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MANAGING AND FINANCING EUROPEAN BANK RESOLUTION

24 March 2014

As part of its London Financial Regulation series, the Financial Markets Group (FMG) organised this one day conference exploring European bank resolution.

Dirk Schoenmaker (Duisenberg School of Finance) opened the conference with a comprehensive overview of the most recent additions and contributions to the policy debate surrounding the European banking union. Schoenmaker placed particular emphasis on the paradigm shift brought about from giving the European Central Bank (ECB) a more important role when it comes to European financial stability. Namely, that the ECB has become a major player at the financial stability board by taking over the rule-making and supervision roles through the Single Supervisory Mechanism (SSM). Also, although deposit insurance as well as the Lender of Last Resort (LOLR) are both still located at a national level, the ongoing debate implies that both will soon be taken over by the ECB too.

Schoenmaker continued by stating that the formation of the European Resolution Authority requires alignment of two very different approaches: market led (Northern Europe) and state led (Southern Europe). The reconciliation of these differences lies in the mixture of two solutions: the bail-in of senior creditors and bailout undertaken by the European Resolution fund. The main proposition advocated by Schoenmaker was the creation of the European Deposit Insurance and Resolution Authority (EDIRA) with financing from a European deposit insurance and resolution fund. Having a single decision-making supranational authority, requires building a single deposit insurance and resolution fund to which the risk-based premia would be paid by all Eurozone banks. Although the need for a supranational approach

for resolutions has been recognised it is yet to be finalised but once it has been, deposit insurance at the supranational level should follow as well.

Maria Nieto (Banco de Espana) acted as discussant for Schoenmaker. Nieto disagreed with Schoenmaker by saying that deposit insurance and resolution funds should not be defined as a single entity. However for deposit insurance, Nieto agreed that there is a strong need for a single deposit insurance fund at the Eurozone level. Finally, she discussed the potential size of the deposit insurance and the resolution fund. Nieto concluded that its size should be endogenous to the strength of the supervision, the quality of the resolution process and credibility, and that it should prompt access to liquidity once crisis is declared.

In the next session **Simon Gleeson** (Clifford Chance) discussed why bank failures are very different from a typical firm bankruptcy. Namely that a bank balance sheet can be solvent, yet at the same time a regulator can close it down deeming it to not have enough capital. **Sean Hagan** (IMF) continued the session with his discussion of two major policy responses following the most recent financial crisis. The first was a large scale intervention of the public system, and the second the implementation of changes in the system to avoid the need for another large public intervention. Hagan then spoke of the elements which, in his opinion, were of most importance for accomplishing these goals set after the crisis. First he mentioned the need for increased cooperation between domestic



Lauren Anderson (Bank of England)



Charles Goodhart (FMG, LSE)



Charles Randell (Bank of England)



Dirk Scholenmaker (Duisenberg School of Finance)



Maria Nieto (Banco de España)



Rosa M Lastra (Queen Mary, University of London)

regulators and national authorities, and in order to achieve this, some minimum level of harmonisation in the resolution directive, as well as the development of relationships that allow coordination to be implemented. Hagan also emphasised the importance of the burden share between public authorities across countries, in case some intervention is needed regardless of the prevention measures undertaken. The issue of the burden share remains to be discussed in the future and, bearing in mind how challenging it is to reach an agreement on the financing of the single resolution fund at the Eurozone level, it is only going to be even more challenging at the global level.

Discussion given by **Rosa M Lastra** (QMUL) outlined three important issues for the ongoing policy debate. Lastra discussed the issue of sufficiency in terms of deposit insurance, and the credibility and difficulty in distinguishing between the illiquidity and insolvency in the resolution process. Lastra also underlined a 4-pillar approach based on harmonisation, recognition, cooperation and information sharing, and funding and burden sharing, as the only way towards a cross-border resolution process.

