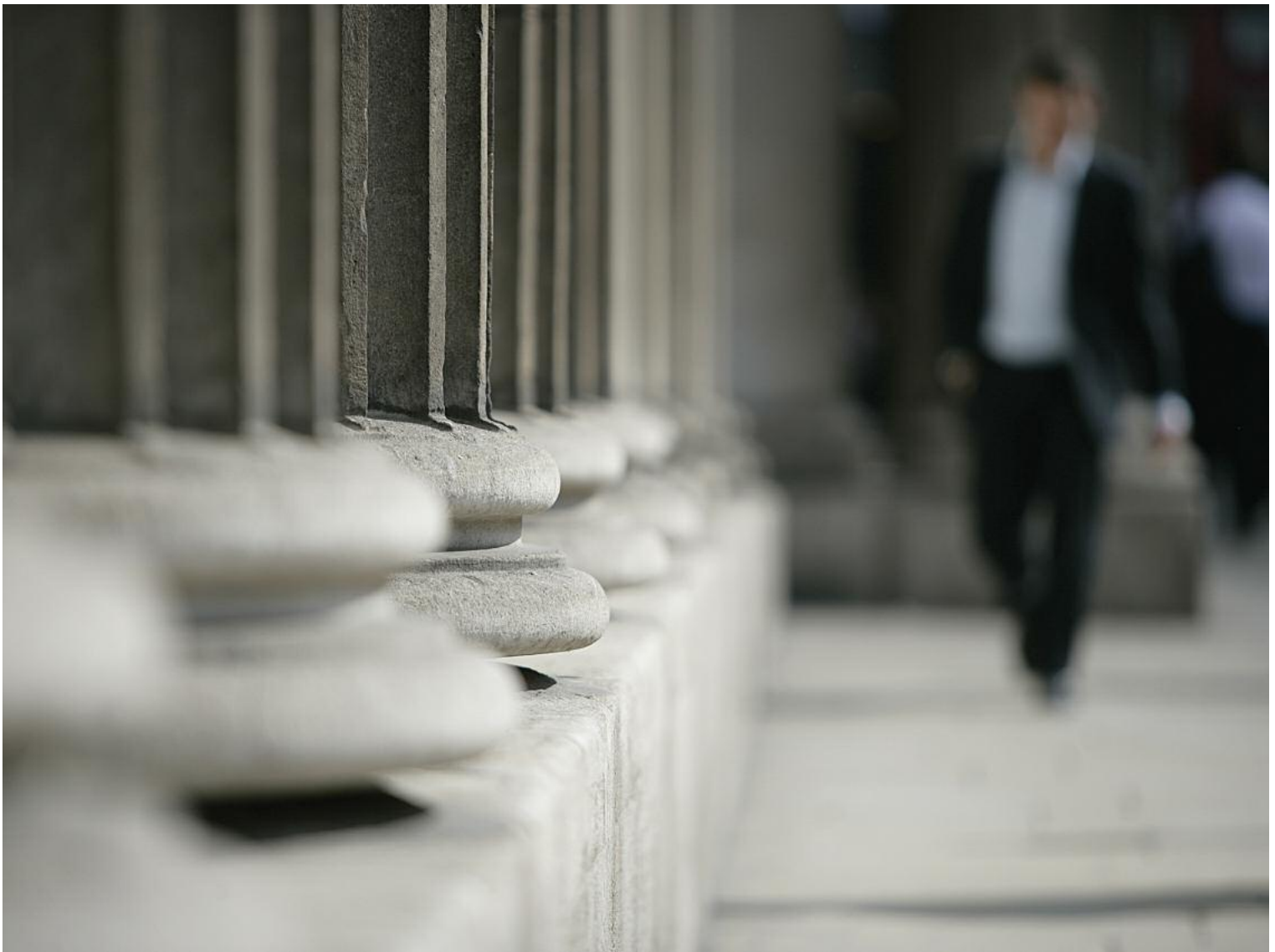


Compendium on the Crisis



IS IT RIGHT TO BAIL OUT THE BANKS?

