

Number 94 Spring/Summer 2013

ISSN 1747-2261

## UNINTENDED CONSEQUENCES OF THE NEW FINANCIAL REGULATIONS A SYSTEMIC RISK CENTRE AND FINANCIAL MARKETS GROUP PUBLIC LECTURE

11 March 2013

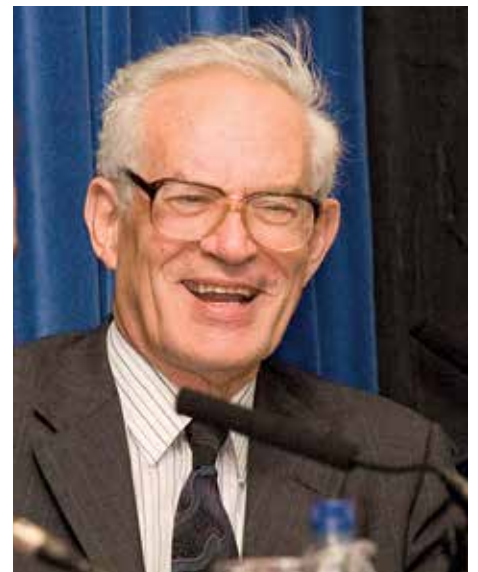
As chair of the event **Christopher Polk** (Director of the Financial Markets Group) started by welcoming the audience to the inaugural public event of the ESRC Systemic Risk Centre at LSE. He continued by explaining that the panel would discuss whether or not the post crisis reforms of financial regulation were effective in protecting us from financial instability. Polk presented the context of this debate in relation to the financial crisis of 2007-09. He stressed the functional perspective of financial regulation; that regulators should take into account the functional needs of the end users of the financial institutions. He posited that to create a more regulated, less unstable, but still effective and innovative financial system is a tremendous challenge

The first part of the event invited each of the panel to evaluate the merits and the unintended or even perverse consequences of the new financial regulations. **Charles Goodhart** (FMG, LSE) started with a general comment that the idiosyncratic risk as a generality is decreasing as we achieve a greater control over our environment in areas such as medicine as well as in finance. Meanwhile, systematic risk is increasing; partly because the design of micro-prudential policies tends to increase the self-similarity in society. He also raised the issue of the interconnectedness of our financial systems so that anything that endangers a part is now more likely to endanger the whole. Therefore the need for a systemic risk centre is now greater than ever. Goodhart went on to explain that since it is not possible to foresee everything, there will

be many unintended consequences of financial regulation. He illustrated the danger of such unintended consequences with two examples. Firstly, at the beginning of the financial crisis there was a call for taxpayers to contribute by increasing the national debt. The response to this was to shift the burden put on taxpayers to the banks. However, Goodhart warned that because effectively the burden will be borne by a group of humans connected to the banks, ie, the creditors, shareholders and employees, the attempt to shift the burden means that banks will have much greater difficulties in raising funding. This is also seen in response to the recent talk about bailing out Cypriot banks, where there are already signs of depositors fleeing banks in the fear that they would ultimately be sharing the banks burden.



**Christopher Polk** (Director of the FMG)



**Charles Goodhart** (FMG, LSE)





**Jon Danielsson** (Director of the Systemic Risk Centre)

The second example he gave was in relation to the Vickers' proposal to separate retail banking from investment banking. Goodhart argued that it is in fact likely to make both parts riskier. On the one hand, because of the restrictions imposed on retail banking activities they primarily invest in property related assets. So a separation means retail banks will be much more focused in properties and lose the diversification that the investment banks have. On the other hand, investment banks will also be worse off because they will now be stripped of the relatively stable deposit base. Meaning that they will be subject to much riskier and costlier funding sources.

**Matt King** (Citi) presented his arguments within three themes. Firstly, he was concerned that financial practitioners are subject to the pressure of the market to optimise their operations within clearly defined risk measures. The complexity of the new proposed form of regulation would lead to the banking sector seeking to take risks that are more difficult to identify and quantify. His second theme centred on the concern that it has not been stressed enough the trade-off between stability and growth. He contended that a main consequence might be political disappointment after the pace of growth slows down. He further pointed out that there can be situations in which greater volatility is socially desirable, pointing to the example of the ban of naked CDS short severely impacting market liquidity. Lastly, he emphasised the potential distortion such regulations have on the financial sectors' risk in the long run. The current interference with the bank, such as bailouts and liquidity supports, can create zombie banks that harm the long-term stability of the financial sector.

**Jon Danielsson** (Director of the Systemic Risk Centre) began by criticising the practice that when there was a call for reform, the regulators only continued to do what they used to do, more intensively.

“(The regulators) forgot the first rule of holes – if you are in one, stop digging.”

Danielsson proposed that instead one should investigate the failure of financial regulation prior to 2007. He gave the example that the new Basel III accord is much more detailed and specific than previous versions. However, this will only give the banks more incentive to take hidden risk in more complex and unlit areas. More importantly, Danielsson pointed out the negligence of endogenous risk that arises due to the interaction of the market participants. He claimed that greater macro-prudential robustness should be the new focus. The existing regulatory reform generally requires harmonisation of banking standards, which can induce greater endogenous risk when banks become more similar. Danielsson further examined the potential unforeseen and unintended consequences of the new regulations, such as Vickers' proposal, the Basel III liquidity requirement, the new rules on bonuses and the ban on CDS short selling in Europe. He concluded that the new rules not only can cause the financial system to be riskier, but also create the illusion of safety. This can make everyone in society worse off.

The next session invited the panel to discuss the issues raised during the previous session. Danielsson started by asking the first question of “what if the response to the crisis was to nationalise the bank and let the taxpayers bear the burden and share the potential reward?” In response Goodhart referred to the case of the Scandinavian countries in 1991, he agreed that it is the most effective way of dealing with the financial crisis and applauded the measures taken with RBS. However Danielsson also warned that the moral hazard problem might induce the banks to become more unstable in the future. The panel also discussed the merits of bail in bonds and CoCo bonds. The next question raised by King was whether shooting a few from time to time serves as a discipline to others. As a response Goodhart



**Matt King** (Citi)

initiated a discussion regarding the relative merit of foreclosing the zombie banks as opposed to regulatory forbearance. He cited the Latin America debt crisis as an example of sensible forbearance. He drew the comparison to the reluctance of the regulators to foreclose bank lending today and suggested that to the UK economy this has been far less disruptive economically, socially and morally.

In the final session the floor was opened to the audience generating a lively discussion. Audience member Jonathan Martin asked whether financial crisis was caused by a failure of monetary policy rather than a failure of financial regulation. Malcolm Knight (Deutsche Bank, Swiss Re and LSE) suggested that regulators collecting and publishing data on banks' risk concentration might lead to fair pricing of risk in the market and render the system safer. However Danielsson remained sceptical of the feasibility of obtaining meaningful and timely data. The panel discussed extensively a comment on the idea of international harmonisation in financial regulation.

The support of the Economic and Social Research Council (ESRC) is gratefully received [grant number ES/K002309/1]

This article was written by Jing Zeng. Jing is in the fourth year of her Finance PhD and has been an FMG student since September 2010.



# DOING WELL BY DOING GOOD? PRIVATE EQUITY INVESTING IN EMERGING MARKETS

30 April 2013

On Tuesday 30 April the Department of Finance organised a private equity event entitled “Doing Well by Doing Good? Private Equity Investing in Emerging Markets”. **Ulf Axelsson** the head of the FMG Abraaj Group research initiative introduced the event.

The theme of the event was private equity’s role in the transformation of the world economy. As Western economies battle to restructure their economies and re-launch growth, South-South investment flows meanwhile have been steadily growing over the last decade. Now vast and exciting investment opportunities are opening up in these global growth markets but can it really be true that best in class returns and socially transformational investments can go hand in hand?

