

BANK OF ENGLAND-HEIF 4 CONFERENCE SOURCES OF CONTAGION

25-26 February 2010

Gary Gorton (Yale University) presented one of his many papers on the repo market and its behaviour in the crisis, beginning by emphasising his primary goal, which was to ascertain what actually happened in the repo market during the crisis.

Professor Gorton argued that it is vital to understand why the spread of *non*-subprime-related assets increased dramatically, a phenomenon that involves the relationship between non-subprime bonds and counterparty risk, and by extension the ways in which this occurrence is related to subprime.

Professor Gorton emphasised the role played by collateral in repo transactions; effectively, collateral is 'money', which guarantees performance on the deposit and can be spent (ie, rehypothecated). Just as in previous banking crises in which there was a currency shortage (or 'currency famine'), this crisis also experienced a collateral shortage. The value of collateral became uncertain, which led to massive haircuts on repo. Consequently, the repo transaction, which is information-insensitive in normal times, became information-sensitive during the crisis. In the course of his empirical work, Professor Gorton found that the augmented non-subprime spreads could be largely explained by an increase in counterparty risk (as captured by the Libor-OIS spread) rather than fundamentals. He argued that this counterparty risk originated from the repo market, through the illiquidity of collateral and an increase in haircuts.



In discussing this paper, **Kevin James** (Bank of England) compared the run on the repo to the Death of Baldur: central banks and regulators had acted to protect the system from all risks except those arising from the 'small and harmless' repo market. As this paper shows, the repo market ended up transmitting counterparty risk to the system as a whole.

Dr James, co-organiser of the conference, then chaired the next session, 'Fire Sales and Contagion'. He introduced the papers by pointing out that there is much talk about how crises propagate to

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BANK OF ENGLAND-HEIF 4 CONFERENCE, 'SOURCES OF CONTAGION'

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Kevin James (Bank of England)

the system, but unfortunately very little empirical work has been done in this area. The following two papers presented try to fill this gap by measuring the impact of fire sales on bond prices.

Andrew Ellul (Indiana University) presented 'Regulatory Pressure and Fire Sales in Corporate Bond Markets', co-authored with Pab Jotikasthira and Christian Lundblad. In their work, the authors tried to measure the impact of fire sales on bond prices. They analysed the financial assets held by insurance companies in order to assess their levels of constraint. Insurance companies are highly regulated with respect to the type of bonds they can hold. For example, they cannot have more than 20 per cent of their assets in speculative grade bonds, and they have specific capital requirements attached to these bonds. Another consequence that may arise when a bond is downgraded from investment grade to speculative grade is that insurance companies may be forced to quickly rebalance their portfolio to keep up with the regulation. This potentially exacerbates the problem, as insurance companies are also the biggest single player in the corporate bond market – generally a 'buy-and-hold' market with very few trades in any given time period. Thus, because the downgrade will affect the whole industry, insurance companies must analyse not only the need for selling, but also who can be a potential buyer and how this interaction will affect the price. Professor Ellul and his co-authors' results exhibit that the price impact worsens, the more constrained a company and the fewer the number of buyers involved (the buyers are often high yield mutual and hedge funds).

Jean Helwege (University of Southern Carolina) addressed the question of whether large trades drive significant pressures on security prices in her talk, 'Fallen Angels and Price Pressures'. A key identification issue surfaces because large trades may be related to news about the fundamentals of the company who issued the security. In this case, the price effect may reflect the change in fundamentals, rather than the large trade. Professor Helwege proposed looking at price effects of downgrades in the US corporate bond market ('fallen angels'). In many situations, downgrades occur well after the bad news about the firm has become public. Using evidence from the stock market, she then argued that the informational content of a considerable number of downgrades is small or nonexistent. At the same time, downgrades are associated with large sales, as insurance companies are forced to sell the



Charles Goodhart (FMG, LSE)

downgraded security simply because of regulatory pressures. After controlling for the informational content of downgrades, she found that the price effects of large trades is insignificant. On the other hand, when the stock market data signals that the downgrade is accompanied by new information about the company's fundamentals, the bond price drops significantly. Professor Helwege concluded that it is the informational content of the downgrades that drives changes in prices, rather than the sale itself. In the discussion, **Iryna Kaminska** (Bank of England) raised the point that, in practice, arbitrage opportunities may appear and asset prices may not reflect fundamentals. She supported this point using data for UK interest rate swaps. Therefore, in her view, prices may reflect other factors, such as demand and supply effects.

More vulnerable banks could raise the interest on their loans, rather than hoard liquidity



Thomas Huertas (Financial Services Authority) and Tony Lomas (PricewaterhouseCoopers)

Thomas Huertas (Financial Services Authority), then presented his work, 'Resolution and Contagion', in which he argued that there are two important sources of financial instability. He emphasised that a relevant change in resolution policy, such as the one that took place in September 2008 when Lehman Brothers filed for bankruptcy, might be a more important cause of financial instability than contagion itself. The risk that a creditor will incur a loss depends considerably on resolution policy. Before the Lehman Brothers event, the risk for big institutions was considered to be very small, however this attitude changed completely after the event because the market considered it to be a radical change in resolution policy. Dr Huertas argued that this suggested the government would not support the stand-alone investment bank and, as a result, investors moved their portfolios away from such institutions toward ones associated with commercial banks, considered to have a higher degree of government support.

Dr Huertas also suggested ideal resolution plans, requiring no taxpayer support, which would minimise the social cost that might arise from an interruption to deposit or security accounts. Financial institutions should offer 'living wills' that would enable them to provide information to authorities at short notice. If this were done, authorities could choose from among four possible resolution methods: early equity injection, share transfer (temporary public ownership), deposit transfer-bridge bank and liquidation-deposit pay-off. The first two should be implemented as going concerns, involving

more taxpayer support and a high degree of moral hazard. The second two methods should be applied as gone concerns: they impose more market discipline, which decreases taxpayer cost at the expense of a higher financial instability.

