

FMG PUBLIC DEBATE: “LSE PERSPECTIVES ON THE SOVEREIGN DEBT CRISIS”

2 November 2011

Only two days after Greek Prime Minister George Papandreou announced a referendum to approve a proposed bailout, LSE experts on Europe and Finance gathered in the New Theatre at LSE, to debate the future of the Eurozone in “LSE Perspectives on the Sovereign Debt Crisis”.

Charles Goodhart (FMG, LSE) a leading expert on monetary policy and financial regulation, chaired the lively discussion. The panelists were: **Bob Hancké** and **Vassilis Monastiriotis**, (European Institute, LSE) and **Dimitri Vayanos** and **Jon Danielsson** (FMG/Finance Department, LSE). They all expressed diverse views, frequently disagreeing and contradicting one another. Even within the departments no consensus formed; Hancké invoked economic reasoning, while Monastiriotis blamed free-market ideology for the crisis; Vayanos insisted on the importance of Greek governmental reform while Danielsson argued that the state should get out of the picture.

Goodhart opened with an incisive précis of recent European financial history, explaining the build-up to the crisis. He said that the weaknesses of the European common currency were recognised from the beginning; the Eurozone lacked political cohesion, a centralised fiscal union and labour mobility. However Goodhart believes that hope for economic and fiscal unification persists. He pointed out that



Charles Goodhart (FMG, LSE) and **Vassilis Monastiriotis** (European Institute, LSE)

Europe now faces two problems; a financial problem and an adjustment problem. Bailouts and austerity measures mitigate the first, but the latter and much bigger problem remains unaddressed, leaving the Union and the currency in great difficulty. In the closing he underlined his own surprise at Prime Minister Papandreou’s announcement of the referendum, “I think it surprised everybody, and it surprised the hell out of the markets.”

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LSE PERSPECTIVES ON THE SOVEREIGN DEBT CRISIS

continued from page 1



Dimitri Vayanos (FMG, LSE)



Bob Hancké (European Institute, LSE)



Jon Danielsson (FMG, LSE)

Hancké asserted that “fiscal crisis is just the tip of the iceberg, something much more fundamental is going on underneath”, namely the interaction of two very different economies—Northwest Europe and Southern Europe—with a common currency and a common central bank. He discussed the costs of uniform monetary policy on inflation and real interest rates, arguing that the current account deficit in the South could not help but explode.

Monastiriotis presented views in stark opposition to Hancké, expressing faith in the Eurozone but criticising policy decisions. He outlined two main problems; firstly that policy makers let markets dictate their decisions and secondly that they maintained blind faith in outmoded economic theories and continued to apply a fixed set of rules even as they themselves were failing. He asserted that European leaders and voters were adherents of disproved ideology – he echoed Keynes’ oft-quoted assertion that “practical men...are usually the slaves of some defunct economist”.

Vayanos opened by saying he would speak to the positive side, namely discussing the way forward for Europe and for Greece in particular. He emphasised that many of the problems and solutions lay inside the financial system, pointing to the important role that finance scholarship can play in reshaping the political and social world. He employed simple but precise economic analysis to explain the failures of the European Central Bank and the manifestation of incentive problems that led to the gross overexposure of German and French banks to peripheral Eurozone debt; thereby he linked analyses of politics and macroeconomics with the finance of private credit. In conclusion, he drew attention to the weakness of Greek institutions, insisting that to regain prosperity the country must remain in the Eurozone and forewarning that should it depart, new capital would cease to flow in.

Danielsson spoke last. He also mixed discussions of government and banking, opening with the assertion that the sovereign debt crisis is not about Greece the same way that the 2007 financial crisis was not about subprime mortgage lending – they are both systemic crises and the current one comprises two sub crises; one in banking and another in Eurozone bonds. Next he turned Monastiriotis’s script on its head, saying that throughout the history of financial crises “government tends to be the worst culprit” so “governmental reform is much more important than financial reform” and that he hopes “that Europe will find a way to keep the European Union alive without the Euro.”

Goodhart’s closing words suggested that any such solution will no doubt be difficult to implement. He said, “I find it difficult to see how this crisis is going to get resolved without a lot of crockery getting broken.”

There is a podcast available of this event. To view it please visit the Financial Markets Group homepage, click on Events, then select Audio podcasts and video streaming.

