



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

Monday, 19th January 2009 - 6.30pm - 8.00pm
Taxation Seminar | Taxing wealth and inheritance: Where to from here? | Emma Chamberlain (Chartered Institute of Taxation)
location: R505, 5th Floor, Lionel Robbins Building, LSE

Wednesday, 21st January 2009 - at 1.00-2.00pm
Lunchtime Workshop | TBC | Lorenzo Naranjo (NYU Stern School of Business)

In the news

[Is Basel II Enough? The Benefits of a Leverage Ratio - Speech and Video Available Online](#) 17 Dec 2008
 The Financial Markets Group hosted the event: 'Is Basel II Enough? The Benefits of a Leverage Ratio'

[The Financial Crisis: An LSE Viewpoint - Now available to watch online](#) 11 Dec 2008
 On 27th November the FMG hosted 'The Financial Crisis: An LSE Viewpoint' which is now available to watch online

Video Available Online - The Financial Markets Group hosted the event: 'Is Basel II Enough? The Benefits of a Leverage Ratio'

The Financial Crisis

home	about	events	news	publications	Corporate Partnership Programmes
research	people	be involved	mailing list	contact	



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

FMG Review

Editor: Professor Bob Nobay

Associate Editor: Tanya Hall

Prepared by: Jan Bena, Claudia Custodio, Ziad Daoud, Elizabeth Foote, Anisha Ghosh, Daniel Metzger, Siti Parida, Yiyi Wang

Designed by: LSE Design Unit
www.lse.ac.uk/designunit

1 FMG Research Debate **3** FMG Research Lecture **4** Recent Advances in High Frequency Financial Econometrics Conference **6** Capital Structure, Liquidity and Governance conference **8** Corporate Governance at LSE **9** RICAPE2 Third Conference **13** Forthcoming conferences **15** FMG Seminars **16** Publications **18** Forthcoming conferences **19** FMG Visitors

FMG Research Debate

The Financial Crisis: An LSE Viewpoint 27 November 2008



Panel discussion: Sir Howard Davies (LSE), Charles Goodhart (FMG/LSE), Sushil Wadhvani (Wadhvani Asset Management LLP), Willem Buiter (FMG/LSE), Matt King (Citi Group), Jon Danielsson (FMG/LSE), David Webb (FMG/LSE)

On Thursday 27 November the Financial Markets Group hosted a research debate on The Financial Crisis: An LSE Viewpoint at the Sheikh Zayed Theatre, LSE. The research debate consisted of a panel of the Director of LSE, Sir Howard Davies, Willem Buiter, Charles Goodhart, Jon Danielsson, Sushil Wadhvani and an expert from the Citi Group, Matt King. They provided a stock-take of the crisis and what has to be done now.

David Webb (Director, FMG/LSE) opened the conference with a brief summary of the crises over the last year and a half. During July 2007 credit spread started to widen and the sub prime crises became evident in the USA. This produced knock-on effects worldwide. A number of big reputed financial firms in the USA/Europe either ceased to exist (Lehman Brothers, Bear stern etc) or were rescued by their governments (AIG, Freddie Mac and Fannie Mae, Northern Rock etc).

The Financial Crisis: An LSE Viewpoint

continued from page 1

Sir Howard Davies (Director, LSE) talked about the three dimensions of the current crisis. On the macro dimension the outlook seems gloomy and the deleverage process is on. On the fire fighting front, authorities are taking a basket of actions in terms of giving support to various financial institutions. Future regulation is the third dimension. He suggested that in the short term banks need to raise capital and start lending. For the long term he set out five main directions to bolster the regulatory framework. First, we need a simple set of mechanisms that better reflect today's markets. He pointed out that there is a problem of legitimacy at present and all concerned parties (emerging economies) need to be represented adequately in any future system. Also the system needs to move more rapidly. Most importantly there is a need for a link between macro economics surveillance and regulation. For all this to take shape there should be a new and sustained political leadership.

Susil Wadhani (CEO, Wadhani Asset Management) talked about how the macro policy behaved when the bubble was forming. He commented that while dealing with macro policies we should keep in mind that a lot of instability may come from asset markets and central banks should set monetary policy when asset price bubbles are emerging. He emphasised the need to explore counter-cyclical tools such as pro-cyclical bank capital and max loan value ratios. He felt that mopping up operations after the burst of the bubble has been difficult because of an external inflation shock and the credit crunch which made monetary policy less effective. However he thinks that we are better placed to deal with the situation compared to the great depression but we should learn from Japan's mistakes during the 1990s.

Jon Danielsson (Reader in Finance, Financial Markets Group, LSE) warned of the danger of over-regulation and said that calls to bring hedge funds under the regulatory umbrella should be resisted. He pointed out that risk is extremely difficult to measure and any regulation based on imperfect risk indicators are likely to be counterproductive. Prof. Buiters however disagreed strongly with this view and suggested that leverage be used as the basis for regulation. He also pointed out that if hedge funds were not regulated, it is likely that other actors would be tempted to call themselves hedge funds in order to avoid regulation.

Matt King (Credit Product Strategist, Citigroup) gave an industry perspective of the problems. He was of the view that there is much liquidity in the short term but it is only coming from the central banks. Banks are not willing to lend long term primarily because they are massively over committed already. He pointed out that banks in less developed economies are doing better than those in developed economies because there the return on the asset is good and banks did not have to resort to leverage (unlike in developed economies). He predicted the recession is going to continue beyond 2009 and investors will turn to credit as rates head toward zero.

In his presentation, **Willem Buiters (Chair in European Political Economy, European Institute and Financial Markets Group, LSE)** stressed on the need for international cooperation and cross-border guarantee of international lending. He suggested that banks were unwilling to lend due to the fear of nationalisation but this failure to lend was likely to lead to nationalisation. He said that the 'system had collapsed' and predicted mass nationalisation of the banking system. According to Professor Buiters nationalisation was the only solution to the twin problems of 'banks not lending' and the 'moral hazard of bailouts'.

Charles Goodhart (Programme Director, Financial Markets Group, LSE) reminded the audience of the paramount importance of stabilising the housing market, given that the housing/sub-prime crisis lies at the heart of the broader financial crisis. He also outlined the risk of high inflation once the situation stabilises owing to the increase in government debt and its monetisation.

During the question and answer session, some members of the audience commented that the pay and incentive structure in the financial services industry might have resulted in excessive risk taking and the resulting crisis. While the panellists acknowledged the need for pay to be linked to long term performance, they felt that this was not a very important part of the current story. When quizzed about the possibility of a collapse of the sterling, the panellists felt that while it is a possibility, at the moment the situation is under control and sterling collapse is not a major concern. Willem Buiters felt that the recent decline in the sterling was a long overdue correction of an overvalued currency and welcomed it.