Finally, Dr Huertas drew on the lessons of the Lehman Brothers intervention to insist on the need for international coordination and the importance of having up-to-date and precise information on the situation of the financial institution. He also recommended changes in financial institutions and in the regulation laws that would promote a smoother resolution plan.

In his discussion of the presentation, **Tony Lomas** (PricewaterhouseCoopers) remarked that the lack of information on the Sunday preceding Lehman's bankruptcy day was an important driving factor of the recent financial turbulence.

The conference closed with a discussion by **Sujit Kapadia** (Bank of England), entitled, 'Liquidity Hoarding, Network Externalities and Interbank Market Collapse', co-authored with Prasanna Gai. The authors used a theoretical networks model to show that precautionary hoarding can cause the entire interbank market to freeze, even in the absence of counterparty risk. According to their model, a bank hit by a negative liquidity shock might withdraw lending to other banks. Since banks are all interconnected, the initial shock is transmitted through the entire system. Even if the banks can find possible replacements for interbank deposits when they lose some of their funding, these liquidity cascades, although rare, will still



Sujit Kapadia (Bank of England)

occur and could lead to a complete market freeze if the shock hits a key lender. They concluded the talk by pointing out that policies that target the interbank market should try to encourage better diversified, or even smaller, interbank funding, and make the critical institutions (key lenders or 'super-spreader') more resilient.

Charles Goodhart (FMG, LSE) started the discussion by enquiring why banks should hoard liquidity. He reasoned that more vulnerable banks could just raise the interest they charge on their loans or, if there is a negative liquidity shock, they could borrow funds overnight in the open market. Banks always have the option to resort to the central bank but they are usually unwilling to do so. One reason might be that banks depends on trust and confidence, so raising rates or going to the central bank might send a bad signal to the other market participants. What makes matters even worse is the fact that central banks, in particular the Bank of England, have moral hazard concerns that might exacerbate liquidity problems.

Conference organised by: **Charles Goodhart** (FMG, LSE) and **Kevin James** (Bank of England)

CORPORATE GOVERNANCE WORKSHOP

1 December 2009



Ian Morley (Corazon Capital)

Ian Morley (Corazon Capital) opened the discussion by raising the question of whether shortcomings in governance mechanisms have played an important role in the emergence of the crisis.

Mr Morley argued that shareholders in general, and professional institutional investors in particular, were supposed to monitor boards' actions. Shareholders who gain because of returns also have a responsibility towards employees and other stakeholders. Concerning the institutional investors, a question that arose was why investors devote most of their time to stock-picking, rather than to actively governing their companies – only an estimated five per cent of their time is dedicated to governance. Mr Morley offered one potential explanation, the problem of 'free-riding': while the costs of monitoring are only borne by the activist investors, all shareholders benefit from it. He concluded his presentation by suggesting the adoption of a stewardship code that promotes and regulates shareholder activism. For instance, investors and companies should agree on a long-term strategy for the company. At the same time, academics must develop a framework and set targets for shareholder activism.

In the second talk, **David Kershaw (LSE)** established that owners are mostly non-active and that their faineance might have contributed to the crisis. He identified regulation as one potentially important mechanism that shapes shareholder activism, arguing that regulation could

push shareholders towards greater activism. He introduced the framework of 'Regulatory Threat Capital' (RTC), for which the main hypothesis is that the goal of activism is not value creation but the accumulation of RTC. This RTC can be spent to buy off the regulator, i.e. it may be used to either reduce the probability of an intervention by the regulator or to alleviate the consequences of a regulatory intervention. In order to succeed, shareholder activism should generate publicity, as activists want to be perceived to be correct in public. Regarding the implementation, he suggested that shareholders be elicited for questions concerning remuneration, rather than for defining a company's strategy. The reason for this is that remuneration interventions generate publicity and are generally perceived as being appropriate by the public. Moreover, shareholders should aim for high profile companies, as involvement in those companies is more likely to generate publicity. He concluded the presentation by offering potential ways to move from RTC to really informed active owners: formerly inactive shareholders should be given incentives so that activism is their preferred choice. For instance, this might be achieved by changing the remuneration structure of fund managers.

Lord Myners (HM Treasury) concluded the presentations. He pinpointed three points during his speech: first, he argued that there are significant discrepancies between what politicians and regulators think about necessary interventions and regulations, and what is desired by the market. While politicians tend to think in 'black and white' categories for simplification and publicity reasons, the market tends to demand more balanced solutions. From this tension emerges a tendency to push towards more extreme answers. Second, he addressed moral hazard problems in the remuneration policy. Risk and rewards usually exhibit an asymmetric relationship, as managers



Geoffrey Owen (LSE) and David Kershaw (LSE)

are very much invested in the gains but are seldom punished for risky strategies. Moreover, the access to cheap borrowing also leads to more risk-taking. As a consequence, Lord Myners suggested that remuneration should be linked to cash flows rather than share prices, and that pay should be deferred. Third, he stressed that regulators should differentiate between funds that invest private money and those that invest public money. In his opinion, there should be no restrictions on private investments, however, the administration of public money should be heavily regulated to control the extent to which risky strategies are allowed.

Only five per cent of shareholder time is devoted to governance



LAURENCE KOTLIKOFF PUBLIC LECTURE

17 February 2010

Laurence Kotlikoff (Boston University) outlined his proposition for the setup of a new financial system after the financial crisis – ‘Limited Purpose Banking’ – in a lecture chaired by **Christopher Polk** (FMG, LSE).