After lunch **Charles Goodhart** (FMG, LSE) spoke about the differences between bail-outs and bail-ins, as well as the underlining advantages and disadvantages for both types of intervention. This discussion is still relevant as the need for bank recapitalisation remains for

many global systemically important banks, as well as in industry where the lack of intervention prevents mergers. Typical problems related to bailouts, such as moral hazard and distributional concerns were mentioned and although bail-ins may address these problems to a certain extent, other disadvantages can arise. One of the bail-in challenges discussed was that bail-in focuses the loss on a small group rather than distributing the burden of loss across the taxpayers of the country, like bailout does. Also, Goodhart emphasised the potential ex post effects on procyclicality and contagion caused by bail-ins which may offset all the benefits they bring when it comes to ex ante reducing the moral hazard.

During his discussion of Goodhart's session, **Jon Danielsson** (SRC, LSE) raised the question of how clear the rules on bail-ins should be? And whether too much clarity might, in fact, induce strategic behaviour which would deem constructive ambiguity as a better approach to construct the bail-in rules?

Charles Randell (Bank of England) began his session by pointing out that tensions exist between the scope of the EU cross-border branch pass-porting and its fragmented resolution regimes. Although the host authority is vested with significant supervisory functions including the power to take prompt corrective actions, a non-European Bank Union (EBU) host authority has a limited say on the choice of resolutions tools. Randell further illustrated this point with a tale of two imaginary banks. Both are headquartered in a Eurozone member state and have branches in non-participating member states. However because the non-participating state's resolution authority is not involved in the joint decision on measures to improve resolvability and because it has no independent resolution powers, contagion may happen through direct cross-border lending and local lending of cross border subsidiaries. **Emilios Avgouleas** (University of Edinburgh) discussed Randell's session and offered two solutions. The first is to negotiate burden sharing arrangements

between EBU and non-EBU member resolution funds for systemic branches in the style of the Baltic/Nordic pact. The second is to tacitly move to subsidiarisation if home or host country is a non-EBU member.

The last speaker of the day, **Thomas F. Huertas** (Ernst&Young) discussed the design of a resolvable bank; one which is safe to fail. The key feature is the separation of investor obligations from customer obligations at the operating bank. The bank should issue customer obligations, while the parent should issue investor obligations to third parties. The investment of the parent in the daughter bank should serve as the transmission link for losses at the bank level and losses to investors at the parent level. Huertas claimed that investors, not taxpayers, should bear the cost of resolution and the bank should continue to perform critical economic functions. **Lauren Anderson** (Bank of England) served as discussant and expressed her concern that the regulation changes which took derivatives trading away from banks, mostly in the US, may increase the transaction cost of counterparties of the bank. She also called for international cooperation among resolution authorities and central banks in building resolvable banks.

This conference was generously supported by the AXA Research Fund and the Economic and Social Research Council (ESRC) [grant number ES/K002309/1].

This article was written by **Una Savic** and **Yiqing Yu**. Both are FMG and Finance PhD students.



NEWS FROM THE FMG

A round-up of the latest news and achievements of the Financial Markets Group.

Grant successes

The FMG has enjoyed significant grant success in the last 6 months with numerous staff members receiving research funding. This success is testament to the fantastic and important research that the FMG does and the impact this research has on the wider world.

HEIF-5 funding for FMG

The FMG was delighted to receive Higher Education Innovation Funding (HEIF-5) from the Higher Education Funding Council for England (HEFCE). HEFCE awards HEIF-5 funding as part of its objective to develop knowledge-based interactions between universities and the wider world, which result in economic and social benefit to the UK.

The FMG will use this funding to develop its existing Corporate Governance (CG) at LSE initiative; the successful inter-disciplinary debate series committed to the promotion of evidence-based research in CG. Like many policy makers, over the last few years the FMG has mainly concerned itself with addressing governance issues prevalent in the UK, Europe and the US. Now that the governance framework has improved dramatically, with the most pressing issues to the developed world having been addressed, the challenge is to turn the debate global.