**Arif Naqvi** (CEO and founder, Abraaj Group) gave a keynote speech entitled “Global Growth Markets: Transforming our world, our businesses, our communities”. His lecture was followed by a panel discussion led by **Felda Hardyman** (Professor of Management Practice at Harvard Business School and Senior Partner at Bessemer Venture Capital), entitled “Doing well by doing good? Private Equity Investing in Emerging Markets”. The panel featured the following leading practitioners: **Tsega Gebreyes** (Managing Partner, Satya Capital), **Arif Naqvi** (CEO and founder, Abraaj Capital) and **Diana Noble** (CEO, CDC).

Axelsson opened the event by thanking Abraaj Group for funding the FMG’s Abraaj Group research initiative and helping to foster research in this relatively nascent investment area. Private equity started around 30 years ago in developed economies. Relative to a private firm model, private equity solves some of the common problems, eg, succession. Although public companies are great for risk-sharing, problems do exist with management-shareholders agency problem for which private



**Arif Naqvi** (CEO and founder, Abraaj Group)

equity offers a solution. It is not clear whether private equity works in emerging markets since there is not much data. Nonetheless, private equity in emerging markets has grown relatively fast. In 2012 alone it invested around 40 billion USD, however it is not clear what future returns will be had on these investments.

Naqvi started his presentation by describing the private equity industry. Private equity as an industry has gone through three stages. The first stage was about maximizing returns by taking as high a leverage as possible; the second stage was about asset aggregation; and the third, current stage, is about defending the business model, eg, talking a lot about sustainability. Private equity is about long-term thinking and its largest investors are pension funds; sovereign and institutional investors. Private equity has a strong future as an equity investment given that most Western pension funds have unfunded liability, and in search for returns they will invest in private equity given that absolute return is higher than on public markets. Most private equity money goes to Western firms that invest in global growth markets however there is a

need for local presence. Private equity needs to invest in economic opportunities and governance to make the ecosystem sustainable. For example Abraaj Group invested five per cent of its top line back to the communities and all 150 firms in its portfolio are expected to be socially responsible.

Naqvi’s lecture focussed on future economic opportunities around the world. He stressed that emerging markets should be termed “global growth markets” given their current role in the world’s economy, ie, they will define growth in the 21st century. Africa has a buzzer and it is not just a resource story; over the next few decades Africa will have around 350 million middle-class people. Today’s Africa resembles the Middle East ten years ago in which Western private equity funds required high returns on capital (IRR around 60-70 per cent and 3-4 times return on invested capital). Investors talk about slowing growth in China and India but it is impossible to have double-digit growth in such big economies forever. Growth in global growth markets is three times higher than in developed economies, so a lot of growth, due to an axial shift in society and





Panel I-r: **Felda Hardymon** (Harvard Business School and Bessemer Venture Capital), **Tsega Gebreyes** (Satya Capital), **Diana Noble** (CEO, CDC) and **Arif Naqvi** (CEO and founder, Abraaj Capital)

growth opportunities, does come from outside China and India. Today, Africa's growth rate is higher than East Asia's. The rise of urbanised middle class will shape the world. In 2008 50 per cent of the world's population was urban, and currently the urbanised population is growing by one million per week. Most of these cities are located in global growth markets. In Africa and Asia a lot of urbanisation creates affluent communities but at the same time it creates a disconnection in society. Cities achieve economies of scale that are not easy to apply in rural areas and this is one reason why cities are the centre of economic life. Typically, capital cities have growth rates around two times higher than their country growth. In the next 30 years there will be around three billion new middle class people and more than 65 per cent of them will be from global growth markets. This shift will reshape the consumer demand – more than 80 per cent of middle class demand will come from global growth markets. Global growth economies will be driven by consumption, which will become 70 per cent of GDP, an increase on today's 55 per cent. Latin America however is different since consumption is already high. Median age in global growth markets is 26 and in Nigeria it is even lower. As there are fewer old people in global growth markets there are fewer to take care of and the pension system is easier to fund. Spending usually peaks at around 40; the

median age in developed markets is around 40, and so the peak has already been reached.

However, to achieve this growth potential, reforms are necessary. The infrastructure needs in global growth economies are enormous, for example just a third of Mexico's roads are paved. Today the global infrastructure market is around 2 trillion USD and South-South infrastructure trade is bigger than North-South. Today there is a big problem in some developed markets such as in Spain where the unemployment rate among young educated people is higher than 50 per cent with no economic opportunities. These problems also exist in some global growth markets such as Pakistan where entrenched political parties can impede growth.

Naqvi's speech was followed by a panel discussion that posed the following questions: how does Private Equity assess opportunities? Can you make money? Is the process of selection the same regardless of the government and its accountability? Are returns the only goal or is doing well also important?

Diana Noble's view on the future is that in the next 10 years there will be a hiatus in Europe and the US due to the financial crisis and global growth markets will provide good returns. This is one reason why CDC fund focuses only on South Africa and Asia. The fund cares about job creation and capital going to harder places

(places where two thirds of the population don't have a permanent job). CDC determines a "hard place for capital" by dividing geography of their investments into four categories according to ease of access to capital; the returns in those regions where capital is hard to flow are the highest. Noble acknowledged that from time to time in order to optimise operations and make the business viable, tough business decisions have to be made.

Tsega Gebreyes followed by explaining how Satya Capital does business on the ground. Satya Capital puts the capital and knowledge to work together with the entrepreneur and then works with other shareholders and management. Usually, Satya is not the only shareholder and very often it doesn't have a majority in the company, therefore working together with other shareholders and management teams is of crucial importance. As an example, Gebreyes described their successful investment in a healthcare business in Nigeria that had only 2 hospitals and struggled to generate 1.2 million USD cash flow. Satya Capital helped recruit talent and implement best business practices. She noted that often family run businesses are very reluctant to change their business practices and when there is no majority in shareholdings it is absolutely necessary to communicate with the family as to how the company can benefit from new business practices.

Naqvi then explained how Abraaj Capital investment in a Karachi power plant turned an unprofitable power generating business into a business that is admired by the whole society. He noted that it is very important to selectively invest, eg, healthcare in Turkey is a good business sector to invest in, because the Turkish government doesn't invest in healthcare therefore private healthcare services will grow.

The event concluded with questions from the audience and closing remarks from Felda Hardymon.

Article written by Milan Martinovic. Milan is a third year PhD student in the Department of Finance, he is also a researcher for the FMG Abraaj Group research initiative.

# THE BANKER'S NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT

10 April 2013

Professor **Anat Admati** (Stanford Graduate School of Business) gave a public lecture based on her new book *"The Bankers' New Clothes: What's Wrong with Banking and What to Do About It"* (published by Princeton University Press), co-authored with Martin Hellwig.

Admati started by describing what is wrong with today's banking system. The banking system is too fragile and can impose significant costs on the economy and taxpayers. Many risks in banking and their associated costs are controllable to some extent and therefore unnecessary. In addition, the system is plagued by distortions and inefficiencies, partly emanating from severe governance problems. Finally, the banking system is not regulated effectively. As a consequence of these various shortcomings, the system does not appropriately serve the economy.

