **Charles Goodhart**. Rosa Lastra (CCLS, Queen Mary, University of London) and **Clas Wihlborg** (Copenhagen Business School) presented their joint work, 'Resolving Cross-Border Banking Crises'. They argue that there is a lack of international standards and rules to deal with cross-border banking crises and insolvencies. Existing rules at the international level are mainly non-compulsory and not enforceable. They are usually drafted in the form of soft laws, at multilateral (eg, the United Nations Commission on Trade Law's model Law for Cross Border Insolvency and the World Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems), regional (eg, the EU's Banking Directive) or bilateral (eg, a Memorandum of Understanding) levels. Rosa Lastra emphasised the *ad hoc* nature of the PCA procedures that are implied in rules at all these levels.

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



They are typically associated not only with problems of harmonisation and of overlapping jurisdictions, but also with a general approach to banks that, by treating them as companies (*Lex Generalis*), do not account for their differentiated role as providers of liquidity (*Lex Specialis*). Focusing on the European institutions, Clas Wihlborg reviews critically their inability to avoid cross-border banking problems, in particular with relation to conflicts of interests between home and host countries. He argues that further steps should be taken so to enhance the European system and advocates the improvement of both national and international instruments. In particular, he makes three proposals that rely on a combination of both national and international/regional institutions: (a) the creation of a European Standing Committee for Crisis Management to alleviate some of the current shortcomings in implementing the EU's directive; (b) the incorporation of international and very large banks under European Company Law and subject to an European *Lex Specialis*; and (c) the certification of national PCA rules and bank insolvency law by an European authority. The two first proposals were put forward by Lastra (2006). In the third, national rules would prevail over regional rules, which could be actually removed. He also explores, on very preliminary and informal bases, the possibility that banking cross-border conflicts be referred to the European Court of Justice.

The second presentation of the session was by **Robert Eisenbeis** (Federal Reserve Bank of Atlanta) and **George Kaufman** (Loyola University). The presentation focused on the regulatory challenges of facing a potential financial crisis, when cross-border banking is important. They discussed the differences in regulation that still exist among different European Union (EU) member countries and the potential conflicts of interests that can arise from this. The presenters also contrasted the differences in regulatory environment between the EU and the United States (US). In particular, they emphasised that in the US there exists a different code for insolvency for the banking and the corporate sector. They proposed four principles to ensure the efficient resolution of banking failures with minimum credit and liquidity losses. These principles include: 1) prompt legal closure of institutions before they become economically insolvent; 2) prompt identification of claims and assignment of losses; 3) prompt reopening of failed institutions and 4) prompt recapitalising and reprivatisation of failed institutions. The presenters proposed a mechanism that is consistent with these principles: a banking organisation, seeking to take advantage of the liberal cross-border branching provisions in the single banking licence available in the EU, should agree to be subjected to a legal closure rule as a positive capital ratio. This ratio could be established by the EU or the home country. The questions following the presentation focused on potential differences between EU and the US regarding the possibility of changing laws and banking sector engaging in non-banking activities in EU.

The final presenter of the session, **Thomas Huertas** (Financial Services Authority), focused on the importance of financial markets in dealing with distressed conglomerates. Financial systems have become more stable, payment system, foreign exchange market, derivatives market and securities settlement systems have become more robust. The systems are now built to withstand failures of even the largest market participants. These improvements should reduce the likelihood that the failure of a conglomerate would be a threat to financial stability. The presenter emphasised that securities markets have helped several conglomerates (eg, Allianz and Credit Suisse) to overcome the pressure on their credit ratings. In light of a more robust financial system, public authorities should encourage firms to turn to capital markets early and continue to strengthen the financial infrastructure. If a conglomerate fails, the authorities should consider whether to use their liquidity-creating powers to prevent other financial institutions to fail, but not necessarily the first institution failing. Further discussions involved issues related to the possibility of several institutions failing at the same time and other shocks that the financial system might face. The questions also addressed issues regarding whether the supervising authority is based in the home or the host country.

