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The Newsletter of the EURO Working Group on Financial Modelling

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# ***NEWSFLOW***

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Number 26

Autumn 2002

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# ***NEWSFLOW***

## **Editor**

Hélène Molenaar  
Erasmus University Rotterdam  
Dept. of Finance & Investments, Room H14-01  
P.O. Box 1738  
3000 DR Rotterdam  
The Netherlands

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## **Invitation to readers**

Readers are invited to actively contribute to the newsletter. Examples are book reviews, announcements, opinions, lists of published papers, etc.

You can also find information about the Euro Working Group on the internet site  
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*NEWSFLOW* is published twice a year (March and October) by the EURO Working Group on Financial Modelling under a grant from the Erasmus University Rotterdam. Circulation: over 400 to 38 countries.

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# Editorial

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## Recent Thrust in Risk Management Research

Over the years the members of the EWGFM have actively engaged in theoretical and applied research covering a wide range of topics in financial modeling. Notable contributions in the development, implementation, and empirical assessment of mathematical and analytical tools to support quantitative financial decisions have regularly been presented at EWGFM meetings. Among the topics covered we can include the use of optimization models for various portfolio management problems, the analysis of fixed-income securities and insurance products, the development of pricing procedures for derivative securities, the development and calibration of stochastic processes to model the dynamic evolution of financial variables (e.g., interest rates, exchange rates), studies of capital markets, to name just a few. The forthcoming 31<sup>st</sup> Meeting of the group in Cyprus will be no exception. The presentations scheduled for this meeting cover a wide range of topics including: studies on real options and flexibility in financial decisions under incomplete and costly information, methods for bankruptcy prediction, applications of neural networks in finance, credit and trade risk, interest rate models, analysis of developments in European markets, etc.

In recent EWGFM meetings there is a discernible thrust towards research in risk management. This was particularly evident at the meeting in Capri last spring. A notable proportion of the talks, by invited speakers as well as by other participants, at that meeting addressed issues concerning the *measurement* and *management* of risks associated with financial decisions in various contexts. Numerous other conferences have focused on risk management issues while several journal issues have recently been devoted to such topics (e.g., the special issue of the *Journal of Banking and Finance*, 26(7), 2002, edited by Giorgio Szegö, the new *Journal of Risk Finance*).

Considerations of risk have always held a central role in financial research. Still, the intensifying momentum towards risk management research is not incidental. It is rather the result of a growing realization by researchers and practitioners alike that financial risk management constitutes a fertile domain not only of research importance but of great practical significance as well. I will attempt to briefly touch on some of the factors that contribute to this growing interest on risk management research and to point out some of the challenges that are posed.

Recent years have witnessed several spectacular collapses of large corporations and fund management firms that were previously considered practically invulnerable to failure. International economic crises (e.g., the Russian crisis in the 1990's and the recent Argentinian crisis) have had far reaching effects. Other significant events (e.g., the September 11 catastrophe and the prospect of war in the Middle East) also have economic repercussions on a global scale. The rapid boost of the technology and telecommunications sectors, the emergence of electronic markets and virtual companies (dot coms), and the subsequent difficulties of these sectors have disturbed financial markets and led to increased volatility. The integration of eastern European and other emerging markets in the international financial system provide opportunities and challenges for the participation of institutional investors in these markets. The introduction of the euro and the forthcoming enlargement of the European Union are reshaping investment alternatives in Europe and beyond. The accelerated pace of liberalization on an international scale gives rise to the globalization of corporate operations and investments, which in turn expose the participants to additional risks. The rapid advancements and proliferation of information and communication technologies provide the means for instantaneous access to information on a global scale and the quick execution of transactions in foreign markets. As a result, changing conditions in one market can quickly propagate leading to greater synchronization of markets.

Besides the macro-factors discussed above, several other factors dictate a continual reevaluation of risk management practices. The continual introduction of increasingly complex derivative products necessitates the development of sophisticated methods for their accurate pricing. Methodologies for designing and customizing innovative financial products are also essential for financial intermediaries. The lack of adequate historical data to calibrate models for investment valuation and performance analysis purposes (e.g., in the case of emerging markets, the newly integrated EU monetary market, or newly emerging technology and service sectors.) require the development of innovative alternative methods of analysis. The performance of investment securities and markets becomes much more highly correlated in times of crises in comparison to their correlations in times of normalcy. Consequently, the effects of diversification, determined on the basis of traditional planning tools (e.g., the mean-variance approach), erode at times of crises. These are precisely the times at which investors expect risk-reduction coverage from diversification. Moreover, the introduction of derivatives and other complex instruments in portfolios

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may result in quite asymmetric return distributions. Analysis tools that rely on the assumption of symmetry (e.g., normality) in return distributions become inapplicable, or at least ineffective, in such cases.

