

# **Annual Report (2006-2007)**

by

## **The K.J. Luke Chair of International Finance and Banking**

June 2007

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The academic year, 2006-2007, marked a milestone in the history of the Shidler College of Business. With a \$25 million contribution by Mr. Jay Shidler, the Shidler College of Business was repositioned to become one of top 25 business schools in the nation. Under the leadership of Dean V. Vance Roley, the Shidler College of Business experienced a remarkable change in its research culture. The K. J. Luke Chair embraced wholeheartedly the idea of upgrading quality of Shidler College of Business research activities and did strive to play a leading and catalytic role in academic research in addition to his normal chores of teaching, service, and outreaching activities throughout this academic year. He will continue this drive to make a meaningful contribution to promoting the research productivity at the Shidler College of Business.

This report summarizes the Luke Chair's annual activities during the past academic year, July 2006 - June 2007. This report is structured as follows:

- I. Academic Research Work
- II. Outreaching Activities
- III. Teaching Activities
- IV. Service Activities

**I. Academic Research Work**

**A. Managing Editor of the *Pacific-Basin Finance Journal***

**1. New Editor Agreement**

The K. J. Luke Chair signed an Editor Agreement with the Elsevier North-Holland to serve as the Managing Editor of the *Pacific-Basin Finance Journal* for another five-year period, 2007-2012. Initially, he seriously considered the trade-off between the continued editorship and the smooth transfer of the editorship to a well-qualified junior academician. He decided to continue his service for two reasons: (i) he felt that another term of editorship would provide a much-needed leadership for the *Journal*; and (ii) the national ranking of the Shidler College of Business in research activities would benefit from his service as the Editor.

**2. Electronic Review System**

During the past academic year, an electronic review process was implemented beginning in August 2006, which significantly improved the manuscript submission and editorial processes.

### 3. Restructuring of the Editorial Board

The Luke Chair initiated a major structuring of the *Journal's* editorial board in August 2006. Summarized below are the changes implemented.

- Jun-Koo Kang of Michigan State University joined Kalok Chan and the Luke Chair as a co-editor as of July 1, 2006.
- The number of associate editors increased from 37 to 44. A total of 18 long-term serving associate editors stepped down while 25 new members joined the board. A list of new associate editors is attached as Appendix A. At present, three countries (Indonesia, Philippines, and Thailand) are not represented on the editorial board. The new team of associate editors represented 13 countries:

#### Geographical Distribution and Total Number of Associate Editors

United States:	24
Canada	3
Hong Kong	3
Singapore	3
Australia	2
Japan	2
China	1
Israel	1
Korea	1
Netherlands	1
New Zealand	1
Taiwan	1
<u>United Kingdom</u>	<u>1</u>
Total	44

### 4. Current Status of the *Journal*

As shown in the geographical breakdown of contributing authors, the *Journal* has been going through an interesting transition. In the first 10 years of publication, approximately 50 percent of the authors were affiliated with universities and institutions in the Asia-Pacific region. The second largest number of authors was from the United States and Canada at about 40 percent of the total and the remainder from Europe. In recent years, however, the percentage of US- and Canada-affiliated authors declined from 40% to 18% while the number of professors affiliated with Asia-Pacific region jumped up to approximately 80%.

#### Geographical Breakdown of Contributing Authors

<u>Region</u>	<u>First 10 Years</u>	<u>Last 4 Years</u>
Australia/New Zealand	25%	37%
East Asia	25%	40%
US and Canada	40%	18%

<u>Europe</u>	10%	5%
	100%	100%

A recent survey article “Faculty Perceptions and Readership Patterns of Finance Journals: A Global View” by E. Oltheten, V. Theoharakis, and N. G. Travlos (*Journal of Financial Quantitative Analysis*, March 2005) reports that the *Journal* is the only Asia-focused publication ranked among the top 30 in finance and economics. The same survey reports that the *Journal* is ranked no. 11 among academic researchers in Australia and New Zealand. Excluding two economics area journals (*Journal of Political Economy* and *American Economic Review*), the *Journal's* ranking moves up to no. 9.

A total of 28 manuscripts were published in 5 issues in the past year. The acceptance ratio remained at around 8%. The *Journal* Office receives on average 180 manuscripts per year.

<u>Issue No.</u>	<u>No. of Ms. Published</u>
Issue 15.3 (2007):	5 manuscripts
Issue 15.2 (2007):	6 manuscripts
Issue 15.1 (2007):	5 manuscripts
Issue 14.5 (2006):	7 manuscripts
<u>Issue 14.4 (2006):</u>	<u>5 manuscripts</u>
5 issues:	28 manuscripts

A special issue focusing on “behavioral finance” will be released shortly. John Nofsinger of Washington State University and Kenneth Kim of University of Buffalo served as guest editors.

On behalf of the *Journal*, the Luke Chair made special arrangements with the Hong Kong Baptist University and the Asian Finance Association to include selected papers from their conferences for future issues of the *Journal*. The Hong Kong Baptist University will host the 2<sup>nd</sup> Asia-Pacific Corporate Governance Conference on August 23-24, 2007, in Hong Kong. The Asian Finance Association will organize its 2007 Annual Meeting on July 5-7, 2007, also in Hong Kong.

## **B. Academic Research**

### Academic Papers

The second versions of two academic papers are under review by two major journals (*Review of Financial Studies* and *Journal of Banking and Finance*) in the finance area after the first submissions received positive reviews. In addition, two first-time submissions are under review. A total of five academic papers is forthcoming in leading academic journals/edited book. This productivity is the result of the Luke Chair's intensified research work during the past academic year.

1. Return Reversals, Idiosyncratic Risk and Expected Returns (co-authored with Wei Huang, Qianqiu Liu, and Liang Zhang): 2<sup>nd</sup> submission is under review by *Review of Financial Studies*.

2. How Does the Call Market Method Affect Price Efficiency? Evidence from the Singapore Stock Market (co-authored with Rosita P. Chang, Greg R. Stone, and Ning Tang): 2<sup>nd</sup> submission under review by *Journal of Banking and Finance*.
3. The Impact of Interbank and Capital Market Competition on Relationship Banking: Evidence from the Japanese Experience (co-authored with Donald R. Fraser and G. Hwan Shin): 1<sup>st</sup> submission to *Journal of Money, Credit and Banking*.
4. The Intraday Impact of Price Limits on Magnet and Momentum Effects (co-authored with Yan Du and Qianqiu Liu): 1<sup>st</sup> Submission to *Journal of Empirical Finance*.
5. Where Does Price Discovery Occur for Stocks Traded in Multiple Markets? Evidence from Hong Kong and London" (co-authored with Sumit Agarwal and Chunlin Liu), 2007, *Journal of International Money and Finance* 26, 46-63.
6. Additional Evidence on the Substitution between Shareholder Monitoring and Regulation: The Japanese Banking Experience during the Late-1980s (co-authored with Kenneth Kim and Sang-Hyop Lee): forthcoming in *Journal of Economics and Business*.
7. Investor Demand for IPOs and Aftermarket Performance: Evidence from the Hong Kong Stock Market (co-authored with Sumit Agarwal and Chunlin Liu) forthcoming in *Journal of International Financial Markets, Institutions & Money*.
8. Earnings Management During Distinct Phases of Capital Demand: Evidence from Japanese Banks," (co-authored with Sumit Agarwal, Souphala Chomsisengphet, and Chunlin Liu) forthcoming in *International Review of Economics and Finance*.
9. Relationship between Bank Monitoring and Firm Value Creation: A Survey (co-authored with G. Hwan Shin) forthcoming in *Institutional and Policy Reforms to Enhance Corporate Efficiency in Korea* (Lee-Jay Cho and Sang-Hyop Lee, editors), (Seoul: Korea Development Institute).