The final session of the conference was a panel discussion chaired by **Charles Goodhart**. The first panellist, **Franco Bruni** (Bocconi University), placed his discussion of PCA in the context of insights gained from recent research questionnaires analysing the interactions between banks, home and host regulators in south-eastern Europe. In terms of the concept of PCA he viewed it as involving both quantitative and qualitative triggers but noted that this wider interpretation raised greater operational difficulties. The second panellist, George French (Federal Deposit Insurance Corporation), moved the discussion onto unanswered questions and concerns relating to the Basel II advanced approach. Three particular concerns were raised: firstly the potential for substantial reductions in risk-based capital requirements (as indicated fourth Quantitative Impact Study, QIS-4, estimates); secondly the level of dispersion of estimated capital requirements produced by banks for similar risk exposures; and, thirdly the potential competitive impact of the different requirements under the advanced and standardised approaches. The final panellist, **Gillian Garcia** (formerly International Monetary Fund), discussed the political debate over PCA and leverage ratios. She highlighted the parallels and differences between the current debate over PCA with the US regulatory response in the late 1980s and early 1990s to the thrift failures and banking problems. The potential benefits and disadvantages of combining a leverage ratio requirement (as in the US) with the Basel II risk-based capital requirements were the focus of the floor discussions.



Imperial College
OF SCIENCE, TECHNOLOGY AND MEDICINE



The London-Oxford Financial Econometrics Workshop

20 November 2006

The first London-Oxford Financial Econometrics Workshop was hosted by FMG on 24 November 2006, partly funded by the Leverhulme Trust.* This workshop was part of the London-Oxford Financial Econometrics Study Group, convened by **Nour Meddahi** (Imperial College), **Andrew Patton** (FMG/LSE) and **Neil Shephard** (University of Oxford). The workshop brought together financial econometricians working in the UK to discuss topics such as density forecasting, variance-covariance measurement and modelling in highly-structured or non-parametric frameworks.

The keynote presentation by **Stephen Taylor** (Lancaster University) focused on multi-horizon comparison of density forecasts for the S&P 500. His joint paper with Mark Shackleton and Peng Yu empirically studies the density forecasting performance of two types of models: ARCH type models with historical data as the input, and option-implied models with option prices as a 'forward-looking' input. The latter approach involves two steps: first estimate the risk neutral density based on the Heston (1993) model, and then the real-world density is recovered by assuming some form of risk premium function. They find that ARCH type models make a better forecast at the one-day horizon, while option-implied models do better in horizons of two and four weeks. As discussant of this presentation, **Andrew Patton** pointed out that ARCH type models are more conditional volatility models than density models, which might explain their inferior performance in density forecasting of longer horizons. He also suggested some methods on improving the forecast evaluation and comparison.



Stephen Taylor, Lancaster University

Neil Shephard, presented a joint paper with Ole E Barndorff-Nielsen, Peter Hansen and Asger Lunde, which studies the properties of subsampled realised kernels estimators of quadratic variation in the presence of noise. The motivation for the estimators is to combine sub-sampling methods and realised kernel methods. After deriving the limit theory for this class of estimators, they find that sub-sampling has no effect on the asymptotic distribution of the estimator based on Kinked Kernels. Furthermore, for the efficient smooth kernels, they show that sub-sampling is even harmful as it increases the asymptotic variance of the estimator. But, for estimators based on discontinuous kernels such as a 'truncated kernel', sub-sampling can overcome the inefficiency resulting from the poor choice of kernel. **Oliver Linton** (FMG/LSE) was the discussant for this paper. He suggested that more flexible assumptions in

* Evolution of Risk Forecasts. Ref No: GRANT F/0004/AF



Michela Verardo and Bob Nobay, FMG/LSE

microstructure noise might alter some conclusions, and a different semiparametric efficient bound might be attained in a broader class of estimators beyond the realized kernels considered in this paper.