Drawing on some of the key points of his recently published book, ‘Jimmy Stewart is Dead – Ending the World’s Ongoing Financial Plague with Limited Purpose Banking’, Professor Kotlikoff argued that this new model of financial institutions and the financial system could offer a regulatory answer to the financial collapse of 2007-2008.

In the first part of the presentation, Professor Kotlikoff identified the main flaws in the construction of the current financial system, which include the limited liability that is a common feature of financial institutions, excessive risk-taking caused by badly aligned incentives and poor transparency of financial institutions. He recalled the history of Bear Stearns investment bank, an institution whose huge balance sheet was managed by people lacking the necessary risk-management expertise. This proved to be a problem because the bank had significant and complex exposures that were undisclosed and not fully understood by the company’s management. Similarly, the risks taken on by many other crucial financial institutions such as Lehman Brothers or Goldman Sachs, remained privy to management and undisclosed publicly. The complexity and the lack of transparency of assets held on the books of financial institutions, together with a too-soft regulatory framework, allowed them to hide significant losses in the long term by avoiding mark-to-market pricing. This whole structure endured because the markets believed

that some institutions had to, and would be, bailed out by the governments if necessary. This obscure set-up of financial markets led to excessive risk taking, but also provided an opportunity for a different kind of illegitimate behaviour.

Professor Kotlikoff discussed in detail the implications of government bailouts in response to systematic shocks, such as the collapse of the financial system in 2007-2008. According to him, the government’s ability to provide protection against such systematic events is illusory. Governments are able to provide protection against systematic shocks to the economy by printing and injecting money into the system, as was the case in the US in 2008. However, doing so leads to inflation, and inflation risks significantly lower the purchasing power of protection. Moreover, some systematic events are uninsurable even by governments.

Professor Kotlikoff identified the lack of transparency and limited liability as the most significant causes of the financial crisis. He argued that many recently debated points, such as leverage, securitisation and proprietary trading, should not necessarily be forbidden because they carry out specific functions in the economy. Professor Kotlikoff then argued that the key to the challenge of reshaping the financial system can be found in the existing structure of the mutual fund industry, as mutual funds proved to be the most resilient investments during the crisis. The idea offered by Limited Purpose Banking is based on the transparent and secure construction of mutual funds. Professor Kotlikoff’s proposed restructure of financial markets models all financial institutions as mutual funds with full transparency and third-party custodians. Each of these financial institutions would have a clearly defined mandate and would fully disclose its actions. The manager of the mutual

The lack of transparency of assets held on the books of financial institutions allowed them to hide significant losses





Laurence Kotlikoff (Boston University)

Limited Purpose Banking would allow investors to be fully aware of the risks their investment was facing

fund would be responsible for the allocation of funds, but the actual assets (funds) would be held by the custodians.

Professor Kotlikoff showed that a wide range of financial institutions could be transformed into mutual funds, discussing how an insurance company could be restructured within this framework, as an example. An insurance company modelled on mutual funds would collect money from its clients to form a pot from which insurance claims would be allotted. The insurance offered would be protection against the idiosyncratic events only. The pot would be finite; thus for systematic events, the payout from the pot to each individual insured person could be significantly limited. Knowledge about the limitations of insurance companies modelled in this way would curb any expectations for publicly sponsored bailout in the event of a systematic shock. The finite pots in every mutual fund, as well as the constrained expectations, would help to prevent possible contagion in the financial system. The limited pot would act as a firewall – a barrier that is clearly absent in the current construction of the financial system for large financial institutions.

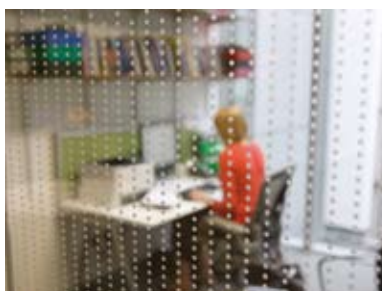
Professor Kotlikoff proposed an additional interesting concept within the framework: a cash mutual fund. The role of this fund would be to safeguard the cash that was paid in by the investors. In this case, the cash mutual fund could be interpreted as a combination of a money market fund with a standard bank account. Such a mutual fund would provide necessary clearing and payment functions.

Professor Kotlikoff argued that the implementation of this new design of the financial system would not be too difficult to implement. Large financial institutions such as Citigroup or JPMorgan would not necessarily need to be closed or partitioned. These companies would simply become fund managers managing a number of transparent mutual funds. Investment banks would be

transformed into investment consultancies, offering advice about investment in mutual funds.

The design of the system would allow for many features already existing in the current financial system, such as leverage, to remain, but every action and transaction would be executed within a transparent framework. This would allow investors to be fully aware of the exposure of the fund and to understand the risks their investment was facing. This model is in complete contrast to the situation before the crisis, wherein big financial institutions were taking on deposits and investing proceedings into highly speculative CDO securities.

In the last part of the presentation, Professor Kotlikoff answered questions from the audience. The first question was about the effect of the new system on the Keynesian multiplier and, hence on the size of M1 in the economy. Professor Kotlikoff argued that the multiplier with this setup of the financial system will be equal to one, but that this was not necessarily a bad thing. Given that the multiplier in the economy will be constant and known, central banks would have much easier task controlling the amount of M1 in the economy. Another question concerned the diversification of the mutual funds. Large financial institutions involved across number of markets and sectors seem to be well diversified, the diversification of the mutual funds would be an important issue. According to Professor Kotlikoff, diversification should not be a problem in the new setup – mutual funds can be well diversified and can be set up to have authorisation to invest across a number of markets and sectors.