Commenting on the funding, **Professor Daniel Ferreira** (member of CG at LSE and the lead applicant on the HEIF-5 bid) said:

“The HEIF-5 funds will enable us to improve the visibility and the overall quality of our events. This is particularly relevant for our Research Debates series, where leading academics and practitioners meet to discuss the latest issues in corporate governance. We will also use the HEIF-5 funds to support new ways of disseminating research on corporate governance and improving its impact beyond the academic sphere.”

One of these new dissemination activities is the making of short videos about current CG topics. They will feature experts in their respective fields and will be a valuable knowledge exchange resource. The first of our videos, about the Pfizer AstraZeneca takeover bid, is now available to view online here lse.ac.uk/Fmgvideos/home.aspx

European Research Council Grant in systemic risk

Professor Kathy Yuan (FMG/Department of Finance, LSE) has been awarded a European Research Council (ERC) Consolidator Grant in relation to systemic risk. The ERC is providing close to €700k for the project over 3 years until May 2017. The aim of the project is to identify new ways to consider and measure systemic financial risks and, more importantly, the linkages between the financial risks and the real economy, and the welfare consequences. Professor Yuan will apply endogenous risk analysis to identify channels for the creation of systemic risk via various feedback loops. The focus will be on the effect of network externality on systemic risk formation. She plans to model and estimate network externality using uniquely available datasets on interbank payment flows in the UK. This analysis is important to understand the role of network in dampening or amplifying shocks and to provide quantitative measurement of network-originated systemic (liquidity/default) risks.

British Academy grant

The British Academy's Research Awards Committee has chosen to support new research by **Dr Moqi Xu** (FMG/Department of Finance, LSE). The work, on CEO Contract Incentives, aims to answer many predictions of contract theory models that are still untested, and will receive funding of just under £10,000.

Commenting on her award, Dr Xu said:

“Well-structured managerial incentive contracts can improve performance and reduce risk. Regulation that fosters such incentives across firms can thus promote long-term economic growth and stability. However, the observed recent growth of UK and US executive compensation levels – and its insensitivity to performance – raises doubts concerning their effectiveness and fairness.

Given the importance and awareness of the issue, there is surprisingly little agreement on what actually constitutes good incentives.

We have collected the most comprehensive set of managerial employment contracts to date. The British Academy grant will allow us to convert the contract text into a database. This can be used to answer many predictions of contract theory models that are still untested, starting with predictions on the renewal terms, evaluation periods, and compensation structure.”



Christopher Polk (Director of the FMG, LSE)



Daniel Ferreira (FMG/Department of Finance, LSE)

FMG Research Associate awarded a SWIFT grant

Dr Tom Kirchmaier (FMG), along with his co-researcher Dr Renée Adams, has been awarded a SWIFT grant of €15,000. They receive this grant for their study on gender diversity which will offer a global perspective of women in finance, through the first cross-country study on the topic of gender diversity on boards of financial firms.

NBER research grant

Dr Moqi Xu has had further grant success, along with **Dr Juanita Gonzalez-Urbe** (both FMG/Department of Finance, LSE), with a research grant of \$10,000 from the Innovation Policy Working Group of the National Bureau of Economic Research (NBER). They are receiving this grant for their research proposal on CEO contract horizon and innovation. The NBER's Innovation Policy Working Group seeks to foster research by economists and other social scientists on the interactions between public policy and the innovation process, and to provide communication mechanisms between researchers and the policy community.

Coller Institute of Venture 2014 research grants

Dr Juanita Gonzalez-Urbe has also been awarded a \$15,000 Coller Institute of Venture's (CIV) research grant. She receives this grant along with her co-author, Dr Lora Dimitrova, for their paper "Corporate venture capital and productivity in pharmaceutical-biotechnology companies". CIV research grants aim to encourage and support original academic research in the field of venture with the goal of making a significant contribution to understanding and shaping the venture ecosystem.

FMG Director awarded EIF research grant

FMG Director **Professor Christopher Polk** and co-author **Dr Dong Lou** (Department of Finance/FMG) have received a research grant from The Scientific Committee of the Europlace Institute of Finance (EIF). Their research paper, "Booms and busts of beta arbitrage: measuring the extent of the low-beta crowd", secured a €10,000 award. The EIF aims to develop research funding at European and international level. Since its inception in 2003, the Institute has promoted exchanges between academics and the banking, finance and insurance sectors. The stated aim of the EIF is to make research funding more focused, more useful, and more international.