Manuscripts under Final Revision

1. The Impact of Short Sales on the Speed of Price Adjustment: Evidence from the Hong Kong Stock Market (co-authored with Crystal Xiaopei Chen)
2. Why CEOs File Bankruptcy in Delaware? (co-authored with Gregory R. Stone)
3. The Returns to Value and Momentum Strategies in Asian Markets" (co-authored with Stephen Brown, Daphne Du, and Liang Zhang)
4. Decimalization, Preferenced Trading, and Order Flow Migration to the NYSE (co-authored with Wei Huang and Ning Tang).
5. A Revisit to Quote Competition for NASDAQ Order Flow under the New Order Handling Rules (co-authored with Ning Tang)

### Manuscripts in Progress

1. Effects of 1997 London Stock Exchange Market Reforms on Market Quality of Trading Execution (co-authored with Rosita P. Chang and Ning Tang)
2. Who Herds with Whom? New Evidence on Herding Behavior of Domestic and Foreign Investors in the Emerging Stock Markets (co-authored with Sumit Agarwal and Chunlin Liu)
3. Inside Blockholdings and Earnings Management in Initial Public Offerings (co-authored with Kyoko Nagata and Toyohiko Hachiya)\*  
  
\* Professor Kyoko Nagata will visit the UH Asia-Pacific Financial Markets Research Center from August 2007 to March 2008 as a visiting scholar to conduct this joint research work.
4. IPO Valuation and Underpricing (co-authored with Cynthia Campbell, Daphne Du, and Ning Tang)
5. Termination of bank loans: A Test of Hold-up Costs or Substitution Hypotheses (co-authored with James Kolari and Hwan Shin)
6. Narrow Framing: Professions, Sophistication and Experience (co-authored with Yu-Jane Liu and Ming-Chun Wang)
7. Continuous Auction Method vs. Call Market Method: An Experience of the JASDAQ market (co-authored with Ken Iwatsubo)

### **C. Financial Markets Policy Research Work**

1. Financial Holding Companies: A Global Perspective” in *Emerging Challenges for the Korean Financial Sector: Development of Pension Markets and Functional Consolidation of Financial Institutions* (co-editors, Young Kwon Cho and S. Ghon Rhee) (Seoul, Korea: Financial News Inc. of Korea, April 2007), 160-175.
2. East Asian Financial Market Integration: Reality or Illusions?” *Jurnal Pengurusan* 25 (2006), 3-17.

### **D. Academic Paper Presentations**

The Luke Chair was involved with the following academic conferences in a variety of capacities:

1. 2007 FMA European Conference, May 30 – June 1, 2007, Barcelona, Spain
  - Program Committee
  - Paper Presentation: “Return Reversals, Idiosyncratic Risk, and Expected Returns” (co-authored with Victor Huang, Qianqiu Liu, and Liang Zhang)
  - Discussant: “Short Interest, Insider Trading, and Stock Returns” by TY Leung of the City University of Hong Kong, Oliver M. Rui, Chinese

University of Hong Kong, and Steven S. Wang, Hong Kong Polytechnic University

2. 2007 China International Conference in Finance, July 9-12, 2007 in Chengdu, China
  - Program Committee
  - Paper Presentation: “How Does the Call Market Method Affect Price Efficiency? Evidence from the Singapore Stock Market (co-authored with Rosita P. Chang, Greg R. Stone, and Ning Tang) and “Return Reversals, Idiosyncratic Risk, and Expected Returns” (co-authored with Victor Huang, Qianqiu Liu, and Liang Zhang)
  - Moderator of a session titled “Information and Securities Prices”
3. 2007 Asian Finance Association (AsFA) Annual Meeting, July 5-7, 2007, Hong Kong
  - Program Committee
  - Paper Presentation: “The Impact of Short Sales on the Speed of Price Adjustment: Evidence from the Hong Kong Stock Market” (co-authored with Crystal Xiaopei Chen) and “How Does the Call Market Method Affect Price Efficiency: Evidence from the Singapore Stock Market” (co-authored with Rosita P. Chang, Gregory R. Stone, and Tony Ning Tang).
  - AsFA Board Meeting
4. The Inaugural Market Microstructure Conference hosted by University of Sydney, March 30, 2007
  - Paper Presentation: “Decimalization, Preferred Trading, and Order Flow Migration to the NYSE” (co-authored with Wei Huang and Ning Tang)
5. 2006 Financial Management Association Meeting in Salt Lake City, Utah, on October 11-14, 2006.
  - Paper Presentation: “Decimalization, Preferred Trading, and Order Flow Migration to the NYSE” (co-authored with Wei Huang and Ning Tang) and “Another Look at Idiosyncratic Risk and Expected Return” (co-authored with Wei Huang, Qianqiu Liu and Liang Zhang)
6. “The 3<sup>rd</sup> Bank of Korea/KAEEA (Korea-America Economic Association) Joint Conference,” held on August 11, 2006.
  - Paper Presentation: “Additional Evidence on the Substitution between Shareholder Monitoring and Regulation: The Japanese Banking Experience during the Late-1980s” (co-authored with Kenneth A. Kim and Sang-Hyop Lee).
7. University of Tokyo: October 2007

- Paper Presentation: “Return Reversals, Idiosyncratic Risk, and Expected Returns” (co-authored with Victor Huang, Qianqiu Liu, and Liang Zhang)
8. Xiamen University, China, November 2006
- Paper Presentation: “Return Reversals, Idiosyncratic Risk, and Expected Returns” (co-authored with Victor Huang, Qianqiu Liu, and Liang Zhang)
9. National Chengchi University, Taiwan, December 2006
- Paper Presentation: “The Intraday Impact of Price Limits on the Magnet Effect” (co-authored with Daphne Yan Du and Qianqiu Liu)”
10. Good Morning Securities Co., Ltd. of Korea, April 2007
- Paper Presentation: “The Intraday Impact of Price Limits on the Magnet Effect” (co-authored with Daphne Yan Du and Qianqiu Liu)”
11. University of New South Wales, March 2007
- Paper Presentation: “Return Reversals, Idiosyncratic Risk, and Expected Returns” (co-authored with Victor Huang, Qianqiu Liu, and Liang Zhang)

#### **E. Publication of Edited Book**

Dr. Young Kwon Cho of the Financial News Daily (Korea) and the Luke Chair co-edited a book titled *Emerging Challenges for the Korean Financial Sector: Development of Pension Markets and Functional Consolidation of Financial Institutions*. This book was published by the Financial News Daily Inc. of Korea in April 2007.

#### **F. Research Grants**

The Luke Chair was a recipient of a 2007 Shidler College of Business Research Grant (\$14,000) to conduct a research project “Why Are Foreign Investors Poorer Performers than Local Investors?”

## **II. Outreaching Activities**

To strengthen working relations with public and private sector institutions and to increase the visibility of the University of Hawaii, the Luke Chair’s outreaching activities were conducted in dual capacities, the Luke Chair and the Executive Director of the Asia-Pacific Financial Markets (FIMA) Research Center. His outreaching activities are grouped into two categories: (i) the programs of the Asian Shadow Financial Regulatory Committee (ASFRC); and (ii) policy research and delivery of speeches for public and private sector institutions.

#### **A. Asian Shadow Financial Regulatory Committee**

The ASFRC is a group of independent experts on economic and financial markets policy issues relevant to the Asia-Pacific region. The current list of the ASFRC

members is attached as Appendix B. ASFRC members are independent of any of the members' affiliated institutions. The policy recommendations of the ASFRC are its own. Typically, ASFRC tries to translate concepts drawn from academic literature into concrete policy recommendations. This committee is a part of the Global Shadow Financial Regulatory Committees which include the committees of United States, Europe, Japan, Latin America, and Asia. ASFRC members meet twice a year to study, critique, and make recommendations on policy issues affecting the region as well as individual economies. The UH FIMA Research Center serves as the Secretariat of the ASFRC. The Luke Chair serves as the chair of a 15-member ASFRC. The Luke Chair will complete the three-year term as the ASFRC Chair in July 2007.