Viral Acharya has written on the optimal resolution of bank failures, the moral hazard of bailing out banks and how off-balance sheet vehicles have exacerbated matters. He and Julian Franks also argue that by guaranteeing banks, the government is providing a free option to banks to increase leverage (i.e. the bank bears no cost of failure, but rather the reward associated with additional risk). The incentive of market participants to monitor banks is also lowered and rating agencies forced to evaluate when the government may or may not bail out a bank. Given these concerns, regulators must charge for guarantees, resulting in banks pricing the cost of failure into their loans and leverage decisions.

At London Business School we work in an environment where it is essential to respond to economic and commercial developments. We regard it as a normal part of what we do.

Individual faculty have been responding to the global economic developments of 2008 and 2009 in what they write as well as what they teach. Their insights help our students, alumni and the wider management community understand what is happening and, as a result, take more informed decisions.

There have also been specific policy contributions, particularly by the Economics Group, with briefings for Heads of State, Central Banks and Finance Ministries, the European Commission, groups of officials and the World Economic Forum.

Not all faculty see eye to eye. Such opposing views illustrate that this is a community of scholars, not the purveyor of a particular line. And contrary to the assertion that business school finance was too heavily focussed on obscure derivative structures and the mispricing of risk, such material is just as applicable in a post-crisis world. In Economics and Finance, course materials have been systematically revised but the story is much the same.

In the following pages, we highlight a number of their contributions to public discourse. This list is not exhaustive, and you'll find more information online at www.london.edu



Andrew Likierman
Dean

Randall S Peterson
Deputy Dean (Faculty)
Professor of
Organisational Behaviour

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leading newspapers and broadcasters quoting our faculty about the crisis since
November 2008

THE ROOTS OF THE CRISIS AND ITS FINISH LINE

The economics faculty have been heavily involved in providing a context for the current crisis. **Richard Portes** is active in the media and in research on both the origins and the implications of the credit crunch. Richard identifies the root cause of the crisis as global macroeconomic imbalances, which brought huge cross-border capital flows. These overwhelmed even the sophisticated financial systems of the US and UK and were partly responsible for asset price bubbles. They also provoked a 'search for yield' which, aided by the credit rating agencies, led to the creation and accumulation of 'toxic assets'. Then, when the crisis broke, central bank coordination was inadequate. Richard's solution? Deal with the global imbalances, as well as the evident weaknesses of the financial regulatory system, he wrote in a co-authored report¹ for G20 officials, and provide a global solution to what is a global crisis.

Lucrezia Reichlin has set out how recessions in the Euro area follow those in the US, but are longer and less pronounced. The economy may recover in 2009, she says, though it may get worse before it gets better. **Hélène Rey** has consulted history. In both the 1997 Asian and the 1980 Japanese crises, she shows how increasing exports helped the economy recover. This is not a feasible strategy in 2009 due to the global nature of today's crisis: no region is eager for imports. Hélène also exposes parallels between the 1930s and the present, in terms of financial deregulation and deflation risk.

The UK will not shake a deep recession until 2010, according to **Andrew Scott**. However, low interest and exchange rates offer hope for the speed of recovery. He predicts less competition in the next upturn, as governments are likely to approve anti-competitive mergers.

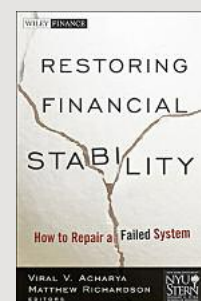
These four faculty members have come together for several briefings. In May they held an event at the School with the IMF, which presented its latest economic outlook to 200 students.

From an organisational perspective, **Michael G Jacobides** has discussed how the neglect of the changing nature of the banking industry ('industry architecture') is the root cause of the crisis. Regulators, banks and investors failed to take heed of these changes, namely the dramatic increase in securitisation over the past ten years, the emergence of new derivatives, and the value placed on rating agencies.

Niro Sivanathan investigates why power creates the illusion of control over uncontrollable situations. Power causes individuals to engage in impulsive and risky behaviour, perhaps leading to some of the risky decisions that contributed to the crisis. This research sheds light on why CEOs chased mergers that were never destined to materialise and why traders placed overly optimistic bets without comprehending the risks involved in leverage.

