

FMG, Queen Mary and European Shadow Financial Regulatory Committee Conference

# Regulatory Response to the Financial Crisis

19 January 2009

The objective of this conference was to analyse the regulatory response to the financial crisis by bringing together a distinguished group of academics, policy-makers and practitioners from the areas of law, economics, business and finance.

## Session 1

### The legal position of the central bank. The case of the Federal Reserve Bank of New York

The first presentation of the day was given by **Thomas C Baxter, Jr.** (Federal Reserve Bank of New York), who talked about the legal position of the central bank, in particular discussing the case of the Federal Reserve. He began by discussing a timeline of events beginning in August 2007, when three of BNP Paribas' investment funds were suspended, through to the present day. Mr Baxter focussed on the series of measures implemented by the Federal Reserve in order to deal with the crisis; from the Term Auction Facility implemented in December 2007, to the announcement in November 2008 of the creation of the Term Asset-Backed Securities Loan Facility. Mr Baxter highlighted that the concern of the Federal Reserve was to provide liquidity as lender of last resort (LOLR), and to reduce any stigma associated with accessing such facilities.

Underpinning such measures is the legal authority of the central bank. With this as the focus of his talk, Mr Baxter discussed Section 13(3) of the Federal Reserve Act; added to the act in 1932, this allows the Federal Reserve to assume extra lending powers, 'in unusual and exigent circumstances'. These extra powers enable the Federal Reserve System to lend, not just to depository institutions, but to a broader category of agents. He described how legal interpretation of Section 13(3) had provided the basis for the Term Securities Lending Facility, announced in March 2008, which was designed to enable the Federal Reserve to alleviate the liquidity problem faced by broker dealers.

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Thomas Huertas (Financial Services Authority)



Charles Goodhart (FMG, LSE)

## Financial Regulation Conference

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Mr Baxter then went on to describe the policy issues surrounding Bear Stearns' crisis, and the way in which the Federal Reserve used its powers to provide liquidity and thus support the purchase of Bear Stearns by JP Morgan Chase. This was one of the many examples Mr Baxter used to argue that the Federal Reserve will do whatever it takes, 'within the bounds of the law', to deal with the financial crisis.

In responding to Thomas Baxter's presentation, **Rosa M Lastra** (Centre for Commercial Law Studies, Queen Mary) discussed the key principles behind the LOLR doctrine. Professor Lastra argued that we need to review the doctrine in the light of the current crisis. In particular, lending to insolvent institutions is a departure from the classic doctrine. She argued that clear procedures must be put in place to help rectify the current crisis, but that the provision of assistance should be at the discretion of policymakers, in order to prevent moral hazard.

### Session 2 Unwinding Lehman Brothers

The session was started by **Tony Lomas** (PricewaterhouseCoopers), who discussed the role of administrators in unwinding insolvent banks – in particular Lehman Brothers which collapsed in mid-September 2008 – and the lessons learned from this process. Mr Lomas began by outlining the differences between legal procedures in the US and the UK. He explained that when the UK branch of the bank (LBIE) filed for administration, its assets were frozen and services were suspended due to the immediate seizure of the company, resulting in a spiral of plummeting investor confidence.

After demonstrating several inefficient administration practices, Mr Lomas argued that the banks should establish contingency plans to make the necessary infrastructure, people and information available to the regulators in such cases. He also pointed out that many investment banks only have reserves in the US, and that a lack of liquid reserves in London exacerbated the situation during the crisis. His other suggestions included retention of trust assets, off-exchange default rules and multi-lateral account reconciliation.



**Vitor Gaspar** (European Commission)

**Lee Buchheit** (Cleary, Gottlieb, Steen & Hamilton) followed as a discussant. He said that the perceived too-big-to-fail status of some large banks encouraged excess risk-taking and that this problem can only be solved with improved regulation and monitoring. However, he also pointed out several limits of regulation, including regulators' lack of knowledge about the

products and risks, and the banks' practice of off-balance sheet financing and leverage.

### Session 3 The rationale of banking supervision



**Geoffrey Wood** (CUBS)

**Thomas Huertas** (Financial Services Authority) started this session by presenting his paper: 'The Rationale for and Limits of Bank Supervision'. He explained that the rationale for bank supervision lies in the protection of depositors and the preservation of economic stability, and argued that supervision is only one corner of a broader tapestry which includes regulation, resolution

and compensation/guarantee arrangements, as well as monetary and fiscal policies. Excellent supervision cannot supersede banks' own management and governance. Dr Huertas said he believed that for supervision to be effective it should be risk-based and proactive, akin to the monitoring that a lender would impose on a borrower. This would allow the supervisor to assess the likelihood that the bank will come close to breaching its covenants or regulations, and to impose conditions on the bank that would reduce the risk of such a breach occurring. After illustrating recent government practices, focussing on the UK, he stated that bank supervision is by no means without limits, and concluded that financial stability cannot be assured without well-functioning monetary policy.