During the past academic year, two ASFRC meetings were held. The first meeting was organized in Auckland, New Zealand, in July 2006. The second was in Manila, Philippines, in February 2007.

### **1. The 5<sup>th</sup> ASFRC Meeting**

The 5th meeting of the ASFRC was held in the Board Room of the Massey University, Auckland, New Zealand, on July 6-10, 2006. The theme of this meeting was "The Political Economy of the Market-Based Financial Regulation." Because the Reserve Bank of New Zealand spearheaded the market- and disclosure-based financial regulation under the leadership of its former governor, Don Brash, it was an appropriate topic for the Committee meeting in New Zealand. The Committee prepared its official position statement titled "Lessons from the New Zealand Model of Market-Based Financial Regulation" which is attached to this report as Appendix C. As the chairman of this Committee, the Luke chair presided over its 2-day meeting on July 7-8.

On July 10, 2006, the Luke Chair served as the moderator of the ASFRC's Special Session organized at the 17<sup>th</sup> Annual Meeting of the Asian Finance Association where its position statement was formally released. At the invitation of the ASFRC, Mr. Tim Ng of the Financial Stability Department of the Reserve Bank of New Zealand delivered a speech "Financial Stability, Financial Regulation, and the Role of Disclosure."

Another important decision the ASFRC made in Auckland was the expansion of the committee membership. The Committee decided to allow two members to represent each of the countries.

### **2. The 6<sup>th</sup> ASFRC Meeting**

The Luke Chair presided over the 6th meeting of the ASFRC held in Manila, Philippines, on February 3-5, 2007. The theme of this meeting was "Regulatory Challenges Posed by Financial Conglomeration." Ms. Ma. Doroless B. Yuvienco, Assistant Governor of the Central Bank of the Philippines, served as a resource guide to provide the ASFRC members with the regulators' perspectives on financial conglomerates.

In view of the absence in the past, the ASFRC decided to terminate the memberships of Mr. Anthony F. Neoh of China and Hong Kong. Because Dr. Chalongsak Sussangkarn of Thailand has been appointed as the minister of finance and Dr. Fan Gang of China is now serving as a member of China's Monetary Board,

they are no longer qualified as shadow committee members. Hence, their memberships were also suspended. The ASFRC members agreed to actively search for new members representing China and Thailand.

On February 5, 2007, the Luke Chair presided over the ASFRC's press conference which was held in the conference room of the Philippine Institute for Development Studies (PIDS). The press conference was attended by approximately 25 local reporters. It was also attended by Dr. Josef Yap, president of the PIDS, and Dr. Gilberto M. Llanto, Senior Research Fellow of the PIDS. Appendix D is a position statement on the regulatory challenges posed by financial conglomeration. In the position statement, the ASFRC emphasized that:

“The financial conglomerate (FC) has become a popular form of financial business. Although they offer benefits of economies of scope and scale, they could generate potentially serious social costs. Since an FC is a financial institution, it is exposed to all the problems arising from informational asymmetry. As a business group, it is also exposed to all the problems of business groups, particularly in Asian economies with opaque ownership, weak corporate governance and inadequate legal systems. Weak regulation of FC creates regulatory arbitrage opportunities. The governments should integrate and tighten the oversight of FC activities, make ownership transparent and accountable, and limit control of FCs by non-financial companies.”

Two local organizations provided logistical support for the ASFRC meeting in Manila. They were the PIDS and the Asian Institute of Management. The ASFRC meetings were held in the conference rooms of the PIDS on Saturday (February 3) and Asian Institute of Management (February 4).

With the Luke Chair's term as the chair of the ASFRC ending in July 2007, Dr. Maria Socorro G. Bautista, Professor of Economics of the University of the Philippines, was elected as the new chair. She will serve a 3-year term beginning from July 2007.

The ASFRC members agreed to hold future meetings as shown below:

- 7<sup>th</sup> Meeting in Hong Kong on July 3-5, 2007, in conjunction with the 2007 Asian Financial Association's annual meeting on July 5-7, 2007 with the theme “Tax Arbitrage and Financial Regulation.” KC Chan of the Hong Kong University of Science and Technology and Leslie Young of the Chinese University of Hong Kong will be co-hosts;
- 8<sup>th</sup> Meeting in Yojakarta, Indonesia, in January 2008. Sri Adiningsih and the Gadjra Mada University will serve as the host of this meeting. The theme and exact dates will be determined after consultation with Dr. Fuad Rahmany, Chairman of the Capital Market Supervisory Agency (BAPEPAM) of the Indonesian Ministry of Finance;
- 9<sup>th</sup> Meeting in Tokyo, Japan, in July 2008 in conjunction with the 2008 Asian Finance Association Annual Meeting. The venue and exact dates will be determined after coordination with the Japanese Shadow Financial Regulatory Committee in which the ASFRC will organize a joint shadow committee meeting. Juro Teranishi of Nihon University and Shin-Ichi Fukuda of the University of Tokyo will be in charge of this meeting.

### **3. Biennial Meeting of Global Shadow Financial Regulatory Committees**

On behalf of the Asian Shadow Financial Regulatory Committee, the Luke Chair plans to attend the 2007 Biennial Meeting of Global Shadow Financial Regulatory Committees (US, Europe, Latin America, Asia, and Japan) to be held in Copenhagen on September 7-9, 2007. The theme of the Global Meeting is "Regulatory Issues Related to Private Equity Funds and Hedge Funds." The Luke Chair had a meeting with Harald Benink, chairman of the European Shadow Financial Regulatory Committee, and George Kaufman, chairman of the US Shadow Financial Regulatory Committee, in Barcelona to discuss the Global Meeting agenda and logistics during the 2007 Financial Management Association European Meeting in Barcelona on May 30 - June 1, 2007.

### **B. Public and Private Sector Institutions**

The Luke Chair continued his policy research work and delivered speeches for a number of public and private sector institutions to increase the visibility of the Shidler College of Business and the University of Hawaii's Asia-Pacific Financial Markets Research Center. With a greater emphasis placed on pure academic research work, the Luke Chair reduced his overseas travel commitments while increasing his academic research-related activities.

#### **1. The 8th OECD Round Table on Capital Market Reforms in Asia**

The Luke Chair participated in the 8th Round Table on Capital Market Reforms in Asia which was organized by the Organization for Economic Co-Operation (OECD) and Asian Development Bank Institute on October 11-12, 2006 in Tokyo, Japan. Andrew Sheng, former Chairman of the Hong Kong Securities and Futures Commission and now Senior Advisor for the China Securities Regulatory Commission, served as the Chair of the Round Table. The 2-day session was attended by 57 participants from 21 OECD member/non-member countries and five multilateral financial institutions (ADB, ADBI, IMF, OECD, and World Bank). In addition, representatives from the International Accounting Standard Board also participated. The majority of participants were chairs, deputy chairs, or commissioners of capital market regulatory agencies of the Asia-Pacific region. In addition, 40 Tokyo Seminar participants who are mid-level managers of capital market regulatory agencies in the region were also present at the Round Table.

The five major themes of this Round Table included (i) capital market reforms in Asia: issues, progress, and challenges; (ii) financial policy landscape; (iii) competition and integration of exchanges and its implications for regulators; (iv) corporate governance; and (v) international convergence of accounting standards. I served as a commentator of the following three presentations in the first session:

- Masahiro Kawai, Director General of the ADB Office of Regional Economic Integration, "Financial Integration and Bond Market Development in East Asia";<sup>1</sup>
- Andrew Sheng, "Building National and Regional Financial Markets: The Asian Experience"; and
- Andrew Large, Former Deputy Governor of the Bank of England, "Developing Supervisory Structures: Observations from Europe."