Article written by **Jason Roderick Donaldson** (FMG, LSE) and **Giorgia Piacentino** (FMG, LSE).

Jason Roderick Donaldson and **Giorgia Piacentino** are both members of the FMG and PhD candidates in LSE’s Finance Department.

Giorgia’s main research interests are financial intermediation with a special focus on delegated portfolio managers, rating agencies and corporate governance. She is a 2011/12 Deutsche Bank Doctoral Fellow.

Jason is working on the theory of financial intermediation and his present focus is on collateral in the interbank market.

FMG RESEARCH PROFILE: DIMITRI VAYANOS AND EURO-NOMICS

Euro-nomics: **A viable architecture** **for the Eurozone**

The ongoing European sovereign debt crisis has highlighted the pressing need to rethink the Eurozone's financial architecture. **Dimitri Vayanos** (FMG, LSE) is contributing to the debate as part of Euro-nomics; a group of European economists who propose to introduce European Safe Bonds (ESBies) as a step towards a more sustainable and robust European financial system.

The Euro-nomics group pinpoints the shortage of safe assets inside the Eurozone as the key flaw of the European financial architecture. Safe assets play a fundamental role inside the financial system, both because they are used as collateral in financial transactions and because prudential regulation requires banks to hold a significant part of their balance sheets in safe assets. It is therefore crucial for financial institutions to have access to an adequate stock of safe assets. However, Europe's fragmented sovereign debt markets cannot offer a sufficient quantity of safe assets to European financial institutions, as the large and liquid market for Treasury bonds does in the United States.

This lack of sufficient European safe assets induced regulators, policymakers and investors to treat all bonds issued by euro-area sovereigns as safe. For instance, Basel criteria consider sovereign bonds held by national banks as risk free assets. Moreover, the European Central Bank accepts sovereign bonds from all its member states as collateral.

According to the Euro-nomics group this practice has led to two problems. Firstly, it created a vicious feedback loop between the European financial system and member states. Which means that many European states are now facing fiscal difficulties because of their efforts to recapitalise their weakened national banks. However on the other hand, the

regulatory environment has induced banks in the Eurozone to invest massively in sovereign bonds and as a result the health of the banking system is now tightly linked to the sovereign fiscal outlook. These two elements create the potential for financial crises driven by the perverse interaction between weak banks' balance sheets and shaky state's fiscal positions.

The second problem is that the absence of a European safe bond contributed to the creation of large capital account imbalances inside the Euro area, which exposed its members to the risk of sudden stops in capital inflows. During tranquil times financial institutions searching for "yield" channelled large capital flows from the Eurozone centre to its periphery. This movement was exacerbated by the regulatory practice of attaching the same risk to sovereign bonds issued by all the euro area members. In times of crisis, investors searching for a "safe haven" abruptly stopped their supply of capital to countries in the euro area periphery, creating great disruption in their financial systems.

A proposal for ESBies

To address these shortcomings the Euro-nomics Group proposes the creation of European Safe Bonds (ESBies). Under this proposal, a European Debt Agency (EDA) would issue ESBies as senior tranches on a portfolio of European sovereign bonds purchased by the EDA. The remaining portfolio would be financed by junior bond claims. To avoid political interference, sovereign debt weights in the EDA portfolio would be explicitly linked to the size of European member states.

This structure would minimise the risk of default for ESBies. Diversification lowers the impact of default by any one European sovereign on EDA portfolio payouts and seniority, in turn, shields ESBies from EDA portfolio payment shortfalls. Credit losses up to the trench threshold are passed on to junior bond holders. For additional protection, the Euro-nomics group proposes that member states could offer guarantees (so-called credit enhancements) to absorb payout shortfalls on ESBies up to a given threshold.

Two regulatory changes would accompany issuance of ESBies. Firstly, the European Central Bank (ECB) would make ESBies its main form of collateral in repo and discounting operations.



Euro-nomics

The Eurozone Going Forward

Secondly, banking regulators would give a zero risk-weighting to ESBies when evaluating bank balance sheets. Risk weights on sovereign bonds themselves should be revised to more accurately reflect underlying credit risk.

How would ESBies help?

By taking on the role of a European safe asset, ESBies could displace the current special position of individual member country sovereign bonds in the European financial system.