**Vitor Gaspar** (European Commission) and **Geoffrey Wood** (CUBS) discussed the paper during the remainder of the session. They briefly reviewed the paper and explained the importance of the functions performed by the financial system and the micro/macro fundamentals for bank regulation and supervision.

### Session 4 Restructuring the financial system: the case of the USA

During this session, **David A Westbrook** (University at Buffalo Law School) discussed the implications of the current crisis for the structure of the financial system from a US perspective. He started by citing Alan Greenspan's description of a 'broken paradigm', and argued that fundamental reform of the financial system is desirable. According to Professor Westbrook, the financial crisis arose from the post-WWII Bretton Woods system. The question we need to ask ourselves is not 'how to regulate the market', he said, but rather 'what kind of market to have'.

Professor Westbrook said that although he believes transparency to be desirable in the financial system, it is difficult to achieve according to



**Harald Benink** (FMG and Rotterdam School of Management)

modern portfolio theory, as a portfolio is synthetic, speculative and imprecise, and that it is becoming outdated due to financial innovations. He claimed that the following 'uncertainties' rather than 'risks' are inherent in the financial market: diversification tends to underestimate systemic risk, complex models do not reflect business reality, and legal structures of derivative contracts make counterparty risks hard to assess. He then concluded that portfolio theory is not coherent with transparency, and so financial contracts must be understood bilaterally. He finally emphasised that financial policy should be based on constructions rather than belated responses.

As a discussant, **Andy Haldane** (Bank of England) pointed to the great 'uncertainty' present in the financial system and said that we need to rethink our financial system and target systematic risk if we are to prevent market failures in the future.

## Session 5 Lender of last resort, deposit insurance and bank insolvency

The session was opened by **Maria Nieto** (Bank of Spain) who presented a paper titled 'Bankruptcy and reorganization procedures for cross-border banks in the EU: Towards an integrated approach to the reform of the EU safety net'. She assessed the economic efficiency of the institutional framework defined by the reorganisation and winding-up directive, and explored additional areas of coordination with other EU directives. She proposed that future reforms of the reorganisation and winding directive should focus on several things, including a common definition of bank insolvency and precise information requirements for host member states in the short term, and on establishing a 'special resolution regime' for cross-border EU banks, and the delegation of the host resolution authority to the home country resolution authority in the medium term.

The second presentation was given by **Gillian G H Garcia** on 'Bankruptcy and reorganisation procedures for cross-border banks in the EU'. The paper pointed out that the current procedures in the EU are highly fragmented and heterogeneous, and suffer from misalignments of operation and supervision of internationally active financial institutions. The following solutions were proposed: at the EU level, we need to align powers of supervisory and resolution authorities for financial groups, place greater reliance on home authority colleges and create a pan-European deposit insurance fund; at the international level, countries need to safeguard critical functions (such as payment and settlement), strengthen national safeguard (for example, with more restricted tranching asset maintenance) and work with key authorities toward pre-arranged firm-specific solutions.

The session continued with **Alistair Milne** (CASS Business School) presenting his paper entitled: 'Maturity mismatch and the rationale for systematic credit risk insurance'. He argued that one of the major causes of the crisis was that banks finance their long-term liabilities by borrowing short-term. He also claimed that the policy measures of the Scandinavian countries were not enough to deal with the aftermath of the crisis. The Scandinavian measures include recognising losses, removing bad assets and recapitalising banks. He argued that the first measure does not address funding gaps and the second measure failed to take into account the fact that banking problems emerge at the peak of the credit cycle.

Finally, **Phil Davis** (Brunel University) presented: 'The lender of last resort and liquidity provision – how much of a departure is the subprime crisis?'. Professor Davis started by explaining the nature of LOLR and liquidity risk, the importance of liquidity risk in crises, and traditional policy responses of the LOLR based on current attitudes and beliefs. Then he looked at the implications of the subprime mortgage crisis on liquidity risk and the LOLR. Professor Davis concluded that there are many challenges facing the LOLR, including longer term provisions and the variety of low quality collateral, and called for reform of liquidity regulation.

Organised by:

**Professor Harald Benink** (FMG and Rotterdam School of Management), **Professor Rosa M Lastra** (Queen Mary, University of London) and **Professor Charles Goodhart** (FMG, LSE).

The conference was part of the ESRC-funded research project, on the Stability of the Global Financial Systems: Regulation and Policy Response, which is part of the ESRC World Economy and Finance research programme. More details are available at the research programme's website: [www.worldeconomyandfinance.org](http://www.worldeconomyandfinance.org)



## Regional Comparative Advantage and Knowledge-Based Entrepreneurship (RICAPE2) Policy Workshop in Brussels

28 January 2009



**Ulrich Hege** (HEC School of Management)

The goal of the RICAPE2 policy workshop was to present a summary of the output of RICAPE2 research to the policy making community, and to receive input from these and other project stakeholders. The

RICAPE2 research project aims to study how knowledge-based entrepreneurship (KBE) can contribute to the creation of regional comparative advantages and to explain the changes in observed patterns in regional growth.