The event is available online on the FMG website
<http://fmg.lse.ac.uk>



Is Basel II Enough? The Benefits of a Leverage Ratio

15 December 2008

Philipp Hildebrand (Vice-Chairman of the Governing Board, Swiss National Bank)

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



Philipp Hildebrand (Swiss National Bank)

He argued that an excessively high degree of leverage in the banking sector has played a key role in the recent crisis. Due to the moral hazard of implicit government guarantees, large banks have held low levels of capital.

In restricting leverage, Dr Hildebrand argued, it is important to take into account the different riskiness of assets held by banks; for this reason, the risk-weighted approach to capital requirements taken by Basel II is important. However, such regulations come at a price; they involve large operational costs and require significant dependency on risk models. The data used for assessment, as well as the models themselves, may poorly reflect reality and the likelihood of certain scenarios.

Philipp Hildebrand, Vice-Chairman of the Governing Board of the Swiss National Bank, gave a lecture on 15 December. He addressed the question of whether the Basel II requirements provide sufficient regulation of banking capital. Throughout his talk, he stressed the need for the Basel risk-weighted capital requirements to be accompanied by a minimum leverage ratio.

As a result, an extra safeguard is needed. For this reason, Dr Hildebrand highlighted the importance of a lower limit on banks' capital-asset ratios, a simple minimum leverage ratio, in addition to the existing Basel requirements. This regulation would be less sensitive to risk models and would provide a complement to risk-weighted capital requirements. Dr Hildebrand also argued that it would be more difficult for banks to arbitrage around two capital ratios.

In discussing the benefits of a minimum leverage ratio, Dr Hildebrand pointed out that off-balance sheet assets could be included in the measurement of the ratio. He also argued against the standard claim that banks' profitability would be hindered by restrictions on leverage; in fact, the performance of low-capitalised banks has been poor.

An important consideration in the design of such a regulation is the danger it may have a procyclical impact on balance sheets; in a downturn, it may increase deleveraging and, in the long run, increase the volatility of credit availability. The Swiss reforms, therefore, require banks to meet a specific leverage ratio in good times, but allow them a lower minimum level in bad times: they offer a cushion on which banks may fall back in bad times.

In summary, while Dr Hildebrand highlighted that a minimum leverage ratio would not address all problems in financial markets, he argued it should be an important tool in curtailing banks' leverage. Such a rule would provide a 'safety valve' to complement the existing Basel requirements.

The event is available online on the FMG website
<http://fmg.lse.ac.uk>

Recent Advances in High Frequency Financial Econometrics Conference

15 November 2008



Anisha Ghosh (FMG/LSE)

Organised with the support of the Leverhulme Trust, this conference discussed recent theoretical and empirical advances in the area of financial econometrics as part of the 'Estimation and Testing with Realised Volatility' research project at LSE. The objective of this research is to investigate issues relating to recent work in continuous time econometrics and their application. The conference concentrated on the topics of volatility measures using high-frequency data, the detection and the role of jumps in continuous-time models and market microstructure.



Oliver Linton (FMG/LSE)

Mark Podolskij (ETH Zürich) opened the conference with a presentation entitled 'Bipower-Type Estimation in a Noisy Diffusion Setting' co-authored with Mathias Vetter (Ruhr-Universität Bochum). The paper provides a class of estimators of integrated volatility (IV) when both jumps and market microstructure noise are present. This class of jump-robust estimators can be thought of as a generalisation of bipower variation to the setting where the observed price is contaminated by market microstructure noise. Dr Podolskij demonstrated that their theory can also be used to estimate integrated powers of volatility and provides feasible central

limit theorems for their estimators. By obtaining a jump-robust estimator of IV as well as an estimator of the whole quadratic variation, the authors can also use their theory to test for the presence of jumps in the underlying price process. The discussant **Almut Veraart** (CREATES, University of Aarhus) complimented the theoretical advances in the paper. She pointed out that it would be beneficial if the authors performed a simulation experiment to see how their asymptotic theory performs in finite samples.

The second paper was presented by **Mathieu Rosenbaum** (CREST and CMAP-Ecole Polytechnique) jointly with Christian Y. Robert (CREST and ENSAE Paris Tech). Entitled 'Ultra High Frequency Volatility and Co-Volatility Estimation in a Microstructure Model with Uncertainty Zones', the paper develops a model for very high-frequency data affected by market microstructure noise. The model is consistent with discrete prices that can only live on a tick grid. In addition, it allows prices to move by more than one tick. The authors estimate the parameter of the model and show how to estimate the integrated volatility of the latent price process. They then move on to the bivariate case and consider the problem of estimating integrated co-volatility between two assets taking into account the asynchronous trading times as well as market microstructure noise. **Ziad Daoud** (FMG/LSE) discussed the paper and made two principle comments. First, he suggested that others might want to test the plausibility of certain models nested within their model, by testing certain restrictions on the parameters. Second he suggested trying to make the distribution theory for the estimator of integrated volatility feasible.

The third paper, entitled 'Duration-Based Volatility Estimation' was presented by **Torben G. Andersen** (Northwestern University), jointly with Dobrislav Dobrev (Federal Reserve Board of Governors) and Ernst Schaumburg (Northwestern University). They develop a new approach to estimating integrated volatility of a general price process. Their approach exploits the relationship between transition times and the magnitude of Brownian increments. It can therefore be thought of as a dual to the classical realised volatility approach. Torben Andersen demonstrated that their duration-based IV estimator is robust to both jumps and the presence

Recent Advances in High Frequency Financial Econometrics Conference

of market microstructure noise. They also investigate the finite-sample performance of their estimator using an extensive simulation study. **Andrew Patton** (University of Oxford) discussed this paper in the context of his current work on data-based ranking of realised volatility estimators. This work aims to compare the accuracy of different IV estimators and to obtain consistent ranking of these estimators. He showed that the duration-based IV estimators proposed in the paper does indeed outperform its competitors.

The fourth paper, 'Nonparametric Stochastic Volatility' was presented by **Federico Bandi** (Graduate School of Business, University of Chicago). It is co-authored with Roberto Reno (Universita di Siena). The paper provides a theory of spot volatility estimation using functional inferential methods. This approach allows for the joint estimation of return and volatility dynamics with nonlinear drift and diffusion functions, leverage effects, and jumps in returns and volatility. The authors' identification approach and asymptotic results rely on weak recurrence assumptions, which is milder than stationarity and mixing and potentially important given the persistent behavior of daily volatility series. The discussant **Marcelo Fernandez** (Queen Mary College, University of London) complimented the theoretical advances in the paper. He pointed out that it would be beneficial if the authors performed a simulation experiment to see how their asymptotic theory performs in finite samples.

The fifth paper, 'Subsampling High Frequency Data' was presented by **Ilze Kalnina** (LSE). The paper proposes a subsampling scheme for conducting inference for a general class of estimators that includes many estimators of integrated volatility. The scheme consistently estimates the asymptotic variance for the estimators when traditional bootstrap and subsampling variance estimators fail to deliver consistent estimates with high frequency data. The author applies the new method to the Two Time Scale estimator of Ait-Sahalia et. al. (2006) for which no alternative inferential methods are available. The discussant **Valentina Corradi** (University of Warwick) complimented the theoretical advances in the paper. She pointed out that it would be beneficial if the author explored the properties of the estimator in the presence of leverage effects that are assumed away in the current version of the paper.

