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Research Programme of the Department of Finance and Financial Sector Management
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Summary

The research programme on Finance deals with aspects of financial decision making for individuals, corporate, and financial institutions and its consequences for the behaviour of financial markets. This has been elaborated in three lines of research: (1) financial management and corporate finance; (2) financial markets; (3) banking and regulation. Within each theme the aim is to perform fundamental research that can be translated into practically useful results. The department stimulates this dual objective by recruiting a balanced mix of full-time academics and academic practitioners to blend the cutting edge of academic and practitioners' insights.

The programme addresses issues with respect to optimal financial management in an Asset/Liability framework. Research questions involve the measurement and modelling of financial risk factors, the communication of risk exposures, and corporate finance issues like optimal governance systems, capital structure determination, and the drivers and effects of merger and acquisition activity. Within a
wider context, the programme studies the repercussions of financial management on financial markets. The effectiveness and efficiency of alternative market mechanisms are studied at different levels of aggregation, ranging from the transaction (microstructure issues) to more aggregated level (asset pricing issues). Finally, given its importance, a separate line of research concerns banking and regulation. This part of the programme addresses the effect of recent changes in the regulatory, monetary, and competitive landscape on the banking sector and on central banks. Special attention is devoted to the issue of financial stability because of both its scientific importance and its policy relevance.

Introduction

The predecessor of the current programme (1996-2000) was evaluated positively by the international panel of experts during the last national research assessment of Dutch universities. The current programme further integrates former lines of research into a coherent framework. Some smaller parts of the programme have been merged to gain further momentum in research performance. The current set-up builds upon the department’s strong points by continuing successful research lines and starting new research directions that have come in reach due to changes in staff composition. For example, the department has recruited two new full time staff members in the field of banking and market microstructure, respectively. Moreover, intensified cooperation with the Executive Teaching Programme in Asset Management (FBA) at the VU has recently led to fundamental research into pricing and managing derivative portfolios. To retain and extend its competitive edge in the national and international academic field, however, the department especially needs additional funding for Ph.D. students. Having more Ph.D. students would address the 2001 assessment committee’s criticism concerning the limited number of Ph.D. theses defended in the department. As the department’s capacity for effective Ph.D. student supervision has more than tripled since the research assessment of 1995, the present context constitutes the ideal opportunity to increase research quality and output highly efficiently over the coming years and to further gain momentum for the research group as a whole.

The programme and its faculty are increasingly internationally oriented. All members recently recruited have relevant international experience and networks. The department also actively invests in this area. For example, one of the department’s senior members has been allowed a research sabbatical to Stern School of Business (NYU) for the academic year 2002-2003 to increase the department’s international exposure and to further its research programme in the direction of corporate finance.

Objectives

The programme aims at providing answers the following four broad research questions:

1. What are the main drivers of good financial management and why?
2. What is the empirical evidence on the (financial) objectives firms try to optimise?
3. What determines the price formation on financial markets and is there scope for improvement in the price formation process?
4. What are the effects on the financial industry of the rapid changes in the regulatory, monetary, and competitive framework?

The programme aims at publishing its research in the top international journals in its field.

Motivation

The importance of financial markets and management is evident. Firms have to compete for scarce sources of funding from investors. These investors want an efficient trade-off between the risk and return dimension of their investments. To obtain a sufficient amount of funds and allocate these funds efficiently, it is important to know how firms should manage their financial and non-financial positions simultaneously (normative aspects of the programme) as well as whether they do so in reality (descriptive aspects of the programme). Apart from the role financial markets have for firms, they also play an important role in the life of individuals. Even if they are unaware of it, most people invest significant proportions of their wealth in financial markets in the form of compulsory pension fund contributions. Pension schemes should answer to the same efficiency trade-off with respect to risk and return as other investment and financing decisions. In this way, fluctuations on financial markets have a direct and significant impact on the welfare of economic individuals. Proper management and measurement of risk is therefore of paramount importance. The academic literature pays ample attention in all the top international academic journals to the issues mentioned above. The department aims to be internationally competitive and recognisable by having its research published in these journals.