The opening remarks of the workshop were made by **Pierre Valette** (European Commission), who focused his comments on the importance of the link between research and innovation, and the need to speed up the movement between the two in the context of economic and financial crisis. He also placed the project in the broader context of the Lisbon 2010 strategy and its impact for the different European regions.

**David Webb** (FMG, LSE), the co-director of RICAPE2, then introduced the project, focusing on its research partners, associated universities, main objectives, focus and research approach.

The first presentation, on societal, legal and economic factors that determine the shape of KBE was given by **Ulrich Hege** (HEC School of Management). Professor Hege summarised the results of 25 working papers on the determinants of KBE which were part of RICAPE work package 1. The working

papers in this package took both theoretical and empirical approaches to the topic. It included a wide array of issues such as behaviour, incentives, culture and institutions, and their impact on KBE, as well as the role of finance and law and their constraints to this process. The empirical work included cross country analysis from within the EU, but also evidence from non-EU countries including the US or China. The main results in this package concluded that behavioural factors like overconfidence, talent and risk aversion are important for KBE. Besides the individual dimension it also looked at the role of social networks, social capital and institutions for the creation of an environment that promotes entrepreneurship. At the firm level, it focused on to role of firm characteristics such as size, financial constraints, legal forms and governance models that either facilitate or impede the process of innovation.

The discussion of the first presentation was by **Georges Noel** (European Private Equity and Venture Capital Association). Mr Noel presented some additional evidence that size and governance models matter for KBE. He cast doubt on the result that small firms have more efficient innovation processes, pointing to instances of large firms with active and effective corporate venture capital departments. Regarding the role of social trust, he criticised the study's European focus, since 60 per cent of capital invested comes from non-European countries. Finally he pointed out that an investigation into the link between demographics and entrepreneurship is missing from the research done so far. It is expected to find that countries with a greater proportion of young people will be more predisposed to entrepreneurship.

**Uwe Waltz** (Goethe University and CFS) then presented on government policy, KBE and shifting patterns of regional comparative advantage. The research focus has been on patterns of KBE in Western Europe and accession countries,







**David Webb** (FMG, LSE)

but also in three fast growing emerging economies: Israel, Brasil and India. This approach allowed an assessment of how different policies affect the local and regional development of

KBE. The main findings presented concluded that local venture capital industry is important for KBE corporate governance mechanisms. Regarding this issue, it was also argued that the right incentives could enhance the productivity of public entities without privatising them, suggesting that it is not the type of institution that matters, but rather the incentive framework in place. On the determinants of KBE regional development, the findings implied that accumulation of local human capital is one of the main sources of a sound and dynamic technological base. In addition, the mix of human capital, technological and societal infra-structure is crucial for attracting high-tech firms to an agglomeration. Finally, on the impact of entry and exit costs of experimentation and innovation, it was shown that exit costs can be more detrimental for firm growth and productivity.

**Klaus Mark** (Kreditanstalt fuer Wiederaufbau) discussed the second session. Mr Mark focused on the process of economic policy and on the role of theoretical and empirical research into this process. He discussed Belezon and Shankermann (2008), on incentives of technology transfer offices in greater detail. He argued that further research is needed on the profitability of licences, spillover effects and macro economic effects.

**Marina Di Giacomo** (Universita di Torino) presented the final session of the workshop, which focused on the links between KBE, regional dynamics in economic activity and regional structural change. The main results included relevant policy implications. The first implications were concerned with the

flexibility of labour markets to facilitate the reintegration of unsuccessful entrepreneurs. Similarly, exits costs should be reduced to a minimum, since frequent exits allow for a more efficient reallocation of resources. In terms of entry barriers, it is shown that loan guarantees should be used to alleviate credit constraints and that corporate taxation cuts facilitate entry in a context of good institutional frameworks. Other policy implications discussed by Dr Digiacoimo related to education and intellectual property (IP) protection. IP protection policies should be implemented as a way to foster innovation and impede imitation. Education is a relevant way to accumulate human capital and constitutes a source of dynamic regional technological advantages. Research has shown that education may increase entrepreneurs' earnings. Finally, Dr Di Giacomo pointed out that general policies seem to be more effective than focused ones for inducing economic dynamism and facilitating successful KBE.

**Gordon Murray** (University of Exeter) discussed the session. Professor Murray focused his talk on the broader topic of interaction between researchers and policy makers. He suggested that there is a gap between the understanding of researchers and policy makers (consumers), and research makers (producers), and considered how this relation could be improved.