Organised by Oliver Linton, Ziad Daoud and Anisha Ghosh

The Financial Markets Group would like to thank the Leverhulme Trust for supporting our research.

The Leverhulme Trust, Estimation and Testing with Realised Volatility (F/07 004/AK)

The final paper, 'Nonparametric Estimation of Conditional Factor Pricing Models Using High-Frequency Data' was presented by **Anisha Ghosh** (FMG/LSE). The paper proposes an approach to estimating conditional linear multifactor pricing models that overcomes some limitations of existing literature: First, the method does not require any specific functional form assumptions about the conditional betas or the factor risk premia, relying instead on continuous-time theory to obtain model free estimates of betas and, second, the author shows how to correct for the measurement error arising from using estimates of latent conditional betas. Pricing errors of time-varying beta models are significantly smaller than those obtained with traditional constant-beta models. The discussant **Kevin Sheppard** (University of Oxford) pointed out that it would be beneficial if the author explored the potential importance of leverage effects assumed away in the paper and the possibility of constructing improved beta estimates.



Federico Bandi (Graduate School of Business, University of Chicago)



Torben G Andersen (Northwestern University)

Capital Structure, Liquidity and Governance

5 December 2008

The first presentation by **Bart Lambrecht** (Lancaster University) addressed how human capital affects firms' capital structure and liquidity policy, and how it influences managerial compensation. In a model (joint work with Grzegorz Pawlina, Lancaster University) of a competitive industry, wealth constrained managers provide human capital that can be transferred across firms. Equityholders give managers access to the physical assets of the firm. The two parties bargain for the firm's free cash-flows. Investment in human and physical capital is complementary and it is balanced by debt and cash. Lambrecht showed that, in their model, there is a negative relation between human capital intensity and leverage and negative debt occurs in volatile and human capital intensive sectors. Payout and managerial compensation depend in recessions on outside options.

Christopher A. Hennessy (London Business School and University of California, Berkeley) presented his paper 'Security Design, Liquidity, and the Informational Role of Prices'. The paper deals with the question of how security design affects endogenous supply of liquidity and incentives for information production and what the implications are on optimal financial structure. He considers a model where bifurcation causes uninformed owners to endogenously supply less or more liquidity. This deters or encourages the acquisition of information. As a result, if information costs are low and project selection is important, firms should encourage information production. On the other hand, if liquidity is important, firms should discourage information production. The redistribution of informational sensitivity via bifurcation can increase/decrease liquidity supply and incentives for information production.

Ron Anderson then presented his paper 'Liquidity and Capital Structure'. This paper aims to answer the general question of why firms hold so much cash. It does this by using a dynamic model that relates liquidity, debt and payout policy, solving for the optimal level of cash holdings. It finds that under the optimal policy the firm targets a cash level that is a non-monotonic function of business conditions and increasing in the amount of long term debt. It also finds that short term debt levels are irrelevant for determining the optimal level of cash holdings. The optimal cash policy exhibits a state dependent financing hierarchy that is consistent with the pecking order theory of capital

structure. In the long term though the model predicts a near irrelevance of capital structure. The predictions of the model are in line with the main empirical finding in the cash holdings literature. While calibrated it matches most of the empirical benchmarks such as cash levels, leverage, equity volatility, yield spreads, default probabilities and recovery rates. The model also estimates the agency costs generated by conflicts of interest between creditors and shareholders. Under optimal cash holdings policy it mitigates some 'asset substitution problems'.



Stewart Myers (MIT Sloan School of Management)

Stewart Myers (MIT Sloan School of Management) gave the Keynote Speech on 'Corporate Finance and Corporate Governance'. As an expert in corporate finance, he discussed some basic but essential issues in the research of this area, and pointed out that the potential causation of the current credit crisis came from market imperfections, as was researched in corporate finance. Stewart reviewed the research in recent years and

criticised that people chased second order problems too much. First order concerns in corporate governance should be finance ownership structure and dynamics, while the topics such as managing risk-aversion, capital market imperfection and private benefit control are second or even third order concerns. Stewart also argued about the proper maximum objective in corporate governance research. In his opinion it should not be a zero-sum game between inside shareholders and outside investors. Moreover, efficiency that models chase should be the maximum total value given the wealth division, instead of maximum investor's value given the size of the pie. Therefore it is better to put the research in a long term perspective with growth and development. Stewart used a table to indicate how the public and private equity changes along two dimensions: life cycle and the nature of the company (how much human capital attached).



Christopher A. Hennessy (London Business School and University of California, Berkeley)

The second session, chaired by **Ian Garrett** (Manchester Business School), focused on the empirical tests of corporate finance.

Thomas Noe (Said Business School) presented the paper 'Where Did All the Dollars Go? The Effect of Cash Flow Shocks on Capital and Asset Structure', jointly written with Sudipto Dasgupta (Hong Kong University of Science and Technology) and Zhen Wang (Hong Kong University of Science and Technology). They studied short-term and long-term cash flow sensitivities of all uses of cash, and how these were related to the degree of financial constraints faced by firms. The empirical results showed that cash savings in the short run, and debt reduction in both the short and the long run, accounted for a substantial fraction of cash flow use. In contrast, investment did not absorb the entire cash flow shock, though it exhibited substantial sensitivity to cash flows in the long run. It was indicated that the tighter the financial constraints, the smaller the fraction of cash flow absorbed by investment and the more by leverage constraints. This research suggested that much of the short-run economic effect of cash flow shocks to the corporate sector may be channelled into the corporate debt market rather than the capital goods market, especially when financing constraints tighten.

The next presentation entitled 'Dynamic Capital Structure under Managerial Entrenchment: Evidence from a Structural Estimation' was given by **Boris Nickolov** (Ecole Polytechnique Federale de Lausanne) co-authored with Erwan Morellec (Ecole Polytechnique

Federale de Lausanne) and Norman Schuerhoff (HEC Lausanne). In this paper they used observed corporate financing choices to infer the degree of managerial entrenchment and the effects of manager-shareholder conflicts on capital structure choices. They first built a dynamic contingent claims model in which financing policy resulted from a trade-off between tax benefits, contracting frictions, and agency conflicts. The analysis from the model demonstrated that entrenched managers issue less debt and rebalance capital structure less often than optimal for shareholders. The paper then used structured econometrics to provide firm-specific estimates of the degree of managerial entrenchment. The results showed that a small cost of control challenge was sufficient to resolve the low and zero-leverage puzzles and explain the time series of observed leverage ratios.



