

THE 25TH ANNIVERSARY OF THE FINANCIAL MARKETS GROUP

January 2012

The Financial Markets Group and Department of Finance at LSE organised a two-day conference and dinner to celebrate the 25th Anniversary of the foundation of the Group.

Over 100 past and current members of the Group, as well as past Steering Committee members joined the founding Chairman, **Sir David Walker**, and the Founding Directors, **Sir Mervyn King** and **Charles Goodhart**, to recall the Group's history and achievements.

The conference involved presentations from a range of members of the Group who had travelled from all over the world to attend the event. The papers presented were selected to reflect the breadth and depth, as well as the chronology of the Group's history and drew upon the contribution of some of the younger members. Over the two days, nine papers were presented and at the end of the first day Charles Goodhart chaired a lively panel discussion on Financial Regulation and proposals to change the regulatory landscape.

Christopher Polk (Director of FMG) introduced the conference with a warm welcome to all the attendees. He thanked everyone for their enthusiasm shown in attending the event and offering to present papers. He noted that it was only possible to select some of the excellent range of papers offered and remarked that the broad scope and high quality of the papers on the programme were a reflection of the success of the FMG. He concluded the opening remarks by thanking Sir David Walker, Charles Goodhart



l-r: **Sir David Walker**, **Christopher Polk** (FMG, LSE), **Sir Mervyn King** (Bank of England), **Charles Goodhart** (FMG, LSE) and **David Webb** (Department of Finance/FMG, LSE)

and Sir Mervyn King for their initiative in founding the FMG 25 years ago.

The first session of the conference was chaired by **Dimitri Vayanos** (FMG) with presentations by **Andrea Caggese** (UPF) and **Guillaume Plantin** (Toulouse). Caggese's paper co-authored with **Anders Perez** (UPF) another past member of the Group entitled "*Aggregate Implications of Financial and Labour Market Frictions*" developed a general equilibrium model with both financial and labour market friction and demonstrated that the precautionary behaviour for firms and households due to uncertainty is an amplifying mechanism for financial shocks. Caggese illustrated how the mechanism works and quantified its impact through a careful

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FMG 25TH ANNIVERSARY CONFERENCE

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Sir Mervyn King (Bank of England)

calibration exercise. A lively discussion ensued as to the economic significance of the results claimed in the paper.

The second paper in this session presented by Guillaume Plantin was on *"Inequality, Tax Avoidance, and Financial Instability"*. Plantin presented a theoretical model of how the increasing returns to tax avoidance can induce risk-averse middle class agents to take on financial risks. He showed that this can lead to more extreme income distribution and went on to show that election pressure may lead incumbent politicians to encourage this kind of risk taking. Finally by interpreting the results from excessive risk-taking as financial instability, he remarked that this model demonstrated how financial instability can be affected by external factors outside the financial system.

The second session, chaired by **Jean-Charles Rochet** (Toulouse) included presentations by **Claudia Custodio** (Arizona State) and **Gilles Chemla** (Imperial College London). Custodio's paper entitled *"The Declining Corporate Debt Maturity: the Impact of Asymmetric Information and New Listings"* presented evidence about the general decrease in corporate debt maturity for US industrial firms from 1976 to 2008, whilst the decrease varies significantly across firms. She then provided an analysis on the potential drivers of this decrease in debt maturity and found that it is mainly driven by the shorter debt maturity of new listings. She showed that firms with higher information asymmetry are the main drivers, whereas agency costs, signalling and liquidity risk theories do not seem to have contributed to the decrease.

Chemla presented *"Equilibrium Security Design and Liquidity Creation by Privately-Informed*

Issuers". The paper uses a security design framework to show how the information sensitivity of securities is co-determined with the degree of market liquidity and market mis-pricing. Having done this he showed that this inefficiency can be ameliorated by government's provision of public liquidity, which also crowds-in private liquidity.

The final session of day one was a panel discussion on banking regulation moderated by Charles Goodhart. Goodhart asked each of the four panellists to give brief presentations and then opened the discussion to the audience. Each of the panellists was asked to discuss one or two principal regulatory reforms that they would make in the light of the financial crisis to improve the workings of the financial system.

Dirk Schoenmaker (Duisenberg School of Finance) focussed on the importance of Macro-prudential regulations which he felt needed to address cross-border banking issues and problems of free-riding more effectively.

Thomas Gehrig (Universität Wien) focused on the Basel process and in particular on the capital requirements. He argued that banks need to hold more equity and that the rules needed to reduce opportunities for strategic manipulation. He questioned the economic rationale for subsidising bank debt via tax shield, in particular if bank leverage leads to financial instability and the associated social costs. **Vittoria Cerasi** (Università degli Studi di Milano-Bicocca) argued that executive compensation, capital regulation and risk management are intricately linked, so when drafting regulation policy regulators should consider them together. She suggested that in order to reduce bank executives' incentive to take excessive risk, their compensation schemes need to be more aligned with stakeholders including creditors and tax payers, not just shareholders. Furthermore, the role of internal governance and in particular the role of the chief risk officer needs further evaluation. Finally, **Rafael Repullo** (CEMFI) offered a critical assessment of the Basel III proposals and argued that more standard economic reasoning should be incorporated in future proposals. He argued that the elephant in the room is proper economic analysis. He provided an analysis showing that the pro-cyclical effect of capital regulation has not been mitigated as banks' self-reporting on



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L-r: **Enrique Sentana** (CEMFI), **Mark Robson** (Bank of England) and **Ian Tonks** (University of Bath)

risk-weighted asset measures are subject to manipulation. Moreover the threat of regulatory capture stemming from regulators' discretion has not been addressed in the current proposal.