Since the regulatory framework would no longer encourage banks to load their balance sheets indiscriminately with European sovereign debt in good times, incentivising them instead towards ESBies, the European banking system would become more resilient to default by any one member state. In turn, as markets would align sovereign debt yields more closely with underlying issuer credit risk, strengthened market discipline would force European member states to tackle capital account and fiscal imbalances more vigorously. The diabolic link between solvency of the banking sector and solvency of national governments could be substantially weakened.

The introduction of ESBies could potentially bring further benefits. The liquidity of an integrated European market for ESBies could lower expected returns demanded by the market for European sovereign debt. The ECB would be able to conduct open market operations using a safer security and would avoid the political economy pitfalls of selective intervention in debt markets of any one member country. ESBies would provide some relief to countries with sovereign debt problems, as the EDA would push up demand for their debt in the short run. Finally, ESBies would provide information to markets on a true European yield curve.

The Paul Woolley Centre for the Study of Capital Market Dysfunctionality



Dimitri Vayanos (FMG, LSE)

The Euro-nomics Proposal and Dimitri Vayanos' Research at the FMG

Dimitri Vayanos' work as part of the Euro-nomics group ties in with his broader research as Director of the Paul Woolley Centre at the FMG.

This research emphasises the role of financial intermediaries for the smooth functioning of financial markets. For instance, in "Equilibrium and welfare in markets with financially constrained arbitrageurs", co-authored with Denis Gromb and published in 2002 (so well in advance of the recent financial crisis), Vayanos shows that market liquidity depends on the capital of financial intermediaries, such as arbitrageurs. If arbitrageurs have to collateralise comparable positions and their wealth is not enough to cover variations in those positions following a price shock, they might be obliged to liquidate the positions, hence sharply reducing the liquidity that they provide to the market. This is related to the debate on systemic risk, ie, on whether a worsening of the financial condition of some market participants can propagate into the financial system with harmful effects. In such a credit crunch situation,

asset prices can markedly diverge from their fundamental value, leading to potentially severe misallocation of resources in the macroeconomy. ESBies offer one mechanism through which financial intermediaries balance sheets can be insulated from the fallout of sovereign default. A more resilient European banking sector will limit contagion and the financial dislocations following potential sovereign default.

The Euro-nomics proposal also links with Vayanos' work on the impact of government or regulation-induced change in the excess demand of bonds on long-term interest rates. In his paper "Price Pressure in the Government Bond Market", co-authored with Robin Greenwood, Vayanos gives striking evidence that government interventions can generate asset demand and move asset prices. He shows how this evidence can be explained through a theory of preferred-habitat for investors. This research supports the Euro-nomics group idea that uniform treatment of sovereign debt in financial regulation may have shored up demand for sovereign bonds, decoupling bond yields from underlying issuer country credit risk. This allowed governments to run capital and fiscal imbalances unchecked by market discipline. The ESBies proposal would remove these distorting demand effects and would allow sovereign yields to more closely reflect issuer country credit risk.

Overall, the Euro-nomics proposal follows closely, in spirit, the research agenda of the Paul Woolley Centre. Efficient allocation of resources through financial markets is far from automatic. Policy makers must constantly reassess the behaviour of market participants and their interaction with the regulatory system. In this spirit, the Euro-nomics group identifies the current treatment of European sovereign bonds in the banking system as distorting factor. ESBies offer an actionable policy proposal to address this issue.

Conclusions

The Euro-nomics proposal does not in itself solve the current fiscal problems in the European periphery countries. Structural macroeconomic reform will be necessary to tackle the capital and fiscal imbalances that have built up. European banks will have to fully recognise the losses they have incurred on their sovereign bond holdings, which may require further rounds of recapitalisation by governments.

But the introduction of ESBies would address a fundamental weakness in the current design of the European financial system. It would also provide some immediate relief in the crisis, showing market participants that European governments are taking a decisive step towards recovery. The introduction of ESBies therefore offers an important building block towards a more viable European financial architecture.

Article written by **Nelson Camanho Costa-Neto** (FMG, LSE), **Luca Fornaro** (FMG, LSE), **Christoph Ungerer** (FMG, LSE) and edited by **Dimitri Vayanos** (FMG, LSE).

Nelson Camanho Costa-Neto is a fifth year Finance PhD candidate. Nelson won the 2011 Deutsche Bank prize in financial risk management and regulation for co-authoring the paper "Credit Rating and Competition".