E · S · R · C
ECONOMIC
& SOCIAL
RESEARCH
COUNCIL

This event was organised jointly by the University of Lancaster and the Financial Markets Group (LSE) and sponsored by the ESRC

Corporate Governance at LSE

The Fiduciary Duties of Activist Shareholders

25 November 2008

Lynn A Stout (Paul Hastings Professor of Corporate and Securities Law, UCLA)

Chair: **Tom Kirchmaier** (FMG, LSE)

Lynn Stout (UCLA) opened her presentation 'The Fiduciary Duties of Activist Shareholders' by pointing out that activist shareholders may have conflicts of interests with respect to the company. As a consequence of conflicts of interest, activist shareholders—by being active in a way to improve their own returns—do not necessarily improve returns for the company's general shareholders. While corporate law governs behaviour of directors with conflicts of interests rather clearly, it has less to say about the actions of shareholders when these are in the same position. Directors have fiduciary duties with respect to their company, duty of care and duty of loyalty. For example, if a director who has a conflict of interest approves a transaction and is decisive in this approval, shareholders can take him/her to court where it is the director's burden to prove that the transaction was fair for shareholders. Lynn Stout argued that similar rules ought to be applied on shareholders with conflicts of interest.

The reasons as to why shareholders' interests are no longer homogenous are: (i) institutional investors have built up significant ownership stakes in many companies, (ii) SEC deregulation in 1992 allowed shareholders to talk to each other, and (iii) the derivatives market was deregulated in 2000 so that OTC contracts became legally enforceable. As a result of these deregulations, for example, an activist hedge fund can buy common stock of a company and simultaneously build up a position in credit default swaps on the same company.

Professor Stout argued that whenever a shareholder has a conflict of interest and was decisive for some resolution about the company, it should be possible for other shareholders to take it to court to check whether the resolution was fair. To avoid legal proceedings, a shareholder with a conflict of interest can seek support from the majority of shareholders before a resolution is approved.



Paul Davies (Department of Law, LSE)

In his discussion **Paul Davies** (Department of Law, LSE) responded by saying that UK public policy is to encourage shareholder activism and therefore any argument against it would be considered very seriously. He also mentioned that as a fiduciary is someone who voluntarily acts in the best interests of others, fiduciary

duties that apply to company board members are hard to extrapolate directly to shareholders.

Attendance at the Corporate Governance at LSE Research Debates is by invitation only.
For more details please contact FMG on 020 7955 6301/7002 or fmg@lse.ac.uk



RICAPE2 Third Conference 9 and 10 October 2008

University of Amsterdam Business School, Finance Group

The third annual RICAPE2 conference covered both theoretical and empirical papers on various topics relating to knowledge-based entrepreneurship. These included incentives, organisational designs and governance mechanisms to promote innovation and different financing sources such as venture capital and private equity. Some of the papers suggested relevant policy implications and showed significant effects in terms of a firm's valuation.

The conference was opened by **Armin Schwienbacher** (University of Amsterdam) who welcomed the conference participants and briefly discussed the RICAPE project. **Uwe Walz** (Centre for Financial Studies, Frankfurt) chaired the first academic session.

Veikko Thiele (Sauder School of Business, University of British Columbia) presented the first paper entitled 'Incentives and Innovation: A Multi-tasking Approach' jointly with Thomas Hellmann (Sauder School of Business, University of British Columbia). Veikko Thiele presented a model on the firms' choice between planned and unplanned activities: exploration and exploitation. This model offers an optimal contract to promote innovation by employees in the context of information asymmetries and difficult performance measurement. It finds that if innovation is highly firm-specific, firms provide lower incentives for standard tasks to encourage innovation, though in equilibrium, employees undertake too few innovations. In addition, the model also derives an optimal tolerance for failure by employees depending on innovation probabilities and an optimal level of investment in innovation depending on the level of innovation appropriability. The discussant **Ulrich Hege** (HEC Paris) made some detailed comments on the model, namely on the choices for the participation constraint, the exogenous nature of the benefits from innovation and on the bargaining power of the agents. He then suggested some extensions on the relationship between remuneration, R&D and spawning and the introduction of innovation property rights (IRP). The audience suggested the benefits of introducing more structure on the definition of 'innovation' tasks and on the managers' characteristics.

The second paper entitled 'Employee Incentives and Teamwork in Human Capital Intensive Firms' was presented by **Paolo Fulghieri** (UNC, CEPR, and ECGI). This paper, co-authored with Meri Sevilir (UNC), studies the effect of a firm's size and focuses on the employees' incentives to exert effort. In human capital intensive firms, value creation depends crucially on innovations generated by its employees, however firms extract rents from employees, reducing their incentives to innovate. The paper models

the choice of firms to hire substitute versus complement employees to promote the competition between them or to benefit from synergies. As a result, they found that for high levels of human capital, the firm remains small to promote employees' incentives while it expands in size for high levels of employees' complementarity. In addition, when synergies are low the firm hires substitute employees, while when synergies are high the firm hires complementing employees. The discussion of this paper was by **Bauke Visser** (Erasmus University Rotterdam) who pointed out the need for clarification of some concepts, namely the firm-specific human capital versus general human-capital and the innovative effort performed by employees. He also suggested some clarification on the impact of complementarity of employees on their outside options value.

Eren Inci (Sabanci University) presented 'Occupational Choice and the Quality of Entrepreneurs'. This paper focussed on the choice between entrepreneurship and wage-earning by individuals with different entrepreneurial ability. Depending on the level of taxation or subsidies, the model predicts different levels of entrepreneurship quality on the economy. This model extends the contracts to a general equilibrium framework where the wage rate and the interest rate are endogenously determined. **Rasa Karapandza** (University of Belgrade) was the discussant and shared some concerns about the different risk premium for workers and entrepreneurs. He also suggested a clarification on the environment in terms of taxes and policy implications.

The first paper of the second session, 'How Do Corporate Venture Capitalists Create Value for Entrepreneurial Firms?' was presented by **Thomas Chemmanur** (Boston College). This paper is joint work with Elena Loutskina. They investigate whether corporate venture capital (CVC) creates value in a different way from independent venture capital (IVC) arguing that this difference should arise from three sources: investment choices, the extent of product market value created and the ease of accessing the equity market. They found that CVC creates value by investing in younger and riskier firms, but did not find significant evidence that CVC creates greater product market value compared to IVC. The discussion of this paper was given by **Ludovic Phalippou** (University of Amsterdam) who pointed out some econometric issues, namely the interpretation of the model and the possible existence of mechanical effects between the size of companies and their exit. In addition he criticized the notion of value creation as being vague and difficult to link to CVC.