Charles Goodhart concluded the panel discussion with three remarks. First, he believes the key problem in the Basel discussion of capital requirement is that there is no common understanding of what the appropriate capital buffer should be to absorb negative shocks and to mitigate risk-taking incentives of bank executives. Second, there is no effective mechanism to impose penalties on banks which reach minimum requirements. He concurred with Repullo that the Basel proposals would benefit from more rigorous economic scrutiny and requested economists to do more work and engage more actively in advisory capacities.

A dinner then followed where Christopher Polk introduced Sir David Walker and Sir Mervyn King who both spoke about the early days of the Group with candour and humour. After dinner David Webb and Charles Goodhart closed the evening with their own memories of the FMG.

Day two opened with a session chaired by **Patrick Bolton** (Columbia University) and presentations by **Fausto Panunzi** (Bocconi), **Christian Hellwig** (Toulouse University) and **Jan Bena** (University of British Columbia). Panunzi's paper on "*Legal Investor Protection and Takeovers*", co-authored with **Mike Burkart** (Stockholm School of Economics), **Denis Gromb** (INSEAD) and **Holger Mueller** (NYU Stern School of Business), pointed out that the link between legal investor protection and efficiency has been studied before but little attention has been given to its effects on takeovers. He showed that in

a multi-bidders context, strong Legal Investor Protection (LIP) facilitates efficient takeovers to take place, as LIP limits post-merger private benefit extraction by the bidder. Thus it allows bidders to borrow more so that the outcome of the bidding contest is more likely to be determined by the efficiency gains of the merger, rather than the initial funding capacity of bidders. With this effect of LIP on funding capacity, he also provided an analysis of the optimal allocation of voting rights and sales of controlling blocks.

In the same session Christian Hellwig presented "*A Theory of Asset Prices based on Heterogeneous Information*". In this theoretical paper, he showed that noisy aggregation of dispersed information can result in a systematic departure of asset prices from the fundamental value arising from the dividend process, as the asset price depends upon the information of the marginal trader. He further showed that the sign of the departure depends upon whether the securities are exposed to upside or downside risks and this information friction can generate excess price variability and low return predictability. By applying this result, he illustrated how the classic Modigliani-Miller Theorem fails in general and security originators can maximise profits by selling equity and debt to different markets with different information frictions.

The final paper in this session was presented by Jan Bena who presented his work on "*Corporate Innovation Activity and Expected Returns*". The paper studies the impact of innovation on asset pricing. He first documented that firms with high relative shares of patents have lower expected returns than less innovative ones, as the innovation leaders tend to have a smaller loading on common risk factors (0.9 market beta versus 1.4). He then provided a theoretical model in a real option framework to show that when firms invest sequentially, the more technologically efficient firm is the leader and always has a lower common risk factor loading than the follower, as is consistent with the evidence.

The final session of the conference was chaired by **Andrew Patton** (Duke) and focussed on financial econometrics, with presentations by **Enrique Sentana** (CEMFI) and **Dennis Kristensen** (UCL). In his presentation entitled "*A Unifying Approach to the Empirical Evaluation of Asset Pricing Models*", Sentana stated that the two main



Kevin James (FMG/Bank of England)

approaches in testing linear factor pricing model, namely regression and Stochastic Discount Factor (SDF) methods, typically yield different estimation results. In this paper he showed that single-step regression methods such as Continuously Updated General Method of Moments (CU-GMM), in contrast to standard two-step or iterated GMM procedures, can produce numerically identical values for the price of risk, pricing errors, Jensen's alphas and over-identifying restriction tests. Thus he argued that there is effectively a single method to empirically evaluate asset pricing models.

In the final presentation of the conference Dennis Kristensen presented his paper "*Smooth Filtering and Estimation of Stochastic Volatility Models Using High-Frequency Data*". The paper was motivated by the fact that dynamic stochastic models are widely used in economics but sometimes the state variables are not observable. Hence, estimating the likelihood of unobserved latent state variables is important but not easy. In this paper he proposed a novel Sequential Monte Carlo (SMC) method for maximum likelihood estimation (MLE) of dynamic latent variable models (DLVM). As opposed to traditional SMC algorithms, this novel method delivers a smooth likelihood approximation and thus allows MLE. He also reported an application of this new algorithm to continuous-time stochastic volatility models.

The conference concluded with a short vote of thanks and closing remarks from **Patrick Bolton** and final closure by **Christopher Polk**.

Reported by **John C F Kuong** (FMG, LSE)

This event was kindly sponsored by the LSE Annual Fund (lse.ac.uk/AnnualFund) and the Department of Finance.