Karim Abadir (Imperial College London) presented his joint work with Gabriel

Talmain, 'Distilling co-movements from persistent macro and financial series'. Macro and financial series usually display strong persistence or long-memory. They argue that spurious correlations would arise if this persistence is not accounted for. The authors suggest a general GLS/ML approach for jointly estimating conditional mean parameters and parameters describing the autocorrelation structure of the errors. In the context of the forward premium of exchange rate, they show that the forward premium puzzle disappears if the proposed method is applied. Discussant **Valentina Corradi** (Warwick University) argued that the fact that the premium puzzle disappears using the paper's characterisation, is not compelling evidence in favour of the model, and suggested that other specifications allowing non-linearities/persistence may reach the same outcome.

Antonio Mele (FMG/LSE) presented his joint work with Valentina Corradi and Walter Distaso, which studies the macroeconomic determinants of stock market volatility and the volatility risk premium. They develop a model in which both dividend processes and risk premium processes are linked to some macroeconomic factors and a closed form representation is obtained by imposing a no-arbitrage

restriction. The empirical part of the paper will estimate the model using data related variance swaps, using a two-step estimation strategy. The discussant, **Christian Julliard** (FMG/LSE), noted the paper's contribution in going beyond the reduced form models. Some suggestions for improvement included the identification of important macro factors and a simpler Bayesian estimation strategy.

Roel Oomen (Warwick University) presented his joint work with Jim Griffin on realised measure of covariance in the presence of non-synchronous trading and noise. They study the properties of three covariance estimators, namely realised covariance, lead-lag-adjusted realised covariance, and the Hayashi and Yoshida estimator. They assume a stationary Poisson sampling and an i.i.d. microstructure noise setup. They find that the efficiency ranking of the three estimators depends on the level of microstructure noise. The standard realised covariance estimator without corrections for non-synchronous trading can be most efficient if the noise is sufficiently high. The discussant **Kevin Sheppard** (University of Oxford) pointed out that stationary Poisson sampling is unrealistic due to the commonly observed diurnality effect in trading activity. He also suggested that a broader class of estimator could be studied.

Finally, **Marcelo Fernandes** (Queen Mary) presented his joint work with Walter Distaso and Valentina Corradi, which studies international market linkages with realised volatility. Their model tries to capture the information transmission between markets by 'volatility spill-over'. They rely on the popular realised measure of volatility in three stock market, China, Japan, and United States. The authors find that China's market has an important impact on the other US and Japanese in terms of volatility linkage. The discussant **Nour Meddahi** pointed out that the information shock presents itself mostly in the form of jump, and therefore realised volatility might not be a good proxy for information transmission.

Sargent-Sims Colloquium Alternative Perspectives on Macro Econometric Policy Evaluation

29 May 2007

9.30am – 6.30pm

New Theatre, E171, East Building, Houghton Street
The London School of Economics and Political Science

This special one day colloquium will focus on the distinct perspectives of Thomas Sargent (NYU) and Chris Sims (Princeton) in macro-econometrics and macro dynamics. The programme will consist of presentations by:

- **Thomas Sargent** (NYU)
- **Chris Sims** (Princeton)
- **Eric Leeper** (Indiana) and
- **Tim Cogley** (UC Davies).

This event is by invitation only

The Programme Committee members are the following members of the Financial Markets Group:

Christian Juillard (Economics Department)
Oliver Linton (Economics Department)
Bob Nobay (Financial Markets Group)
Andrew Patton (Accounting and Finance Department)

This event is organised with the support of the **Bank of England**, the **Accounting and Finance Department at LSE**, and the **Suntory and Toyota International Centres for Economics and Related Disciplines (STICERD) at LSE**.

Please visit the FMG website for further information:
<http://fmg.lse.ac.uk>

London Financial Regulation Workshops

5 March 2007

Thomas Huertas (Financial Services Authority)

'European Financial Regulation –
Some Unfinished Business'

12 March 2007

Apostolos Gkoutzinis (Shearman and Sterling, LLP)

'Internet Banking and International
Market Access: The Causes of
Incomplete Financial Integration
and What To Do About Them'

Taxation Seminars

5 February 2007

Stephen Smith (University College London) and
Richard Brown (HM Treasury)

'"Missing trader" Fraud and the
Future of VAT'

30 April 2007

Budget and Finance Bill

Panel discussion



Discussion papers



DP 563 (UBS Pensions Series 041)

The Economics of Pensions

Nicholas Barr, Peter Diamond

This paper sets out the economic analytics of pensions. After an introductory discussion, successive sections consider the effects of different pension arrangements on labor markets, on national savings and growth, and on the distribution of burdens and benefits. These are controversial and politically highly salient. While we are open about expressing our own views, the main purpose of the paper is to set out the analytical process by which we reach them, to enable readers to form their own conclusions.

