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EIF RESEARCH CALL 2011
RESULTS

- ***"The Role of Shocks to Bank Lending, Risk-Taking and Securitization for the U.S. Business Cycle?"***
  Wolf WAGNER – Tilburg University

  Abstract: In this project we want to empirically identify various types of shocks to the financial system with the purpose of studying their macroeconomic consequences. To this end we have developed a simple model that allows us to identify i) shocks to the risk-appetite of banks, ii) securitization shocks, iii) lending shocks, iv) monetary policy shocks. Using structural vector autoregressive (SVAR) model we want to implement this model in a second step using E.U and U.S. data. Once the SVAR has been estimated, it should be possible to examine the dynamic effects and evaluate the macroeconomic relevance of the various shocks. In particular, we want to answer questions such as: How important are shocks to the banking system for the macroeconomy, relative to other shock such as those coming from monetary policy? Was the boom in securitization and lending prior to the crisis driven by shocks to securitizations themselves or by easy monetary policy? How does monetary policy affect the risk-taking incentives of banks?

- "***Investors'Behavioral Biases and Attention***"
  Joël PERESS, INSEAD

  Abstract: A growing body of research shows that investors are inattentive, and that their inattention is detrimental to the efficiency of financial markets. The goal of this research project is to explore empirically whether the opposite also holds, i.e. whether excessive attention harms efficiency. The project builds on a stream of evidence documenting the importance of behavioral biases among investors. In particular overconfidence and a reluctance to realize losses (the "disposition effect") have been shown, thanks to data from brokerage houses on individual investor trades, to be important determinants of retail investors trading strategies. Using similar data, this project will investigate the interaction between behavioral biases and attention. Specifically, it will ask whether drawing more attention to a stock mitigates or exacerbates the biases which influence investors' decision about this stock.

- "***Risk and Individual Investor Behavior: A Market Microstructure Approach***"
  Hedi BENAMAR, HEC Paris

  Abstract: This research project aims at understanding, with a market microstructure approach, the behavior of individual investors in the presence of risk and uncertainties. Understanding how individuals behave when facing financial risks, what determines their financial decisions and why they are trading are three fundamental questions as

more and more individuals have today an easy access to financial markets. Using a large and unique database from a major French broker with more than 15 million transactions from 1999 to 2010, I plan to obtain results that would be meaningful for brokerage regulation (do we have to protect the individual investor? What is the optimal trading channel?), economic policies (how to teach people to avoid making irrational mistakes on markets?) and global market welfare and stability.

- ***"Finance and Labor"***
  Giovanni PICA, University of Salerno

  Abstract: How do financial market development affect employment, wages and unemployment risk? This issue is much under-researched, in spite of their prominence in public debate, often ideologically polarized between those who consider finance as socially harmful and those who view it as an efficient allocation machine. Most economic research indicates that financial development raises output growth, but is silent about its effects on the labor market: does it also raise employment and wages? If so, is it at the expense of greater employment risk and inequality? And how does the potential for systemic financial instability affect the answers to these questions? This research project purports to break new ground on these issues, using a combination of analytical modelling and empirical analysis.

- **"*Maintaining Adequate Bank Capital*"**
  Mark FLANNERY, University of Florida

  Abstract: The new regulatory procedures coming from Basel III, the Financial Stability Board,the U.S. Dodd-Frank Act, etc. all purport to increase the stabilty of financial firms and the financial system. However, the supervisory system has long suffered from a governance failure that is not addressed by any of these reforms: the apparent inability of large banks' supervisors to force institutions to re-capitalize when their economic capital falls (leverage rises). In large measure, this reflects supervisory frameworks that define solvency in terms of book accounting standards, rather than market investors' assessments of an institution's solvency. This paper will explain that financial stability requires a procedure for timely maintaining adequate bank capital in a volatile and uncertain economic environment. Yet none of the recent reforms really addresses this issue. There remains a central governance failure of large financial institutions, which might also be identified as a structural failure of the supervisory process. The paper will then suggest ways to address the failure in an effort to control the "too big to fail" problem and to maintain a stable financial system.

- **"*The Credit Ratings Game*"**
  Stefan HIRTH, Aarhus University

  Abstract: We analyze credit rating agencies and competition. A shortcoming of existing models is that they only consider competition in duopoly, although the U.S. market consists of three major players, and even ten organizations that are designated as Nationally Recognized Statistical Rating Organizations. I develop a framework using Evolutionary Game Theory to analyze the interaction of credit rating agencies in a competitive market with more than two agencies. I show that significant changes in market structures and outcomes can happen for any arbitrary current market size, for example when one new agency enters a market currently consisting of two, three, or ten agencies. Furthermore, honest rating behavior can indeed be achieved as a result of high

competition. Alternatively, it can be implemented by regulatory measures like abolishing the "issuer pays" model or by a centralized monitoring of ratings quality.