Luca Fornaro is a fifth year Economics PhD candidate. He is currently working on the relationship between crises, exchange rate regimes and macroprudential policies.

Christoph Ungerer is a fourth year Economics PhD candidate. His research focuses on markets with search frictions (the bond market, labour markets, and the property market).

Nelson, Luca and Christoph are the FMG's 2011/12 Paul Woolley Centre Scholars.

SPECIAL LONDON FINANCIAL REGULATION SEMINAR: A TALK BY GARY GENSLER ON THE GLOBAL REFORM FOR DERIVATIVES MARKETS

13 October 2011



Chairman Gary Gensler (US Commodity Futures Trading Commission)

US Commodity Futures Trading Commission (CFTC) **Chairman Gary Gensler** visited the FMG to deliver a talk on the latest changes and challenges in regulating global derivatives markets.

Chairman Gensler recognised the failure of the financial and regulatory system during the recent financial crisis and current financial uncertainty in the US and Europe. He went on to identify swap products (interest rate swaps, foreign exchange swaps, credit default swaps), created over the last 30 years, as playing a major role in the latest market turmoil. Given that markets work best when they are transparent and open, there is no reason why swaps should not be regulated just as other derivatives are (eg, futures have been regulated since the 1930s).

In 2010 US Congress enacted the Dodd-Frank Act which will enable swap regulation. The CFTC and Securities and Exchange Commission (SEC) will oversee swaps (both OTC and exchange traded) by creating three pillars of regulation: transparency (via a real-time reporting and swap execution facility), a clearing house, and dealers' regulation. Given that in the US alone the total amount of outstanding swaps contracts have a value of around 300 trillion USD, introducing transparency via regulation will have a significant impact on the economy by lowering spreads and thereby lowering costs for companies. On the other hand, swaps clearing should be all encompassing, ie, swaps should be cleared both on and off the exchange. System stability and risk mitigation will be ensured by dealers' regulation through capital, liquidity and margin requirements.

Moreover, in order to ensure smooth functioning of the global market, regulation should be aligned between continents. Currently

the CFTC is working together with its European counterpart to ensure this, however Gensler acknowledged that more should be done in this field as it is essential that foreign regulation is comparably consistent and comprehensive.

During the Q&A session several questions were addressed regarding the risk of overregulation. Gensler was firm about the need for regulation and the benefits it will bring by lowering transaction costs and reducing systemic risk.

He added that it is absolutely essential that the regulation becomes global since capital moves freely and instantly across the globe. There was a debate about what portion of the outstanding 620+ trillion USD swaps will be cleared globally; Gensler gave a rough estimate that around 80 per cent of the global interest rate swaps market (the biggest swaps market) will be regulated.

There is a podcast available of this event. To view it please visit the Financial Markets Group homepage, click on Events, then select Audio podcasts and video streaming.

Seminar organised by **Andrei Kirilenko** (Commodity Futures Trading Commission), and **Christopher Polk** (FMG, LSE).

Reported by **Milan Martinovic** (FMG, LSE). Milan is a second year PhD candidate in Finance. Milan's research interests lie in private equity and venture capital, and executive compensation.



CORPORATE GOVERNANCE AT LSE RESEARCH DEBATE: “ON CORPORATE GOVERNANCE: A VIEW FROM THE US”

19 October 2011



Martin Lipton (Wachtell, Lipton, Rosen & Katz)

In an event sponsored by Corporate Governance at LSE and the Law and Financial Markets Project, **Martin Lipton** founding partner of Wachtell, Lipton, Rosen and Katz gave a talk at LSE entitled “On Corporate Governance: A View from the US”.

Martin Lipton specialises in advising major corporations on mergers and acquisitions and matters affecting corporate policy and strategy. He has also written and lectured extensively on these subjects.

David Kershaw (Law Department, LSE) was the responding commentator for the evening. The event saw Lipton discuss a broad range of topics including his pioneering role in the development of takeover defences in the United States and his view on the role of the corporation and its relationship to shareholders and other stakeholders. He also discussed current developments in the United States including the early US experience with “say on pay” and the lessons from the financial crisis on board composition. A lively debate followed between

representatives of UK institutional shareholders, corporate law firms, regulators and academics.

Corporate Governance at LSE is a research initiative launched by the Financial Markets Group, under the Corporate Finance and Governance Research Programme, to address the need for cross-border and interdisciplinary research in Corporate Governance. To this effect the programme brings together academics from Finance, Law, Economics and Management, and actively seeks collaboration opportunities with professional bodies, corporations and groups.