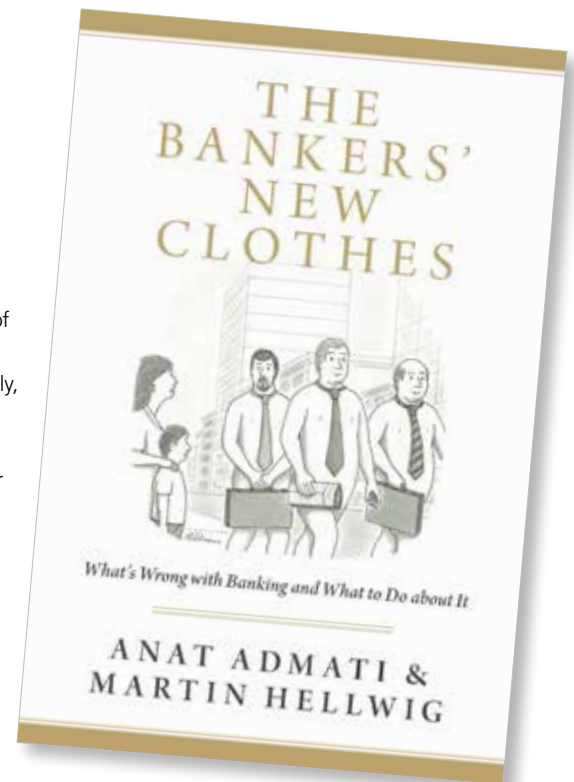
The banking system is fragile mainly because it relies excessively on debt funding, especially short-term debt which makes it vulnerable to runs and liquidity problems. The interconnectedness of the system generates contagion through fire sales and information channels. Also, the system is opaque and plagued by hidden risks and regulatory loopholes. Important inefficiencies and distortions include the too big/systemic/many to fail syndrome, as well as inefficient lending and investment that manifest themselves in boom and bust cycles. Governance problems are also at the heart of banking system distortions. The decisions taken by bankers, especially their risk-taking behaviour, have consequences for a series of agents, including shareholders, creditors and society as a whole. While bankers benefit from the upside, taxpayers bear the downside risks of bank distress through bailouts and guarantees.

Current efforts to fix the system, such as improved resolution regimes and the regulation of activities (eg, ring-fencing, Volcker rule) are unsatisfactory. Resolution regimes that allow banks to fail and

prevent bank failures from harming the rest of the economy raise many difficult issues, such as cross-border cooperation. More importantly, when the resolution procedure is triggered, much damage has already been inflicted on the economy. On the other hand, it is unclear how the regulation of activities can address the issues described above. Systemic risk and the too important to fail syndrome are not limited to specific activities. They apply to insurance companies, investment banks, hedge funds and depository institutions alike. In addition, many small banks with focussed activities can fail at the same time and become too many to fail.

Admati and Hellwig therefore propose to impose a ratio of equity to total assets (as opposed to risk-weighted assets) of about 20-30 per cent. This number is rather arbitrary. Existing models rely on flawed assumptions and are therefore inadequate to quantify the optimal target. Ideally, the target should be "where it does not matter anymore". The proposal is meant to prevent rather than cure financial crises. Bankers often argue that banking crises are as unavoidable as if they were natural disasters; Admati however challenges this claim as well as other arguments commonly used by bankers to justify their behaviour. The main argument put forward by bankers against the introduction of higher equity requirements, ie, that a safer banking system would require sacrificing lending and economic growth, is flawed. Equity is different from the reserve assets that banks need to "hold" and that sit idle on the balance sheet. Equity is a source of funding, not an asset. Bankers use confusing narratives to rationalise the lack of reform and to perpetuate the way in which they have done business before the crisis.

Admati argued that we can have a safer banking system without sacrificing any of its benefits and at no cost to society. Banks are excessively indebted not because they have to, but because it is profitable for them and they are able to leverage excessively because of the failures of the existing regulatory and legal environment. In



effect, banks act as if they were homeowners with mortgages worth 97 per cent of the value of their home, with only a three per cent down payment. Such small equity buffers are unprecedented in non-financial corporations. An obvious source of equity funding is retained profits. Thus the most immediate measure would be to prevent dividend payments and share buy-backs.

Admati commented on the current lack of lending despite the extremely loose monetary policy environment. The transmission mechanism is broken for two reasons. Banks do not lend because they are highly distressed (debt overhang problem) and because the regulatory risk weights deter them from lending to businesses. Raising more equity should help alleviate the debt overhang problem and address the issue of gambling for resurrection. Expressing equity requirements as a percentage of total, rather than risk-weighted assets, should help alleviate distortions created by regulation. The issues that lie at the heart of the lack of lending are agency problems between bankers and their creditors. Increasing equity should alleviate these problems.

The emergence of peer-to-peer lending shows that there is a lending gap that banks do not fill. Banks are supposed to make the lending process more efficient (eg, because they have an advantage in collecting information about a



**Anat Admati** (Stanford Graduate School of Business)

large number of borrowers). The fact that these potentially less efficient forms of lending emerge shows that banks are not appropriately fulfilling their role.

When asked about the need for regulating banks' activities, Admati responded that regulating activities is much more difficult and costlier to achieve than regulating the funding mix. The Volcker rule is an example of how difficult the process can get. In addition, the separation of activities is not a guarantee for limiting interconnectedness. Breaking up banks would not in itself provide a solution as the too many to fail syndrome would persist. However, it would allow the regulator to regulate different entities differently, ie, adjust equity requirements to the type of activities that banks perform. Finally, Admati believes that increasing equity requirements should only have a marginal impact on what banks do.

The last point made by Admati was that governance reforms may be needed alongside larger equity buffers in order to limit the risk-

taking behaviour of banks. One argument often used by bankers is that stricter capital regulations will induce banks to take higher risks in order to maintain high Return on Equity (ROE). However, this is a sign that there are serious governance problems in banking. Raising equity buffers may help alleviate these problems since shareholders will bear more of the downside risks. However there will remain a lot of governance problems that need to be addressed, eg, the way that performance is measured based on accounting items that can be manipulated and short-termism resulting from high reporting frequency.

This article was written by Isabelle Roland. Isabelle is a third year PhD candidate in Economics and a research student in the FMG. Isabelle was recently awarded a Paul Woolley Centre scholarship for 2013-14.

## ATHANASIOS ORPHANIDES LONDON FINANCIAL REGULATION SEMINAR

15 May 2013



**Athanasios Orphanides** and **David Marsh** (Chairman and co-founder of OMFIF)

At the beginning of May the FMG were pleased to host Dr Athanasios Orphanides, who delivered a special London Financial Regulation seminar entitled "The politics of the euro area crisis and Cyprus". Orphanides was Governor of the Central Bank of Cyprus from 2007-12 and, following Cyprus' entry into the euro-zone in 2008, was a member of the European Central Bank's Governing Council. He oversaw Cyprus' adoption of the new currency.

During the seminar, Orphanides identified what he saw as the weaknesses of the euro regime; the vulnerabilities of the Cyprus economy; and, the failings of domestic adjustment in the face of the looming crisis. The seminar was chaired by David Marsh (Chairman and co-founder of OMFIF).

You can view Orphanides' presentation slides on the FMG website: [lse.ac.uk/fmg/home.aspx](http://lse.ac.uk/fmg/home.aspx)

This special London Financial Regulation seminar was organised with the support of the Official Monetary and Financial Institutions Forum (OMFIF) and LSE's Hellenic Observatory.





# CYPRUS AND ITS IMPLICATIONS

22 April 2013

The financial crisis, and bail-out, that has recently afflicted Cyprus has represented a tragedy for Cyprus and complications for the rest of the Eurozone. On the evening of 22nd April 2013, a panel of speakers gathered at LSE to discuss the Cypriot financial crisis and its consequences.

The first panellist, **Kate Phylaktis** (Cass Business School), started by describing the background to the financial turmoil in Cyprus. After the Turkish invasion in 1974, the Cypriot government decided to change the structure of the economy from agriculture to international business service. Thanks to its English speaking population and low level of corruption, Cyprus attracted a vast amount of deposits from Russia and Eastern Europe and the financial sector expanded to eight times the size of the Gross Domestic Product of the country. Compared to other Eurozone countries with large financial sectors such as Luxembourg and Ireland, Cyprus had big (relative to GDP) concentrated domestic banking sector and domestic loans, and deposits were significant business for these banks. While the domestic business was profitable and the banks had no investment in structured financial products and derivatives, the Cypriot banks had a disproportionately large exposure to both Greek sovereign bonds and business loans. According to a report from Standard and Poor's; loans to Greece amounted to €22 billion or 168 per cent of GDP. The worsening economic condition in Greece has resulted in significant losses in the banking sector which has proved to be too big for the Cypriot government to deal with alone.