AN OVERVIEW OF RECENT WORK BY PROFESSOR CHARLES GOODHART, PROGRAMME DIRECTOR, RISK AND REGULATION



Charles Goodhart (FMG, LSE)

Professor Charles Goodhart, CBE, co-founded the FMG with Bank of England Governor Mervyn King in January 1987. Professor Goodhart continues to play an active part in the group's activities, contributing a myriad of financial regulatory research and commentary articles. He was invited to reflect on some of his recent contributions on the analysis of the ongoing crisis in the financial system. In future issues of the FMG Review we will carry contributions in the main areas of the group's research endeavors, by other members.

These last three years (since August 2007) have been an extraordinarily busy time for an economist like me, who focuses on financial regulation even when they are supposedly retired.

The first, which may be my more lasting contribution, was, however, begun well before 2007, in fact in 2005. This input comes in the form of a long book, 'The Early History of the Basel Committee on Banking Supervision, 1974-1997'. This is an authoritative record of the BCBS's work in these years, taken largely from the BCBS/BIS archives. The more urgent pressure of work arising from the crisis has actually delayed its publication, but it will make the subject matter of greater interest and relevance. With any luck this book will be published by the end of 2011.

The second strand of my work is a continuous stream of policy-related papers on this topic. The most important single monograph has been the Geneva Report on 'The Fundamental Principles of Financial Regulation' (2009), which I organised. My earlier papers in this vein were gathered together and published as 'The Regulatory Response to the Financial Crisis' (Edward Elgar, 2009). Since then, I have given evidence before two Parliamentary Committees on this subject (see Bibliography A & B), and have some seven (or more, dependent on definitions) further papers – since the book above, that have either been published, or are in process of publication (see Bibliography C-J). These aforementioned papers are in addition to some ten other articles/papers on monetary analysis more broadly (see Bibliography K-T).

The third strand of work consists of formal modelling work that aims to provide a more rigorous basis for policy advice. Financial stability problems arise because of the possibility of default. Indeed, without default there would be no need for banks or money! Yet most current macroeconomic models just assume default away. For nearly a decade now Dimitrios Tsomocos (who does the hard modelling work) and I, with a variety of co-authors, most recently mainly Dr Tsomocos' PhD students, have been working away at a genre of models that put default, money and banks in a central role. Some recent and current papers in this set are given in the bibliography (i-vii). A collection of these papers, and my regulatory papers, will be put together in two forthcoming (2011) volumes to be published by Edward Elgar. A couple of other academic papers, with Segoviano and Schoenmaker (viii-ix), are also shown there.

The final aspect of my work in this field involves my assistance in running the London Financial Regulation Seminar. Since the start of 2008 we have run five conferences on aspects of this subject, and approximately three or four evening seminars each term. At the end of 2008 we successfully concluded an ESRC-financed programme at FMG. The wind down of joint, collaborative work within the FMG was largely a consequence of the much-regretted departure of Professors Hyun Song Shin and Nobuhiro Kiyotaki, to Princeton, as well as my own retirement. Let us hope that it can be regenerated.

Financial stability problems arise because of the possibility of default, yet most macroeconomic models just assume default away

Bibliography

- I The Early History of the Basel Committee on Banking Stability
- II The Regulatory Response to the Financial Crisis
 - Parliamentary evidence, A-B
 - Policy-oriented papers, C-J
 - Other academic papers, K-T
- III Modelling Work with Tsomocos, Vols 1 and 2, (i-vii)
Work with Segoviano and Schoenmaker, (viii-ix)
- IV Conferences, 2008-2010

I The Early History of the Basel Committee on Banking Stability (expected to be published 2011)	
II The Regulatory Response to the Financial Crisis	
Parliamentary evidence	
A	Evidence given at the House of Lords European Union Committee on <i>The Future of EU Financial Regulation and Supervision</i> , 14th Report of Session 2008-09, Volume I: Report and Volume II: Evidence, HL Paper 106-I and 106-II.
B	Evidence given at the House of Commons Treasury Committee on <i>Too Important to Fail – Too Important to Ignore</i> , Ninth Report of Session 2009-10, Volume II, HC 261-II.
Policy-oriented papers	
C	'Is a Less Pro-cyclical Financial System an Achievable Goal?', <i>National Institute Economic Review</i> No 211, January 2010.
D	'Liquidity Management', paper presented at Jackson Hole Conference, August 2009, forthcoming in the Proceedings, FRB Kansas City.
E	'Living Wills as a Catalyst for Action', (with E Avgouleas and D Schoenmaker), Duisenberg School of Finance Policy Paper, No 4, February 2010.
F	'Financial Regulation', chapter in Layard and Boone (eds) book on Financial Crisis.
G	'The Boundary Problem in Financial Regulation', <i>National Institute Economic Review</i> , Vol 206, No 1, pp 48-55, October 2008.
H	'The Changing Role of Central Banks', to be presented at BIS Annual Conference, June 2010.
I	'Banks and the Public Sector Authority', <i>Banks and Bank Systems</i> , Vol 4, Issue 4, pp 5-12, 2009.
J	How, if at all, Should Credit Ratings Agencies (CRAs) be Regulated?, Chapter 9 in <i>Time for a Visible Hand: Lessons from the 2008 World Financial Crisis</i> , edited by S Griffith-Jones, J A Ocampo and J E Stiglitz, Oxford University Press, 2010.
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M	'Interest Rate Forecasts: A Pathology', (with Wen Bin Lim), forthcoming IJCB.
N	'Macro Theoretical Failures', Chapter in <i>The Economic Crisis and the State of Economics</i> , edited by R Skidelsky and C W Wigstrom, Palgrave Macmillan, February 2010.
O	'Quantitative Easing: Necessary, Successful and Ready to Wind Down', (with M Baker and C Sleeman), Morgan Stanley Research Europe, 23 November 2009.
P	'Searching for a Metric for Financial Stability', (with O Aspachs, M Segoviano, D Tsomocos and L Zicchino), LSE FMG Special Paper 167, 2006
Q	'The Commissioned Historians of the Bank of England', Festschrift volume for Professor F Capie, edited G Wood, forthcoming 2010.
R	'The Continuing Muddles of Monetary Theory: A Steadfast Refusal to Face Facts', <i>Economica</i> , Vol 76, Issue s1, pp 821-830, October 2009.
S	'The Interest Rate Conditioning Assumption', <i>International Journal of Central Banking</i> , June 2009, pp 85-108.