Krishnamurthy Subramanian (Emory University) presented the paper: 'Firm Boundaries in the New Economy: Theory and Evidence'. This paper includes both a theory model and corresponding empirical tests, and aims to answer the following questions: how do knowledge-intensive firms decide among M&A, joint ventures, alliances, and arms-length contracts; how is knowledge shared among knowledge-intensive firms; and how do arrangements differ between knowledge-intensive firms and firms in traditional industries. The empirical evidence is consistent with the model predictions, and shows that license, R&D agreement and cross-technology transfers become less likely in a strategic alliance when both firms' ability to expropriate each other increases; and that a majority joint venture becomes more likely than an alliance when one firm's ability to expropriate increases while the other firm's decreases. **Zacharias Sautner** (University of Amsterdam), who discussed the paper, showed some concerns regarding the proxy the author uses for ex-post expropriability and suggested some extensions to the paper. Namely, to better explore the data given its quality and to use alternative econometric methods.

Thomas Chemmanur (Boston College) presented a second paper: 'IPO Waves, Product Market Competition, and the Going Public Decision: Theory and Evidence' a joint work with Jie He (Boston College). This paper offers a new rationale for IPO waves and timings to go public, pointing out which industries are more likely to generate IPO waves and its impact on firm's performance. The main findings suggest that firms going public in hot rather than cold periods, or going public later than earlier on a wave have, on average, poorer post-IPO performance and a greater amount of cash at hand. The model provides theoretical foundations for these results. The discussant of this paper was **Amit Bubna** (Indian School of Business) who offered alternative explanations for the results. He pointed out that firms going public in cold markets might perform better simply because they have more cash at hand and that the cost of capital might be lower in hot IPO times.

Merih Sevilir (Kenan-Flagler Business School) presented 'Going Public To Acquire: The Acquisition Motive for IPOs', jointly with Ugur Celikyurt (Kenan-Flagler Business School) and Anil Shivdasani (Kenan-Flagler Business School). The authors empirically test three hypotheses connecting IPOs to M&A using US data on IPOs from 1994 to 2004. The first, according to the capital infusion hypothesis, is that financing events provide capital, allowing companies to grow. This would imply more cash financed M&A activity and investments in CAPEX and R&D after IPOs. Secondly, according to the acquisition currency hypothesis, IPOs create public stock that can be used to pay for M&A and therefore, stock financed M&A should be higher when bidder equity is more overvalued. Finally, the uncertainty resolution hypothesis suggests that IPO resolves uncertainty regarding bidder valuation, allowing the optimal acquisition and investment strategy post-IPO. The empirical results show evidence supporting all three hypotheses.

Uwe Walz (Centre for Financial Studies, Frankfurt) suggested it was difficult to test if M&A activity was a motive for IPO or an opportunity after the IPO. For instance, since overvaluation is only realized after the IPO it cannot be a motive. He recommended further investigation of firm characteristics such as age and growth opportunities and a comparison with non-IPOs firms. Finally, he pointed out the relation between ownership and concentration, since big shareholders might make cash financed acquisitions more difficult.

Klaus Schaek (Bangor Business School, University of Wales) presented 'Small and Medium Enterprises, Banking Relationships and the Use of Venture Capital', joint work with Allen Berger (Moore School of business, University of South Carolina). This paper formulates and tests the hypothesis about the determinants and performance effects of venture capital (VC) using data for Small and Medium Enterprises (SME) in the UK, Italy and Germany. They found that younger and larger SMEs are more likely to use VC and that multiple bank relationships are a substitute for VC. Finally they found that VC funded firms exhibit higher growth and invest more in R&D. **Christoph Zott** (Insead) discussed the paper and shared major concerns with respect to VC and multiple bank relationships being really substitutes. He argued that for some firms VC and banks are the only source available, and not alternatives. Finally he recommended the authors to sharpen the focus of the paper, to boost the literature review and to add information on the survey.

The last paper presented on the first day of the conference was 'Connections and Information Acquisition in Capital Allocation' by **Mariassunta Giannetti** (Stockholm School of Economics) and Xiaoyun Yu (Kelley School of Business, Indiana University). The authors developed an equilibrium theory to investigate the relationship between financiers and entrepreneurs. Depending on the level of development financiers allocate capital on the basis of prior connections instead of collecting information on the potential quality of alternative entrepreneurs. In this model, entrepreneurs with different quality levels compete to attract capital and financiers decide when it is optimal to collect information about these players. The more distant the entrepreneurs are, the more costly it will be to acquire information about their quality. The model predicts both underinvestment and overinvestment in information acquisition. The results have implications for formal financial markets, namely the characteristics that are more likely to attract entrepreneurs' capital raising activities. The discussant of this paper was **Javier Suarez** (CEMFI). He commented on some assumptions he found unusual including the decreasing returns to scale as general technology and constant returns to scale as entrepreneurial technology; the scarcity of capital with respect to entrepreneurs' demand and the absence of entry decisions by entrepreneurs and the nonattendance of endogenous capital accumulation.

The first paper of the second day of the conference was presented by **Julia Hirsh** (Universidad Iberoamericana & CFS) titled: 'Why do Contracts Differ Between VC Types? Market Segmentation Versus Corporate Governance.' This paper is coauthored with Uwe Walz (CFS). The paper consists of a theoretical model and corresponding empirical tests explaining the differences between types of VC contracts: local independent, international independent, bank dependent and public. These four types of contracts correspond to the four different treatments for analysis of the average treatment effect on the treated. The empirical test is run using a dataset of VC contracts in Germany. The authors found that different VC types provide significantly different contracts to their portfolio firms, including both important selection effects and substantial differences in corporate governance approaches of different VC types. The results carry significant implications for the comparison of corporate governance and contract design across different countries. In discussing the paper **Vyacheslav Dombrovsky** (BICEPS) showed some concerns regarding the sample representatives and suggested the authors include more stylized facts on the different types of VC contracts.



Gustavo Manso (MIT) presented 'Are Incentives Detrimental to Innovation', a joint work with Florian Ederer (MIT). The paper consists of a controlled laboratory experiment where players are subject to different incentive schemes while performing an innovation task. The authors provide evidence that a combination of tolerance for failure, and reward for long term success, is effective while motivating innovation. They also found that the threat of termination can undermine incentives for innovation, while golden parachutes can alleviate these innovation-reducing problems. **Enrico Perotti** (Amsterdam Business School) discussed the paper. He focused on the definition of innovation, saying that it is not clear as to what an innovative process is and if it always necessarily creates value.

'Corporate Governance and Innovation: Theory and Evidence', by Haresh Sapra (The University of Chicago), Ajay Subramaniam (Georgia State University) and **Krishnamurthy Subramaniam** (Emory University), was presented by the last author. They developed a theory on the effects of both external and internal corporate governance mechanisms on innovation. The models predict a U-shape relationship between innovation and takeover pressure; a positive relationship between monitoring intensity and innovation and finally a negative relationship between the sensitivity of innovation to changes in takeover pressure and monitoring intensity. The empirical tests using both time series and cross-sectional difference-in-differences methods show strong evidence supporting the model. The discussion of this paper was by **Riccardo Calcagno** (VU University of Amsterdam and Tinbergen Institute) who pointed out that innovative projects might not be always the most profitable ones and that this might be a driving part of the innovation 'smile'. He also showed major concerns regarding the signal on the quality of the project saying that this is difficult to interpret.