**George Lemos** (Capital Finance Strategy Ltd) followed and discussed the process of the bailout negotiation. In July 2011, following the start of discussions about Private Sector Involvement in Greek sovereign debt, investors started to feel concerned about the Cypriot banks' exposure to Greece. The Cypriot government first obtained a €2.5 billion loan from Russia in early 2012 and eventually requested a bailout from Troika (European Commission, European Central Bank, and International Monetary Fund) in June 2012. In March 2013, after months of negotiation, the final package was approved consisting of: a €10 billion loan from Troika; the dissolution of the second biggest Cypriot bank, Laïke, whose good assets and insured deposit are to be absorbed by the Bank of Cyprus; and a yet-to-be-determined "bail-in" penalty on the unsecured creditors. Lemos concluded with a critique on the opaqueness of the estimation of the key figures in the package, like the size of the bailout and the penalty on the unsecured creditors.

**Charles Goodhart** (FMG, LSE) was the last speaker of the evening and he discussed the implication of the Cypriot bailout to the rest of Europe. He first emphasised that policy makers should aim to break the vicious cycle between banking sector and sovereign risk, in order to prevent the on-going financial distress in Europe

from spiralling out of control. To achieve this, a Europe-wide banking union is needed along with deposit insurance, resolution mechanism and a recapitalisation mechanism like the European Stability Mechanism. The Cypriot case, nonetheless, was a shift away from euro-wide financing mechanisms towards bail-in from individual banks' uninsured depositors. Goodhart argued that while this may reduce the moral hazard problem and the involvement of tax-payers' money, it created risk of contagion in terms of capital flight from the troubled members and further divergence of Eurozone member countries, putting the common currency at a greater risk. He concluded with an observation that a single supervisory mechanism in Europe would have been particularly useful in the Cyprus crisis, as the Euro-wide supervisor would have been able to detect the large Greek exposure of Cypriot banks and assess the risk imposed on them when haircuts were applied to Greek bonds.

This article was written by John (Chi Fong) Kuong. John is a fourth year PhD candidate in Finance and a research student in the FMG. His main research interests are financial regulation, asset pricing with market imperfection, contract theory and corporate finance.



## 4NATIONS CUP

We are very pleased to announce that FMG member and visiting Professor in Finance, **Stavros Panageas**, was part of the winning team at this year's 4nations cup competition. The 4nations sees the most promising young scholars in financial economics battle it out in a day of mini-seminars. The aim of the game is to demonstrate your intellectual prowess and convince the audience to vote for you and your nation. Stavros and team mate **Samuli Knupfer** (LBS), continued the UK's reign as undefeated champions.



Stavros Panageas (left)

## THE PAUL WOOLLEY CENTRE FOR THE STUDY OF CAPITAL MARKET DYSFUNCTIONALITY SCHOLARSHIPS PROGRAMME 2013-14

The Paul Woolley Centre for the Study of Capital Market Dysfunctionality, established within the FMG, invited applications from LSE economics and finance PhD students for the 2013-14 Paul Woolley Centre Scholarship programme. The programme aims to financially support students pursuing postgraduate research in the areas covered by the Paul Woolley Centre research agenda:

- Contracts and organisational structure
- Market frictions and asset prices
- Allocative efficiency and the macro-economy
- Policy implications.

The scholarships were awarded by a committee consisting of Christopher Polk (Director of the FMG), Dimitri Vayanos (Director of the Paul Woolley Centre) and Paul Woolley (Founder of the Paul Woolley Centre). The Scholars are based within the Paul Woolley Centre and the FMG where they can work closely with its staff and faculty.

For the 2013-14 academic year scholarships were awarded to **Alex Clymo**, **Isabelle Roland** and **Shiyang Huang**.



Alex Clymo

Alex is a fourth year PhD student in the Department of Economics. Before commencing his PhD, Alex received a BA in Economics from Cambridge University (St John's College) and a Masters in Economics from LSE. His research interests include macroeconomic and financial modelling with sunspots, business cycles and monetary economics.

Isabelle is a third year PhD student in the Department of Economics. Her research focuses on current developments and vulnerabilities in the banking sector and their impact on the real economy. In particular, she is currently working on the topics of asset encumbrance and



Isabelle Roland

zombie lending in the UK. Her broader research interests are in finance, especially banking and corporate finance and macroeconomics. Prior to her PhD she received a BSc in Economics from the University of Leuven in Belgium, an MSc in Economics and an MRes in Economics from LSE.

Shiyang was awarded a scholarship in 2012-13, due to his progress and the level of work that he's demonstrated it has been decided to renew his scholarship for an additional year.

The Paul Woolley Centre for the Study of  
**Capital Market Dysfunctionality**



Shiyang Huang



## DEUTSCHE BANK DOCTORAL FELLOWSHIP 2013-15

The Deutsche Bank Doctoral Fellowship Programme was established with the generous support of Deutsche Bank.

These two year fellowships are awarded to first-rate students on an annual basis and aim to support students as they pursue their doctoral studies at LSE in affiliation with the FMG. As a Deutsche Bank fellow students are awarded £18,000 per year for up to a maximum of two years. The award is intended to cover tuition fees along with the research and living expenses incurred by the recipient as part of their full-time research at LSE.

Awardees must demonstrate an outstanding aptitude for financial research and have the intention of pursuing doctoral research in the following areas:

- Financial risk measurement
- Risk management
- Financial regulation.

The Deutsche Bank doctoral fellowship for 2013-15 was awarded to **Hoyong Choi**.

Hoyong Choi is a second year PhD student in the Department of Finance and has been a member of the FMG since 2012. Prior to joining LSE, he worked at Korea Investment & Securities after graduating from Yonsei University. Hoyong's research interests include asset pricing, fixed income and financial econometrics. In his paper "Information in (and not in) Treasury options", he examines term premia in the US Treasury markets using a novel approach that incorporates information in Treasury options into affine dynamic term structure models.



Hoyong Choi

## FMG LEAVERS 2013

It is with a heavy heart that the FMG must say goodbye to a large number of our students who are leaving the FMG and LSE this summer following the successful completion of their PhDs. They have all been sterling examples of FMG research students and will be missed greatly. We wish them all the best and every success for their future.

Before they sneak off *Review* caught up with them to talk about their time in the FMG and their future plans.



**Toni Ahnert**

*What is your new role?*

I am joining the Financial Studies Division at the Bank of Canada. It's a research economist position with about three quarters of my time for research and the remainder for policy work.

*What do you think will be the biggest challenge?*  
Canadian winters!

*What will you miss about LSE/FMG?*

The friendly atmosphere, all of my nice colleagues and the FMG Christmas party.

*Give one tip for those coming to the job market next year*

Cast your net widely.



**Michael Boehm**

*What is your new role?*

I will be an assistant professor at the University of Bonn. The role involves research and teaching.

*What are you looking forward to the most about your new role?*

The colleagues there are really nice and it is a good research environment.

*What do you think will be the biggest challenge?*

Finding a good balance between teaching and research and being away from my partner who needs to stay in London for her job.

*What will you miss about LSE/FMG?*

The great people. I had a fun time and made really good friends.

*Give one tip for those coming to the job market next year*

Do as well as you can in the interviews (that's where I messed up).



**Nathan Converse**

**What is your new role?**

Starting in September 2013, I will be working as an economist in the Global Financial Flows section of the Division of International Finance at the Federal Reserve Board in

Washington DC. In addition to continuing my own research into the impact of financial uncertainty on firms' investment decisions, I will monitor and analyse capital flows in and out of the US.