DP 564 (UBS Pensions Series 042)

Compensating Wage Differentials for Defined benefit and Defined Contribution Occupational Pension Scheme Benefits

Joachim Inkmann

The theory of equalizing differences suggests that employer-provided pension benefits should be compensated by reduced wage benefits for an employee's given productivity potential. This paper presents an empirical analysis of compensating

wage differentials for occupational pension scheme benefits in the UK using the newly available English Longitudinal Study of Ageing. The data allows us to differentiate between Defined benefit (DB) and Defined Contribution (DC) schemes and to consider different measures of pension benefits based on current contributions and changes in accrued pension benefit rights. In our preferred specifications we find evidence for perfect compensating wage differentials for both occupational DB and DC pension scheme benefits.

DP 565

Consistent Measures of Risk

Jon Danielsson, Bjørn N. Jorgensen, Mandira Sarma, Casper G de Vries, Jean-Pierre Zigrand

In this paper we compare overall as well as downside risk measures with respect to the criteria of first- and second-order stochastic dominance. While the downside risk measures, with the exception of tail conditional expectation, are consistent with first-order stochastic dominance, overall risk measures are not, even if we restrict ourselves to two-parameter distributions. Most common risk measures preserve consistent preference orderings between prospects under the second-order stochastic dominance rule, although for some of the downside risk measures such

consistency holds deep enough in the tail only. In fact, the partial order induced by many risk measures is equivalent to second-order stochastic dominance. Tail conditional expectation is not consistent with respect to second order stochastic dominance.

DP 566

Choice of Corporate Risk Management Tools under Moral Hazard

Jan Bena

This paper examines the choice of tools for managing a firm's operational risks: cash reserves, insurance contracts, and financial assets under an optimal financing contract that solves moral hazard between insiders and outside investors. Risk management is valuable as it reduces the costs of raising external financing, increases debt capacity, lessens underinvestment, and improves welfare. I show that insurance is superior as it facilitates the outside financing relationship but leads to inefficient excessive continuation if used without coverage limits. When insurance against an operational risk is not available, the firm uses financial assets instead or resorts to holding cash reserves.



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

No abstract available

SP 167

**Searching for a Metric for
Financial Stability**

Oriol Aspachs, Charles Goodhart, Miguel
Segoviano, Dimitrios Tsomocos, Lea Zicchino

No abstract available

Forthcoming Discussion and Special Papers

Discussion Papers

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 168

**'Current State of Cross-Border
Banking'**

Christiaan van Laecke, Dirk Schoenmaker

Visitors to the FMG

November 2006 – January 2007

Arnaud Boot (University of Amsterdam)
Niki Cleal (Pensions Policy Institute)
Roberta Dessi (Universite' de Toulouse)
Michael Devereux (Oxford University Centre for Business Taxation)
Chris Evans (ATAX, University of New South Wales)
Simon Gallagher (HM Treasury)
Rene Garcia (Universite' de Montreal)
Simon Gervais (Duke University)
Eric Ghysels (University of North Carolina)
Will Goetzmann (Yale University)
Harrison Hong (Princeton)
Howell Jackson (Harvard Business School)
Ilan Kremer (Stanford University)
Will Morris (General Electric and European Tax Policy Forum)
Han Ozsoylev (Said Business School, Oxford)
Manju Puri (Duke University)
Matt Spiegel (Yale University)
Hui Tong (Bank of England)
Ross Valkanov (University of California, San Diego)
Jeff Zwiebel (Stanford University)







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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FMG Review

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