Restoring Financial Stability: How to repair a failed system

Viral Acharya, examines 18 cracks in the financial system (he suggests there are more to be discovered!), but concludes that fixing each issue would be too costly. By fixing a few, the financial foundation can be stabilised, financial structures rebuilt and innovation and markets can once again flourish



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articles written by our faculty for the *Financial Times*' "Managing in a downturn" special series

¹ Available as an e-book www.voxeu.org/reports/G20_ebook.pdf

SEPARATING THE WHEAT FROM THE CHAFF

Paolo Volpin writes about the failures of credit ratings through rating inflation and insufficiently precise disclosure of information about the underlying pool of securities. Regulators should require rating agencies to be paid by investors rather than by issuers (or at least constrain the way they are paid by issuers), he says, and force greater disclosure about the underlying pool of securities.

Suleyman Basak and **Anna Pavlova** discuss the incentives of money managers to gamble when underperforming and conclude that it is in the best interest of investors to put constraints on fund managers. Anna also wrote in the *Review of Economic Studies* about the severity of financial contagion during economic crises.

Stephen Schaefer suggests that regulation reach beyond the banking system, and that it should be broader and consistent across countries.

In work published by the The Adam Smith Institute, Marketing Senior Fellow, **Tim Ambler**, counters that a stricter regulatory environment will not solve this crisis. “More regulation creates the illusion of control, and may even serve to decrease the transparency” that is so necessary, he writes. The crisis was created not by regulation, or the lack of it, but by the supervisory failure by the regulators.

In a number of papers, **Raman Uppal** confronts the tradeoffs of derivatives, risk and volatility. He shows that derivatives, which allow for improved risk sharing, also lead to an increase in the volatility of stock market returns (these can be substantially greater than that of aggregate dividend growth, or ‘fundamental volatility’). Raman also finds that overconfident investors overreact to public signals and introduce an additional risk factor, causing stock prices to be excessively volatile. And it is difficult for this excess volatility to be arbitrated away by rational investors. He adds that during a recession, investors pull out of unfamiliar assets and invest in more familiar assets – a flight to familiarity.

Catalina Stefanescu’s new research allows rating agencies and banks with internal rating systems to estimate the riskiness of assets within credit classes that have historically had no defaults at all (for example, the riskiness of AAA-bonds).

Guillaume Plantin has written a variety of papers ranging from the sub-prime mortgage market (showing the relationship between housing bubbles and income shocks on house prices and default levels) to the destabilising impact of forcing financial institutions to mark their loans and securitised products to market.

From a strategy perspective, **Julian Birkinshaw** has looked at the ways in which management failure contributed to the problems via flawed incentives, miscalculated risk and misallocated resources. He argues for an increasing focus on the personalisation of decision making to complement the formal systems used by most large organisations. **Freek Vermeulen** draws parallels between current and previous collapses – the common cause is the structural failure of management, who allowed excessive specialisation, greed and who consistently failed to question the ways of doing things when times were good.

James Dow believes that it is striking that no contingency plan existed to deal with a major financial crisis: many of the policy responses were worked out ad hoc, and the division of responsibility between politicians and financial regulators. He also suggests that the credit crisis masks a more serious long-term crisis in the equity markets: low returns are exacerbating low savings rates, through closure of company pension funds and by discouraging individual saving, which will lead to inadequate pension provision.

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faculty podcasts about the economic crisis produced for our website

HELPING MANAGEMENT RESPOND

Companies should use the recession as an opportunity to create value, according to **Don Sull**. He suggests challenging the status quo and forcing hard choices. Don also recommends acquiring assets from struggling firms and responding to changing customers' demands. Don's new book, *The Upside of Turbulence: Seizing Opportunity in an Uncertain World*, will be on shelves in October 2009.

James Dow believes that it is striking that no contingency plan existed to deal with a major financial crisis: many of the policy responses were worked out ad hoc, and the division of responsibility between politicians and financial regulators was not set out clearly in advance. **Steve Currall** has suggested that the downturn may lead to a shift in society toward greater transparency in corporate governance and increased emphasis on socially responsible corporate actions.

To help companies survive the recession, **Chris Higson** has considered what makes firms vulnerable. Past business cycles show what happens to the sales, costs and balance sheets of firms in recession. His research describes how asset markets close in recession, when failing firms most need to access them.

John Mullins reminds entrepreneurs that the downturn is a great time to start a new business. Large companies have become more conservative and less likely to pursue opportunities, he says; crucial resources like rent and management talent are now cheaper and more abundant; and customers are looking for new solutions that can help them cut costs.