**What are you looking forward to the most about your new role?**

I am very much looking forward to being more engaged with current economic events and to being involved in policy discussions. Not only is this very exciting, but I anticipate that the policy work I will be doing will be a fertile source of research ideas.

**What do you think will be the biggest challenge?**

Although the community of finance and economics researchers at the LSE is large by the standards of most universities, it is nonetheless intimidating to be joining an institution with more than 300 extremely talented economists on staff.

**What will you miss about LSE/FMG?**

I will miss teaching a lot. Teaching both undergraduates and masters students at LSE has been very rewarding.

**Give one tip for those coming to the job market next year**

Starting as soon as possible, practice talking about your research in an engaging way. In addition to a well-polished job market talk, you should have well-crafted one, three, five and 15-minute pitches. These should quickly let the person you are talking to know why your research is both interesting and important. Getting people interested in your research can make the difference between being a merely good candidate to being a stand-out who quickly gets invited for a flyout.



**Nelson Camanho da Costa-Neto**

**What is your new role?**

I will be an assistant professor of finance at Católica-Lisbon School of Finance & Economics. The role will involve producing research, teaching

undergraduate and graduate students and probably tutoring as well.

**What are you looking forward to the most about your new role?**

During my interviews at Católica it was clear to me that the faculty and environment are very friendly and cooperative. They have a very good infra-structure and ambitious plans for the near future. I am looking forward to joining such a wonderful group and hope to be able to meet their expectations in me. Besides that, Lisbon is such a nice place and I am counting down the days until I move there.

**What do you think will be the biggest challenge?**

Producing consistently high quality research in finance.

**What will you miss about LSE/FMG?**

I will miss the friendly chats with my colleagues and staff. I will miss the office that was somehow "home" to me over the last 4 years. I will miss the excellent supervision of Dimitri, Christopher and Daniel and of course I will also miss the excellent research environment.

**Give one tip for those coming to the job market next year**

Don't overthink it! Improving your job market paper is your best strategy for getting a good placement. It is also important to have a very polished version of the paper by the end of August.



**Luca Fornaro**

**What is your new role?**

I will be a researcher at CREI and an adjunct professor at the Universitat Pompeu Fabra, in Barcelona.

**What are you looking**

**forward to the most about your new role?**

I am looking forward to being part of a top research institution in international economics and being surrounded by an exciting intellectual environment.

**What do you think will be the biggest challenge?**

My biggest challenge will be improving the quality of my research so as to publish it in top journals.

**What will you miss about LSE/FMG?**

I will miss the vibrant intellectual atmosphere, as well as the sense of community and cooperation that characterises the FMG.

**Give one tip for those coming to the job market next year**

Be proud of your work and enjoy the process!





### Giorgia Piacentino

#### What is your new role?

I will be an assistant professor at Olin Business School at Washington University. My job will involve doing research and teaching Corporate Finance to Undergraduate

and MBA students. Basically, being an assistant professor is the same as being a PhD student but with more money and more responsibilities!

#### What are you looking forward to the most about your new role?

I am looking forward to my new title, it sounds fancy! Actually, I look forward to interacting with the great faculty at Washington University, especially since they are particularly strong in intermediation theory, a main focus of my own work.

#### What do you think will be the biggest challenge?

Adapting to American life! I have never lived in the US, but I have gathered that it is quite different from Europe. I am a bit scared, but at the same time I am looking forward to it. I feel optimistic about the other challenges that I am sure I will encounter along the way.

#### What will you miss about LSE/FMG?

I will miss my friends and co-authors as well as the intellectual environment. I had a lovely time in my three years in the FMG and in my four years at LSE, building very strong friendships and co-authorships. I will also miss Paul Woolley coming out of his office and commenting on a book that I bought or on a conference!

#### Give one tip for those coming to the job market next year

Practice – and, as far as possible, don't stress out! It's a lot of fun once you get the hang of it. After one pretty bad seminar I gave, I decided to relax and have fun, and it worked. In the end the job market is a way to talk to super smart and interested people about what you (and they) enjoy doing the most!



### Christoph Ungerer

#### What is your new role?

I am now working for the Troika economic adjustment programme in Greece. In discussions with the government, our team is assessing the macroeconomic, fiscal and

financial situation in Greece as well as progress on the government's structural reform agenda.

#### What are you looking forward to the most about your new role?

My new role is about hands-on economic policy-making at a historic moment for the Eurozone. The work pressure and responsibility can be heavy, but this also binds the team together very closely.

#### What do you think will be the biggest challenge?

The job involves frequent travel between Brussels and Athens as well as long hours. Sometimes it can feel like you end up living between cities.

#### What will you miss about LSE/FMG?

The FMG makes for a unique collegial environment at the intersection between work in Finance and Economics at the LSE. The positive attitude of staff and students makes you start every day with a smile. I learned a great deal from the many conversations that were kicked off at the FMG water cooler. In the end, my time at the FMG was a crucial period for my thesis.

#### Give one tip for those coming to the job market next year

Define your goals early and tailor your profile appropriately.



### Marcella Valenzuela

#### What is your new role?

I will be an assistant professor at Universidad de Chile.

#### What are you looking forward to the most about your new role?

Research and teaching in equal measures.

#### What do you think will be the biggest challenge?

This is the beginning of a new chapter in my life which is a big challenge in itself.

#### What will you miss about LSE/FMG?

I will miss all the conversations and idea sharing with my colleagues in the FMG. The people I've met in the FMG have enriched my life.

#### Give one tip for those coming to the job market next year

My advice is to just keep focussed, persevere and work hard.



### Ilknur Zer

#### What is your new role?

I will be an Economist at the Board of Governors of the Federal Reserve System.

#### What are you looking forward to the most about your new role?

Finally not being a student anymore! I can continue on research, and even real time applicable research. Hence I am excited and looking forward to a new start.

#### What will you miss about LSE/FMG?

The amazing community and research friendly environment. If you're stuck on anything you can always find another student who knows the solution and is ready to help.

#### Give one tip for those coming to the job market next year

Try to stay calm and believe in yourself and your research!



# FMG EVENTS

Events that have taken place since the publication of the previous Review in March 2013 (Winter issue)

## Conferences

### **The second annual 4nations cup**

3 May 2013

### **The sixth annual Paul Woolley Centre conference**

6-7 June 2013

### **Economic Networks and Banking conference**

5 July 2013

## Public Lectures

### **Unintended consequences of the new financial regulations**

11 March 2013

Chair: Christopher Polk (Director of the FMG, LSE)

Speakers: Jon Danielsson (Director of the Systemic Risk Centre /FMG, LSE), Charles Goodhart (FMG, LSE) and Matt King (Citi)

### **The bankers' new clothes: what's wrong with banking and what to do about it**

8 May 2013

Chair: Charles Goodhart (FMG, LSE)

Speaker: Anat Admati (Stanford Graduate School of Business)

### **Doing well by doing good? Private equity investing in emerging markets**

30 April 2013

Chair: Felda Hardyman (Harvard Business School)

Speaker: Arif Naqvi (The Abraaj Group)

Panellists: Tsaga Gebreyes (Satya Capital) and Diana Noble (CDC)

## Capital Markets Workshops

### **Parameter learning in general equilibrium: the asset pricing implications**

20 March 2013

Lars Lochstoer (Columbia University)

### **Information percolation in segmented markets**

1 May 2013

Darrell Duffie (Stanford)

### **The role of investibility restrictions on size, value and momentum stock returns around the world**

8 May 2013

Andrew Karolyi (Cornell)

### **Firm volatility in granular networks**

15 May 2013

Stijn Van Nieuwerburgh (Stern School of Business, NYU)