Alexander Popov (Tilburg University) presented 'On the Real Effects of Private Equity Investment: Evidence From Firm Entry', a joint paper with Peter Roosenboom (RSM). This empirical paper analyses the relation between the volume of private equity (PE) and firm entry in European economies using merged Amadeus datasets and EVCA databases. The US-industry entry rate is used as a benchmark due to its friction free financial markets. The authors found significant heterogeneity across countries with respect to entry, as well as private equity levels with respect to GDP and firm stages at which private equity is used. They also found that PE investment benefits firm entry, especially at competitive, R&D intensive and capital intensive industries. Finally they found some evidence that PE is relevant while promoting the development of larger firms and employment, but only for the period 2004-2005. The paper was discussed by **Eric Nowak** (University of Lugano, Swiss Finance Institute) who pointed out that the paper has very relevant policy implications for the EU, although, he was not fully convinced with the data quality and with some of the results. The proof of causality is an issue because alternative hypotheses were not excluded and time variations remained to be explained.

The last paper of the conference, 'Venture Capital Conflicts of Interest: Evidence from Acquisitions of VC-backed Firms' was presented by **Rajarishi Nahata** (Baruch College). The paper is co-authored with Ron Masulis (Vanderbilt University) and focuses on the costs of venture capital (VC) and its implications for companies. The authors identified four potential sources for conflicts of interest in VC: illiquidity, inexperience, self dealing and CVCs strategic focus. Specifically they addressed the following questions: can VC participation in many private targets be an explanation for the

higher profitability of acquisitions of privately held firms? Are VC-backed target deals different from other private firm acquisitions? Are acquirer shareholder wealth effects different for VC-backed targets? Lastly, are purchase price to book value ratios different for VC-backed targets? The data in use corresponds to completed acquisitions of privately held firms from 1991 to 2006 available at Thomson Financial's M&A and VentureXpert databases. The main results provided evidence consistent with the 'VC Liquidity Pressure' Hypothesis (lower target purchase price to book value ratios); the 'VC Self Dealing' Hypothesis (higher acquirer CARs and lower target purchase price to book value ratios) and with the 'CVC Strategic Focus' Hypothesis (higher acquirer CARs).



Marco Da Rin (Tilburg University, ECGI, IGIER-Bocconi)

Marco Da Rin (Tilburg University, ECGI, IGIER-Bocconi) discussed the paper, classifying it as an ambitious paper engaging in a difficult analysis. Regarding the sample construction and data, he showed some concerns with the existence of a non-listed acquirers bias and possible industry-specific acquisition waves that might be reflected in the VC-backed sample. He also suggested alternative econometric methods in order to deal with causality and some possible extensions focusing on self dealing problems, and by exploiting the variation in acquisition/ firm/VC characteristics.

The afternoon session started with the Keynote speech by **Amar Bhidé** (Columbia Business School). The main

topic of the keynote speech was innovation and globalisation. Amar started by sharing his optimistic view on globalisation, pointing out the usual argument that the growth of India and China offers larger markets for high tech companies in the West like Boeing Microsoft and Intel, but also that benefits will be realised in the purely domestic untraded sectors like the retail trade, insurance and health care. To support his view throughout his speech he used the results of an in-depth study of 106 VC-backed businesses and some known facts of modern economy and technostucture. He continued by pointing out some evidence for the limits of globalisation for innovative firms:

- The limited number of truly multinational firms 'being everywhere', since the great majority of firms sell only in the US. The complexity of innovative products makes it difficult to sell outside the US.
- Uncertainty and costs affect decisions – firms tend to choose countries where English is spoken.
- Companies tend to choose highly developed countries in terms of technology
- Europe tends to be chosen more than Japan, because of cultural and other practical issues

RICAFE2 Third Conference

- Sales and marketing support costs are an issue – development requires regular interaction with the client and therefore the sales force should be close to the development team.

In addition to this evidence he argued that offshoring is not an imminent threat: the North can benefit from Chinese and Indian innovations, since high level innovations are also mobile. At the same time, he expects growth and innovation to happen in the services economy in the US, which is un-traded, and accounts for 70% of the GDP/employment. Finally he focused on the idea of non-destructive creation, which he believes to be an essential feature of technological progress. New products, even if manufactured off-shore, should generate domestic service employment and add value.

He finished by saying that Technostructure evolved in such a way that development in China and India will certainly have a positive effect on the rest of the world.

Amar's presentation was followed by a panel discussion, chaired by **David Webb** (LSE). The general theme of the panel discussion was on 'Globalization and Entrepreneurship' with the following participants:

1 Peter Cornelius (Alpinvest)

2 Boris Veldhuijzen van Zanten (a Serial Internet Entrepreneur)

3 David Webb (FMG/LSE)

4 Tsvi Vinig (Amsterdam Business School & Director of the Science Park Amsterdam Center of Entrepreneurship)

5 Amar Bhidé (Columbia Business School)

Boris Veldhuijzen van Zanten first introduced himself as having already sold several companies, mostly startups. He illustrated an example of the difficulty of communication between different teams that partly explains why cross-border outsourcing is still not common in the VC industry. It is easier and better to develop something new with general foundations.

According to **Peter Cornelius**, the two biggest Dutch pension funds invest heavily in the VC industry. The most important factors for VC firms are to build networks, to get ideas and invest in opportunities. Cross-broader VC investments are still relatively rare in terms of either transaction number or investment value. There still exists severe home biases when it comes to VC investment. There is nevertheless a significant heterogeneity among VCs. When choosing the investment target in foreign countries, what matters most is the entrepreneurial environment. Peter gave many examples. Many cross-border VC investments are particularly difficult due to the lack of local players, next to legal enforcement problems. He finally concluded by saying that, under current circumstances, it is difficult to predict future business models.

Tsvi Vinig developed several ideas around measurement problems pertaining to entrepreneurship and globalisation. There is no unique definition for both terms. In order to view the whole picture, it is important to 'measure' what the current situation is. Moreover, the pattern over time and across countries needs further understanding as well. He described some databases; but he expressed concerns about the data quality and comparability across databases. He mentioned the GEM index and the World Bank data that both use different methodologies. The OECD has been trying to address these problems though. The bottom line is that we don't have the data for measurement, let alone data to understand the impact that globalisation brings to entrepreneurship. Finally it limits our capability to give sound policy recommendations.

The Regional Comparative Advantage and Knowledge-Based Entrepreneurship (RICAFE2) Research network includes the London School of Economics and Political Science (FMG), the Department of Economics and Finance of Turin University, the Center for Financial Studies (Frankfurt), HEC School of Management (Paris), University of Amsterdam, University of Tilburg, Baltic International Centre for Economic Policy Studies, University of Lugano, Indian School of Business, Technion (Israel), and the Belgrade Laboratory for Quantitative Finance.