The Law and Financial Markets Project is an academic and practitioner based initiative established by LSE and based in LSE’s Law Department. The project, amongst other things, aims to bridge the gap between lawyers in the commercial world and those in academic institutions. It provides opportunities for UK and overseas lawyers to participate in the study of how law serves and interacts with financial market activity.

Research debate organised by: **Tom Kirchmaier** (FMG, LSE). Reported by **David Kershaw** (Department of Law, LSE).



NEW MEMBERS OF STAFF



Moqi Xu is a Lecturer in Finance at LSE. She specialises in empirical corporate finance; especially capital structure, mergers and acquisitions, equity issues, and governance. Much

of her work is on the time horizon of executives. Moqi obtained her PhD from INSEAD and her MBA from Tulane University. She also worked as a Fellow Associate at McKinsey & Company, Vienna.



Daniel Paravisini is the Gary Winnick and Martin Granoff Associate Professor of Business, at the Graduate School of Business of Columbia University. He is

also a visiting Reader at LSE and has a PhD in Economics from the Massachusetts Institute of Technology. Daniel has devoted particular attention in his research to the incentives of agents in financial institutions and to the role of banks in the transmission and amplification of real shocks, with a focus on the effect of credit fluctuations on international trade. His work is published in leading finance journals and has twice received the Brattle Award; given to the best papers in Corporate Finance published in the *Journal of Finance* every year. Daniel is also a research affiliate of the National Bureau of Economic Research, the Bureau for Research and Economic Analysis of Development, the International Growth Centre and the SME Initiative at Innovations for Poverty Action.



Frankie Clarke is the new Events, Communications and Publications Officer for the FMG. Before joining the FMG Frankie worked at Newcastle University as Alumni Relations

coordinator after gaining her BSc in Business and Management from Aston Business School.



VISITING SCHOLARS



Petri Jylhä is visiting the FMG from Aalto University (formerly Helsinki School of Economics) where he is expected to earn his PhD in Finance in the spring of 2012.

His research interests include asset pricing, hedge funds, market frictions, international finance, and delegated portfolio management. Petri's paper "Speculative Capital and Currency Carry Trades", a joint work with Matti Suominen of Aalto University, is published in the *Journal of Financial Economics*. Currently, he studies topics such as liquidity provision by hedge funds, effect of capital flows on hedge fund returns, and misreporting of hedge fund returns. At Aalto University, Petri has been involved in teaching undergraduate courses in investments and derivatives, and a doctoral course in corporate finance. He also advises undergraduate students on their theses.

"Coming from a relatively small department it's great to have so many people around you and so much happening all of the time. This results in the biggest benefit for me: exchange of ideas. I will hopefully get a lot of high quality feedback on my own research and I hope to be exposed to a great variety of ideas and questions that other people are working on and presenting."

Petri Jylhä (FMG visiting Scholar 2011)



Vladimir Vladimirov is a fifth year PhD student in the Department of Finance at Goethe University Frankfurt. His main research interests lie in the area of

theoretical corporate finance, security design, and auction theory. His job market paper shows that cash constrained bidders in auctions fully pass on their costs of financing to the seller. He co-authored a paper with Roman Inderst (formerly of the FMG, LSE) on how preserving debt or equity capacity affects financing decisions when capital needs to be raised at short notice. His other research includes an empirical study on the effect of creditor rights on the indirect costs of bankruptcy. Prior to starting his PhD, he obtained a Masters degree from Ludwig Maximilians University in Munich. He is on the job market this year and says his ideal job would be as an Assistant Professor within a finance department.



NEW RESEARCH STUDENTS

"I like the fact that the FMG is very active in terms of organizing seminars and conferences that attract outstanding academics and policymakers. In particular, I like the efforts that the FMG makes in order to contribute to the current policy debate, for example by organizing policy related events."

Luca Fornaro (FMG Research Student and 2011/12 Paul Woolley Centre Scholar)

"The FMG has a collaborative atmosphere for researchers in every field of finance. The major benefit of being at the FMG is that it allows a researcher to communicate and test ideas with fellow researchers. It's great when you have a question and can just walk a few minutes to an expert on this topic."