2014 AQR Insight Award

As well as receiving an EIF grant, **Christopher Polk** and **Dong Lou** have also received an honourable mention as finalists in the 2014 AQR Insight Award with their paper "Comomentum: inferring arbitrage activity from return correlations". The AQR Insight Award honours and encourages applied innovation in academic research. It recognises important, unpublished papers that provide the most significant new practical insights for tax-exempt institutional or taxable investor portfolios.

Conference Participation

Professor Anderson at the European Risk Forum

Professor Ron Anderson (FMG/Department of Finance, LSE) was invited in March to speak at the DTCC Risk Forum in Brussels about "Systemic risk: creation and perception". Here he outlines the main points from his presentation:

I argue that as compared to past financial crises, that of 2007-08 highlighted the critical role played by complexity, opacity and inadequate data analysis by market participants and regulators. This complexity is likely to remain with us so long as the economy and financial system remain globalised, and while economic policy and financial regulation is in the hands of national authorities with very imperfect international coordination. To prepare for the systemic risks of the future and hopefully to manage them, we need to remember that risk (a probability distribution over a set of possible events) emerges from uncertainty through a process. This involves firstly, the perception of the relevant possible outcomes in a frame imposed by our imagined courses of action and secondly, by the assessment of the relative likelihoods of these events through "modelling" ie, some combination of measurement, estimation and deductive reasoning. Systemic risk emerges endogenously in the economy through the interplay of economic factors. As new risks are perceived but not yet assessed there is a danger of a massive move towards prudence that provokes a crisis. We have a collective interest in facilitating the process of learning about system wide risks in a continuous, decentralised way. In struggling to perceive and assess emerging systemic risk we should recall how risks build up through the process of intermediation involving credit transformation, maturity transformation and liquidity transformation. Currently, the re-regulation of banking is reducing leverage, increasing liquidity on the asset side and

reducing maturity mismatch in regulated banks. This is creating huge incentives to effect the fundamental transformations through non-bank intermediaries and markets, that is, to build up the "new shadow-banking" sector. How this will work is difficult to forecast. It will be determined by a number of forces, but one worth emphasising is the changing market infrastructure involving CCP's, custodians, depositories and settlement systems. The risks will go where the financial flows go. If these flows remain opaque, data analysis will be inadequate, and systemic risks will be perceived too late, as in 2007-08. This is why the aggregation and dissemination of information sources now flowing to trade repositories is a crucial piece of the global effort to promote financial stability.



Ron Anderson (FMG/Department of Finance, LSE)



Kathy Yuan (FMG/Department of Finance, LSE)



Moqi Xu (FMG/Department of Finance, LSE)

THE PAUL WOOLLEY CENTRE SCHOLARSHIP PROGRAMME 2014-15

The Paul Woolley Centre for the Study of Capital Market Dysfunctionality (PWC), established within the FMG, invited applications from LSE economics and finance PhD students for its 2014-15 scholarship programme.

These scholarships aim to financially support students pursuing postgraduate research in the areas covered by the Paul Woolley Centre research agenda:

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

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

For the 2014-15 academic year scholarships were awarded to **Sergei Glebkin**, **Alex Clymo** and **Isabelle Roland**.

Sergei Glebkin is a 3rd year PhD student in the Department of Finance. Before beginning his PhD at LSE he received a BSc and MSc in Physics from Moscow State University and a MA in Economics from New Economic School. His research interests include asset pricing, liquidity and auctions. Sergei has been an FMG student since October 2013.

Alex and Isabelle were both awarded scholarships in 2013-14. Following a review of their research and progress to date, their scholarships have been renewed for a further year. Shiyang Huang, a PWC scholar for 2012-14, has also received a scholarship extension until the end of Michaelmas term 2014.