T	'Monetary Policy Regimes and Economic Performance: The Historical Record, 1979-2008', (with L. Benati), this chapter updates the Bordo and Schwartz chapter in Volume 1A of the <i>Handbook of Macroeconomics</i> to the period 1979-2008, to be published in 2011.
III Modelling Work with Tsomocos	
i	'Analysis of Monetary Policy and Financial Stability: A New Paradigm', (with C Osorio and D P Tsomocos), CESifo Working Paper No 2885, CESifo Group Munich, 2009.
ii	'Analysis of Financial Stability', (with D.P. Tsomocos), in <i>Frontiers in Central Banking. (Elsevier Series: Frontiers of Economics and Globalization)</i> , edited by P L Siklos, M T Bohl and M E Bohar. Elsevier, forthcoming, 2010.
iii	'Modelling a Housing and Mortgage Crisis', (with D.P. Tsomocos and A.P. Vardoulakis), in <i>Financial Stability, Monetary Policy and Central Banking</i> , edited by C Echeverria, R Fuentes and D Gray, Series in on Central Banking, Analysis and Economic Policies. Central Bank of Chile, forthcoming, 2010.
iv	'On Dividend Restrictions and the Collapse of the Interbank Market', (with U M Peiris, D P Tsomocos and A P Vardoulakis), <i>Annals of Finance</i> , forthcoming, 2010.
v	'State Prices, Liquidity, and Default', (with R A Espinoza and D P Tsomocos), <i>Economic Theory</i> , Vol 39, pp 177-194, 2009.
vi	'The Optimal Monetary Instrument for Prudential Purposes', (with P Sunirand and D P Tsomocos), <i>Journal of Financial Stability</i> , forthcoming, 2010.
vii	'The Optimal Monetary Policy Instrument, Inflation Versus Asset Price Targeting, and Financial Stability', (with C Osorio and D Tsomocos), in <i>Inflation Targeting Twenty Years on</i> . Edited by D Cobham, Ø Eitheim and S Gerlach, Norges Bank, Cambridge University Press, Cambridge, forthcoming, 2010.
Work with Segoviano and Schoenmaker	
viii	'Banking Stability Measures', (with M Segoviano), IMF Working Paper 09/4, 2009.
ix	'Fiscal Burden Sharing in Cross-Border Banking Crises', (with D Schoenmaker), <i>International Journal of Central Banking</i> , Vol 5, No 1, pp 141-165, 2009.

IV Conferences, 2008-2010	
30 January 2008	The Regulatory Response to the Financial Crisis
19 January 2009	The Regulatory Response to the Financial Crisis
2-3 July 2009	Conference on Financial Stability
25-26 February 2010	Sources of Contagion
8-9 June 2010	Financial Innovation and Market Performance

Speakers at financial regulation events in 2010

Tobias Adrian (New York Federal Reserve)

David Aikman (Bank of England)

Peter Andrews (Financial Services Authority)

Ray Barrell (NIESR)

Bruno Biais (Toulouse School of Economics)

Lee Buchheit (Cleary Gottlieb Steen & Hamilton LLP)

Jon Danielsson (FMG, LSE)

Phil Davis (NIESR)

Panicos Demetriades (University of Leicester)

Andrew Ellul (Indiana University)

Gary Gorton (Yale University)

Jean Helwege (University of South Carolina)

Thomas Huertas (Financial Services Authority)

Kevin James (Bank of England)

Iryna Kaminska (Bank of England)

Sujit Kapadia (Bank of England)

Tom Kirchmaier (University of Manchester and FMG, LSE)

Rosa Lastra (Queen Mary, University of London)

Ross Levine (Brown University)

Robert Litan (Brookings)

Tony Lomas (PricewaterhouseCoopers)

Andrei Medvedev (Financial Services Authority)

Stefano Micossi (CEPS-Assonine)

David Miles (Bank of England)

Alistair Milne (City University)

Richhild Moessner (Bank for International Settlements)

Philippe Mueller (FMG, LSE)

Rhiannon Sowerbutts (Bank of England)

Per Strömberg (Institute for Financial Research, Stockholm)

René Stulz (Ohio State University)

Sam Theodore (FSA)

Dimitri Vayanos (FMG, LSE)

Isabel von Köppen-Mertes (European Central Bank)

Matthew Willison (Bank of England)

Geoffrey Wood (CASS)

NEW MEMBERS OF STAFF



Maria Cecilia

Bustamante is an Assistant Professor of Finance at LSE. She received her PhD in Finance from the Swiss Finance Institute at the University of Lausanne. As a doctoral student

she was awarded a grant by the Swiss Finance Institute to visit the Haas School of Business at the University of California, Berkeley for one year in 2007, and was also awarded a travel grant by the NYSE to present her paper on new issues' markets at the WFA in 2008. The Porphyrogenis Foundation in Switzerland awarded her the Best Dissertation Award in 2009.