Huaizhi Chen (FMG Research Student)



Toni Ahnert is a 2011/12 Deutsche Bank Doctoral Fellow and is a third year PhD candidate in Economics, under the supervision of Margaret Bray (Economics Department) and

Dimitri Vayanos (FMG). His research interests are banking, systemic risk, financial crisis and macro-prudential regulation. He published a co-authored policy chapter in an IMF book on fiscal consolidation. The chapter derives lessons from the UK fiscal adjustment episodes of the previous four decade and hopes to inform the current debate.



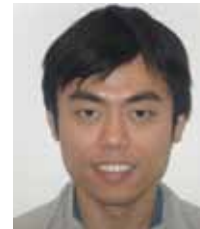
Svetlana Bryzgalova is a PhD candidate in Economics, and is in the third year of her PhD under the supervision of Peter Robinson (Economics Department) and Christian Julliard

(FMG). She has an interest in empirical asset pricing, and is collaborating with Christian on her research.



Gennaro Catapano is a fifth year PhD candidate in the Department of Finance, under the supervision of Mikhail Chernov (FMG). His research interests are theoretical and empirical

asset pricing and he is collaborating on research with Christian Julliard (FMG):



Huaizhi Chen is a PhD candidate in Finance and is in the second year of his PhD, under the supervision of Mikhail Chernov (FMG). His research interests are fixed income markets and

empirical asset pricing.



Luca Fornaro is a 2011/12 Paul Woolley Centre Scholar and a fourth year PhD candidate in the Economics Department, under the supervision of Gianluca Benigno and Christopher

Pissarides (both in the Economics Department). His research interest is international macro-economics and he is currently working on the relationship between crises, exchange rate regimes and macro-prudential policies. Luca is writing a paper with Gianluca on exchange rate policy and growth.





Yiqing Lu is a PhD candidate in Finance, and is in her second year, under the supervision of Kathy Yuan (FMG). Her research interests are financial intermediation, corporate finance and

contract theory.



Milan Martinovic is a PhD candidate in Finance and is in his second year, under the supervision of Ulf Axelson (FMG). His research interests are private equity and venture capital

and executive compensation.



Thomas Maurer is a fourth year PhD candidate in Finance, under the supervision of Dimitri Vayanos (FMG), Jack Favilukis (FMG) and Stavros Panageas (Booth School of Business). His

research interests are general equilibrium asset pricing, learning in financial markets, demographic change and uncertainty in finance, investment and endogenous capital accumulation.



Christoph Ungerer is a 2011/12 Paul Woolley Centre Scholar. He is currently in his fourth year of a PhD in Economics, under the supervision of Christopher Pissarides (Economics Department).

His broad research interests are finance, macro-economics and applied econometrics; he is currently focussing on markets with search frictions (the bond market, labour markets and the property market).



Marcela Valenzuela is a fourth year PhD candidate in Finance, under the supervision of Christian Julliard (FMG) and Christopher Polk (FMG). Her research interests are financial econometrics,

asset pricing and market microstructure; she is currently collaborating on research with Jon Danielsson (FMG) and Kevin James (FMG and Bank of England).



Yu-min Yen is in his fifth year of a PhD in Finance, under the supervision of Oliver Linton (Cambridge University) and Christian Julliard (FMG). His research interests are financial econometrics,

fixed income securities, and portfolio choice; he is currently collaborating on research with Philippe Mueller and Andrea Vedolin, both FMG members.



Ilknur Zer is in her fourth year of a PhD in Finance, under the supervision of Jon Danielsson (FMG) and Kevin James (FMG and Bank of England). Her research interests are asset pricing (empirical),

market microstructure and financial risk analysis.

"I think the opportunity to communicate and share research ideas and experience is the most exciting part of being at FMG. The research seminars organised here are extremely useful, allowing one to broaden one's horizons."

Svetlana Bryzgalova (FMG Research Student)



FMG EVENTS

Events that have taken place since the publication of the previous *Review* in July 2011 (Spring/Summer issue, No 88).