Second, the issue of financial stability has become increasingly important over the last few years. There is a lively debate in the current academic literature on whether the wave of regulatory reform and quantification in risk measurement and management will lead to a (financially) safer world. The outcome of this debate is far from clear, but its practical and academic relevance is indisputable. By building on the expertise of its members, the department wants to contribute to the area of financial stability from both a theoretical and empirical perspective.

Many of the research topics of the current programme can also be found in related research programmes on finance at other universities. The current programme at the VU aims to be distinctive in its emphasis on Asset/Liability Management (ALM) issues. Since 1996, the university has spurred the research in this area by allocating new research time to a research programme in ALM. The national research assessment of Dutch universities by an international committee in 2001 has given a positive evaluation of this programme, which is especially interesting in view of its relatively short time of existence. To exploit the positive evaluation, the programme’s strong points should be reinforced. This can be done by opening up new research directions in the field of ALM and related areas over the coming years in addition to the existing themes. These extensions are in line with remarks made by the research assessment (2001) committee.
Research methods

Perhaps different from some other areas in (business) economics, many high-quality data sources exist for financial research. Financial and accounting data is readily available from several commercial data providers and the use of such data is well-accepted in empirical academic research. Apart from empirical work, the programme also uses a more theoretical modelling approach to financial management problems. The techniques used for this type of research range from purely analytical to simulation based analyses for obtaining insight into the effects of different policies and/or methodologies.

Description of the programme

In the following sections descriptions are given of the three research themes in the programme on Finance. It should be noted, though, that in practice the different themes are heavily intertwined. This shows in the fact that several of the programme’s researchers collaborate and work on more than one of the three themes. Moreover, some of the concrete research topics are on the borderline between two themes.

A. Financial Management and Corporate Finance

The first line of research addresses issues pertaining to how firms should attract funds, allocate capital, and manage risk. A key component in this approach is asset/liability management (ALM): the simultaneous management of both sides of a firm’s balance sheet. ALM focuses on how firm and institutions can efficaciously use available (financial) policy instruments to create value for stakeholders. ALM is encountered at institutions such as banks, insurance companies, pension funds, housing corporations, etc. The current line of research in ALM in the programme focuses on methodology, where the modelling of risk factors and the optimisation of financial decisions form the key components. The key research question is what is driving the optimal decisions under different circumstances. This part of the programme aims to develop further into the direction of new investment opportunities beyond the scope of common modelling tools (credits, hedge funds, insurance risks). Such investment opportunities call for new measures of risk, new empirical models, and new optimisation techniques. A second extension concerns the inclusion of derivatives and the management of derivative portfolios from a portfolio perspective.

Though tools are an essential ingredient of ALM analyses, in practice ALM is a process within an organisation rather than a mere application of tools. The process usually consists of 3 iterative steps: (1) setting and identifying goals, means and restrictions, (2) applying ALM tools to identify optimal ALM strategies given the goals, means, and restrictions, and (3) a evaluation of optimal strategies and a feedback loop. There is a high degree of interaction between stages 1 and 3, stemming from the fact that management becomes more aware of its preferences when confronted with measurable outcomes of ALM studies. Such increased awareness leads to a further delineation of goals and means. Due to the strategic aspects of ALM, ALM committees are usually located in the upper layers of an institution’s governance structure. This more process orientated perspective to ALM forms an interesting possible extension to the current line of research in ALM. The relevant
research questions for such an extension pertain to the strategic aspects of ALM for service organisations, the proper set-up (and success factors) of an ALM process and its communication within the organisation, the perception of risk and goals for ALM, and the control with related IT aspects.

Apart from the issue of ALM, this first theme of the programme also concerns corporate finance topics. In their pursuit of value creation, companies try to structure their information flows, their governance structure, and performance measurement systems in an optimal way given their preferences and perception of reality. In addition to the internal financial management issues, an important research question is whether companies succeed in communicating their policies transparently to financial markets. The programme’s perspective in addressing issues in corporate finance is mainly empirical. Using available data, the programme focuses on testing available corporate finance theories and (in)validating existing paradigms. Specific items that are being investigated concern the price of control and its relation with governance, manipulation of accounting data, and dividend and capital structure issues.