### **Resident networks and firm trade**

22 May 2013

Chris Malloy (Harvard Business School)

### **X-CAPM: an extrapolative capital asset pricing model**

29 May 2013

Nick Barberis (Yale)

### **Dynamic portfolio choice with frictions**

5 June 2013

Nicolae Garleanu (Berkeley)

### **Estimating the benefits of contractual completeness**

12 June 2013

Gregor Matvos (Chicago Booth)

### **The term structure of currency risk premia**

26 June 2013

Hanno Lustig (UCLA)

### **Debt maturity and the liquidity of secondary debt markets**

3 July 2013

Max Bruche (Cass Business School)

## Lunchtime Workshops

### **The scale of predictability**

13 March 2013

Andrea Tamoni (FMG, LSE)

### **Hedging in fixed income markets**

20 March 2013

Philippe Mueller (FMG, LSE)

### **Shadow banking and bank capital regulation**

1 May 2013

Guillaume Plantin (LSE)

### **Asset management contracts and equilibrium prices**

8 May 2013

Dimitri Vayanos (FMG, LSE)

### **Financing constraints and a firm's decision and ability to innovate**

15 May 2013

Vassilis Hajivassiliou (LSE)

### **Unfriendly creditors**

22 May 2013

Daniel Ferreira (FMG, LSE)

### **Offsetting disagreement and security prices**

29 May 2013

Dong Lou (FMG, LSE)

### **Intermediary leverage cycles and financial stability**

5 June 2013

Nina Boyarchenko (Federal Reserve Bank of New York)

### **Financial entanglement: a theory of incomplete integration, leverage, crashes, and contagion**

12 June 2013

Stavros Panageas (FMG, LSE)

### **CEO salary dynamics**

26 June 2013

Moqi Xu (FMG, LSE)

## London Financial Regulation Seminars

### Cyprus and its implications

22 April 2013

Kate Phylaktis (Cass Business School), George Lemos (Capital Finance Strategy Ltd) and Charles Goodhart (FMG, LSE)

### Financial liberalisation and capital adequacy of models in financial crises

29 April 2013

Ray Barrell (Brunel University)

### Do we need regulation of bank capital? Some evidence from the UK

17 June 2013

Geoffrey Wood and Forrest Capie (both Cass Business School)

## PhD Seminars

All seminars are given by current LSE PhD students

### A micro-foundation for information sharing in financial markets

21 March 2013

Ji Shen (Department of Finance/FMG)

### Volatility, risk premia and predictability

2 May 2013

Huaizhi Chen (Department of Finance/FMG)

### Spurious factors in linear asset pricing models

9 May 2013

Svetlana Bryzgalova (Department of Economics/ FMG)

### Self-fulfilling models

16 May 2013

Sergei Glebkin (Department of Finance/FMG)

### Information in (and not in) Treasury options

23 May 2013

Hoyong Choi (Department of Finance/FMG)

### Information liquidity and information acquisition complementary

30 May 2013

Shiyang Huang (Department of Finance/FMG)

### An empirical study of contractual compensation

6 June 2013

Yiqing Lu (Department of Finance/FMG)

### The effect of FTSE 100 turnover

13 June 2013

Christian von Drathen (Department of Finance/FMG)

### Collateralised short-term debt and self-fulfilling crisis

20 June 2013

John Kuong (Department of Finance/FMG)

### Procyclical promises instigate instability

27 June 2013

Jason Donaldson (Department of Finance/FMG)

## Corporate Governance at LSE: Brownbag Seminars

### Making it to the top: from female labor force participation to boardroom gender diversity

13 May 2013

Tom Kirchmaier (FMG, LSE)

## Paul Woolley Centre Brownbag Seminars

### Liquidity trap and excessive leverage

7 May 2013

Alp Simsek (MIT)

### Dynamic equilibrium under market segmentation

21 May 2013

Georgy Chabakauri (FMG, LSE)

### Dynamic risk sharing and asset prices

4 June 2013

Dimitri Vayanos (FMG, LSE)

### High frequency trading

11 June 2013

Andrei Kirilenko (MIT Sloan)



# DISCUSSION PAPERS

Discussion papers are authored primarily by FMG staff, associates and research students, and provide specialist insights into cutting edge financial markets research currently being carried out at the FMG.

Research undertaken under the core FMG Research Programmes is published in the FMG Discussion Paper (DP) series. The Paul Woolley Centre for Capital Market Dysfunctionality (PWC) and the AXA-funded Risk Management Programme (AXA) also publish some of their research as FMG Discussion Papers.

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DP 715

## From female labor force participation to boardroom gender diversity

Renée B Adams and Tom Kirchmaier

The list of barriers to female representation in management is analogous to the list of barriers to female labor force participation. Accordingly, we examine whether low female labor force participation is the main reason few women hold seats on corporate boards using data from 22 countries over the 2001-10 period. Using a novel country-level measure of female participation on corporate boards, we show first that the representation of women on boards across countries is actually worse than most surveys suggest. We then examine the extent to which female labor force participation and institutional and country-level characteristics are related to boardroom diversity. We find that labor force participation is significantly related to the representation of women on boards when part-time and unemployed workers are excluded. However, cultural norms, the presence of boardroom quotas and codes promoting gender diversity are also correlated with female representation. This suggests that economic and cultural factors may be important barriers to female career advancement, but that preferences may be less important. While quotas may overcome problems of discrimination, they may be too narrow a policy tool to address other causes of female underrepresentation in management.

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DP 716

## International correlation risk

Philippe Mueller, Andreas Stathopoulos and Andrea Vedolin

We provide novel evidence of priced correlation risk in the foreign exchange market. Currencies that perform badly (well) during periods of high

exchange rate correlation have high (low) average returns. We also show that high (low) interest rate currencies have high (low) correlation risk exposure, providing a risk-based justification for the carry trade. To address our empirical findings, we consider a general equilibrium model that incorporates preferences characterized by external habit formation and home bias. In our model, currencies which depreciate when conditional exchange rate correlation is high command high risk premia due to their adverse exposure to global risk aversion shocks.

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DP 717

## Investors' horizons and the amplification of market shocks

Cristina Cella, Andrew Ellul and Mariassunta Giannetti

This paper shows that during episodes of market turmoil 13F institutional investors with short trading horizons sell their stockholdings to a larger extent than 13F institutional investors with longer trading horizons. This creates price pressure for stocks mostly held by short horizon investors, which, as a consequence, experience larger price drops, and subsequent reversals, than stocks mostly held by long horizon investors. These findings, obtained after controlling for the withdrawals experienced by the investors, are not driven by other institutional investors' and firms' characteristics. Overall, the evidence indicates that investors with short horizons amplify the effects of market-wide negative shocks by demanding liquidity at times when other potential buyers' capital is scarce.

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DP 718 and PWC Paper 33

## Cross-market timing in security issuance

Pengjie Gao and Dong Lou

The conventional view of market timing suggests an unambiguous, negative relation between equity misvaluation and the equity share in new issues



that is, firms with overvalued equity issue more equity and, all else equal, less debt. We question this conventional view in the paper. Using price pressure resulting from mutual funds' flow-induced trading to identify equity misvaluation, we first show that equity and debt prices are affected by the same shocks, but to different degrees. Next, we document substantial cross-sectional variation in the sensitivity of issuance decisions to equity misvaluation. In particular, firms with sufficient internal resources increase equity issues and yet decrease debt issues in our measure of equity misvaluation; in contrast, firms that are heavily dependent on external finance increase both equity and debt issues, to take advantage of the misvaluation in both. In sum, this paper provides evidence that equity and debt can be jointly (mis) priced, and more important, examines the resulting impact on firms' issuance decisions.