FINANCIAL MARKETS GROUP – A HISTORY

To mark the 25th Anniversary of the Financial Markets Group **Christopher Polk** (Director, FMG) and **David Webb** (Head of Department of Finance, LSE and former FMG Director) take a look at the FMG's impressive history.

January saw us celebrate the 25th anniversary of the foundation of the Financial Markets Group. The Group was founded by Sir David Walker, Charles Goodhart and Sir Mervyn King with the intention of encouraging academic research in the workings of financial markets and their interaction with the real economy, and to encourage academic research into the regulation of financial markets and institutions. At the time, just as today, financial markets were subject to considerable change with "Big Bang" having occurred only several months earlier and of course the October '87 crash yet to happen. The Group was initially based in the Economics Department and, under the leadership of Charles and Mervyn, brought together a number of young academics and some very good graduate students. The early days of the Group's research very much reflected the interests of the co-directors who encouraged a number of the younger members of staff to direct their research towards financial markets, and also encouraged some of our best graduate students to develop research careers in the finance area. From the outset the Group established itself as a major centre in the UK for first class conferences and seminars on the major regulatory issues of the time, bringing together the world's best academics and practitioners to further our understanding. The Group also became a natural place for some of the world's best academics to visit for both short and extended periods of time. When one looks back at the past Annual Reports of the Group one cannot fail to be impressed with the sheer quality of the visitors in those early days and indeed throughout the Group's entire history. FMG colleagues from those early days, in a variety of ways, have gone on to have outstanding careers with five having served on the Monetary Policy Committee either as internal or external members. Others have gone on to successful careers in central banking, the Civil Service, international organisations including the IMF and World Bank, as well as in the City. One is of course the current Director General of the Office of Fair Trading. A remarkable number have gone on to have successful academic careers.

After the departure of Mervyn to the Bank of England in early 1991 David Webb assumed the Directorship and the landmark event in

that period was the establishment of the FMG as an ESRC Research Centre for the period 1994-2004. At this juncture Sir David Walker stood down as Chairman of the Group and was succeeded by Rupert Pennant-Rea and subsequently by Brian Quinn and John Trueman, to all of whom we owe a debt of gratitude. Throughout this period the Group significantly developed greater strength in core areas of asset pricing and corporate finance research. The strength and success throughout this time was due, more than anything else, to the sheer quality and commitment of the excellent graduate students that the Group was able to attract. We are immensely proud of what they did whilst they were here and their subsequent achievements, many of whom have gone on to have very strong academic careers, some even becoming academic field leaders. The Group also benefitted enormously from the commitment in those days of a handful of academics, making it even more remarkable that it succeeded in making the imprint that it has.

If one reads the Annual Reports and Quarterly Reviews of the Group over the last 25 years, one cannot help but be struck by the high quality of conferences that have been run, with over 130 events having been organised. Although it's not our intention to name names here, Charles Goodhart should be given special mention for the incredible commitment he has shown over the years to establishing the FMG as one of Europe's principal centres for regulatory research, and undeniably the principal forum for academic and practitioner debate of the evolving landscape of financial regulation. Our principal seminar series of capital markets and financial regulation have also served as central fora for the dissemination of our work to the broader academic and practitioner communities.

In the 25 years of the Group's history the profile of finance research and teaching has changed dramatically almost everywhere and in particular at the LSE. The FMG has not only served as a home for graduate students, Research Officers and Research Fellows, and the host for our research and its dissemination, but is really the birth place of what is now the Department of Finance at the LSE. The original membership of the FMG was almost entirely from the Economics Department. In 1991 Finance

was established as a small group within the Accounting and Finance Department and this group complemented a slightly larger group in the Economics Department, but the FMG was the place that gave identity to finance as an area of research at the LSE. The growth of finance teaching over the years and complimentary growth in the number of academic faculty lead to the establishment of a separate Finance Department in 2007. Today this Department has 34 academic faculty positions. The Department and the FMG are now fully complementary activities with the FMG, under the Directorship of Christopher Polk since 2009, still remaining the central hub of research and in particular maintaining the crucial role of bringing together the finance faculty and colleagues in the Economics Department, as well as graduate students from both departments.

The early days of the FMG were very dependent upon funding from banks and the role played by Sir David Walker to ensure the steady funding during those early days, together with the commitment of the members of the Steering Committee must be acknowledged, and for this we are extremely grateful. In subsequent years, we were fortunate enough to secure substantial amounts of public funding, in particular through the ESRC Centre Grant and a significant number of large ESRC, EPSRC and Leverhulme grants. We have also hosted numerous EU research networks on a whole range of central topics. We think this investment has shown a good return over the years, both in terms of supporting the development of young talent and the production of around 900 special and working papers, many of which have been disseminated through our conferences and seminars. In more recent times we have been fortunate in complementing this grant money with large sums of programme specific research funds from non-public sources, notably Deutsche Bank, UBS, AXA and Abraaj Capital. Special note should be given to Paul Woolley who generously endowed a whole programme of research, funding the "Centre for the Study of Market Dysfunctionality" within the FMG.

To conclude, we hope the FMG has fulfilled some of the early vision of its founders, and on behalf of the current FMG and the Department of Finance at the School we believe we owe the Group a thank you for the significant role that it played, not just in so many of our lives but in

the creation of finance as a strong research and teaching area at the LSE.