RICAFE2 is funded by the European Commission, DG-Research, under the 'Citizens and governance in a knowledge-based society' (FP6) programme, grant CIT5-CT-2006-028942.



Forthcoming Roundtable Debate

The Governance of Audit Firms

22 January 2009

Alistair Johnston (Global Vice Chairman, KPMG),
Paul Lee (Director, Hermes Equity Ownership
Service), **Kevin McMeeking** (Exeter Business
School), **Norman Murray** (Chairman, Cairn Energy)
and **Alan Thomson** (Non-Executive Director,
Johnson Matthey).

Chair: **Sir Geoffrey Owen**

An effective and respected audit profession is essential to sound capital markets. Among listed companies and other major entities, the market for audit services is dominated by a small number of large firms. Today the risk of such a firm leaving the market, for whatever reason, is a matter of continuing concern as this could lead to significant disruption in capital markets in the UK and globally.

Enhancing confidence in their governance is one way that an audit firm may be able to reduce the risk. Transparency about their governance arrangements may also help users of audit services make more informed choices. The governance of major audit firms is increasingly attracting the interest of regulators.

This Corporate Governance at LSE event offers an opportunity to debate issues such as the governance structures and risk management of large audit firms. The debate can also help to inform the FRC and ICAEW's current consultation on a code of governance for large audit firms.

Organisers: Sir Geoffrey Owen (Department of Management, LSE) and Dr Tom Kirchmaier (FMG/ LSE and MBS)

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 Tom Kirchmaier, MBS and Financial Markets Group, LSE
Sir Geoffrey Owen, Department of Management, LSE

Further information is available on the Corporate Governance at LSE website:
www.lse.ac.uk/corporateGovernance



Housing, Financial Assets and the Economy

19 May 2009

The Financial Markets Group will be hosting a two day conference on Housing, Financial Assets and the Economy which will take place at the LSE on the 18th and 19th of May 2009.

This conference is the final communication event of the 'Home Ownership, Housing Collateral and Aggregate Fluctuations' research project at FMG. This three-year research grant is funded by the Economic and Social Research Council (ESRC) in the context of the Phase II of the Council's World Economy and Finance Research Programme. The project research is led by Dr Alex Michaelides and aims to understand the role of housing markets in business cycle fluctuations and the monetary transmission mechanism in the presence of housing. More information about this project is available at the FMG website (<http://fmg.lse.ac.uk/research/>)

The **Housing, Financial Assets and the Economy** conference will concentrate on understanding the joint determination of consumption, housing and asset prices in the macroeconomy.

Confirmed presenters include:

- Sydney Ludvigson (New York University)
- Martin Schneider (Stanford University)
- Francois Orttaglo Magne (University of Wisconsin-Madison School of Business)
- Joao Gomes (The Wharton School University of Pennsylvania)
- Paul Willen (Federal Reserve Bank of Boston)
- Paolo Surico (Bank of England)
- Tim Besley (LSE)
- Chris Carroll (Johns Hopkins University)
- Nobu Kiyotaki (Princeton University)
- Rachel Ngai (LSE)
- Morris Davis (University of Wisconsin-Madison School of Business)
- Kalin Nikolov (Bank of England).

The conference is organised by **Alex Michaelides** (FMG and Economics Department, LSE).

The full programme will be available from the FMG website soon. Attendance to the conference is by invitation.

For more information please contact the FMG administration on 020 7955 6301 or fmg@lse.ac.uk



FMG Seminars Lent Term 2009

London Financial Regulation Seminar

19 January	All day Conference on 'The Regulatory Response to the Financial Crisis'.	16 March	Rosa Lastra (CCLS and QMU), and L. Garicano (LSE), on 'Rethinking the Architecture of Financial Stability'.
23 February	Marianne Schulze-Ghattas (International Monetary Fund & FMG/LSE) on 'Financial Contagion from Mature to Emerging Markets – Evidence and Policy Issues'	23 March	Prof. Lars Jonung (research advisor, DG ECFIN, European Commission), on 'Lessons from the Nordic Financial Crises of the 1990s'.

The organisers of this seminar series are (by alphabetical order):

Professor E. Philip Davis (Brunel University) • **Professor Charles Goodhart** (Financial Markets Group, LSE) • **Dr Thomas Huertas** (Financial Services Authority) • **Professor Rosa Maria Lastra** (Centre for Commercial Law Studies, Queen Mary, University of London) • **Dr Alistair Milne** (Cass Business School) • **Professor Geoffrey Wood** (City University Business School).

For more information please call 020 7955 6301 or visit the FMG website at <http://fmg.lse.ac.uk/>

Taxation Seminar

19 January	Emma Chamberlain (Chartered Institute of Taxation) on 'Taxing wealth and inheritance: Where to from here?'	9 March	Chris Wales (Lucida plc) on 'The HMT-HMRC 'Policy partnership' three years on'
9 February	Stephen Smith (University College London) on 'Economics and arithmetic of a 'Green Tax Shift''	27 April	The Budget and Finance Bill: A panel discussion
		18 May	TBC

The organisers of this seminar series are **Jonathan Leape** • **Ian Roxan** • **Judith Freedman** • **Malcolm Gammie** • **David Oliver**

The LSE Financial Markets Group gratefully acknowledges financial support from STICERD and the LSE Department of Law.

For updated information on the seminars, please check <http://fmg.lse.ac.uk/events>



Discussion Papers



DP 609

Asset Pricing Tests with Long Run Risks in Consumption Growth

George M Constantinides, Anisha Ghosh

The Bansal and Yaron (2004) model of long run risks (LLR) in aggregate consumption and dividend growth and its extension that captures potential co-integration of the consumption and dividend levels, are tested on a cross section of asset classes and rejected using annual data over the period 1930-2006 and using both annual and quarterly data over the post-war period. The reversal of earlier empirical conclusions is partly due to the increase in the power of the tests resulting from two observations under the null. First, the latent state variables and, therefore, the pricing kernel are known as functions of observables such as the interest rate and the market-wide price-dividend ratio. Second, the parameters of the time-series processes of consumption and dividend growth, the LLR variable, and its conditional variance impose constraints on the parameters of the pricing kernel. The value of the persistence parameter of the LLR variable that best fits the data implies that its half-life is shorter than that of the business cycle.

DP 610

Can Rare Events Explain the Equity Premium Puzzle?

Anisha Ghosh, Christian Julliard

Probably not. First, allowing the probabilities attached to the states of the economy to differ from their sample frequencies, the Consumption-CAPM is still rejected by the data and requires a very high level of Relative Risk Aversion (RRA) in order to rationalize the stock market risk premium. This result holds for a variety of data sources and samples - including ones starting as far back as 1890. Second, we elicit the likelihood of observing an Equity Premium Puzzle (EPP) if the data were generated by the rare events probability distribution needed to rationalize the puzzle with a low level of RRA. We find that the historically observed EPP would be very unlikely to arise. Third, we find that the rare events explanation of the EPP significantly worsens the ability of the Consumption-CAPM to explain the cross-section of asset returns. This is due to the fact that, by assigning higher probabilities to bad - economy wide - states in which consumption growth is low and all the assets in the cross-section tend to yield low returns, the rare events hypothesis reduces the cross-sectional dispersion of consumption risk relative to the cross-sectional variation of average returns.