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<sup>1</sup> Dr. Kawai is now the dean of the Asian Development Bank Institute.

In his discussion, the Luke Chair stressed that the reason why the creation of regional market activities in Asia has been fizzling out is that too much emphasis is placed on the public sector's role by ASEAN+3 (China, Japan, and Korea) finance ministers process and the executives' meeting of Asia-Pacific Central Banks. The public sector does not have to spearhead the creation of a regional bond rating agency, a regional clearing and settlement system, a regional trading system, or Asian bond funds because as long as business volume is justified, private organizations will jump in. The Luke Chair reminded the participants that regional integration and globalization were being achieved without the public sector's involvement in the equity market side. Shareholding of domestic securities by foreign investors amount to over 30% in Korea, 30% in Thailand, 25% in Japan, and 20% in Taiwan. The globalization of the region's equity markets was not initiated by the public sector in the region. Capital market authorities simply served as facilitators, eliminating impediments to cross-border investments. The Luke Chair further emphasized that the public sector and government bureaucracy became the impediment to the smooth regional integration of Asian bond markets. The Luke Chair knew that market regulators from Asia must have felt uncomfortable about his argument (especially senior members of Japan's Ministry of Finance who have been spearheading the regional bond market projects) but he believed that that was the cold reality Asian market regulators faced.

## **2. The 21<sup>st</sup> Pacific Economic Community Seminar**

The Luke Chair participated in the 21<sup>st</sup> Pacific Economic Community Seminar which was held on December 7, 2006 in Taipei, Taiwan. The Seminar was organized by the Chinese Taipei Pacific Economic Cooperation Committee (CTPECC) and the Taiwan Institute of Economic Research, an in-house research center of the China Trust and Commercial Bank. The theme of this conference was "Outlook of Free Trade and Financial Cooperation in the Asia-Pacific Region." The Seminar was opened by Vice President of Taiwan, Hsiu-Lien Lu. It was a small conference with approximately 80 participants from the banking and securities industries and academicians.

From the United States, Peter A. Petri (Carl J. Shapiro Professor of International Finance, and Dean, International Business School, Brandeis University), participated as a speaker on the trade issue in the Asia-Pacific region. Peter is currently visiting the East-West Center during his sabbatical leave. The Luke Chair's speech was on the financial market integration with a special focus on Asian bond markets in a session entitled "Asia-Pacific Financial Integration."

During the seminar program, the Luke Chair met a number of people who were all speakers or moderators of the seminar and may become important contacts in Taiwan for the Asia-Pacific Financial Markets Research Center's work. They included:

- Dr. David S. Hong, President of the Taiwan Institute of Economic Research
- Dr. Rong-I Wu, Chairman of the Taiwan Futures Exchange and former Vice Premier
- Mr. Gary K. L. Tseng, Director General, Banking Bureau, Financial Supervisory Commission
- Dr. William T. Lin, Director of the Taiwan Stock Exchange and Taiwan Futures Exchange

- Jeffrey L. S. Koo, Chairman of the China Trust and Commercial Bank, who was the host of the Seminar.

### 3. The 2007 Shanghai Forum

The Luke Chair delivered a speech, titled “Financial Market Integration in East Asia: Asian Bond Market Initiatives,” at the 2007 Shanghai Forum on May 25-27, 2007. He served as a lead speaker for a session “Monetary and Financial Cooperation in East Asia under Economic Cooperation.” In the same session, the following speakers delivered their speeches:

- Naoyuki Yoshino, Keio University (Japan), “Development of Asian Bond Market: Infrastructure Bonds and Small Business Financing Bonds”
- Wei Zhang, Tianjin University (China), “Price Discovery Mechanism of the Regional Capital Market”
- Hongzhong Liu, Fudan University, “Mode Choice of the Financial Cooperation in East Asia”
- Bin Qi, China Securities Regulatory Commission, “From Prosperity to Maturity”

The Shanghai Forum is an international academic and policy research conference held biennially that was launched in May 2005 in conjunction with the Centennial celebration of Fudan University. The theme of the 2007 Shanghai Forum was “Economic Globalization & the Choice of ASIA” with five sub-themes covering monetary & financial cooperation; Asian economic integration; Asian energy consumption; and population and socio-economic development. Participation at the conference was high, with about 1,000 in attendance. There were 25 keynote speakers that included:

- Michael Spence, 2001 Nobel Laureate in Economics and Senior Fellow of Hoover Institution
- Min Zhu, Vice President, Bank of China

In his speech, Michael Spence listed 7 challenges facing China:

- Maintaining high growth
- Managing economic relations with the rest of the world
- Managing Rural to Urban Migration
- Replacing social insurance and social services formerly provided by State Owned Enterprises (SOEs)
- Narrowing large urban-rural productivity differentials
- Improving governance of SOEs
- Managing income Inequality

Michael Spence also spoke in support of: (i) measured appreciation of currency; (ii) continuing need for direct credit and other controls on investment in the transition; and (iii) continuing capital control. The Luke Chair was sure that all three policy recommendations were exactly what the Chinese authorities wanted to hear. Given the overheated equity market in China and its immature financial regulatory structure, the Luke Chair had to agree with him that the capital control would be something necessary in this volatile market situation. Otherwise, the Chinese financial system may

breakdown, which may cause a systemic risk of global proportion. The Luke Chair also agreed with him that building capital markets and increasing efficiency of investment process represent a high policy priority for China.

The Luke Chair was pleased to observe that a large number of academic papers on Asian common currency and monetary integration were presented at the Forum. Even though it would be a slow and cumbersome process, the Luke Chair felt that the creation of Asian Monetary Fund would be a matter of time in the region.

#### **4. Senior Bank Management Seminar by Compass Bankshares, Inc.**

The Luke Chair attended the Senior Bank Management Seminar organized by the Compass Bankshares, Inc. on September 25-30, 2006, in Maui. The Compass Bancshares, Inc. is a \$34 billion financial holding company in the U.S. Southwestern region and it operates over 400 full-service banking offices in Alabama, Arizona, Colorado, Florida, New Mexico and Texas. It is among the top 30 U.S. bank holding companies by asset size and ranks among the top earners of its size based on return on equity. The Compass Bank stock is one of component stocks of the S&P 500 Index and the Dow Jones Select Dividend Index.

The participants in the seminar were presidents/CEOs and senior directors of regional banks in the Southwestern part of the United States. The Luke Chair's speech titled "China's Economy and Financial Markets: Opportunities and Challenges," (co-authored with Dr. Rosita P. Chang) was well-received by 125 participants in the seminar. In his presentation, the Luke Chair discussed major weaknesses of the Chinese banking sector and financial markets and potential problems associated with an extensive sterilization program of foreign capital inflow conducted by the People's Bank of China. The total amount of foreign exchange reserves in China was reaching almost \$1 trillion at the time of speech.

Other speakers at the seminar included: (i) Allan Landon, CEO Bank of Hawaii; (ii) Sherman Katz of the Carnegie Endowment for International Peace; (iii) Don Powell, former chairman of FDIC; and (iv) Rear Admiral John J. Prendergast of the, U.S. Pacific Fleet, among others.

#### **5. The 40<sup>th</sup> Annual Meeting of the Board of Governors of the Asian Development Bank**

The Luke Chair attended the 40<sup>th</sup> ADB Annual Meeting organized in Kyoto, Japan, on May 4-8, 2007. Approximately 3,000 participants attended this Meeting and concurrent seminar programs. The meeting was opened by Mr. Koji Omo, Minister of Finance (Japan).