David Webb

Head of Department
of Finance

Christopher Polk

Director
Financial Markets Group

FMG Review: 1987-2011

Since the first edition of the FMG Review was published in December 1987, there have been a total of 90 editions each documenting the latest research and news from the Centre. To give you a taster of how the FMG has evolved over the years we've compiled a selection of Review covers.



NEW RESEARCH PROGRAMME: FINANCIAL REGULATION AND RISK MANAGEMENT

The Financial Regulation and Risk Management Research Programme was formed in January 2012 following a merger between 3 existing FMG Research Programmes:

1. AXA-LSE Risk management and regulation of financial institutions,
2. Regulation and Financial Stability, and
3. Risk Management and Fixed Income Markets.

These Programmes are now represented as research stems within the **Financial Regulation and Risk Management Research Programme**.

About the Programme

The Financial Regulation and Risk Management Research Programme covers a broad range of theoretical and empirical issues in banking and financial intermediation, financial regulation and risk management. The research produced by its members is highly relevant to policy-makers and practitioners. Research in this Programme is supported by the AXA Research Fund and Deutsche Bank. Since 2009, The AXA Research Fund has funded the on-going research project "AXA-LSE Risk Management and Regulation of Financial Institutions" which studies risk management and the regulation of financial institutions in light of the current financial crisis.

The main research areas of the Programme are:

- The structure of banking and financial intermediation.
- Assessment of the nature, form and organisational structure of financial regulation, both in the UK and world-wide
- The nature, propagation and control of financial crises and international financial architecture
- Evaluation of the links in the global financial system and the implications for the measurement and management of risk and asset management practices
- The development and application of macro-prudential supervision
- Compensation and governance systems in financial institutions
- Empirical analysis of credit and fixed income markets
- The nature of liquidity risk and the effect on market turbulence

In addition to the regular London Financial Regulation Seminar series, this Research Programme holds a sizeable number of conferences and workshops every year. Both the Deutsche Bank PhD Fellowship and the Deutsche Bank Prize in Financial Risk Management and Regulation have also been established under this Programme.

Programme Members

Directors

Ron Anderson, Charles Goodhart and David Webb

Senior Researchers

Vicente Cuñat
Jon Danielsson
Amil Dasgupta
Daniel Ferreira
Antonio Mele
Philippe Mueller
Yves Nosbusch
Andrea Vedolin
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Miguel Segoviano
Ian Tonks
Dimitrios Tsomocos

Deutsche Bank Scholars

Toni Ahnert
Giorgia Piacentino

Website

lse.ac.uk/fmg/researchProgrammes/financialRegulationAndRiskManagement



BANKING STRUCTURE, REGULATION AND COMPETITION CONFERENCE

25 November 2011

Charles Goodhart

(FMG, LSE) welcomed all conference participants and gave the first keynote speech looking at the disadvantages of the proposals put forward in the Vickers report (report of the Independent Commission on Banking).

He cautioned that the report's objective of enhanced competition may be counter-productive with a detrimental effect to financial stability. He went on by arguing that a key, yet unstated, objective of the report is a reduction in the taxpayer's exposure to the financial system, as seen in the cases of Icesave and Northern Rock. In particular he warned that the gains from diversification would be absent under the new regime, ring-fenced banks may have to take riskier investment decisions and that UK investment banks would be put at a competitive disadvantage because of higher funding costs. Goodhart finished his talk by outlining an alternative consisting of high capital ratios based on equity only, prompt corrective action and temporary public ownership.

The next keynote speaker was **Adrian Blundell-Wignell** (OECD) who focused on the benefits of the Vickers report's proposals. He argued that the commission's objective was less about saving taxpayer money than the prevention of financial instability in the first place. Strong emphasis ought to be put on common equity for that purpose by contrasting evidence on the risk taking of banks. He demonstrated that more risk taking occurs when a bank has a high regulatory capital ratio, while less occurs if it has a lot of common equity. He also distinguished between socially useful financial innovations and those that are less so, for example if it only served regulatory or tax arbitrage. He concluded by highlighting how separation of financial institutions or ring-fencing helps to avoid costly contagion.

The first session focused on the legal and economic aspects of structural reform.



Rosa M Lastra (FMG/ Centre for Commercial Law Studies, Queen Mary, University of London)

Charles Randell (Slaughter & May) emphasised the role of banking resolution, thus taking a favourable view on the Vickers report. He explained that there is little global appetite for the size component of "too big to fail" but issues of complexity and interconnectedness are addressed. Randell also discussed the need for convergence of national resolution schemes and international burden sharing. He argued that although ring-fencing is a good idea, incentive issues remain such as; the move of business to the shadow banking system, passporting and contagion associated with bail-in agreements.

Richard Reid (ICFR) continued by emphasising the role of avoidance of regulation and the great deal of innovation needed to get around regulation. He also observed that there has been a change in regulatory priorities. Moving on, he explored the potential properties of an optimal financial system in terms of incentives, size, and complexity. Finally, he predicted that the shadow banking system is likely to be the greatest beneficiary from the proposed legislation.