Dr Bustamante's research interests include theoretical and empirical corporate finance, industrial organisation, contract theory and the asset pricing implications of corporate decisions. In a recent job-market paper, Dr Bustamante assesses the joint interaction of real and financing frictions in firms' dynamic investment and financing decisions. The paper provides a rationale for the documented poor empirical performance of neoclassical investment models based on the joint effect of real and financing frictions on investment. Her work also elaborates on the effects of asymmetric information on firms' investment and financing decisions. In a different paper, she studies how firms time their decision to raise public equity when outside investors lack information about their future investment prospects.

Her current research studies the impact of both real and financing frictions of different types on corporate investment decisions and stock returns. In particular, her work elaborates on how the effect of real and financing frictions may bias standard empirical tests of investment, how asymmetric information may induce hot and cold markets in new issues' markets, and how the underlying economic behaviour of firms in imperfectly competitive product markets may induce alternative patterns in investment and asset prices.



Georgy Chabakauri

joined the Finance Department at LSE in September 2009. He holds a PhD in Finance from London Business School, a PhD in Mathematics from Moscow State University

and a Master of Arts in Economics from New Economic School.

Dr Chabakauri's research interests are in the area of portfolio choice in incomplete markets, risk management and asset pricing. His paper 'Dynamic Mean-Variance Asset Allocation', co-authored with Professor Suleyman Basak, is forthcoming in the Review of Financial Studies. This paper derives explicit closed-form solutions for the dynamic mean-variance asset allocation problem in incomplete markets via dynamic programming by explicitly accounting for the time-inconsistency of the problem. Another paper co-authored with Professor Suleyman Basak, entitled 'Dynamic Hedging in Incomplete Markets: A Simple Solution', studies a classical problem of mean-variance hedging of risks associated with non-tradable assets in incomplete markets by minimising the hedging error variance, and derives a closed-form solution to the problem that retains the intuitive structure of complete-market hedges. Dr Chabakauri's paper 'Asset Pricing in General Equilibrium with Constraints' develops a methodology for studying the implications of portfolio constraints (such as short sale, borrowing and restricted participation constraints) for general equilibrium asset pricing in a Lucas tree economy populated by heterogeneous investors. In particular, this paper demonstrates that portfolio constraints that limit the proportion of wealth allocated to stocks can explain many empirically observed patterns in the data, such as countercyclical stock return volatilities and market prices of risk, procyclical price-dividend ratios, as well as excess volatility of stock returns.

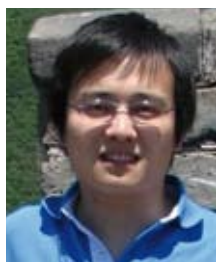
Since joining the LSE, Dr Chabakauri has been teaching the introductory finance course for the Masters programme in management, and the pre-session course in quantitative methods for the MSc Finance and Economics programme.


Christian Julliard

is a Lecturer in the Department of Finance and a senior research associate of the FMG. He was awarded a PhD from the Department of Economics at Princeton University, where he

was also affiliated with the Bendheim Centre for Finance and the Woodrow Wilson School of Public and International Affairs. He first joined the LSE Economics Department in 2005 and was awarded tenure in 2009, and has also held a Visiting Assistant Professor of Economics and Finance position at the Tepper School of Business at Carnegie Mellon University. Dr Julliard is also a research affiliate of the Centre for Economic Policy Research's International Macroeconomics and Financial Economics programmes, an editorial board member of the *Review of Economic Studies* and an Associate Editor of *Economica*. His research has been published in top economics and finance journals, such as the *Journal of Political Economy* and *The Review of Financial Studies*.

Dr Julliard's research interests span macroeconomics, finance and the frontier of applied econometrics. His work shows that the central insight of the consumption capital asset pricing model, that an asset's expected return is determined by its equilibrium risk to consumption, is supported by the data, if we measure risk by the covariance of an asset's return and consumption growth over many quarters following the return. His research also shows that money illusion can explain asset price movements in markets, like the residential housing market, that are naturally characterised by limits to arbitrage. His research has also focused on the interaction between human capital risk, equilibrium asset prices, households' optimal portfolio choices, the interaction between financial and macroeconomic disasters, and international financial diversification.



Dong Lou joined the LSE in 2009 as a Lecturer in Finance. He received his PhD in Financial Economics from Yale University's School of Management and a BS in Computer Science from the Fu Foundation

School of Engineering and Applied Science at Columbia University.

Dr Lou's research mostly focuses on understanding market inefficiencies and how their effects distort resource allocations in the real economy, such as the allocation of physical capital and managerial effort. In his PhD dissertation he shows that mutual fund investment-flow-induced trading can cause a long-lasting return effect in the stock market and that this return effect is responsible, or partially responsible, for some well-documented and puzzling phenomena in asset pricing. In some follow-up projects, Dr Lou has studied the potential effects of temporary price pressure in the equity market on firms' debt financing and investment decisions, as well as firms' interactions with non-equity stakeholders, such as suppliers and customers. In a recent project, Dr Lou analyses price pressure effects in other securities, in particular securities in the treasury market, and finds that treasury securities, despite the long-held belief that they are immune to short-term liquidity shocks, also exhibit significant patterns of temporary price pressure effects.

Dr Lou teaches investments to MSc Management students.



DISCUSSION PAPERS

DP 638

Organizational Diseconomies in the Mutual Fund Industry

Fabian Garavito

I document how the organizational form of a mutual fund affects its investment strategies. I show that centralized funds tilt their portfolios to hard information companies whereas decentralized funds tilt their portfolios to soft information companies. I also show that the investments of decentralized (centralized) mutual funds in soft (hard) information companies outperform those of centralized (decentralized) funds. Moreover, decentralized funds show an ability to forecast soft information companies' future returns and a disability at forecasting hard information companies' future returns. On the other hand, centralized funds do not seem to be able to forecast the returns of hard information companies, but they show disability at forecasting hard information companies' future returns. The results corroborate the main predictions of Stein (2002). The results also shed light on the increase in demand for large stocks and the positive relationship between performance of portfolio concentration documented in the literature.