One ADB-commissioned report was released by a Group of Eminent Persons.<sup>2</sup> This report discusses the new roles of the ADB as a multilateral financial institution in the year 2020 when Asian economies become “middle income countries” since poverty reduction would be less important than now. The report makes the following recommendations: (i) move from fighting poverty to supporting faster and more inclusive growth; (ii) move from economic growth to environmentally sustainable growth; and (iii) move from a primarily national focus to a regional and ultimately global focus. In support of these new directions, the following six core activities are identified:

- infrastructure
- financial development
- energy and environment
- regional integration
- technological development
- knowledge management.

At the Board of Governors meeting, these recommendations received mixed reactions. In particular, the U.S. government was against the recommended changes largely because it believed that the ADB should remain focused on poverty reduction and that the underlying premises of this report were too optimistic. In the Luke Chair’s opinion, the ADB’s role will become marginalized as a development institution. It is understandable that ADB management wants to play a meaningful role in regional economic and financial integration to avoid becoming marginalized. However, this kind of changes will be determined by international politics, not by a single report.

The Luke Chair participated in the following seminar programs in addition to the ADB Board of Governors Sessions:

- “Emerging Asian Regionalism: Ten Years after the Crisis” organized by the Asian Development Bank
- “Partnerships for Advanced Asian Bond Markets---Credit and Financial Engineering” co-organized by Asian Development Bank and Japan Bank for International Cooperation
- “A Global Economy in Transition: Prospects for Investment Returns” organized by Asian Development Bank
- “Towards Regional Prosperity in Asia---How can Japan and other Asian countries contribute to enhancing financial markets?” co-organized by Institute for International Monetary Affairs, Ministry of Finance (Japan) and Mitsubishi UFJ Financial Group

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<sup>2</sup> This group included: Supachai Panitchpakdi (Chair), former Secretary-General of the UN Conference on Trade and Development; Isher Judge Ahluwalia, Chairperson, Indian Council for Research on International Economic Relations; Nobuyuki Idei, Chief Corporate Advisor, Sony Corporation; Caio Koch-Weser, Vice Chairman, Deutsche Bank Group; Justin Yifu Lin, Professor and Director of the China Center for Economic Research, Peking University; and Lawrence Summers, Charles W. Eliot University Professor, Harvard University.

- “Investor Seminar” by J. P. Morgan Chase

Numerous new and old ideas floated during the Annual Meeting. Summarized below are the Luke Chair’s opinions about them:

1. A plan for the ADB to manage some of Asia’s \$3 trillion foreign exchange reserves: This was a most ridiculous idea which did not make any sense because even the ADB charter would not allow it to do so and the Luke Chair believed that the ADB did not have trained personnel to do the work.
2. Creation of a new multilateral agency to issue infrastructure bonds: This idea did not make sense either. Infrastructure bonds are nothing but an instrument securitizing future income streams from infrastructure projects. Why do we have to create another layer of bureaucracy to do the private sector’s work?
3. Creation of regional clearing and settlement systems and regional bond rating agencies: As long as trading volume is large enough, international clearing and settlement organizations will come in. Why do we need something which can be done by private sector organizations? A regional rating agency is an idea of increasing cost of bond issues in the region once implemented because U.S. and European institutional investors will ask for ratings by international bond rating agencies rather than regional agency.
4. Multilateral Swap Arrangements under the Chiangmai Initiative: The Chiangmai Initiative was launched in May 2000 at the 33rd ADB Annual Meeting in Thailand to create bilateral swap arrangements of foreign exchange reserves among Asian economies. So far, the bilateral arrangements cover \$90 billion among six countries in Asia. Now ASEAN+3 finance ministers want to push for multilateral swap arrangements. With foreign exchange reserves reaching \$3 trillion in Asia, why does Asia need it? What Asia needs is an Asian monetary fund for the sole purpose of coordinating monetary and fiscal policy to support an Asian common currency.

The 41st ADB Annual Meeting will be held in Madrid, Spain, in May 2008.

## 6. The 8<sup>th</sup> Seoul International Financial Forum

The 8<sup>th</sup> Seoul International Financial Forum was held in Seoul on April 26 -27, 2006. The theme of this Forum was “Investment Banking Business and New Financial Market Opportunities.”<sup>3</sup> The UH Asia-Pacific Financial Markets (FIMA) Research Center is one of four co-organizers which include: the Financial News Daily Corporation, ABN-

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<sup>3</sup> In 2005, the Korean Ministry of Finance and Economy proposed the Financial Investment Services and the Capital Market Act (commonly known as the Capital Market Consolidation Act) to promote a “financial big bang.” The proposed Act is expected to facilitate financial innovation in developing new financial products and reforming the fragmented legal framework governing different types of financial institutions to create investment banks that will offer consolidated financial investment services. The selection of them was motivated by the new reform measures under this new Act.

AMRO, and JP Morgan Chase. This is the fourth year the FIMA Research Center participated in the Forum as a co-hosting organization.

Approximately 400 from the local banking, insurance, and securities industries participated in the Forum. Keynote addresses were delivered by:

- Seok-Dong Kim, Vice Minister of the Korean Ministry of Finance and Economy
- Young-Tak Lee, Chairman and CEO of the Korea Exchange
- Jeung Hyun Yoon, Governor of the Korean Financial Supervisory Service

The Luke Chair delivered a speech titled "Investment Strategies in Asian Equity Markets." He highlighted the effectiveness of value, momentum, and contrarian investment strategies in Hong Kong, Korea, Singapore, and Taiwan based on research papers co-authored with Stephen Brown of New York University.<sup>4</sup>

## **7. The 2<sup>nd</sup> International Finance Conference Program**

Dr. Yung Joon Lee, Professor of Economics of the Pusan National University, and the Luke Chair served as co-chairs of the Second International Finance Conference held on November 13, 2005 in Pusan, Korea. The UH FIMA Research Center was one of four co-hosts of this conference along with Pusan National University's Asian Institute for Regional Innovation, the Korea Institute for International Economic Policy, and the Korean Regional Finance Association.

The theme of the conference was "The Northeast Asian Financial Hub: Broader Policy Implications for Korea and the Busan Metropolitan City." The following keynote speakers delivered their speeches:

- Dr. Kihwan Kim, International Advisor of Goldman Sachs and Chairman of the Korean Pacific Economic Cooperation Council
- Mr. Byongwon Bahk, Vice Minister, Korean Ministry of Finance and Economy
- Mr. Serck Joo Hong, President of Korea Investment Corporation
- Mr. Jung-Hwan Lee, President, Korea Exchange

At the conference, the Luke Chair chaired a session titled "Lessons from Regional Financial Centers" in which he invited two lead speakers:

- Dr. David K. Ding, Director, Center for Research in Financial Services Nanyang Technological University, Singapore
- Dr. Geng Xiao, Professor of Finance, University of Hong Kong

David Ding is now with the University of New South Wales (Asia) in Singapore to serve as the Foundation Professor of Finance. Geng Xiao will take up the new position

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<sup>4</sup> Three background papers include: "The Return to Value Strategies in Asian Stock Markets" (co-authored with Stephen Brown and Liang Zhang); "The Returns to Value and Momentum Strategies in Asian Markets" (co-authored with Stephen Brown, Daphne Du, and Liang Zhang); and "The Returns to Momentum/Contrarian Strategies in Asian Markets" (co-authored with Stephen Brown and Daphne Du).

as the director of the Brookings-Tsinghua Joint Research Center in Beijing. Both talked about major policy initiatives that developed Hong Kong and Singapore as regional financial centers.

About 100 participants from the local securities and banking industry and faculty and graduate students from Pusan National University attended the conference.