Alex Clymo



Sergei Glebkin



Isabelle Roland



Shiyang Huang

DEUTSCHE BANK DOCTORAL FELLOWSHIP 2014-15

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

These fellowships are awarded to first-rate students on an annual basis and aim to support them as they pursue their doctoral studies at LSE in affiliation with the FMG.

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

- Financial risk measurement
- Risk management
- Financial regulation.

The Deutsche Bank fellowship for 2014-15 has been awarded to **Jonathan Pinder**, a PhD student in the Department of Economics. Jonathan's research focuses on the implications of incorporating financial intermediaries into macroeconomic models, and the possible consequences of policy including macroprudential regulation. He has a BA in Economics from Sidney Sussex College, University of Cambridge, and a MSc and MRes (both in Economics) from LSE. Jonathan will be based in the FMG from October 2014 where he will work closely with our students and staff, including **Hoyong Choi** our existing and other Deutsche Bank fellow for 2014-15.



Jonathan Pinder



Hoyong Choi

FMG LEAVERS 2014

This summer we must say goodbye to four of our FMG students. They are leaving us to take up graduate positions following the successful completion of their PhD. Here they answer questions about their new positions.



**Christian
von Drathen**

What is your new role?

I will be assistant professor of finance at the University of Texas Dallas.

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

A variety of things: becoming part of highly rated research university, teaching a valuation course to MBAs and moving to the US.

What do you think will be the biggest challenge?

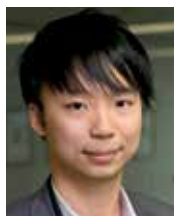
Managing my work-life balance and making tenure.

What will you miss about LSE/FMG?

I will miss all of my FMG colleagues and also the luxury of being able to walk to work.

Give one tip for those going on the job market next year.

An original job market paper goes a long way..! Also try to show methodological skills in different fields.



**John C.F.
Koung**

What is your new role?

I will be an assistant professor of Finance at INSEAD in Fontainebleau, doing research and teaching MBA students.

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

Everything! Especially after being a PhD student for so long, but more specifically surviving in Paris with my basically non-existent French.

What do you think will be the biggest challenge?

I was once told that a good researcher is a happy researcher. I guess the biggest challenge is to manage the stress of being in a tenure-tracked position and remembering to have fun.

What will you miss about LSE/FMG?

The people; I am very grateful to have friends and colleagues at the FMG who have made the whole PhD experience very enjoyable. I have also learned tremendously from the participants of numerous conferences and workshops organised by the FMG.

Give one tip for those going on the job market next year.

Be cautiously optimistic. After sending out the package, it's all about interviews and fly-outs. Your state of the mind will have a definitive impact on your performance and hence, the outcomes. I have encountered people who are left disappointed because of their initially too high expectations and also those overly worried of not getting any job. Embrace the uncertainty of this matching process but also constantly remind yourself that you are ready because otherwise the Department wouldn't have recommended you to go on the market in the first place. Relax and hope for the best.



Jing Zeng

What is your new role?

I will be an assistant professor at Frankfurt School of Finance and Management.

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

I look forward to interacting with the great faculty at Frankfurt and I'm also excited about moving to Frankfurt, another vibrant international city.

What do you think will be the biggest challenge?

Publication pressure aside, I will have to learn German!

What will you miss about LSE/FMG?

I have made some dear friends and received friendly advice from faculty members. The newly introduced drinks event after the Capital Markets Workshop seminars are great for interacting with various members of the FMG; they will be especially missed!

Give one tip for those going on the job market next year.

Stay focused and be the best you can be!



Jason R. Donaldson is also leaving the FMG. He will take up an assistant professor position at Olin Business School, Washington University in St Louis.

FMG EVENTS

Events that have taken place since the publication of the previous Review in March 2014 (Winter 2013-14 issue)

Conferences

The seventh annual Paul Woolley

Centre conference

5-6 June 2014

Capital Markets Workshops

Measuring skill in the mutual fund industry and Assessing asset pricing models using revealed preference

30 April 2014

Jules van Binsbergen (Stanford)

Investor sophistication and capital income inequality

7 May 2014

Marcin T Kacperczyk (Imperial)

Did bad mortgage origination practices distort house prices?