DP 639 (PWC 5)

Liquidity and Asset Prices: A Unified Framework

Dimitri Vayanos and Jiang Wang

We examine how liquidity and asset prices are affected by the following market imperfections: asymmetric information, participation costs, transaction costs, leverage constraints, non-competitive behavior and search. Our model has three periods: agents are identical in the first, become heterogeneous and trade in the second,

and consume asset payoffs in the third. We examine how imperfections in the second period affect different measures of illiquidity, as well as asset prices in the first period. Besides nesting multiple imperfections in a single model, we derive new results on the effects of each imperfection. Our results imply, in particular, that imperfections do not always raise expected returns, and can influence common measures of illiquidity in opposite directions.

DP 640

Regime Switching in Volatilities and Correlation between Stock and Bond Markets

Runquan Chen

This paper studies the correlation and volatilities of the bond and stock markets in a regime-switching bivariate GARCH model. We extend the univariate Markov-Switching GARCH of Haas, Mitnik and Paoletta (2004) into a bivariate Markov-switching GARCH model with Conditional Constant Correlation (CCC) specification within each regime, though the correlation may change across regimes. Our model allows separate state variable governing each of the three processes: bond volatility, stock volatility and bond-stock correlation. We find that a separate state variable for the correlation is needed while the two volatility processes could largely share a common state variable, especially for the 10-year bond paired with S&P500. The 'low-to-high' switching in stock volatility is more likely to be associated with the 'high-to-low' switching in correlation while the 'low-to-high' switching in bond volatility is likely to be associated with the 'low-to-high' switching in correlation. The bond-stock correlation is significantly lower when the stock market volatility is in the high regime, but higher when the bond volatility is in its high regime.

DP 641

A Preferred-Habitat Model of the Term Structure of Interest Rates

Dimitri Vayanos and Jean-Luc Vila

We model the term structure of interest rates as resulting from the interaction between investor clienteles with preferences for specific maturities and risk-averse arbitrageurs. Because arbitrageurs are risk averse, shocks to clienteles' demand for bonds affect the term structure – and constitute an additional determinant of bond prices to current and expected future short rates. At the same time, because arbitrageurs render the term structure arbitrage-free, demand effects satisfy no-arbitrage restrictions and can be quite different from the underlying shocks. We show that the preferred-habitat view of the term structure generates a rich set of implications for bond risk premia, the effects of demand shocks and of shocks to short-rate expectations, the economic role of carry trades, and the transmission of monetary policy.

DP 642

Financial Volatility and Economic Activity

Fabio Fornari and Antonio Mele

Does capital markets uncertainty affect the business cycle? We find that financial volatility predicts 30 per cent of post-war economic activity in the United States, and that during the Great Moderation, aggregate stock market volatility explains, alone, up to 55 per cent of real growth. In out-of-sample tests, we find that stock volatility helps predict turning points over and above traditional financial variables such as credit or term spreads, and other leading indicators. Combining stock volatility and the term spread leads to a proxy for (i) aggregate risk, (ii) risk-premiums and

SPECIAL PAPERS

(iii) monetary policy, which is found to track, and anticipate, the business cycle. At the heart of our analysis is a notion of volatility based on a slowly changing measure of return variability. This volatility is designed to capture long-run uncertainty in capital markets, and is particularly successful at explaining trends in the economic activity at horizons of six months and one year.

DP 643

A Flow-Based Explanation for Return Predictability

Dong Lou

This paper proposes and tests an investment-flow based explanation for three empirical findings on return predictability – the persistence of mutual fund performance, the ‘smart money’ effect, and stock price momentum. Since mutual fund managers generally scale up or down their existing positions in response to investment flows, and the portfolios of funds receiving capital generally differ from those that lose capital, investment flows to mutual funds can cause significant demand shocks in individual stocks. Moreover, given that mutual fund flows are largely predictable from past fund performance and past flows, this paper further establishes that flow-induced price pressure is predictable. Finally, this paper shows that such flow-based return predictability can fully account for mutual fund performance persistence and the ‘smart money’ effect, and can partially explain stock price momentum.

SP 185

The Value of Interest Rate Forecasts?

Charles Goodhart and Wen Bin Lim

This monograph brings together a collection of papers on interest rate forecasts, most of which have already appeared as separate Special Papers. In recent years there has been a developing trend whereby the Central Bank publishes a forecast of the path that it expects that the policy-determined short-term rate will follow over the forecast period, two or three years ahead.

SP 186

Bankruptcy and Reorganization Procedures for Cross-border Banks in the EU: Towards an Integrated Approach to the Reform of the EU Safety Net

Gillian G H Garcia, Rosa M Lastra, María J Nieto

This article analyzes the complexities of reorganizing and liquidating banks that have cross-border activities within the EU in the present institutional framework that is defined by the relevant directives and national remedial supervisory, pre-insolvency and insolvency procedures. Against this background, the objectives of this article are threefold: First, the paper assesses the economic efficiency of the institutional framework that is defined by the Reorganization and Winding-Up Directive (2001/24/EC) and it identifies aspects that can hamper efficient cross-border bank resolutions. These are issues on which policy makers should focus at the time of reforming the present framework. Second, it explores areas of coordination with other EU directives that also deal with relevant aspects to bank financial crisis management. Third, it makes policy recommendations for reform.