## **8. Distinguished Lecture at the Xiamen University**

The Luke Chair visited Xiamen University on November 15, 2006, at the invitation of the Institute for Financial and Accounting Studies and the School of Management. Xiamen University was founded in 1921 by Mr. Tan Kah Kee, an overseas Chinese. In 1937, it became a national university. Currently, it has 4,900 faculty members and 20,000 undergraduates and 12,500 graduates (1,500 are Ph. D. students) studying in 70 undergraduate programs, 240 master programs and 135 Ph.D. programs in two major campuses in Xiamen and Zhang Zhou. It has highly ranked engineering and business programs in China.

I delivered a lecture on “Financial Markets Integration in Asia” to about 200 students and faculty members. My speech was the 197<sup>th</sup> of its distinguished lecture series since the University’s inception. I discussed the feasibility of economic and financial market integration in the East Asian region. My lecture session was presided by Dr. Shinong Wu, Vice President of Xiamen University, and Dr. Qian Sun, Director of the Institute for Financial and Accounting Studies.

## **III. TEACHING ACTIVITIES**

### **A. Ph.D. Level Teaching**

During the Spring semester of 2007, the Luke Chair offered a Ph.D. seminar class - FIN 704 “Asian Finance.”

### **B. Supervision of Ph.D. Dissertation Work: Dissertation Chair**

The Luke Chair has been continuing his involvement in the Ph.D. dissertation research by the finance-area Ph.D. students in his capacity as dissertation chair. During the academic year, the following three Ph.D. students completed their dissertation research under the Luke Chair’s guidance. Gregory R. Stone joined the University of Nevada as an assistant professor of finance, Crystal Xiaopei Chen joined the North Eastern Illinois University as an assistant professor of finance and Daphne Yan Du joined the Barclays Global Investors as a research fellow.

- Gregory R. Stone (2004-2006)

Dissertation Topic: “Racing to the Bottom” Again? Why Firms File Bankruptcy in Delaware

- Crystal Xiaopei Chen (2004-2006)

Dissertation Topic: The Impact of Short Sales on the Speed of Price Adjustment: Evidence from the Hong Kong Stock Exchange

- Daphne Yan Du (2004-2006)

Dissertation Topic: An Anatomy of the Magnet Effect: Evidence from the Korea Stock Exchange High-Frequency Data

The Luke Chair has been serving as dissertation committee chair for four students in the Ph.D. Program:

- Jack De Jong:

Dissertation Topic: Exchange Traded Fund\*

\*Final Defense is scheduled in August 2007

- Liang Zhang:

Dissertation Topic: Asset Pricing Issues of Penny Stocks

- Iris Zuo:

Dissertation Topic: Stock Price Manipulation

- Feng Wu:

Dissertation Topic: Downside Risk and Stock Returns

### **C. MBA and Undergraduate Courses**

The Luke Chair's MBA level teaching was conducted by offering BUS 617 "Managerial Finance" in the Spring Semester of 2007.

## **IV. SERVICE ACTIVITIES**

The Luke Chair's internal and external service activities are geared to the promotion of academic research work.

### **A. External Service**

#### **1. The 2006 China International Conference in Finance**

The Luke Chair participated in the 2006 China International Conference in Finance (CICF 2006) held in Xi'an, China, on July 17-20, 2005. The CICF was organized by Tsinghua University's China Center for Financial Research and the MIT Sloan School of Management. Charles Cao of Penn State University and Wang Tan of University of British Columbia were the Program Co-Chairs. Stephen A. Ross, the Franco Modigliani Professor of Financial Economics of MIT, delivered his keynote address. The total

number of participants in the CICF 2006 was approximately 150 from the United States and East Asian countries. From East Asian countries, academic researchers from Hong Kong University of Science and Technology, University of Hong Kong, Chinese University of Hong Kong, Singapore Management University, National University of Singapore, and Nanyang Technological University were active at this conference. Professors from universities in Taiwan and Thailand were also present. In contrast, the absence of professors from Korea and Japan was interesting. The Luke Chair believed that their absence was simply indication of inward looking attitude of Japanese and Korean academic institutions. The CICF 2006 comprised 50 academic paper sessions (including 14 sessions conducted in Chinese) and one keynote address session. About 130 papers written in English were submitted.

The keynote address by Stephen Ross was titled “A Neoclassical Look at Behavioral Finance: A Tale of Two Anomalies.” Being a neoclassical economist, he was not happy about the new area of finance research relying heavily on psychology to resolve many of anomalies, even though he admitted the existence of many market anomalies that current finance theories are unable to explain. His concluding remark was that “Thank God for many anomalies but it appears that we finance scholars must resolve them ourselves.”

The Luke Chair served on the program committee of the Conference and chaired an academic session “Corporate Governance and Ownership Structure.” During the conference, he targeted good quality papers that may be publishable in the *Pacific-Basin Finance Journal* and talked to potential contributing authors. Because the CICF 2006 attracted a large number of well-known scholars from the United States, Australia, and Asia, this conference was a good forum to meet many current and future associate editors of the *Journal* to keep up with their academic activities. The *Journal* is in the process of reorganizing its editorial board and this will be completed in early August. Current associate editors who were in Xi’an include:

- Kalok Chan, USTHK
- Eric Chang, U of HK
- David Ding, NTU of Singapore
- Allaudeen Hameed, NUS of Singapore
- Lilian Ng, U of Wisconsin

New incoming associate editors who were in Xi’an include:

- Arturo Bris, Yale University
- Charles Cao, Penn State
- A. Subrahmanyam, UCLA
- Gary Xu, Peking U
- John Wei, USTHK
- Mark Weinstein, USC
- Jiang Wang, MIT

## **2. 18<sup>th</sup> Annual Meeting of the Asian Finance Association**

The 18<sup>th</sup> Annual Meeting of the Asian Finance Association (AsFA) was held on July 9-12, 2006, in Auckland, New Zealand. It was hosted by Massey University, under

the sponsorship of Westpac Institutional Bank, INFINIZ, and Standard & Poor's, and New Zealand Institute for the Study of Competition and Regulation. The meeting was attended by approximately 300 participants from 15 countries. A total of 78 academic sessions and 5 special sessions, and 2 keynote address sessions were organized at the meeting. William F. Sharpe, the 1990 Nobel Laureate in Economic Science and STANCO 25 Professor Emeritus of Stanford University, and Mark J. Flannery, the Bank of America Professor of Finance at the University of Florida, served as keynote speakers.

The Luke Chair served as the Chair for a Special Session "Meet the Editors." Bruce Grundy, Editor of the *International Review of Finance*, and Mark Flannery and I served as panel members.<sup>5</sup> It was quite a popular session at the AsFA Annual Meeting, with more than 80 participants attending.

I also participated in the AsFA Board Meeting on July 9. The Board approved the following venues of future annual meetings:

- July 2007: Hong Kong
- July 2008: Tokyo, Japan

### **3. The 2007 FMA European Conference**

The Luke chair participated in the 2007 Financial Management Association European Conference on May 30 - June 1, 2007, in Barcelona, Spain. Javier Estrada of IESE Business School of the University of Navarra (Barcelona) was the program chair. Approximately 250 academicians (mostly from Europe and United States) attended the Conference. I presented a paper titled "Return Reversals, Idiosyncratic Risk, and Expected Returns" which was co-authored with Victor Huang, Qianqiu Liu, and Liang Zhang. I also served as a commentator on a paper titled "Short Interest, Insider Trading, and Stock Returns" written by TY Leung of the City University of Hong Kong, Oliver M. Rui, Chinese University of Hong Kong, and Steven S. Wang, Hong Kong Polytechnic University. The Luke Chair also was in a number of academic sessions focusing on: (i) behavioral finance; (ii) asset pricing; (iii) initial public offerings; (iv) banking sector bankruptcy; (v) banking supervision; (vi) mutual funds; and (vii) market microstructure theory.