14 May 2014

John Griffin (University of Texas)

Stock market valuations across US states

21 May 2014

Christian Lundblad (The University of North Carolina)

Why do banks practice regulatory arbitrage? Evidence from usage of trust preferred securities

28 May 2014

Réne M Stulz (Fisher College of Business)

International liquidity and exchange rate dynamics

4 June 2014

Xavier Gabaix (NYU, Stern)

Do MBAs pick winning stocks when choosing their first job?

11 June 2014

Paul Oyer (Stanford)

Sovereign risk and currency returns

25 June 2014

Christian Wagner (CBS)

Stock returns over the FOMC cycle

2 July 2014

Annette Vissing-Jorgensen (Haas)

Lunchtime Workshops

CEO contract horizon and innovation

30 April 2014

Juanita Gonzalez-Urbe (FMG, LSE)

Do anti-takeover provisions work? To the discontinuity (and beyond)

7 May 2014

Vicente Cuñat (FMG, LSE)

A work in progress

14 May 2014

Dong Lou and Christopher Polk (both FMG, LSE)

Synthetic or real? The equilibrium effects of credit default swaps on bond markets

21 May 2014

Martin Oehmke (Columbia)

Misallocation of talent in competitive labour markets

28 May 2014

Daniel Ferreira (FMG, LSE)

Debt, taxes and liquidity

4 June 2014

Patrick Bolton (Columbia)

Market maker pricing in anticipation of prospective order flow

11 June 2014

Ailsa Roell (Columbia)

Credit ratings and security design

25 June 2014

Joel Shapiro (Said Business School and FMG visitor)

Funding liquidity CAPM: international evidence

2 July 2014

Andrea Vedolin (FMG, LSE)

London Financial Regulation Seminars

A bank's progress

12 May 2014

Dimitrios P. Tsomocos (Said Business School) and Kevin James (Financial Conduct Authority)

Focus on the determination of bank recovery

2 June 2014

Charles Goodhart (FMG, LSE) and Miguel Segoviano (IMF)

Electronic money

9 June 2014

Richard Olsen (Olsen Ltd)

The SRM: the state of play

23 June 2014

Emiliano Tornese (European Commission)

Lessons for financial regulation and supervision from Cyprus

7 July 2014

Panicos Demetriades (University of Leicester)



PhD Seminars

All seminars are given by current
LSE PhD students

Co-pricing stocks and bonds: the estimation

12 May 2014

Wendy Yan (Department of Finance/FMG)

Dynamic equilibrium with rare events and value-at-risk constraint

19 May 2014

Cheng Zhang (Department of Finance/FMG)

A recipe for market discipline in loan sale

2 June 2014

Luana Zaccaria (Department of Finance/FMG)

The provision of incentives and feedback of managerial compensation

9 June 2014

Yiqing Lu (Department of Finance/FMG)

Investment waves under cross learning

16 June 2014

Shiyang Huang (Department of Finance/FMG)

Credit Market Competition and Corporate Investment

23 June 2014

Jason Donaldson

Spurious factors in linear asset pricing models

30 June 2014

Svetlana Bryzgalova (Department of Finance/FMG)

Corporate Governance at LSE: Brownbag Seminars

National culture, corporate governance practices and firm performance

1st July 2014

Kai Li (Sauder School of Business)

Paul Woolley Centre Brownbag Seminars

Revealing shorts: an examination of large short position disclosures

6th March 2014

Adam Reed (The Kenan-Flagler Business School)

Absolute Strength: Exploring Momentum in Stock Returns

20th March 2014

Huseyin Gulen (Perdue)

Credit market frictions and labour productivity in the UK: theory and evidence

17th June 2013

Isabelle Roland (FMG, LSE)

Learning, active investors, and the returns of financially distressed firms

10th June 2014

Christian Opp

DISCUSSION PAPERS

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

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

DP 728

Product market competition and industry returns

M Cecilia Bustamante and Andrés Donangelo

This paper shows that product market competition has two opposing effects on asset returns.