Simon Gleeson (Clifford Chance) explained the limitations of market discipline given the overreliance on statistical models for assessing risk exposure. He argued that doing so will lead to an "aggregate failure" of all market participants. He suggested that a higher equity ratio would in fact lead to more deleveraging instead of raising more equity. By comparing leverage ratios to ring-fencing, he argued in favour of the former. He concluded by noting that the key issue is not bank resolution but rather the resolution of a bank



Centre for Commercial Law Studies

group operating in multiple jurisdictions, thus calling for a global bankruptcy resolution scheme.

Emilios Avgouleas (University of Manchester) questioned whether economies of scale in banking exist. While there is some benefit for customers, he stated that little diversification takes place due to herding. He also discussed that the imposition of arbitrary boundaries is required for ring-fencing. Finally, he elaborated on the link between competition and financial stability stating that it is not fully understood yet.

The afternoon session resumed with the topic of EU bank regulation and structural reform.

Rosa M Lastra (CCLS, Queen Mary, University of London) talked about the boundaries of EU bank regulations. She started by examining the concerns surrounding the status quo of banking regulations in the EU and their need to be reformed. For instance, resolution and crisis management in the EU is still predominantly a national issue despite its bewildering complexity. Also, the "lender of last resort function" is partly performed by the European Central Bank (ECB) and partly by the nation with no harmonised framework. Finally, she stressed the importance of better communication about early intervention, cross-border resolution, exit strategy for state aid and crisis management policy.

The next speaker **Dirk Schoenmaker** (Duisenberg School of Finance) focused on cross-border resolution in Europe. He claimed that the main problem is cross-border externalities, i.e. the failure of large banks poses substantial risks to other nations in the EU, while these externalities are ignored at a national level. He then suggested that to maintain stability and proper cross-border banking, supranational supervision and burden sharing are needed and to some degree national authorities have to compromise. Lastly he outlined the necessary roles that the European Central Bank, European Resolution Authority and European Banking Authority would play in a European regime.

Gustaf Sjöberg (Stockholm University) provided a historical and economic background to structural reform in Sweden. He explained that the Swedish financial system is concentrated:



Dirk Schoenmaker (Duisenberg school of finance)

four major banks control 80 per cent of assets and they depend heavily on foreign wholesale funding. He then went on to share some of his observations of the reform. For instance, the Swedish Central Bank demands higher capital ratios than the rest of Europe, there are also no proposals on competition and supervision and discussions about Special Resolution Regime are still in progress.

Eva Hupkes (Financial Stability Board) ended the session with the FSB's key attributes for effective resolution regimes. She explained that the goal is to set a new international standard which can be used as a point of reference for reforms of national resolution regimes; especially those with an emphasis on the recovery and resolutions plans for Global Systemically Important Financial Institutions (G-SIFIS).

The next discussion topic was "Governance of Ring-fenced Entities and Regulation of Risk and Conduct". The moderator **Ian MacNeil** (University of Glasgow) began by explaining the nature of ring-fencing and summarising the key aspects of the Independent Commission on Banking (ICB) proposals regarding governance, regulation of risk, and conduct.

The first panellist **David Rouch** (Freshfields) discussed the issues with the ICB proposals regarding governance. He questioned the effectiveness of non-executive directors as monitors of banks' behaviour. In particular, there could be a fundamental conflict of interest between monitoring the ring-fenced entities and maximising shareholder value. For example relying on short-term cheap funding exposes banks to a liquidity risk but increases profit for shareholders. He concluded by saying that developing a sound culture within the group is important to enhance governance but is difficult to implement.

Chris Bates (Clifford Chance) talked about "Primary Loss Absorbing Capital", in particular "Bail-in" bonds which aim to capitalise banks when an adverse state occurs. He argued that "Bail-in" bonds could be costly to issue as the ICB proposals suggest that they are subordinate to deposit, secured debt and unsecured debt. In addition according to the ICB proposals, "Bail-in" bonds will be issued in the form of long-term debt. Bates believes that it will be hard to raise new funding in this way when crisis hits therefore making it counter-productive in distressed times.

The last panellist **Niamh Maloney** (LSE) discussed the conduct of business proposals

in the ICB report. She first noted that the report suggests a cross-market reform but that key details about the implementation are missing, and that there is no assessment of the cumulative impact on these reforms. Maloney was also concerned that there will be a number of unintended consequences as a result of these wide-ranging reforms and that there is the potential of being gamed by participants.

Alistair Milne (Loughborough University) concluded the conference with succinct remarks on all the speakers in the conference.

Papers and slides from the conference are available at lse.ac.uk/fmg

Conference organised by: **Emilios Avgouleas** (International Financial Markets and Financial Law, Manchester University), **Charles Goodhart** (Financial Markets Group, London School of Economics), **Rosa M Lastra** (Centre for Commercial Law Studies, Queen Mary, University of London), **Iain MacNeil** (School of Law, Glasgow University) and **Richard Reid** (International Centre for Financial Regulation).

Reported by **Toni Ahnert** (FMG, LSE) and **John C F Kuong** (FMG, LSE)

Toni is a 2011/12 Deutsche Bank Doctoral Fellow and is a fifth year PhD candidate in Economics.

John is a third year Finance PhD candidate. His research interests include: financial regulation, asset pricing with market imperfections and contract theory.