Listed below are the three keynote speakers:

- José Viñals (Ph.D., Harvard University), Deputy Governor of the Bank of Spain
- Elroy Dimson, BGI Professor of Investment Management, London Business School
- Jay Ritter, Joe B Cordett Eminent Scholar, University of Florida

Dr. Viñals' keynote address was interesting because he talked about the regional integration of financial markets in the Euro zone. He characterized the 1990s as the

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<sup>5</sup> Mark Flannery used to serve as an associate editor of the *Journal of Money, Credit and Banking* and is now associate editor of the *Journal of Banking and Finance*, *Journal of Financial Intermediation*, *Journal of Financial Services Research*, and *Financial Review*.

period of monetary integration in Europe while the 2000s as the period of financial market integration. Elroy Dimson's speech focused on equity premium while Jay Ritter's presentation was on recent trends in international cross-border IPOs.

The Conference was held in the newly built IESE Business School building. The physical facilities were the best among many business schools I visited in the U.S., Europe, and Asia. The IESE faculty comprises 96 full-time members, 35 part-time professors, and 35 visiting professors from more than 20 countries. The IESE has 10 endowed chair professorships. It offers a full-time MBA, executive MBA, and global executive MBA programs with a student population of 600.

The 2008 FMA European Conference will be held in Prague on June 4-6, 2008.

#### **4. Service for Academic Journals**

The Luke Chair has been serving as an editorial board member for

*Gadjar Mada University International Journal of Business* (1999-Present)  
*Journal of Accounting, Management, and Economic Research* (Journal Riset Akuntansi, Manajemen, Ekonomi) (2002-Present).

#### **5. The Ohana Pacific Bank**

The Luke Chair is an outside director of the newly established Ohana Pacific Bank. This bank is a state-chartered bank and began its operations from June 1, 2006. This Bank serves ethnic minority business owners (Koreans, Chinese, Filipinos, Viet Nameese, and Indonesians) in Hawaii.

#### **6. MIR Investment Management Ltd.**

The Luke Chair is a Research Advisor for the MIR Investment Management Ltd., providing background research work on Asian markets in terms of value/momentum/contrarian investment strategies. The MIR Investment Management Ltd. is the best performing asset management company in Australia, serving mainly institutional investors. MIR Asia was set up in Singapore to launch investment funds specializing in Asian financial markets.

#### **7. National University of Malaysia**

The Luke Chair has been serving as an External Assessor for the Department of Finance and Banking of the Faculty of Business and Accounting, January 2007 – April 2008.

#### **B. Internal Service: University and College Committee Work**

The Luke Chair has been actively involved with the University-level committee as well as the Shidler College of Business committees.

- University Research Council (2005-Present)
- Shidler College of Business Research Committee (2006)
- Review Committee for Shidler College of Business Endowed Chair Professors (2007)
- Co-Chair, Strategic Planning Task Force (Scholarship), 2006

## Appendix A: Pacific-Basin Finance Journal: Editorial Board

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## **Appendix B: An Updated List of ASFRC Members (as of February 2007)**

### **Country Members**

- Hong Kong: K. C. Chan (Ph.D., University of Chicago)  
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Leslie Young (Ph.D., Oxford University)  
Professor of Finance and Executive Director, Asia-Pacific Institute of Business, Chinese University of Hong Kong
- Indonesia: Sri Adiningsih (Ph.D., University of Illinois)  
Professor of Economics  
Faculty of Economics, Gadjadara University
- Japan: Juro Teranishi (Ph.D., Hitotsubashi University)  
Professor of Economics, Nihon University  
  
Shin-Ichi Fukuda (Ph.D., Yale University)  
Professor of Economics, University of Tokyo
- Korea: Sang-Yong Park (Ph.D., NYU)  
Professor of Finance, Yonsei University  
  
Dosoung Choi (Ph.D., Penn State University)  
Professor of Finance, Seoul National University
- Malaysia: See Yan Lin (Ph.D., Harvard University)  
Pro-Chancellor, Universiti Sains Malaysia  
Former Deputy Governor, Bank Negara Malaysia
- New Zealand: Martin Young (Ph.D., Massey University)  
Professor of Finance, Massey University
- Philippines: Maria Socorro Gochoco-Bautista (Ph.D., Columbia University)  
Professor of Economics, University of the Philippines  
  
Melanie S. Milo (Ph.D., Australian National University)  
Senior Research Fellow, Philippine Institute for Development Studies
- Singapore: David K. Ding (Ph.D., University of Memphis)  
Professor of Finance  
University of New South Wales Asia
- Taiwan: Chen-Min Hsu (Ph.D., Johns Hopkins University)  
Professor of Economics, National Taiwan University

Edward H. Chow (Ph.D., Indiana University)  
Professor of Finance and Dean of College of Commerce  
National Chengchi University

- U.S. & Korea: S. Ghon Rhee (Ph.D., Ohio State University)  
K. J. Luke Distinguished Professor of Finance and Executive  
Director, Asia-Pacific Financial Markets Research Center,  
University of Hawaii

**Invited Member**

- Netherlands: Harald Benink (Ph.D., Maastricht University)  
Professor of Finance, Erasmus University Rotterdam and Senior  
Research Associate, Financial Markets Group, London School of  
Economics and Chairman, European Shadow Financial  
Regulatory Committee

**Appendix C:  
Asian Shadow Financial Regulatory Committee**

***Lessons from the New Zealand Model of  
Market-Based Financial Regulation***

**Statement No. 6  
Auckland, New Zealand, July 10, 2006**

The New Zealand model of market-based financial regulation is widely regarded as an innovative approach to financial regulation. The underlying philosophy of this model relies on three pillars of discipline:

- (i) self-discipline by banks in the management of their risks, primarily by reinforcing the role of directors in taking ultimate responsibility for the performance of banks;
- (ii) market discipline based on a policy of disclosure in tandem with a policy of not bailing out failed institutions; and
- (iii) a regulatory discipline that is focused on financial stability rather than depositor protection and implemented with adequate capital requirements and less intrusive supervisory requirements.

In a market-based regulatory approach, depositors and other creditors are not insulated from bank losses. They thus have an incentive to monitor banks, and banks are required to disclose relevant information about their financial and operating conditions. Ideally, for market discipline based on full information disclosure to work, there should be neither explicit nor implicit deposit insurance. Strengthened internal governance of banks and minimum supervisory requirements also represent desirable ingredients of market-based financial regulation.

In New Zealand, considerable emphasis has been placed on self-discipline by banks in risk management, primarily by holding directors personally liable for the performance of banks under their stewardship. The responsibility of directors is widely recognized to have led to much improved corporate governance practice of banks even before the introduction of the U.S. Sarbanes-Oxley Act of 2002. Banks have become more conservative in their risk taking and this has reduced systemic risk in the financial system. Disclosure of a bank's condition has allowed banks to better monitor each other, enhancing competition and efficiency through peer pressure. Disclosure-based regulation has allowed market regulators to take an arm's length approach to bank regulation, which has reduced the costs of compliance and enforcement. Moreover, it has contributed to the lowering of entry barriers to the banking industry, and consequently, leveled the playing field. More information disclosure and lower entry barriers contrast sharply with practices in many Asian countries, where authorities are reluctant to reveal sensitive information about a bank's condition to the public for fear that this might induce bank runs, and to fully open the banking industry to foreign players for fear that this might result in the significant presence of foreign banks.

Although market-based regulation is intellectually appealing, the New Zealand model may not be fully applicable in other countries. This is mainly because having no protection for small depositors is politically infeasible in many countries in Asia. Nonetheless, market discipline on a limited extent could be promoted by explicitly making large depositors and other creditors open to bank losses, which currently is not the case in many Asian countries.