#### DP 719 and PWC Paper 34

### Industry window dressing

Huaizhi Chen, Lauren Cohen and Dong Lou

We explore a new mechanism through which investors take correlated shortcuts. Specifically, we exploit a regulatory provision governing firm classification into industries: A firm's industry classification is determined by the segment that has the majority of sales. We find strong evidence that investors overly rely on this primary industry classification. Firms just above the industry classification cutoff have significantly higher betas with respect to, as well as more sector mutual fund holdings and analyst coverage from, that industry, compared to nearly identical firms just below the cutoff. We then show that managers undertake specific actions to exploit investor shortcuts. Firms around the discontinuity point of 50 per cent sales are significantly more likely to have just over 50 per cent of sales from a "favourable" industry. Further, these firms just over the cutoff have significantly lower profit margins and inventory growth compared to other firms in the same industries, consistent with these firms slashing prices to increase sales. These same firms, however, do not exhibit different behaviours in any other aspect of their business (eg, CapEx or R&D),

suggesting that it is not a firm-wide shift of focus. Last, firms garner tangible benefits from switching into favourable industries, such as engaging in significantly more SEOs and stock-financed M&As.

#### DP 720 and PWC Paper 35

### Does herding behaviour reveal skill? An analysis of mutual fund performance

Hao Jiang and Michela Verardo

This paper finds that fund herding, defined as the tendency of a mutual fund to follow past aggregate institutional trades, is an important predictor of mutual fund performance. Examining actively managed US equity mutual funds over the period 1990-2009, we find that funds with a higher herding tendency achieve lower future returns. The performance gap between herding and antiherding funds is persistent over various horizons and is more pronounced in periods of greater investment opportunities in the active management industry. We show that fund herding is negatively correlated with recently developed measures of mutual fund skill and provides distinct information for the predictability of mutual fund performance. Overall, our results suggest that fund herding reveals information about the cross-sectional distribution of skill in the mutual fund industry.

#### DP 721 and PWC Paper 36

### Inferring arbitrage activity from return correlations

Dong Lou and Christopher Polk

We propose a novel measure of arbitrage activity to examine whether arbitrageurs can have a destabilizing effect in the stock market. We apply our insight to stock price momentum, a classic example of an unanchored strategy that exhibits positive feedback since arbitrageurs buy stocks when prices rise and sell when prices fall. We define our measure, which we dub comomentum, as the high-frequency abnormal

return correlation among stocks on which a typical momentum strategy would speculate. We show that during periods of low comomentum, momentum strategies are profitable and stabilizing, reflecting an under reaction phenomenon that arbitrageurs correct. In contrast, during periods of high comomentum, these strategies tend to crash and revert, reflecting prior overreaction resulting from crowded momentum trading pushing prices away from fundamentals. Theory suggests that we should not find destabilizing arbitrage activity in anchored strategies. Indeed, we find that a corresponding measure of arbitrage activity for the value strategy, covalue, positively forecasts future value strategy returns, and is positively correlated with the value spread, a natural anchor for the value-minus-growth trade. Additional tests at the firm, fund, and international level confirm that our approach to measuring arbitrage activity in the momentum strategy is sensible.

#### DP 722 and PWC Paper 37

### Mortgage hedging in fixed income markets

Aytek Malkhozov, Philippe Mueller, Andrea Vedolin and Gyuri Venter

We study the feedback from hedging mortgage portfolios on the level and volatility of interest rates. We incorporate the supply shocks resulting from hedging into an otherwise standard dynamic term structure model, and derive two sets of predictions which are strongly supported by the data: First, the duration of mortgage-backed securities (MBS) positively predicts excess bond returns, especially for longer maturities. Second, MBS convexity increases yield and swaption implied volatilities, and this effect has a hump-shaped term structure. Empirically, neither duration, nor convexity are spanned by yield factors. A calibrated version of our model replicates salient features of first and second moments of bond yields.

You can download all FMG Discussion Papers for free from: [lse.ac.uk/fmg/workingPapers/home.aspx](http://lse.ac.uk/fmg/workingPapers/home.aspx)

# SPECIAL PAPERS

Special Papers investigate broader ideas in the financial markets than the Discussion Papers. They often follow conferences at which debates have stimulated further research and cooperation between participants and the wider academic and professional financial community.

SP 213

## Banking union: what will it mean for Europe?

Thomas F Huertas

Banking union will change the face of Europe. It will significantly deepen integration in what is arguably the key sector of the economy. For the Member States that join the banking union, this will mean signing up for “more Europe”. This will raise not only technical questions as to how banking union will actually work, but also political questions. These relate to how that deeper Europe should be governed and how the banking union will fit within the EU as a whole. This paper outlines what has to be done in order to make banking union a change for the better, one that will in fact break the link between banks and sovereigns so that neither the euro nor the EU is at risk from banks and banks are not at risk from sovereigns.

SP 214

## A Coasean approach to bank resolution policy in the Eurozone

Gregory Connor and Brian O’Kelly

The Eurozone needs a bank resolution regime that can work across seventeen independent nations of diverse sizes with varying levels of financial development, limited fiscal co-responsibility, and with systemic instability induced by quick and low-cost deposit transfers across borders. We advocate a Coasean approach to bank resolution policy in the Eurozone, which emphasises clear and consistent contracts and makes explicit the public ownership of the externality costs of bank distress. A variety of resolution mechanisms are compared including bank debt holder bail-in, prompt corrective action, and contingent convertible bonds. We argue that the “dilute-in” of bank debt holders via contingent convertibility provides a clearer and simpler Coasean bargain for the Eurozone than the more conventional alternatives of debt holder bail-in or prompt corrective action.

SP 215

## Bank capital standards: a critical review

Rainer Masera

As a consequence of the 1929 Stock Market Crash and the subsequent Great Depression, the pendulum of financial regulation swung towards heavier and broader regulation, notably with: (i) greater emphasis on bank safety and protection of depositors and (ii) forced separation of the various functions and segments of the industry.

SP 216

## Maintaining confidence – understanding and preventing a major financial institution failure mode

David Murphy

This paper proposes the solvency/liquidity spiral as a failure mode affecting large financial institutions in the recent crisis. The essential features of this mode are that a combination of funding liquidity risk and investor doubts over the solvency of an institution can lead to its failure. We analyse the failures of Lehman Brothers and RBS in detail, and find considerable support for the spiral model of distress. Our model suggests that a key determinant of the financial stability of many large banks is the confidence of the funding markets. This has consequences for the design of financial regulation, suggesting that capital requirements, liquidity rules, and disclosure should be explicitly constructed so as not just to mitigate solvency risk and liquidity risk, but also to be seen to do so even in stressed conditions.

SP 217

## What should we do about (Macro) Pru? Macro prudential policy and credit

Ray Barrell and Dilruba Karim

Credit growth is widely used as an indicator of potential financial stress, and it plays a role in the new Basel III framework. However, it is not clear how good an indicator it is in markets that have been financially liberalised. We take a sample of 14 OECD countries and 14 Latin American and East Asian countries and investigate early warning systems for crises in the post Bretton Woods period. We show

that there is a limited role for credit in an early warning system, and hence little reason for the Basel III structure. We argue that the choice of model for predicting crises depends upon both statistical criteria and on the use to which the model is to be put.

SP 218

## **“Theory anchors” explain the 1920s NYSE Bubble**

Ali Kabiri

The NYSE boom of the 1920s ended with the infamous crash of October 1929 and subsequent collapse in common stock prices from 1929-32. Most approaches have suggested an overvaluation of 100 per cent, usually dating from mid-1927 to September 1929. Excessive speculation based on high real earnings growth rates from 1921-28, amid a euphoric “new age” for the US economy, has been given as the cause. However, the 1920s witnessed the emergence of new ideas emanating from new research on the long-term returns to common stocks (Smith, 1924). The research identified a large premium on common stocks held over the long term compared to corporate bonds. This, in turn led to the formation of new investment vehicles that aimed to hold diversified stock portfolios over the long run in order to earn the large equity risk premium. Whilst such an approach was capable of earning substantial excess returns over bonds, new ideas derived from the research led to a change in stock valuations. The paper reconstructs fundamental values of NYSE stocks from long run dividend growth and stock volatility data, and demonstrates why such a change in theoretical values was unjustified. Investors switched to valuing stocks according to a new theory, which ignored the compensation for stock return volatility, which made up the Equity Risk Premium (ERP), on the assumption that “retained earnings” were the source of the observed ERP.