This conference was generously supported by the International Centre for Financial Regulation, the Law and Financial Markets Review published by Hart Publishing and the Centre for Commercial Law Studies and Queen Mary University.



DEALING WITH THE EU CRISIS: THE ROLE AND RESPONSIBILITY OF THE BANKS

31 January 2012



Urs Rohner (Credit Suisse Group)

Urs Rohner, the Chairman of the Board of Directors of Credit Suisse Group, talked about a domino effect of the unsustainable financial system that resulted in the EU Sovereign Debt Crisis and high default risk among private banks.

He emphasised the interconnectedness between the private banking sector and government and addressed how banks, the primary dealers of government debt, contributed to the sovereign debt's poor management as well as how the current debt crisis in many European countries is playing a role in raising banks default risks.

First of all, Rohner drew the audience's attention to the globally high level of public debt. He views the loss in government revenues as accounting for a great part of these public debts. He said that, while the level of public debt has remained high for the last few years,

the value of government bonds has decreased sharply since the 2008 Banking Crisis.

Then Rohner spoke about the radical changes in the banks' view on government bonds that he has observed in the field. Unlike pre-crisis when "liquidity" referred to cash or government bonds, he said that government bonds are no longer viewed as a convenient tool that is stable in price. He warned that the market is becoming more and more volatile, showing a decrease after each EU summit and that the public debt is now out of control.

The lecture then moved on to look at the impact of sovereign debts on the private sector. Rohner said that such sovereign debt exposure was reflected in the European banks' under-performance which started even before the Lehman Brothers bankruptcy triggered the current financial crisis. He was however concerned that the layers and relationships between sovereign debt and the private banking sector are not transparent enough to enable them to be controlled.

Despite the difficulties of disentangling the relationship, the financial market has witnessed strong interconnectedness between governments and banks through the domino effect of structural imbalance in the financial system, which gave rise to the Eurozone sovereign debt crisis and increased bank default rates in the region. Given this, Rohner explained that there has to be voluntary private sector involvement for restructuring of Eurozone sovereign debt and that this would prevent a worse situation from arising. At the same time, he also emphasised that banks are responsible

for making the sovereign debt market more attractive. Rohner suggested that, in the long-term, banks should continue a close relationship with governments and regulators and become involved in the process of regulatory reform. He added that, while doing so, banks should consider whether such reforms can contribute to raising national GDP.

David Webb (FMG, LSE), who chaired the lecture, raised a discussion about whether we should expect banks to return to the traditional role of connecting savers and borrowers. Audience questions followed about whether there is an actual risk of default in Greece or if instead there will be an orderly default.

Article written by **Min Park** (FMG, LSE)

Min is a Management PhD candidate and is researching the possible influences that different stakeholder groups can have on top management incentives.

This lecture is part of the LSE European institute – APCO worldwide perspectives on Europe lecture series and was kindly sponsored by the European Institute.



FMG EVENTS

Events that have taken place since the publication of the previous *Review* in December 2011 (Autumn issue).

Conferences

Banking structure, regulation and competition
25 November 2011

Public Lectures

Dealing with the EU crisis: The role and responsibility of the banks
31 January 2012
Speaker: Urs Rohner (Chairman of the Credit Suisse Group)
Chair: Professor David Webb (FMG, LSE)

Capital Markets Workshops

Specialisation, productivity and financing constraints
12 October 2011
Robert Marquez (Boston University)

Volatility, the macroeconomy 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 (Kelley School of Business, Indiana University)

Is the stock market just a side show? Evidence from a structural reform
9 November 2011
Murillo Campello (Cornell University)

Risking other people's money: Gambling, limited liability, and optimal incentives
16 November 2011
Peter DeMarzo (Stanford Graduate School of Business)

Trade dynamics in the market for federal funds
23 November 2011
Gara Afonso (Federal Reserve Bank, New York)

Systemic sovereign credit risk: Lessons from the US and Europe
30 November 2011
Francis Longstaff (Anderson School of Management, UCLA)

A glass half full: Contrarian trading in the flash crash
7 December 2011
Jialin Yu (Columbia University)

Search frictions and the liquidity of controlling blocks of shares
11 January 2012
Enrique Schroth (University of Amsterdam)

Managing human capital risk
18 January 2012
Martin Schmalz (Princeton University)

The multi-horizon dynamics of risk and returns
25 January 2012
Andrea Tamoni (Bocconi University)

The real cost of conglomerates
1 February 2012
Rui Silva (University of Chicago)

Consumption-based asset pricing with loss aversion
8 February 2012
Marianne Andries (University of Chicago)

Lunchtime Workshops

Lender moral hazard and reputation in originate-to-distribute markets
16 November 2011
Andrew Winton (University of Minnesota)

Financing bidders in bankruptcy and takeover auctions
23 November 2011
Vladimir Vladimirov (Goethe University Frankfurt)

Optimal credit screening, securitisation, and market crashes
30 November 2011
Ulf Axelson (FMG, LSE)

Foreign ownership of US debt: Good or bad?
7 December 2011
Jack Favilukis (FMG, LSE)

Strategic banks and systemic externalities
11 January 2012
Andrea Buffa (London Business School)