There was then an open discussion on the topics presented. Ulrich Hege commented on the demand for more research on the impact of demographics on KBE, pointing out that if it is the case that there is a positive correlation between age and successful entrepreneurship, then this is bad news for Europe. Uwe Waltz remarked on the link between entrepreneurship and overall macro-economic benefits, providing some evidence from India. Alf Vanags criticised the lack of welfare analysis in the project's research approach and suggested more debt analysis of education as a determinant of success in KBE.

The final remarks were made by David Webb and Pierre Valette. Professor Webb concluded by saying that the main goals of the RICAFe2 research project had been attained. The outcome being not only a significant set of high quality working papers but also important conclusions with relevant policy implications. Mr Valette ended the conference by remarking on the usefulness and relevance of the research presented, and the potential for further research.

# Corporate Governance at LSE

## Audit Firm Governance Roundtable Debate

22 January 2009



**Sir Geoffrey Owen** (Department of Management, LSE)

An effective and respected audit profession is essential for 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 risk, and transparent 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, who would like to develop a mechanism that can help to reduce the risk of potential failure of audit firms, and potentially allow new participants to enter the market for large audits. The roundtable debate



**Tom Kirchmaier** (FMG and Manchester Business School)

aimed at contributing to the current consultation process by the FRC and ICAEW on a code of governance for large audit firms.

The details of this debate are non-attributable.

The Audit Firm Governance panel consisted of the following speakers: **Alistair Johnston** (KPMG), **Paul Lee** (Hermes Equity Ownership Service), **Kevin McMeeking** (Exeter Business School),

**Norman Murray** (Cairn Energy) and **Alan Thomson** (Johnson Matthey). The event was chaired by **Sir Geoffrey Owen** (Department of Management, LSE).

Organised by:

**Sir Geoffrey Owen** (Department of Management, LSE) and **Dr Tom Kirchmaier** (FMG and Manchester Business School).



**Kevin McMeeking** (Exeter Business School), **Paul Lee** (Hermes Equity Ownership Service), **Alistair Johnston** (KPMG), **Norman Murray** (Cairn Energy), **Alan Thomson** (Johnson Matthey), **Sir Geoffrey Owen** (Department of Management, LSE)

## FMG and LSE Student Union Private Equity Society Event Alternative Investments Conference 19-20 January 2009



Josef Ackermann (Deutsche Bank)

Held at the Marriott hotel, Grosvenor Square, the Alternative Investments Conference (AIC) featured a mix of workshops, speeches and panel discussions from distinguished figures in the industry. The conference was a unique opportunity for would-be hedge fund and private equity managers to exchange views with over 40 industry leaders and pioneers, as well as a fantastic chance to meet over 350 students and academics from more than 65 universities around the world. **David Webb** (FMG, LSE) said: 'the forum is an excellent chance for the industry and academia to interact in such a crucial period for alternative investments'.

A core idea at this year's conference was the 'next epoch' of the alternative asset management industry at a time when the pros and cons of hedge funds are being reassessed, and examined how the industry is adapting in terms of investment strategies and fund structures. The conference presented a wide array of thoughtful opinion on the shape the industry is likely to take and provided an analysis of recent events.

Keynote speeches by **Dr Josef Ackermann** (Deutsche Bank) and **Victor Haghani** (private investor) explored recent events in the financial markets and shared novel ideas on the future of alternative investments.

Over three years, the AIC has grown into the world's largest conference on private equity and hedge funds for students. Organisers received more than five applications for every place, with applications from leading universities and business schools around the globe.

Speakers at the conference included: **Josef Ackermann** (Deutsche Bank), **Michael Hintze** (CQS), **Randall Dillard** (Liongate Capital Management), **Aron Landy** (Brevan Howard Asset Management), **Victor Haghani** (private investor), **Sir Howard Davies** (LSE), **Jon Moulton** (Alchemy Partners), **David Fitzgerald** (The Carlyle Group), **John Hahn** (Providence Equity Partners), **Lionel Assant** (Blackstone Group), and **Hughes Lepic** and **Ed Siskind** (Goldman Sachs).



David Webb (FMG, LSE) and Victor Haghani (private investor)

The conference was organised by:

**Jan Bucher, Akhil Chainwala and Dominik Nagly** (Private Equity Society).

Sponsored by:

Liongate Capital Management, Shenyin Wanguo Securities Co, Winton Capital Management, Sankaty Advisors, J P Morgan, Blackstone, The Carlyle Group.

## FMG conferences

Public lecture by Dr Mario Nava

### European Financial Regulation and the Financial Crisis

17 March 2009

The FMG and Cairn Capital hosted a public lecture by **Dr Mario Nava**, head of the Financial Market Infrastructure unit at the European Commission, on 'European Financial Regulation and the Financial Crisis, with a special emphasis on the Credit Markets'.