Public Lectures

LSE Perspectives on the Sovereign Debt Crisis

2 November 2011

Chair: Charles Goodhart (FMG, LSE)

Panelists: Jon Danielsson (FMG, LSE), Bob Hancké (European Institute, LSE), Vassilis Monastiriotis (European Institute, LSE), and Dimitri Vayanos (FMG, LSE)

Capital Markets Workshops

Dynamic Risk Management

5 October 2011

Adriano Rampini (Duke University)

Specialisation, Productivity and Financing Constraints

12 October 2011

Robert Marquez (Boston University)

Volatility, the Macro-economy and Asset Prices

19 October 2011

Ravi Bansal (Duke University)

Political uncertainty and risk premia

26 October 2011

Lubos Pastor (University of Chicago Booth School of Business)

Stronger Risk Controls, Lower Risk: Evidence from US Bank Holding Companies

2 November 2011

Andrew Ellul (Indiana University, Kelley School of Business)

Is the Stock Market Just a Side Show? Evidence from a Structural Reform

9 November 2011

Murillo Campello (Cornell University)

Lunchtime Workshops

Stock Market Tournament

5 October 2011

Kathy Yuan (FMG, LSE)

Inefficient Investment Waves

12 October 2011

Peter Kondor (Central European University)

Social Proximity and Loan Outcomes

19 October 2011

Daniel Paravisini (FMG, LSE)

Is Historical Cost Accounting a Panacea? Market Stress, Incentive Distortions and Gains Trading

26 October 2011

Andrew Ellul (Kelley School of Business Indiana University)

Smart Buyers

2 November 2011

Mike Burkart (Stockholm School of Economics)

Asset Pricing Implications of Demographic Change

9 November 2011

Thomas Maurer (FMG, LSE)

London Financial Regulation Seminars

The Optimal Role and Structure of the Financial Policy Committee

5 October 2011

Debate between Willem Buiter (Citigroup) and Charles Goodhart (FMG, LSE)

Global Reform for Derivatives Markets

13 October 2011

Gary Gensler (US Commodity Futures Trading Commission)

What is the Source of the Turmoil in the Markets for Currencies and Assets?

24 October 2011

Robert Aliber (University of Chicago)

PhD Seminars

All seminars are given by current LSE PhD candidates.

What prices asset returns?

6 October 2011

Svetlana Bryzgalova (FMG/Economics Department)

Endogenous Information Acquisition with Monopolistic Market Makers

13 October 2011

Sean Lew (Finance Department)

Confidential Treatment Requests

20 October 2011

Terence Teo (FMG/Finance Department)

Contingent Capital and Bank Regulation

27 October 2011

Jing Zeng (FMG/Finance Department)



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 as part of the core FMG Research Programmes is published in the FMG Discussion Paper (DP) series. The Paul Woolley Centre for Capital Market Dysfunctionality (PWC) has also published some of its research as FMG Discussion Papers, as has the AXA-funded risk management programme (AXA).

DP 688 (PWC26)

CDS Auctions

Mikhail Chernov, Alexander S Gorbenko, Igor Makarov

We analyse credit default swap settlement auctions theoretically and evaluate them empirically. In our theoretical analysis, we show that the current auction design may not result in the fair bond price and suggest modifications to the auction design to minimize mispricing. In our empirical study, we find support for our theoretical predictions. We show that an auction undervalues bonds by 10%, on average, on the day of the auction and link this undervaluation to the number of bonds that are exchanged during the auction. We also document a V-shaped pattern in underpricing during the days surrounding the auction: in the days leading up to the auction, the extent to which bonds are underpriced declines, while after the auction, the extent to which they are underpriced increases, with the smallest underpricing coming on the day of the auction.

DP 689 (PWC27)

Delegated Activism and Disclosure

Amil Dasgupta, Konstantinos Zachariadis

Mutual funds hold large blocks of shares in many major corporations. Practitioners and regulators alike have been concerned that mutual funds use their proxy votes in a pro-management manner in order to garner lucrative pensions administration contracts, thus hindering shareholder value. Such concerns led the SEC to mandate the disclosure of mutual fund proxy votes starting in 2003. We present a simple model of mutual fund proxy voting in the presence of potential business ties. Our model generates clean predictions on how funds would vote both prior and subsequent to mandatory

disclosure. We provide theoretical foundation for the limited activism of mutual funds and demonstrate that mandatory disclosure is not a panacea. We also show that the strategic interaction between multiple mutual fund blockholders of comparable size can generate counterintuitive non-monotone relationships with relevant empirical implications.

This discussion paper won a *Paul Woolley Centre discussion paper prize*.