Does going public affect innovation?
18 January 2012
Shai Bernstein (Harvard University)

The causal effect of bankruptcy law on the cost of finance
25 January 2012
Nicolas Serrano-Verlade (Oxford University)

Capital controls and international financial stability a dynamic general equilibrium analysis in incomplete markets
1 February 2012
Adrian Buss (House of Finance, Goethe University)

The impact of asymmetric information about collateral values in mortgage lending
8 February 2012
Johannes Stroebe (Stanford University)

Optimality of securitised debt with endogenous and flexible information acquisition
15 February 2012
Ming Yang (Princeton University)

Deliberate limits to arbitrage
29 February 2012
Igor Makarov (London Business School)

London Financial Regulation Seminars

Restructuring in the Euro-zone

15 November 2011

Lee Buchheit (Cleary Gottlieb)

Economies of scale in wholesale banking

28 November 2011

Ronald Anderson (LSE)

Banks and mimics regulation supervision

5 December 2011

Andrew Powell (Inter-American Development Bank)

Current regulatory challenges

30 January 2012

Andrea Enria (European Banking Authority)

Macroprudential instruments

6 February 2012

Sujit Kapadia and Iain de Weymarn (Bank of England), and Daryl Collins (Financial Services Authority)

The role of prudential supervision: Monitor and minder?

27 February 2012

Tom Huertas (Ernst & Young)

Bank regulations and the crisis of 2008

14 March 2012

Wladimir Kraus (University of Aix-Marseille)

Time to overhaul Basel bank-capital rules

26 March 2012

Stefano Micossi and Jacopo Carmassi (Assonime)

PhD Seminars

All seminars are given by current LSE PhD candidates.

Sparse weighted norm minimum variance portfolios: An econometric analysis and demand-based analysis of CDS basis trading

10 November 2011

Yu-Min Yen (FMG/Finance Department) and Qi Shang (Finance Department)

Contract-implied and flow-induced incentives in the asset management industry

17 November 2011

Gabriela Domingues (FMG/Economics Department)

Asset pricing when heterogeneous institutions care about relative performance

24 November 2011

Shiyang Huang (FMG/Finance Department)

Short-term debt and self-fulfilling crises

1 December 2011

John Kuong (FMG/Finance Department)

Optimal liquidity regulation

8 December 2011

Toni Ahnert (FMG/Economics Department)

Opacity and market discipline: A cross country analysis

2 February 2012

Ilknur Zer (FMG/Finance Department)

Asymmetric information, coordination and market

9 February 2012

Jing Zeng (FMG/Finance Department)

The effects of mutual fund flows on firm investment

16 February 2012

Nelson Costa-Neto (FMG/Finance Department)

Taxation Seminars

Taxation and Scottish devolution

16 January 2012

Iain McLean (Oxford University)

DISCUSSION PAPERS

Discussion Papers are authored primarily by FMG staff, associates and research students and provide specialist insights into the 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 Financial Regulation and Risk Management programme (AXA).

DP 693

Explaining the structure of CEO incentive pay with decreasing relative risk aversion

Pierre Chaigneau

It is established that the standard principal-agent model cannot explain the structure of commonly used CEO compensation contracts if CRRA preferences are postulated. However, we demonstrate that this model has potentially a high explanatory power with preferences with decreasing relative risk aversion, in the sense that a typical CEO contract is approximately optimal for plausible preference parameters.

DP 694

Performance pay, CEO dismissal, and the dual role of takeovers

Mike Burkart, Konrad Raff

We propose that an active takeover market provides incentives by offering acquisition opportunities to successful managers. This allows firms to reduce performance-based compensation and can rationalise loss-making acquisitions. At the same time, takeovers remain a substitute for board dismissal in the replacement of poorly performing managers. The joint impact of the two mechanisms on managerial turnover is, however, multi-faceted: In firms with strong boards, turnover and performance-based pay are non-monotonic in the intensity of the takeover threat. In firms with weak boards, turnover (performance-based pay) increases (decreases) with the intensity of the

takeover threat. When choosing its acquisition policy and the quality of its board, each firm ignores the adverse effect on other firms acquisition opportunities and takeover threat. As a result, the takeover market is not sufficiently liquid and too few takeovers occur.

DP 695

On the drivers of commodity co-movement: Evidence from biofuels

Francisco Peñaranda, Augusto Rupérez Micola

We use the recent introduction of biofuels to study the effect of industry factors on the relationships between wholesale commodity prices. Correlations between agricultural products and oil are strongest in the 2005-09 period, coinciding with the boom of biofuels, and remain substantial until 2011. We disentangle three possible drivers for the linkage: substitution, energy costs, and financialisation. The timing and magnitude of the biofuels-to-oil relationships are different to those of other commodities, and far higher than can be justified by costs and financialisation. Substitution and costs drive the monthly correlations of long-term futures and each of the three contribute equally to the daily co-movement of the short-term ones. The findings survive many robustness checks and appear in the stock market.