In conclusion, the New Zealand model of market-based financial regulation has positive aspects that can be considered by other countries in Asia. In particular, self-discipline in corporate governance by making directors take ultimate responsibility for the risk management as well as information disclosure is invaluable and should be adopted. Disclosure-based market discipline exerted by large depositors and other creditors could also be promoted. For self-discipline and market discipline to be effective, however, a well-functioning institutional infrastructure, such as the legal and accounting systems, credit rating and securities analysis, media, etc., must be in place. Asian countries lacking such an infrastructure thus need to put more effort to attain it.

**Appendix D**  
**Asian Shadow Financial Regulatory Committee**

***Regulatory Challenges Posed by Financial Conglomeration***

**Statement No. 7**  
**Manila, Philippines, February 5, 2007**

**Abstract**

The financial conglomerate (FC) has become a popular form of financial business. Although they offer benefits of economies of scope and scale, they could generate potentially serious social costs. Since an FC is a financial institution, it is exposed to all the problems arising from informational asymmetry. As a business group, it is also exposed to all the problems of business groups, particularly in Asian economies with opaque ownership, weak corporate governance and inadequate legal systems. Weak regulation of FC creates regulatory arbitrage opportunities. The governments should integrate and tighten the oversight of FC activities, make ownership transparent and accountable, and limit control of FCs by non-financial companies.

**Statement**

A financial conglomerate (FC) is a group of companies under common ownership and control that provides significant services in different financial sectors (banking, insurance and securities). The FC has become a popular framework for the organization of financial services. In the late 1980s, the European Union adapted its laws to allow universal banks and financial conglomerates. In response, the US passed the Gramm-Leach-Bliley Act in 1999 to repeal the Glass-Steagall Act. There followed in the US a wave of mergers and acquisitions across commercial banks, investment banks and insurance companies. Japan has had extensive cross-holdings of shares, which bound banks and insurance companies into company networks. Elsewhere in Asia, banks are often integrated into corporate pyramids.

Financial conglomeration is driven by the search for market power in global competition and the leverage of brand names and reputation. Social benefits have been claimed: economies of scope (e.g., in the use of information and cross-marketing to consumers) and economies of scale (e.g., in information technology and network externalities). However, empirical research has not yet found conclusive evidence of economies of scale and/or scope in financial firms.

Financial conglomeration presents two sets of problems: those related to business groups and those pertaining to financial firms. All business groups are susceptible to problems of related-party transactions that shift value to controlling shareholders. These problems have been addressed by mandating disclosure and regulating corporate governance to protect minority shareholders. Financial firms are subject to problems of information asymmetry, moral hazard and contagion. Recognition of these problems has led to regulation of financial institutions and markets. Regulators focus on the fitness and propriety of managers and directors, conflicts of interest, information disclosure and capital adequacy. Safety nets have been constructed to limit contagion, e.g., deposit

insurance. Financial conglomerates compound the problems inherent in business groups as well as in financial firms. Most obviously, they exacerbate information asymmetry by increasing the information that must be assessed to evaluate capital adequacy. They exacerbate moral hazard as the conglomerates become “too big to fail”. They exacerbate the risk of contagion as problems in a company trigger a run on another affiliated company. They exacerbate conflicts of interest, both in the marketing of financial products and in related-party financial transactions. They permit risk to be shifted across asset classes, e.g., to banks whose assets are protected by deposit insurance, or via securitization to bypass capital adequacy requirements. Finally, they attenuate the ability of regulators to address the problems just listed.

Most countries regulate banks, insurance companies and security companies as stand-alone entities. When these are integrated into a conglomerate, there is an urgent need to integrate the regulatory structure to head off the problems of contagion, conflict of interest and regulatory arbitrage. To take one key example: the safety of bank deposits is presumed to be the primary duty of the bank’s board and management, the organizational principle of the bank’s corporate governance and internal control mechanisms, and the primary function of the bank’s capital requirement. Bank regulators operate under this presumption, imposing inspections and regulations to address these issues. But new problems arise if the bank is ultimately under the control of persons with an interest in a non-financial company or a company that issues and trades securities. Such persons could have an interest in the bank that jeopardizes its capital and the security of deposits. Financial regulators may not have the information, skills or mandate to prevent this conflict of interest.

These problems are not merely theoretical. They have already occurred — twice over. They brought on the greatest financial disaster in all history. The Great Crash of 1929, which led to the Great Depression of 1931-38, was exacerbated by the use of bank loans to fund securities speculation. To prevent a recurrence, the Glass-Steagall Act of 1932 separated banks from the securities firms. But the Gramm-Leach-Bliley Act effectively repealed the Glass-Steagall Act. Quickly there formed financial conglomerates such as JP Morgan/Chase, Citibank/Travellers/Shearson Lehman etc. Soon afterward, serious abuses were discovered by New York’s Attorney General who imposed fines totaling US\$400 million on essentially all the leading firms on Wall Street. It is significant that the problems of financial conglomerates were discovered and punished by someone outside the US financial regulatory system. This case highlights the regulatory gap that financial conglomerates can exploit even in a country that boasts a sophisticated system of financial regulation.

The US has now strengthened its corporate governance with the Sarbanes-Oxley Act which imposes more disclosure and greater independence of directors. The SEC and the New York Stock Exchange have strengthened the firewalls between financial activities within the same conglomerate. Various Asian countries have adopted other useful measures. For example, central banks in many Asian countries approve the board of each bank and ensure that it has sufficient stature and independence. However, these measures can be inadequate when the legal and regulatory systems are weak and enforcement is unreliable. The recent financial scandal in Taiwan brings home to East Asia the problems posed by related party transactions between financial institutions and associated companies. Thus, the rise of financial conglomerates poses an urgent challenge. We must adapt our regulatory structures to address the new problems in corporate governance, capital adequacy, risk management and transparency.

As it takes time to change the structure of financial regulation, existing regulators ought to set up immediately a forum for the exchange of information and the notification of incipient problems. For example, some countries like the Philippines already have such a mechanism. Laws and regulations should immediately be modified to mandate the free flow of information across regulatory bodies with appropriate safeguards. In the longer term, the structure of financial regulation needs to adapt to the new issues that we have noted:

1. One regulatory body should be appointed to take the lead to review the corporate governance of FCs. This is to ensure that each subsidiary has a board of directors with the authority and independence so that the subsidiary's business conforms to existing regulations and laws and that subsidiary managers fulfill their fiduciary duties. For example, if the key decisions in a bank subsidiary are, in fact, vested in the board and managers at the top of the conglomerate, then they are the ones who should be subjected to the tests of fitness, propriety and conflicts of interest.
2. This regulatory body should take the lead to review the ownership structure of each financial conglomerate to ensure that each of its subsidiaries has adequate capital and that the capital of one subsidiary is not entangled in obligations to another, possibly riskier, subsidiary. A transparent capital structure is needed to guard against contagion should investors lose confidence in one of the subsidiaries. This could be achieved by mandating a transparent holding company structure and restricting cross-shareholding.
3. As financial statements are intended to provide information to regulators and investors, the design of any FC should meet a simple test: can its financial statements be understood? Do the financial statements disclose the information in a timely manner that a regulator or professional investor requires to determine its capital adequacy, riskiness and profitability?
4. Financial regulators should be empowered, as in Korea, to regulate the ownership of a bank to guard against effective control by a party that has an interest in securing related party loans, e.g., a party that also controls a non-financial corporation.
5. In view of the severe regulatory challenges posed by FCs and the problems that have been revealed in the region, Asian regulators should further develop their skills in monitoring cross shareholding and preventing conflicts of interest to deal with risks posed by financial conglomeration.