SP 219

## **The potential instruments of monetary policy**

C A E Goodhart

In most standard (Dynamic Stochastic General Equilibrium, DSGE) macro-models, there is a single riskless rate, set by the Central Bank in accord with some reaction function, as developed by John Taylor (1993-99). In this model all agents can lend and borrow at this same rate, because default, and hence credit risk, is assumed away. The one extra degree of freedom that a Central Bank may have in such a model is to play on the public’s expectations of their future policy. In particular, some have argued that, should a lower, zero bound to nominal interest rates be hit in a depression, then the Central Bank should publicly aim to achieve higher future inflation in order to lower real interest rates now.

SP 220

## **The optimal finance structure**

C A E Goodhart

Banking developed rather differently in Anglo-Saxon countries than on the European Continent and in Japan. In Anglo-Saxon countries, notably the UK and the USA, banks started up before the emergence of large scale industry. Such banks were usually small, unlimited liability partnerships in the UK, and financially fragile. An important determinant of successful continuing business was to avoid getting too involved in concentrated lending to (associated) private firms; lending was to be at arms length and diversified. Where, even then, there was a need for large-scale finance, eg, for canals and then railroads, this could and should be provided by, relatively efficient, capital markets, both for bonds and equities. But the entrepreneurs of such large firms and governments, at various levels, did not generally have the necessary information and skills to access financial (and

foreign) markets, so there sprung up another tier of financial intermediaries who used their market skills and information to provide such large entities with access to capital markets. These were the merchant banks (or Accepting Houses) in London, or the broker/dealers (at a somewhat later date, especially after Glass-Steagall) in the USA. Thus in these countries banks were, originally, primarily retail in character, serving the (well-to-do in the) local community, with a separate tier of investment banks acting as keepers of the gateway to efficient capital markets for those large institutions needing access to such markets.

SP 221

## **Safe to fail**

Thomas F Huertas

Banks cannot be made failsafe. But they can be made safe to fail, so that the failure of a bank need not disrupt the economy at large nor pose cost to the taxpayer. In other words, banks can be made resolvable, and “too big to fail” can come to an end. To do so, the authorities, banks and financial market infrastructures (FMIs) need to prepare in advance for what amounts to a pre-pack reorganisation of the bank that the resolution authority can implement over a weekend, if the bank reaches the point of non-viability in private markets/fails to meet threshold conditions. This pre-pack consists of two principal elements: (i) a recapitalisation of the bank through the bail-in of investor instruments and (ii) the provision of liquidity to the bank in resolution. Creating such a pre-pack solution should form the core of the resolution plans that authorities are developing for globally systemically important financial institutions (G-SIFIs). We start by setting out the conditions that must be met for a bank to be resolvable. The paper then outlines that this “safe-to-fail” test can be met under a variety of banking structures under a so-called Single Point of Entry approach where the home country resolution authority acts as what amounts to a manager of a global resolution syndicate.



## SPECIAL PAPERS CONTINUED

How banks are organised matters less than what banks, authorities and financial market infrastructures do to prepare for the possibility that resolution may be required. That agenda for action concludes the paper.

SP 222

### Too big to fail in banking: what does it mean?

George G Kaufman

Interest in TBTF resolutions of insolvent large complex firms has intensified in recent years, particularly in banking. TBTF resolutions protect some in-the-money counterparties of the targeted insolvent firm from losses that would be suffered if the usual bankruptcy resolution regimes used in resolving other firms in the industry were applied. Although special TBTF resolution regimes may reduce the collateral spill-over costs of the failure, the combined direct and indirect costs from such “bailouts” may be large and financed in part or total by taxpayers. Thus, TBTF has become a major public policy issue that has not been resolved in part because of disagreements about definitions and thereby the estimates of the benefits and costs. This paper explores these differences and develops a framework for standardizing the definitions and evaluating the desirability of TBTF resolutions more accurately.

SP 223

### Can regulation, supervision and surveillance save Euroland?

Leif Pagrotsky

The lesson that regulation and supervision of banks and financial markets must improve has now at last become conventional wisdom among politicians in Europe in the wake of the on-going crisis. Much work, and much EU and BIS meeting

time, has been devoted to these issues and much more will be needed. EU capitals will be busy analysing and negotiating for some time yet.

SP 224

### Macro-modelling, default and money

C A E Goodhart, Dimitrios Tsomocos and Martin Shubik

Mainstream macro-models have assumed away financial frictions, in particular default. The minimum addition in order to introduce financial intermediaries, money and liquidity into such models is the possibility of default. This, in turn, requires that institutions and price formation mechanisms become a modelling part of the process, a “playable game”. Financial systems are not static, nor necessarily reverting to an equilibrium, but evolving processes, subject to institutional control mechanisms themselves subject to socio/political development. Process-oriented models of strategic market games can be translated into consistent stochastic models incorporating default and boundary constraints.

SP 225

### U.K. monetary policy: observations on its theory and practice

S G B Henry

In a dramatic change from the euphoria in the early 2000s based on a widespread belief in the “success” of the partial independence of the Bank of England, UK policymakers are now faced with great uncertainties about the future. The Coalition government responded to the financial crisis by changing the responsibilities for banking supervision and regulation and creating new institutions to deal with them. The UK was not alone in such moves and there is increased attention world-wide to greater regulatory powers and state-dependent

provisioning as key to any future financial architecture. However, changes to the conduct of monetary policy are also necessary. Using the UK experience up to 2008 as a case study, we argue that the authorities here placed too much faith in the proposition that inflation-forecast targeting by an independent central bank was all that was needed. Over the previous two decades evidence accumulated that both undermined the belief that the low inflation with stable growth during the so-called “Great Moderation” was due to the new policy regime and that showed systemic risk in the financial sector was rapidly growing. We maintain that these two things were in evidence well before the financial crisis in 2008-09 and the leadership at the BoE was in error not to factor them into their interest rate decisions early on. Had this evidence been taken more seriously and had proactive action been taken based upon it, the effects of the world-wide financial crisis on the UK would very probably have been smaller. This episode highlights both the shortcomings in the DSGE paradigm favoured by the BoE and other central banks for their macroeconomic analysis as well as the very considerable difficulties in practice in creating the sort of open and transparent monetary institutions envisaged in the academic literature.

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## FORTHCOMING PAPERS

### FMG Discussion Papers

#### Rights offerings, trading, and regulation: a global perspective

Massimo Massa, Theo Vermaelen and Moqi Xu

## VISITORS TO THE FMG MARCH 2013 – JULY 2013

**Anat Admati** (Stanford Graduate School of Business)

**Ray Barrell** (Brunel University)

**Ron Bird** (PWC, Sydney)

**Nick Barberis** (Yale)

**Bruno Biais** (Toulouse School of Economics)

**Nina Boyarchenko** (Federal Reserve Bank of New York)

**Max Bruche** (Cass Business School)

**Andrea Buffa** (BU School of Management)

**Forrest Capie** (Cass Business School)

**Max Croce** (Kenan-Flagler Business School)

**Hans Degryse** (KU Leuven and Tilburg University)

**Darrell Duffie** (Stanford)

**Lerby Ergun** (Erasmus University Rotterdam)

**Nicolae Garleanu** (Berkeley)

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