DP 696

Smart buyers

Mike Burkart, Samuel Lee

In many bilateral transactions, the seller fears being underpaid because its outside option is better known to the buyer. We rationalise a variety of observed contracts as solutions to such smart buyer problems. The key to these solutions is to grant the seller upside participation. In contrast, the lemons problem calls for offering the buyer downside protection. Yet in either case, the seller (buyer) receives a convex (concave) claim. Thus, contracts commonly associated with the lemons problem can equally well be manifestations of the smart buyer problem. Nevertheless, the information asymmetries have opposite cross-sectional implications. To avoid underestimating the empirical relevance of adverse selection problems, it is therefore critical to properly identify the underlying information asymmetries in the data.

DP 697

The effect of risk preferences on the valuation and incentives of compensation contracts

Pierre Chaigneau

We use a comparative approach to study the incentives provided by different types of compensation contracts, and their valuation by risk averse managers, in a fairly general setting. We show that concave contracts tend to provide more incentives to risk averse managers, while convex contracts tend to be more valued by prudent managers. Thus, prudence can

contribute to explain the prevalence of stock-options in executive compensation. We also present a condition on the utility function which enables to compare the structure of optimal contracts associated with different risk preferences.

DP 698

Borrow cheap, buy high? The determinants of leverage and pricing in buyouts

Ulf Axelsson, Tim Jenkinson, Per Strömberg, Michael S. Weisbach

Private equity sponsors pay special attention to designing capital structure, making buyouts an interesting setting for examining capital structure theories.

In a detailed international sample of buyouts, we find that buyout leverage is unrelated to factors that drive public firm leverage, such as industry factors and other cross-sectional characteristics, contrary to what standard capital structure theories suggest. Instead, variation in economy-wide credit conditions is the main driver of leverage and pricing in buyouts, while having little impact on public firms. Higher deal leverage is associated with lower buyout fund returns, suggesting that acquirers overpay when access to credit is easier.

DP 699

Bond variance risk premia

Philippe Mueller, Andrea Vedolin, Yu-Min Yen

Using data from 1983 to 2010, we propose a new fear measure for Treasury markets, akin to the VIX for equities, labelled TIV. We show that TIV explains one third of the time variation in funding liquidity and that the spread between the VIX and TIV captures flight to quality. We then construct Treasury bond variance risk premia as the difference between the implied variance and an expected variance estimate using autoregressive models. Bond variance risk premia display pronounced spikes during crisis periods. We show that variance risk premia encompass a broad spectrum of macroeconomic uncertainty. Uncertainty about the nominal and the real side of the economy increase variance risk premia but uncertainty about monetary policy has a strongly negative effect. We document that bond variance risk premia predict excess returns on Treasuries, stocks, corporate bonds and mortgage-backed securities, both in-sample and out-of-sample. Furthermore, this predictability is not subsumed by other standard predictors.

You can download all Discussion Papers for free from: lse.ac.uk/fmg/workingPapers/home.aspx

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 collaboration 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 to influence policy.

SP204

The political economy of European Monetary Union

A R Nobay

This is a revised version of a paper delivered at the 1990 meeting of the Hellenic Economic Association in Athens, Greece.

This paper, by Bob Nobay, was written in the interval between the publication of the Delors Committee Report, in 1989, and the signing of the Maastricht Treaty in 1992. It documents the political incentives, notably to protect the single market structure, and within that the Common Agricultural Policy, that led to the adoption of EMU, a step taken without the support of a serious consideration of how adjustment to asymmetric shocks might be handled within EMU, an oversight which has now turned out to be of major consequence.

SP205

Legal aspects of bank bail-ins

Simon Gleeson

The aim of the bail-in proposal is that governments should have an alternative option to taxpayer-funded rescues of systemic banks. It operates through a mechanism whereby an insufficiently solvent bank can be returned to balance sheet stability by writing down not only the claims of its subordinated creditors but also some of its senior creditors; converting their claims to equity. To be effective, the mechanism should be "hybrid", in that the terms of the relevant instruments should provide for the bail-in to operate through private contract, but the power to trigger the bail-in and to determine the extent of write-down and the resulting compensation should be vested in the relevant public authority.

You can download all Special Papers for free from: lse.ac.uk/fmg/workingPapers/home.aspx

FORTHCOMING PAPERS

FMG Discussion Papers

Transparency in the financial system: Rollover risk and crises

Matthieu Bouvard, Pierre Chaigneau and Adolfo de Motta

Is historical cost accounting a panacea? Market stress, incentive distortions and gains trading

Andrew Ellul, Chotibhak Jotikasthira, Christian T Lundblad and Yihui Wang

VISITING SCHOLARS



Jonatan Saúl is a fifth year PhD student visiting the FMG from the Department of Business at Carlos III University of Madrid (UC3M), where he is expected to complete his PhD in Business Administration

and Quantitative Methods in the spring of 2012. Jonatan's main research interest is in the area of term structure of interest rates, particularly on understanding the benefits that inflation-linked bonds provide to the different stakeholders in the economy. At UC3M, Jonatan has been involved in teaching undergrad courses as well as teaching Master courses at the Instituto de Empresa Business School. He also has consultancy experience within the financial engineering sector.

"The FMG is the best research centre in Europe and probably the world. Being at the FMG and having the opportunity to attend high quality seminars is a huge benefit to me. I also think that discussions, both with Professors and PhD students, will be really beneficial to me."

Jonatan Saúl (FMG visiting Scholar)

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