The recession is an opportunity to eliminate ineffective marketing programmes, says marketing professor **Nirmalya Kumar**. However, he also recommends that companies with strong market positions and balance sheets should increase their marketing budgets (when competition will be reducing theirs) as it provides a disproportionate share of voice.

As **Paddy Barwise** pointed out in his 1999 book, *Advertising in a Recession*, Barclaycard and Gold Blend made significant gains by following such a strategy. Other companies, such as BMW, gained share by simply continuing their strategy and investment while others cut back. To quote Sam Walton, founder of Wal-Mart, 'I was asked what I thought about the recession. I thought about it and decided not to take part.'

Tim Ambler argues that, in a downturn, companies should be careful of cutting marketing budgets to save money in the short term, because this short term will be followed by another short term. If the company is to survive, it needs at least to maintain brand equity for the future. **Marco Bertini** believes that the way consumers' process price information in the current economic climate is fundamentally different and they will now seek value

Glow: How You Can Radiate Energy, Innovation and Success

Lynda Gratton explains survivor syndrome after job cuts. It is more important than ever for managers to inspire confidence in staff by being optimistic and future orientated. Pessimism can paralyse productivity and the decision-making process. The recession is a great time for companies to change traditional ways of working so as to improve productivity. More access to virtual working, reducing the number of face-to-face meetings, formulating strategy from the bottom up and increasing gender diversity at senior levels all help.



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years of detailed capital market histories for 17 countries and three regions in the Credit Suisse Global Investment Returns Yearbook 2009 and in the accompanying Sourcebook¹

– **Elroy Dimson, Paul Marsh** and **Mike Staunton** analyse the impact of the recent market turmoil. They compare the recent bear market with other periods of market stress. They argue that despite the high volatility of equities, investors should nevertheless keep faith with stocks.

¹ The yearbook can be downloaded free of charge from www.tinyURL.com/DMSyearbook

LOOKING FORWARD

Michael Jarrett discusses survivors' syndrome and the guilt of retaining ones job. In order to boost morale, employers need to ensure staff are doing meaningful jobs and managers should increase their exposure by 'walking the floor'. **Julian Birkinshaw** and **Huw Jenkins** also look at the risk management decisions of banks and argue that a key feature of the banks that weathered the crisis in good shape was their ability to personalise their risk management processes. Such personalisation incorporates three features – high quality insight, individual accountability, and a supportive culture. Personalisation does not replace formal systems and procedures – it works alongside them as a complementary mechanism for reducing the likelihood of poor risk management decisions being made.

Nigel Nicholson's work shows that reliance on traditional power and incentives is futile in the new era we are entering. Leaders need to become more insightful into their people, more effective in creating frames of meaning for motivation and action, more skilful in fostering collaboration for innovation and change, and more courageous and resourceful in their decisions.

Rob Goffee and **Gareth Jones** have emphasised that the most significant aspects of leadership in turbulent times is the provision of a future vision, steadfastness to core values and the ability to adapt and change. In the debate about executive remuneration, **Andrew Likierman** has proposed new ways of linking performance and reward by focussing on forward-looking as well as backward-looking measures. **Zeger Degraeve** argues that rewarding short-term results causes crises and proposes that managers should be evaluated on long-term effectiveness. He argues that rewarding good decision-making and execution processes rather than results produces better business leaders.

DELIVERING IDEAS

In September, we launched a new series of Executive Workouts, intense, two-day programmes for executives. We also added additional elements to our existing programmes, such as H  l  ne Rey's special briefing to a recent Senior Executive Programme. The School is also working with several major corporate clients to give them customised guidance on how to get the best value from their existing resources devoted to Executive Education.

For more information about these courses, visit www.london.edu/execed

Over the past year, our faculty have addressed alumni in Athens, Munich, Rio de Janeiro, Abu Dhabi, Hong Kong, New York, Cairo and Singapore about the crisis.

To learn more about upcoming alumni events, alumni should visit Portal

Portal.london.edu

Our 2009 Global Leadership Summit was titled Leadership in Challenging Times. This day-long event brought academics, top business leaders and opinion formers together to debate the challenges facing the leaders of today and tomorrow.

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journalists and 18 faculty have met at Media Breakfasts on campus to discuss the recession, how to fix the markets, and financial regulation