- "***Illiquidity Risk and Contagion: Theory and Experimental Evidence***"
  Radu VRANCEANU, ESSEC Business School

  Abstract: Besancenot and Vranceanu (2011) have analyzed investors' behavior subject to an "illiquidity" constraint, where the success of a risky project depends on the participation of a minimum number of investors. They have unveiled the insidious nature of the illiquidity risk: as long as a first illiquidity default does not occur, investors do not seem able to fully internalize it. After several defaults, agents manage to coordinate on a default probability above which they refuse to participate to the project. This new project carries a step further the former analysis; it aims to determine how the illiquidity default thershold changes when "soft messages" can be exchanged between two groups of subjects playing the "illiquidity game". The main reserch questions are whether default in one group should rise the odds of default in the other group, and what type of messages are the most prone to bring about default. Policy implications are straigthforward.

- "***Counterparty Risk Externality: Centralized Versus Over-the-Counter Markets***"
  Viral ACHARYA, New York University, Stern School of Business

  Abstract: We model the opacity of over-the-counter (OTC) markets in a setup where agents share risks, but have incentives to default and their financial positions are not mutually observable. We show that this setup results in excess "leverage" in that parties take on short OTC positions that lead to levels of default risk that are higher than Pareto-efficient ones. In particular, OTC markets feature a "counterparty risk externality" that we show can lead to ex-ante productive inefficiency. This externality is absent when trading is organized via a centralized clearing mechanism that provides transparency of trade positions, or a centralized counterparty (such as an exchange) that observes all trades and sets prices competitively. While collateral requirements and subordination of OTC positions in bankruptcy can ameliorate the counterparty risk externality, they are in general inadequate in addressing it fully.

- "***The Effects of Asset Price Bubbles for Long-Term Investors***"
  Erik KOLE, Erasmus University Rotterdam

  Abstract: The current theoretical literature makes contradicting predictions regarding the impact of an investor's horizon on his optimal trading strategy in the presence of bubbles. We analyze this relation empirically using a Regime Switching Model to identify bubbles and crashes. We base our analysis on industry returns and use conventional asset pricing models to proxy for fundamental value. Preliminary results show high positive returns after bubbles at the one-month horizon. At intermediate horizons of 2-4 months our findings are mixed, but thereafter, for horizons up to five years,returns following a bubble are again more positive than returns in the absence of a bubble. For a mean-variance as well as a downside-risk averse investor's, the weight allocated to the bubbly asset is higher for horizons up to 5 years. These findings suggest that even for a rather unsophisticated trader who does not follow daily market news, riding bubbles is a more profitable strategy than refraining from investing in the bubbly asset. Given the broad range of horizons during which riding bubbles is the optimal strategy, our results question the idea that bubbles are zero-sum games.

- "***What Drives Financial Innovation ?: A Look into the European Retail Structured Products Market***"
  Boris VALLEE, HEC Paris

  Abstract: The purpose of this project is double: first, to identify the factors that foster financial innovation and the ones that limit it, from both the supply and demand sides; second, to determine the effects of financial innovation in terms of market efficiency and welfare. To answer these research questions, we will focus on a specific market that has met phenomenal growth and innovation in the last decade: the retail structured products market. Debate on causes and effects of financial innovation is key for financial markets, as recently illustrated in the sub-prime markets.

- "***The Real Effects of Euro Volatility : Evidence from 750 000 French Companies***"
  Christophe PERIGNON, HEC Paris

  Abstract: The goal of this research project is to study the real economic effects of currency (FX) risk for French companies. The key questions we want to investigate are: (1) What is the level of FX risk exposure of French companies? (2) Do French firms hedge FX risk, and to which extent? (3) For those that do hedge, which hedging techniques are put in place? (4) For those that do not hedge, what are the main reasons for not hedging? (5) Finally, what are the implications of FX risk exposures for firms' investment decisions and performance? To address these fundamental questions, we will conduct the first national survey of French companies' FX exposure. To do so, we will create an online questionnaire that we will send to a large number of French companies. In order to cover a large fraction of the French economy, we will collaborate with the MEDEF (Mouvement des Entreprises de France), which is the largest organization of French companies. We already obtained approval from Julien Guez, the MEDEF Chief Economist, for sending our online questionnaire to the 750 000 companies that are affiliated with MEDEF. To our knowledge, the MEDEF membership directory represents a major part of the French corporate sector. Our unique dataset will cover 77 different industries, both private and public companies, and large multinational corporations and SMEs.