SP 187

Central Bank Co-operation and International Liquidity in the Financial Crisis of 2008-09

William A Allen and Richhild Moessner

The advent of the financial crisis in August 2007, and its subsequent intensification, has largely eroded the hitherto apparently sharp distinction between monetary and financial stability, and it has led to a revival of central bank co-operation. The purpose of this paper is to describe and explain how things have changed, focussing on the main innovation in central bank cooperation during this crisis, namely the emergency provision of international liquidity through bilateral central bank swap facilities, which have evolved to form interconnected swap networks. We discuss the reasons for establishing swap facilities, relate the probability of a country receiving a swap line in a currency to a measure of currency-specific liquidity shortages based on the BIS international banking statistics, and find a significant relationship in the case of the US dollar, the euro, the yen and the Swiss franc. We also discuss the role and effectiveness of swap lines in relieving currency-specific liquidity shortages, the risks that central banks run in extending swap lines and the limitations to their utility in relieving liquidity pressures.

FORTHCOMING DISCUSSION AND SPECIAL PAPERS

Discussion Papers

DP 644

Attracting Investor Attention through Advertising

Dong Lou

DP 645

Technology Adoption Vintage Capitol and Asset Prices

Xiaoji Lin

DP 646

Stronger Risk Controls Lower Risk Evidence from US Bank Holding Companies

Andrew Ellul and Vijay Yerramilli

DP 647 (AXA 2)

Risk Appetite and Endogenous Risk

Jon Danielsson, Hyun Song Shin,
Jean-Pierre Zigrand

DP 648 (AXA 3)

On Dividend Restrictions and the Collapse of the Interbank Market

Charles Goodhart, M.U. Peiris, Dimitrios Tsomocos,
Alexandros Vardoulakis

DP 649 (AXA 4)

Modelling a Housing and Mortgage Crisis

Charles Goodhart, Dimitrios Tsomocos,
Alexandros Vardoulakis

Special Papers

SP 188

Living Wills

Thomas Huertas

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Crash 08: a regulatory debacle to be mended

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British Monetary Targets 1976 to 1987: a View from the Fourth Floor of the Bank of England

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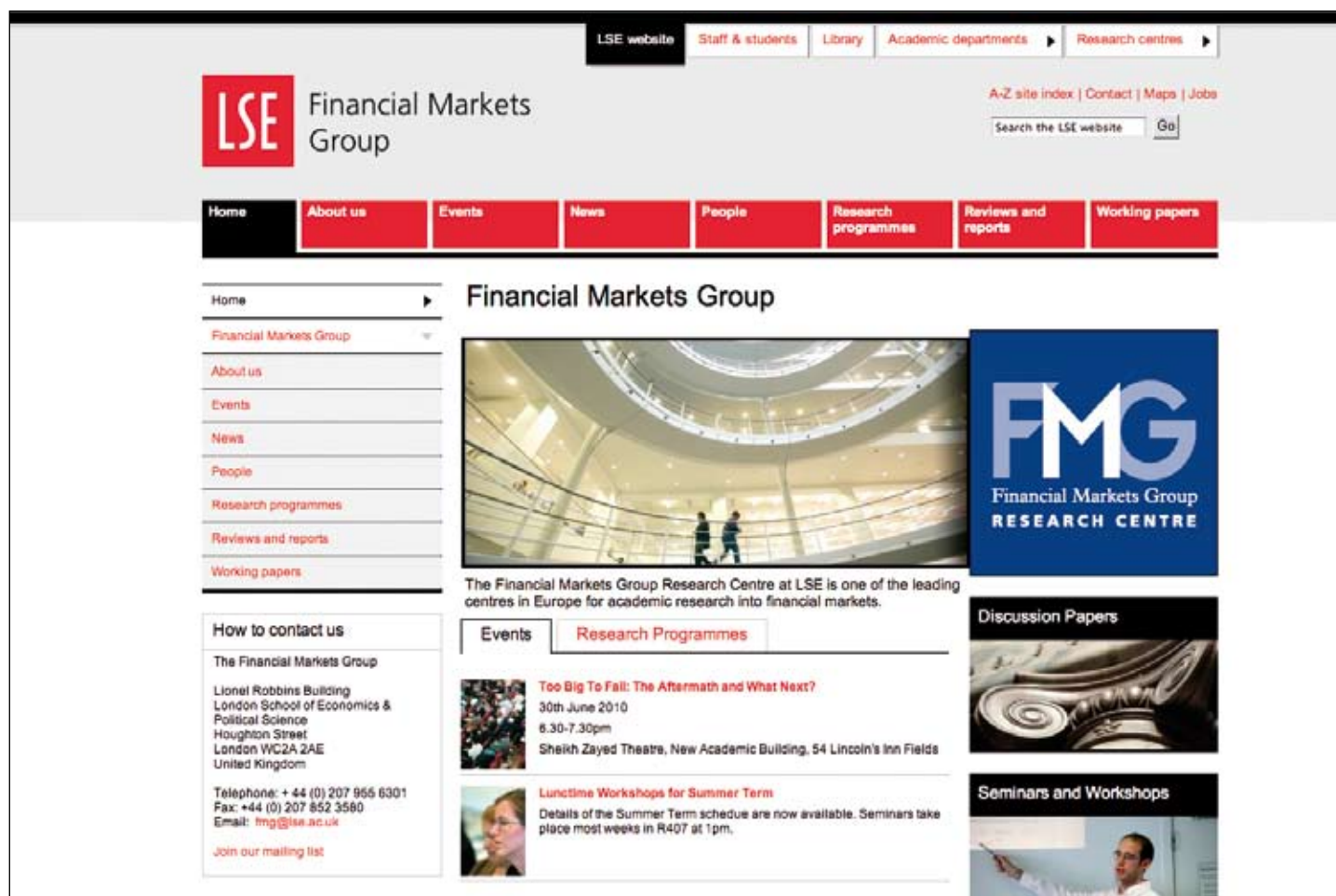
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