FMG and Deutsche Bank Conference

### Reforming the Global Architecture of Financial Regulation: What are the crucial steps?

19 March 2009

The Financial Markets Group and Deutsche Bank hosted a one day conference entitled: 'Reforming the Global Architecture of Financial Regulation: What are the crucial steps?'

The conference began with an analytical session to help identify the underlying weaknesses that led to the financial crisis, and the factors which have aggravated it. It then proceeded to panel discussions which attempted to identify key features that increase the stability of the financial system. The conference also dealt with the types of reform measures needed to ensure a restructured financial system is less prone to crisis.

**Keynote Speech:** 'Reforming the Global Financial Architecture: A Banker's Perspective', by **Josef Ackermann**, CEO of Deutsche Bank Group and Visiting Professor of Economics at LSE.

Speakers included:

**Ron Anderson** (FMG, LSE)

**Hugo Banziger** (Deutsche Bank)

**Markus Brunnermeier** (Princeton University)

**Sir Howard Davies** (FMG, LSE)

**Charles Goodhart** (FMG, LSE)

**Andrew Haldane** (Bank of England)

**Alan Howard** (Brevan Howard Associates)

**Matt King** (Citigroup)

**Malcolm Knight** (Deutsche Bank and LSE)

**Sylvie Matherat** (Banque de France)

**Peter Praet** (International Cooperation and Financial Stability, National Bank of Belgium)

**Andreas Preuss** (Deutsche Boerse)

**Raghuram G Rajan** (University of Chicago)

**Gillian Tett** (Financial Times)

**David Webb** (FMG, LSE)

**William White** (Economic and Development Review Committee, OECD)

The conference was organised by: **Hugo Banziger** (Deutsche Bank), **Malcolm Knight** (Deutsche Bank and LSE) and **David Webb** (FMG, LSE).



# Housing, Financial Assets and the Economy

18-19 May 2009

This conference is the final communication event of the Home Ownership, Housing Collateral and Aggregate Fluctuations research project at the FMG, and will focus on understanding the joint determination of consumption, housing and asset prices in the macroeconomy.

The three-year Home Ownership, Housing Collateral and Aggregate Fluctuations research project has been funded by the ESRC, as part of Phase II of its World Economy and Finance research programme. The project research is led by **Dr Alex Michaelides** (FMG and Department of Economics, LSE) and aims to understand the role of housing markets in business cycle fluctuations and the monetary transmission mechanism in the presence of housing.

Confirmed presenters include:

**Tim Besley** (LSE)

**Christopher Carroll** (Johns Hopkins University)

**Morris Davis** (University of Wisconsin-Madison School of Business)

**Joao Gomes** (The Wharton School University of Pennsylvania)

**Nobu Kiyotaki** (Princeton University)

**Sydney Ludvigson** (New York University)

**Rachel Ngai** (LSE)

**Kalin Nikolov** (Bank of England)

**Francois Ortaglo Magne** (University of Wisconsin-Madison School of Business)

**Martin Schneider** (Stanford University)

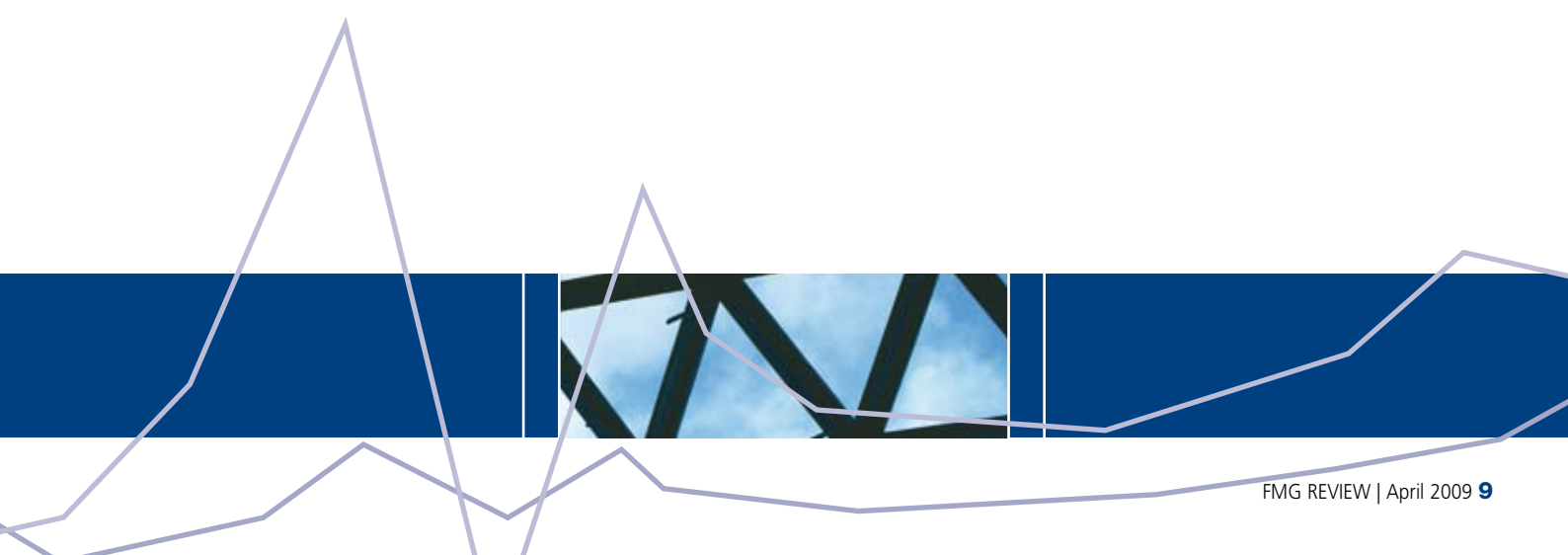
**Paolo Surico** (Bank of England)