The first relates to the procyclical nature of the value destruction from expansion of competitors, which lowers exposure to systematic risk in more competitive industries. The second is related to the narrower profit margins due to competition, which increase exposure to systematic risk. We find that the first effect dominates the second, so that firms in more competitive industries

generally earn lower asset returns. Our results are robust to using five alternative measures of competition and to controlling for the sample selection bias of publicly listed firms.

DP 729

CEO job security and risk-taking

Peter Cziraki and Moqi Xu

We use the length of employment contracts to estimate CEO turnover probability and its effects on risk-taking. Protection against dismissal should encourage CEOs to pursue riskier projects. Indeed, we show that firms with lower CEO turnover probability exhibit higher return volatility, especially idiosyncratic risk. An increase

in turnover probability of one standard deviation is associated with a volatility decline of 17 basis points. This reduction in risk is driven largely by a decrease in investment and is not associated with changes in compensation incentives or leverage.

DP 730 and PWC Paper 38**Liquidity risk and the dynamics of arbitrage capital**

Péter Kondor and Dimitri Vayanos

We develop a dynamic model of liquidity provision, in which hedgers can trade multiple risky assets with arbitrageurs. We compute the equilibrium in closed form when arbitrageurs' utility over consumption is logarithmic or risk-neutral with a non-negativity constraint. Liquidity is increasing in arbitrageur wealth, while asset volatilities, correlations, and expected returns are hump-shaped. Liquidity is a priced risk factor: assets that suffer the most when liquidity decreases, eg, those with volatile cashflows or in high supply by hedgers, offer the highest expected returns. When hedging needs are strong, arbitrageurs can choose to provide less liquidity even though liquidity provision is more profitable.

DP 731 and PWC Paper 39**Ties that Bind: how business connections affect mutual fund**

Dragana Cvijanović, Amil Dasgupta and Konstantinos Zachariadis

We investigate how business ties with portfolio firms influence mutual funds' proxy voting using a comprehensive dataset spanning 2003 to 2011. In sharp contrast to the prior literature, we show that the proxy voting of mutual funds is significantly influenced by their business ties with portfolio firms. Our result holds at the level of individual proposals after robustly controlling for unobserved heterogeneity across firms and fund families and over time as well as for the effects of ISS recommendations and fund family holdings. We also show that the influence of business ties on proxy voting is strongest for highly contested shareholder proposals where proxy votes are most relevant for firm value. Finally, we show

that the prominent class action lawsuits of 2006 against 401(K) sponsors and providers had differential effects on the voting of different fund families depending on whether they were sued, thus unearthing a potential link between investor attention and corporate governance.

DP 732**The economics of collateral**

Ronald W. Anderson and Karin Jøeveer

In this paper we study how the use of collateral is evolving under the influence of regulatory reform and changing market structure. We start with a critical review of the recent empirical literature on the supply and demand of collateral which has focussed on the issue of "collateral scarcity". We argue that while limited data availability does not allow a comprehensive view of the market for collateral, it is unlikely that there is an overall shortage of collateral. However, it is quite possible that there may be bottlenecks within the system which mean that available collateral is immobilized in one part of the system and unattainable by credit-worthy borrowers. We then describe how these problems sometimes can be overcome by improved information systems and collateral transformation. We discuss how collateral management techniques differ between banks and derivatives markets infrastructures including, in particular, CCPs. In order to assess the impact of alternative institutional arrangements on collateral demand, we introduce a theoretical model of an OTC derivatives market consisting of investors and banks arrayed in several regions or market segments. We simulate this model under alternative forms meant to capture the implications of moving to mandatory CCP clearing and mandatory initial margin requirements for non-cleared OTC derivatives.