B. Financial Markets

The research line on financial markets covers issues in market microstructure, asset pricing, and market design. The red line between these topics is the behaviour and realisation of financial asset prices. Market microstructure research studies the behaviour of price formation in financial markets at the transaction level. Important issues in this area are the flow and speed of information, the number and types of active traders and their optimal policies, transaction costs, and the speed of adjustment of prices to new market conditions. These topics are addressed from both a theoretical and empirical perspective. Besides their academic relevance, these topics are also clearly relevant for policy makers in the current setting with rapidly developing trading systems, automation, Internet, and consolidation of alternative trading systems and floors.

At a higher level of aggregation (daily, monthly), the research on asset price behaviour takes a slightly different perspective. The main issue here is whether there is a clear-cut relationship between return and risk of an asset. While formal theoretical models usually state that there should be such a relationship (“no return increase without a corresponding risk increase”), there is ample empirical evidence casting doubt on the theoretical framework. The most important topics addressed by the programme in this area concern the time varying nature of the risk-return relationship and its coherence with macroeconomic conditions, the reaction of financial markets to increased information flows (investor relationships), and the behaviour of risk over time (including volatility modelling).

The final issue in the programme’s theme on Financial Markets concerns the design of new markets. Such markets might be created to trade alternative sources of risk. One can think of two different settings. One setting is that in which a market is set up for a relatively familiar risk factor. In that case, lessons may be drawn from similar markets for the same risk factor. Typical examples include setting up markets to cover producer price risk (e.g. cocoa) in Sub-Saharan countries. Research questions are: what are the main impediments to an efficient operation of the financial market; how can such impediments be removed, or if not, what second-best solutions can be
derived and implemented. A different setting is the birth of new markets for old or new risk factors. One can think of markets for weather risk, catastrophe risk, etc. The scope, depth, behaviour, and viability of such markets, as well as their repercussions on existing markets, are relevant topics for research.

C. Banking and Regulation

The banking sector has witnessed a strong degree of consolidation and (re)-regulation. Both the US and Europe have seen a large number of mergers over the past decade, with a focus on large or mega-mergers in the past few years. This has led to a reshaping of the financial landscape with corresponding effects on the role of (central) banks, the relationship between banks and customers, and the stability of the financial system as a whole. Moreover, the introduction of the Euro/EMU and the birth of financial conglomerates have called for a rethinking of the role of central banks and other regulators. The research line on Banking and Regulation addresses these issues in the following way.

To study the issue on how consolidation has affected the financial landscape, the programme focuses on aspects of relationship lending and on the market’s perception of bank mergers. The issue on relationship lending is well suited to check whether consolidation has spread out across all banking segments, or whether some banks are still able to exploit niches in the market. Alternatively, economies of scale and scope may have led to increased competition for banks that specialise in relationship lending, manifesting itself in relaxed conditions for granting loans. Another issue is the market’s perception of the effect of bank mergers. Especially given the recent wave of mega-mergers a non-linear (and non-monotonic) relationship might be postulated between merger size and risk premia due to an increase in the number of banks that are deemed Too-Big-To-let-Fail. The programme aims at generalising its current empirical findings in this area to other regions of interest.

The issues of Too-Big-To-let-Fail and the relaxation of loan conditions lead to the question of the stability of and policy effectiveness in the banking system and the financial system as a whole. These questions have become even more important in the wake of a new regulatory environment (the New Basle Capital Accord), the continuing emergence of economic and/or financial crises, and the EMU. The programme studies the effect of these developments on the financial sector. Some of the major questions concern the effectiveness of the proposed new regulations in ensuring stability, the role of regulators and central banks in the new environment, and the effectiveness of monetary policy in an integrated Europe. As an aside, the regulatory developments also take place outside the banking framework, for example, in the pensions and insurance industry. The programme also pays attention to stability and regulatory issues in this area. This can be deemed especially relevant given the 2000-2002 down ward movement in stock markets and its effect on the Dutch pension sector.

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