**Paul Willen** (Federal Reserve Bank of Boston)

The conference is organised by **Dr Alex Michaelides** (FMG, LSE).

The full programme will be made available on the FMG website shortly.

Attendance at the conference is by invitation only.



# Paul Woolley Centre Second Annual Conference

28-29 May 2009

The Paul Woolley Centre was established at the LSE in September 2007. Research at the centre aims at understanding the workings of capital markets and the social efficiency of allocations these markets achieve. The research departs from the Arrow-Debreu view of frictionless markets, and emphasises the role of financial institutions (such as investment banks, mutual, hedge, and pension funds) in influencing prices and allocations.

The main themes of its research are:

## Contracts and organisational structure:

What contracts should govern the agency relationship between investors and fund managers? How do contracts influence managers' investment policies? What determines the organisational structure of the fund-management industry?

## Market frictions and asset prices:

How do frictions such as asymmetric information, market-entry costs, or agency impact the informational efficiency of prices? What are the implications for market liquidity and for phenomena such as excess volatility or contagion?

## Allocative efficiency and the macro-economy:

Frictions can generate allocative inefficiencies, such as imperfect risksharing and misallocation of capital in the macroeconomy. How important are these inefficiencies and how can they be measured?

## Policy implications:

Can regulatory policies mitigate market inefficiencies? For example, can changes in contracts between investors and managers, or the introduction of new assets, generate Pareto-improvements?

The Paul Woolley Centre is holding a conference each year based on these broad themes, as well as related research questions. The goal is to bring together researchers working on such questions, disseminate their research, and stimulate the development of new ideas.

**Professor Andrei Shleifer** (Harvard University) will give a keynote address. The programme of the centre's first conference can be found on the centre's website:

**[www.lse.ac.uk/collections/paulWoolleyCentre/events/FirstAnnualConference.htm](http://www.lse.ac.uk/collections/paulWoolleyCentre/events/FirstAnnualConference.htm)**



# The Internal Governance of Firms: the Role of Managers, Organisational Structure, Formal and Informal Incentives

**26-27 June 2009**

The recent financial crisis has brought firm governance back into the spotlight. In hindsight, internal governance and incentive mechanisms in banks, financial institutions, credit rating agencies and regulatory agencies appear to have failed to deal with the issues that led to the crisis. Our goal is to hold an academically-oriented conference where leading scholars in economics and finance will present and discuss the latest cutting edge research on internal governance of firms and their consequences for financial institutions and regulators.

The conference will include both theoretical and empirical research emphasising the following topics:

- Compensation and incentives
- Executive characteristics, managerial abilities, skills and biases
- Organisational structure, leadership and coordination

Attendance at the conference is by invitation only.

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# London Financial Regulation Conference

**2-3 July 2009**

Two of the major academic reports on the financial crisis have emanated, primarily though not entirely, from the FMG with, 'The Fundamental Principles of Financial Regulation', Geneva Report, 2009, and from the Stern School of Business at NYU, in the shape of their book, 'Restoring Financial Stability: How to Repair a Failed System'. Many of the key authors of both monographs and several other leading experts will be leading discussions on continuing key issues, such as liquidity, quantitative easing, and remuneration.