DP 733 and PWC Paper 40**Activist funds, leverage, and procyclicality**

Mike Burkart and Amil Dasgupta

We provide a theoretical framework to study blockholder activism by funds who compete for investor flow. In our model, activists are intrinsically able to raise the value of target firms through monitoring. Competition for investor flow induces them to enhance the returns generated by monitoring by raising external funding at the level of the target firm. We adopt a microfounded approach to account for the lack of macro-state contingency in such financing contracts and show that debt is optimal for raising external funding. When good funds are sufficiently better than bad funds, competition for flow can generate excessive leverage which fosters debt overhang in low macroeconomic states and shuts down activist effort. As a result, investing in activist hedge funds is more desirable when macroeconomic prospects are good. Our model thus links the observed procyclicality of activism with documented increases in the leverage or payouts ratios of target firms. In addition, the model generates several new testable implications and reconciles seemingly contradictory evidence on the wealth effects of activism for shareholders and bondholders.

You can download all FMG Working 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. They often follow conferences at which debates have stimulated further research and cooperation between participants and the wider academic and professional financial community.

SP 228

The ECB as lender of last resort: banks versus governments

Adalbert Winkler

With the OMT program the ECB has de facto taken over the role as a lender of last resort (LoLR) for euro area governments. While this has been welcomed by some, many policymakers and economists, in particular in Germany, have strongly criticized the ECB for taking this step, even though it has been motivated by the same monetary policy considerations as the ECB's role as a LoLR for banks. This paper addresses four arguments that are used to explain why it is acceptable to have the ECB as a LoLR for banks, while a LoLR role for governments has to be rejected. Overall we find that the arguments fail to convince. At the same time, all of them suggest that decisive steps towards fiscal and banking union are needed for the ECB to act as a successful LoLR for governments in the medium and long term.

SP 229

Competition and credit control

C.A.E Goodhart

The Bank of England's "consultative document" on Competition and Credit Control was published on May 14th, 1971. It was a landmark occasion, representing a decisive break with the prior

system of maintaining direct controls over the, main components of the, UK banking system; the intention was now to achieve the monetary authorities' objectives of policy via the operation of market mechanisms, notably adjustments in interest rates and open market operations. Although the "credit control" aspect was, over the next few years, notably less successful than the encouragement of competition amongst the banks, (where the London Clearing Banks previously had maintained a restrictive cartel with the support of the authorities), nevertheless the direction of travel towards a more liberal, market based system, remained, despite a partial reversion towards a partial direct control system in the guise of the "corset", introduced at the end of 1973, and finally laid to rest in June 1980.

SP 230

A resolvable bank

Thomas F. Huertas

Making banks resolvable is a key component of the regulatory reform programme enacted in response to the crisis. A resolvable bank is one that is "safe to fail": it can fail and be resolved without cost to the taxpayer and without significant disruption to the financial markets or the economy at large. This paper designs such a bank. The design's key feature is the separation of investor obligations from customer obligations

at the operating bank. This is broadly achieved where the bank issues customer obligations, such as deposits and derivatives, and the parent issues investor obligations to third parties with the investment of the parent in the daughter bank serving as the transmission link for losses at the bank level to losses to investors at the parent level. This transmission of losses to the parent serves to recapitalise the bank-in-resolution. This in turn assures the solvency of the bank-in-resolution and provides the basis for the operating bank to obtain liquidity and continue customer operations. In sum, investors, not taxpayers, bear the cost of resolution and the bank continues to perform critical economic functions. The design works not only for a bank in a single jurisdiction, but also for internationally active banking groups with branches and/or subsidiaries in foreign jurisdictions. Indeed, the design can form the basis for international cooperation among resolution authorities and central banks, so that they can establish "constructive certainty" as to the path they would follow, should a global systemically important bank need to be resolved.

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Collier Institute of Venture 2014 Research Grants
Dr Juanita Gonzalez-Urbe (FMG/Department of Finance), along with co-author Dr. Lora Dimitrova, has received a \$15,000 **Collier Institute of Venture (CIV)** research grant for their paper 'Corporate venture capital and productivity in pharmaceutical-biotechnology companies'. CIV

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