DP 690

Investment banking careers: An equilibrium theory of overpaid jobs

Ulf Axelson, Philip Bond

We develop an optimal dynamic contracting theory of overpay for jobs in which moral hazard is a key concern, such as investment banking. Overpaying jobs feature up-or-out contracts and long work hours, yet give more utility to workers than their outside option dictates. Labour markets feature “dynamic segregation,” where some workers are put on fast-track careers in overpaying jobs and others have no chance of entering the overpaying segment. Entering the labour market in bad economic times has life-long negative implications for a worker’s career both in terms of job placement and contract terms. Moral hazard problems are exacerbated in good economic times, which leads to countercyclical productivity. Finally, workers whose talent would be more valuable elsewhere can be lured into overpaying jobs, while the most talented workers might be unable to land these jobs because they are “too hard to manage”.

DP 691

What is the Consumption-CAPM missing? An Information-Theoretic Framework for the Analysis of Asset Pricing Models

Anisha Ghosh, Christian Julliard,
Alex P Taylor

We study a broad class of asset pricing models in which the stochastic discount factor (SDF) can be factorised into an observable component and a potentially unobservable, model-specific one. Exploiting this decomposition we derive new entropy bounds that restrict the admissible regions for the SDF and its components. Without using this decomposition, to a second order approximation, entropy bounds are equivalent to the canonical Hansen-Jagannathan bounds. However, bounds based on our decomposition have higher information content, are tighter, and exploit the restriction that the SDF is a positive random variable. Our information-theoretic framework also enables us to extract a non-parametric estimate of the unobservable component of the SDF. Empirically, we find it to have a business cycle pattern, and significant correlations with both financial market crashes unrelated to economy-wide contractions and the Fama-French factors. We apply our methodology to some leading consumption-based models, gaining new insights about their empirical performance.

DP 692 (PWC28)

The Wall Street Walk when Blockholders Compete for Flows

Amil Dasgupta, Giorgia Piacentino

An important recent theoretical literature argues that the threat of exit can represent an effective form of governance when the blockholder is a principal. However, a significant fraction of equity blocks is held by delegated portfolio managers. How do agency frictions arising from the delegation of portfolio management affect the ability of blockholders to govern via the threat of exit? We show that when blockholders are sufficiently career concerned exit will fail as a disciplining device. Our results have testable implications on the relative degree to which different classes of delegated portfolio managers use exit as a form of governance.

This discussion paper won a *Paul Woolley Centre discussion paper prize*.

SPECIAL PAPERS

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

Research published in the Special Paper series often plays a role in public debate, being a vehicle for FMG staff to comment on topical questions in finance and influence policy.

SP 201

The European Collapse of 2012/13

Charles Goodhart

Looking back now with the benefit of hindsight, the disastrous European collapse of 2012/13 appears from the vantage point of 2020 to have had a certain grim inevitability. Yet at the time, and in the years leading up to this debacle, it was far from clear what the future would hold, and many protagonists, especially in the policy-making arena, continued to contend that all would turn out alright, especially if their own policy proposals were followed.

SP 202

Minsky's Financial Instability Hypothesis and the Leverage Cycle

Sudipto Bhattacharya, Charles Goodhart, Dimitrios Tsomocos, Alexandros Vardoulakis

Busts after periods of prolonged prosperity have been found to be catastrophic. Financial institutions increase their leverage and shift their portfolios towards projects that were previously considered too risky. This results from institutions rationally updating their expectations

and becoming more optimistic about the future prospects of the economy. Default is inevitably harsher when a bad shock occurs after periods of good news. Commonly used measures to forecast risk in the system, such as VIX, fail to capture this phenomenon, as they are also biased by optimistic expectations. Competition among financial institutions for better relative performance exacerbates the boom-bust cycle. We explore the relative advantages of alternative regulations in reducing financial fragility, and suggest a novel criterion for improvement of aggregate welfare.

SP 203

The Macro-Prudential Authority: Powers, Scope and Accountability

Charles Goodhart

Neither the achievement of price stability, via the MPC, nor the application of micro-prudential oversight, via the FSA, led to overall financial stability. There is a gap that needs to be filled by a macro-prudential authority (M-PA), FPC in the UK. The only macro-prudential instrument used heretofore has been the publication of Financial Stability Reviews (FSR). While worthy, these have been ineffective.

FORTHCOMING PAPERS

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Philippe Mueller, Andrea Vedolin, Yu-Min Yen

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