Attendance at this event is by registration only. To register please email Tanya Hall: [t.hall@lse.ac.uk](mailto:t.hall@lse.ac.uk)



# Capital Markets Workshop

## Summer Term 2009

18 March	<b>John Campbell</b> (Harvard University)
29 April	<b>Robert Whitelaw</b> (NYU Stern School of Business)
6 May	<b>Mitchell Petersen</b> (Kellogg University)
13 May	<b>Steve Ross</b> (MIT)
27 May	<b>Moto Yogo</b> (Wharton, University of Pennsylvania)
3 June	<b>Jean-Charles Rochet</b> (Toulouse)
10 June	<b>David Scharfstein</b> (Harvard Business School)
24 June	<b>Andrei Shleifer</b> (Harvard University)

The seminar series is organised by:

**Jack Favilukis** and **Stephane Guibaud** (FMG, LSE).

**The Capital Markets Workshop meets regularly throughout the academic year at 5pm on Wednesdays in room R405, 4th Floor, Lionel Robbins Building. For updated information on the seminars, please check <http://fmg.lse.ac.uk/events/>**





# Discussion Papers



DP 615

## Some Determinants of the Price of Default Risk

Ronald W Anderson

In this paper we study the pricing of credit risk as reflected in the market for credit default swaps (CDS) between 2003 and 2008. This market has newly emerged as the reference for credit risk pricing because of its use of standardised contract specifications and has achieved a higher level of liquidity than typically prevails in the markets for the underlying notes and bonds of the named corporate issuers. We initiate our exploration by studying a particular case which allows us to set out some of the issues of CDS pricing in a simple way. We show that for the purposes of accounting for relatively short-term changes of CDS spreads, an approach based on the structural (or firm-value based) models of credit risk faces an important obstacle in that reliable information about the firm's liabilities required to calculate the distance to default are available only quarterly or in some cases annually. Thus structural models account for short-term movements in credit spreads largely by changes in the issuer's equity price. In the case studied we show the effect of equity returns in explaining weekly changes of spreads is insignificant and of the wrong sign. In examination of particular episodes when the CDS spread was particularly delinked from the firm's equity series, we find that a likely explanation is changes in expectations about the firm's planned capital market operations. Since these are hard to

capture in an observed proxy variable, we argued that this motivates the use of latent variable models that have recently been employed in the credit risk literature. We further see that movements in the CDS spreads for the particular name chosen are highly correlated with an index of CDS spreads for industrial Blue-chip names.

DP 616

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

Valentina Corradi, Walter Distaso,  
Antonio Mele

This paper introduces a no-arbitrage framework to assess how macroeconomic factors help explain the risk-premium agents require to bear the risk of fluctuations in stock market volatility. We develop a model in which return volatility and volatility risk-premia are stochastic and derive no-arbitrage conditions linking volatility to macroeconomic factors. We estimate the model using data related to variance swaps, which are contracts with payoffs indexed to nonparametric measures of realized volatility. We find that volatility risk-premia are strongly countercyclical, even more so than standard measures of return volatility.

DP 617

## The Optimal Monetary Instrument for Prudential Purposes

C A E Goodhart, P Sunirand, D P Tsomocos

The purpose of this paper is to assess the choice between adopting a monetary base or an interest rate setting instrument to maintain financial stability. Our results suggest that the interest rate instrument is preferable, since during times of a panic or financial crisis the Central Bank automatically satisfies the increased demand for money. Thus, it prevents sharp losses in asset values and enhanced asset volatility.

DP 618

## Control Rights Over Intellectual Property: Corporate Venturing and Bankruptcy Regimes

Sudipto Bhattacharya, Sergei Guriev

We develop a theory of control rights in the context of licensing interim innovative knowledge for further development, which is consistent with the inalienability of initial innovator's intellectual property rights. Control rights of a downstream development unit, a buyer of the interim innovation, arise from its ability to prevent the upstream research unit from forming financial coalitions at the ex interim stage of bargaining, over the amount and structure of licensing

## Publications

fees as well as the mode of licensing, based either in trade secrets or on patents. We model explicitly the equilibrium choice of the temporal structure of licensing fees, and show that the innovator's ex interim financial constraint is more likely to bind when the value of her innovation is low. By constraining the financial flexibility of the upstream unit vis-à-vis her choice over the mode of licensing of her interim knowledge, the controlling development unit is able to reduce the research unit's payoff selectively in such contingencies. This serves to incentivise the research unit to expend more effort ex ante, to generate more promising interim innovations. We further show that such interim-inefficient control rights can nevertheless be renegotiation-proof.

DP 619

### Central Banks and Financial Crises

Willem H Buiter

The paper draws lessons from the experience of the past year for the conduct of central banks in the pursuit of macroeconomic and financial stability. Macroeconomic stability is defined as either price stability or as price stability and sustainable output or employment growth. Financial stability refers to (1) the absence of asset price bubbles, (2) the prevention or mitigation of systemically significant funding illiquidity and market illiquidity and (3) the prevention of insolvency of systemically important financial institutions. The performance of the Fed, the ECB and the Bank of England is evaluated in terms of these criteria. The Fed is judged to have done worst both as regards macroeconomic stability and as regards one of the two time dimensions of financial stability: minimizing the likelihood and severity of future financial crises. As regards 'putting out fires' (dealing with the immediate crisis), the Bank of England gets the wooden spoon for its early failure to perform the lender of last resort and market maker of last resort roles.