DP 611

Do Errors in Forecasting Inflation Lead to Errors in Forecasting Interest Rates?

Wen Bin Lim, Charles Goodhart

In the first of three related, and consecutive, papers we showed that forecasts for short-term policy interest rates in NZ and UK deteriorated over the first six months to a point when they became useless, after the first two quarters. Moreover they were ex post biased, underestimating future interest rates during upturns and the reverse during downturns. Both NZ and UK have been inflation targeters during our data period. In this second paper we ask, first whether inflation forecasts exhibit the same syndrome as the related interest rate forecasts, and whether errors in the inflation forecast may help to explain errors in the interest rate forecast. We find that the pattern of inflation forecast errors is qualitatively much the same as those for interest rates, but that the inflation forecasts are quantitatively better, both in terms of prediction error and of bias. The evidence on the relationship between inflation forecast errors and interest rate forecast errors is mixed. Over the whole time period, both in NZ and UK, there is no such relationship. But if one should strip out certain short periods, when domestic interest rates appear to have been affected by external factors, then there does seem to be such a relationship, with under (over) estimates of future inflation associated with under (over) estimates of future policy interest rates.

DP 612

Interest Rate Forecasts: A Pathology

Wen Bin Lim, Charles Goodhart

This is the first of three prospective papers examining how well forecasters can predict the future time path of short-term interest rates. Most prior work has been done using US data; in this exercise we use forecasts made for New Zealand (NZ) by the Reserve Bank of New Zealand (RBNZ), and those derived from money market yield curves in the UK. In this first exercise we broadly replicate recent US findings for NZ and UK, to show that such forecasts in NZ and UK have been excellent for the immediate forthcoming quarter, reasonable for the next quarter and useless thereafter.

DP 613

Do Reputational Concerns Lead to Reliable Ratings?

Beatriz Mariano

This paper examines to what extent reputational concerns give rating agencies incentives to reveal information. It demonstrates that, in a simple model in which a rating agency has public and private information about a project, it may ignore private information and even contradict public information in an attempt to minimize reputational costs. A monopolistic agency can act conservatively by issuing too many bad ratings when a project is expected to be good based on private and public information. In a competitive setting, an agency becomes bolder and can issue too many good ratings when a project is expected to be bad based on private and public information. The paper provides a reason for why competition in the ratings industry might lead to overly optimistic ratings even in the absence of conflicts of interest.

DP 614

Forecasting Bankruptcy and Physical Default Intensity

Ping Zhou

This report presents two of our investigations: one is to obtain an accurate forecast for the corporate bankruptcy; the other is to obtain a physical default intensity. Both investigations were based on the hazard model, using only firm-specific accounting variables as predictors. Different methods, such as the list-wise deleting, closest-value imputation and multiple imputation, were applied to tackling the problem of missing values. Our empirical studies showed that the multiple imputation performed the best amongst these methods and led to a forecasting model with economically reasonable predictors and corresponding estimates.

Special Papers

SP 176

The Emergence of Cross-Border Insurance Groups within Europe with Centralised Risk Management - sp176

Sander Osterloo, Dirk Schoenmaker, Otto Winkels,

This paper analyses the degree of internationalisation of insurance business. Using a novel dataset of 25 large EU insurance groups, we find that the insurance industry has a strong international orientation. About 55 per cent of the business of these large insurance groups is conducted abroad. The cross-border activities are

predominantly within Europe (30 to 35 per cent) and less so in the rest of the world (20 to 25 per cent). Next, this paper examines the impact of internationalisation on the organisational structure. We find a clear trend towards centralising risk and capital management activities within large insurance groups, though insurance remains at the same time a local business. Applying the hub and spoke model, we identify which functions are executed at the centre (hub) and which functions are performed at the local business units (spokes).



Forthcoming Discussion and Special Papers

DP 615

Some Determinants of the Price of Default Risk

Ron Anderson

DP 619

Central banks and financial crises

Willem H. Buiter

DP 616

Macroeconomic Determinants of Stock Market Returns, Volatility and Volatility Risk-Premia

Valentina Corradi, Antonio Mele, Walter Distaso

DP 620

Information Linkages and Correlated Trading

Paolo Colla, Antonio Mele

Special Papers

SP 177

The Regulatory Response to the Financial Crisis

C.A.E. Goodhart

DP 617

The Optimal Monetary Instrument for Prudential Purposes

Charles Goodhart, Dimitrios Tsomocos, Pojanart Sunirand

DP 618

Control Rights over Intellectual Property: Corporate Venturing and Bankruptcy Regimes

Sudipto Bhattacharya, Sergei Guriev



Visitors to the FMG

Torben Andersen (Northwestern University)

Federico Bandi (Chicago Graduate School of Business)

Franco Bruni (Bocconi University)

Arnoud Boot (University of Amsterdam)

Patrick Bolton (Columbia University)

Pierre Collin-Dufresne (Columbia University)

Valentina Corradi (University of Warwick)

Brandon Davies (GARP Risk Academy)

Marcelo Fernandes (Queen Mary, University of London)

Thierry Foucault (HEC Paris)

Carola Frydman (MIT)

Ian Garrett (Manchester Business School)

Alan Granwell (DLA Piper)

Christian Hellwig (UCLA)

Christopher Hennessy (London Business School)

Philipp Hildebrand (Swiss National Bank)

Howell Jackson (Harvard Law School)

Richard Johnson (Financial Services Authority)

Ilze Kalnina (LSE)

Ron Kaniel (Duke University)

Leonid Kogan (MIT)

Kai Kohlberger (Financial Services Authority)

Matt King (Citigroup)

Ray LaBrosse (University of Warwick and Patterson & LaBrosse Financial Consultants Ltd)

Bart Lambrecht (Lancaster University)

Albert Marcet (Universitat Autònoma de Barcelona)

Paul Morton (Reed Elsevier)

Stewart Myers (MIT Sloan School of Management)

Thomas Noe (Said Business School)

Andrew Patton (University of Oxford)

Grzegorz Pawlina (Lancaster University)

Mark Podolskij (ETH Zürich)

Uday Rajan (University of Michigan)

Mathieu Rosenbaum (Ecole Polytechnique, Paris)

James Sams (KPMG)

Kevin Sheppard (University of Oxford)

Costis Skiadas (Northwestern University)

Lynn Stout (UCLA)

Oren Sussman (Said Business School)

Almut Veraart (CREATES, University of Aarhus)

Annette Vissing-Jorgensen (Northwestern University)

Stef van Weeghal (Linklaters)

Sushil Wadhwani (Wadhwani Asset Management)