DP 620

### Information Linkages and Correlated Trading

Paolo Colla, Antonio Mele

In a market with informationally connected traders, the dynamics of volume, price informativeness, price volatility, and liquidity are severely affected by the information linkages every trader experiences with his peers. We show that in the presence of information linkages among traders, volume and price informativeness increase. Moreover, we find that information linkages improve or damage market depth, and lower or boost the traders' profits, according to whether these linkages convey positively or negatively correlated signals. Finally, our model predicts patterns of trade correlation consistent with those identified in the empirical literature: trades generated by neighbour traders are positively correlated and trades generated by distant traders are negatively correlated.

## Special Papers

SP177

### The Regulatory Response to the Financial Crisis

C A E Goodhart

In this paper I shall take the causes, developments and economic consequences of the financial dislocations of the last six months as given and generally understood, having already written extensively on this subject, in a more academic vein in the Journal of International Economics and Economic Policy and in a more popular format in the February, 2008, issue of Prospect. Instead I want to turn to the regulatory implications, and official responses, of this continuing event. Being British, this inevitably focuses primarily on issues pertaining to the UK.

## Forthcoming Discussion and Special Papers

### Discussion Papers

DP 621

#### The Paul Woolley Centre Working Paper Series No 1 An Institutional Theory of Momentum and Reversal

Dimitri Vayanos, Paul Woolley

DP 622

#### Foreign Bank Entry: A Liquidity Based Theory of Entry and Credit Market Segmentation

Nikolaj Schmidt

DP 623

#### Foreign Bank Entry: The Stability Implications of Greenfield Entry vs. Acquisition

Nikolaj Schmidt

DP 624

#### Best Ideas

Randy Cohen, Christopher Polk, Bernhard Silli



DP 625

**The Credit Crisis and the Dynamics of Asset Backed Commercial Paper Programs**

Nikolaj Schmidt

DP 626

**Understanding Portfolio Efficiency with Conditioning Information**

Francisco Peñaranda

Special Papers

SP 178

**Risk, Uncertainty and Financial Stability**

C A E Goodhart

# Visitors to the FMG

## January-March 2009

**Ulf Axelson** (Stockholm School of Economics)

**Matthieu Bouvard** (University of Toulouse)

**Maria Cecilia Bustamante** (Universite de Lausanne)

**Giacinta Cestone** (Queen Mary, University of London)

**Georgy Chabakauri** (London Business School)

**Emma Chamberlain** (Chartered Institute of Taxation)

**Ing-Haw Cheng** (Princeton University)

**Moshe Cohen** (MIT)

**Jennifer Dlugosz** (Harvard University)

**Lord Eatwell** (Queens College Cambridge)

**Douglas Gale** (New York University)

**Antonio Guarino** (UCL)

**Jens Hilscher** (Brandeis University)

**Alistair Johnston** (KPMG)

**Lars Jonung** (European Commission)

**Leonid Kogan** (MIT)

**Paul Lee** (Hermes Equity Ownership Service)

**Dong Lou** (Yale School of Management)

**David Martinez-Miera** (CEMFI)

**Kevin McMeeking** (Exeter Business School)

**Norman Murray** (Cairn Energy)

**Lorenzo Naranjo** (NYU Stern School of Business)

**Anya Obizhaeva** (University of Maryland)

**Stefano Rossi** (Stockholm School of Economics)

**Marianne Schulze-Ghattas** (IMF)

**Stephen Smith** (University College London)

**Andreas Stathopoulos** (Columbia University)

**Alan Thomson** (Johnson Matthey)

**Adrien Verdelhan** (Boston University)

**Chris Wales** (Lucida plc)



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**FMG**  
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, 15th October 2008 - at 1.00-2.00pm**  
**Lunchtime Workshop** | The Effect of Credit Rationing on the Shape of the Competition-Innovation Relationship | Jan Bena (FMG/LSE)  
location: R407, FMG, 4th Floor, Lionel Robbins Building, LSE

**Wednesday, 15th October 2008 - at 5.00pm**  
**Capital Markets Workshop** | Smooth Ambiguity Aversion Toward Small Risks and Continuous-Time Recursive Utility | Costis Skiadas

### In the news

Special London Financial Regulation Seminar announced - Howell Jackson (Harvard Law School) **13 Oct 2008**  
Professor Howell Jackson (Harvard Law School) will give a special lunch seminar as part of the London

Managing International Financial Instability Public Lecture - Conference slides available **9 Oct 2008**  
Date: Tuesday 7 October 2008 Time: 6-7.30pm Venue: Sheikh Zayed Theatre, New Academic Building Speaker

**In the press: Jon Danielsson provides an analysis on "What happened to Iceland"** - Jon Danielsson (FMG/LSE) investigates the factors that caused

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## FMG Review

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