The Basel Accord has imposed risk measurement and reporting requirements in the banking sector. Similar regulations are introduced throughout the financial industry. Besides the need to conform to regulations, corporate executives and financial analysts are increasingly realizing the usefulness and competitive necessity to adopt effective risk monitoring and risk management procedures in their operations. The productivity and viability of financial operations often hinge on the effective use of such procedures. The need to examine total risk exposure and the effect of multiple risk factors in a holistic fashion is increasingly appreciated. Hence, financial intermediaries are adopting tools that examine the risks associated with both the assets and liability sides of their balance sheets in an integrated fashion. Enterprise-wide risk management approaches are gradually becoming entrenched in financial management practice.

The discussion above touches on some of the factors that dictate a reexamination of means for monitoring and controlling risks. The research community has responded positively to the need for the development of increasingly sophisticated risk measurement and risk management tools. Substantial research effort is being devoted in this regard. The following are some of the relevant topics that are being studied. The development of stochastic programming models for portfolio management and investment analysis purposes. These tools help to examine the impacts of uncertain factors on alternative decision strategies. Developments of stochastic programming models and solution algorithms, coupled with significant advancements in computing technologies now enable the solution of very large decision problems (considering many investment alternatives and a large number of plausible scenarios) in a wide range of financial applications. Studies on the theoretical properties of alternative risk measures lead to the adoption of measures that give more complete depictions of the risk profiles of investments (e.g., more appropriate measures for skewed distributions). Methods for modeling extreme event scenarios provide extremely useful basis for analysis. These approaches are particularly useful when the performance of investments in crises conditions is significantly different than under normal situations (e.g., changes in their correlation regimes), as well as in cases when there are not sufficient historical data to calibrate more traditional analysis models. Significant research effort is also directed towards the study of credit risk problems. These cover credit risks for sovereign states, corporate bond issues, commercial and personal loan classifications, credit card limits, etc. These are only a few of the relevant research topics that have attracted research attention. Numerous other challenging problems of theoretical and practical significance require their rightful attention.

This is the second time a meeting of the EWGFM is organized in Cyprus. Together with Stavros Zenios we had organized the 13<sup>th</sup> EWGFM meeting in Pafos in March 1993. The 31<sup>st</sup> EWGFM meeting will take place in Ayia Napa, Cyprus, November 7-9, 2002. Ayia Napa is a popular tourist resort on the south-east coast of Cyprus, about a 30-minute drive from Larnaca airport. Although it is just a small town, during the summer months Ayia Napa is bustling with activity. It is well known for its beautiful golden sandy beaches and its active nightlife during the summer which attract a large number of sea- and sun-loving tourists. A number of quality hotels line up the coast, while numerous other facilities cater to diverse needs of visitors. November is not a particularly busy month and the atmosphere at the time of the meeting should be quaint and relaxed. The venue of the meeting (Adams Beach Hotel) is a modern hotel situated on a nice stretch of beach. It offers quality conference halls, all modern amenities and a wide range of facilities and services. The central square of Ayia Napa, where an old monastery is situated, is about a 20-minute walk away.

Cyprus has a well-developed and competitive economy, focused primarily on the service industry. Tourism is certainly a major economic sector, along with banking, insurance and other financial services, shipping, telecommunications, consulting, etc. Cyprus has experienced healthy economic growth in the last two decades. Because of its healthy economy, in particular, as well as its democratic institutions and the similarity of its economic, administrative, legal, educational and social systems to those of Europe, Cyprus admittedly holds the front-runner position among all candidate states to join the European Union. All EU evaluation reports on Cyprus' candidacy attest to this fact. The current year is a particularly challenging time for Cyprus, critical for its future in many ways, as the final decision on its application to join the European Union will be decided at the meeting of the Heads of EU-member states in Copenhagen in December. The large majority of Cypriots view favorably and with great hope the prospect of the country's accession to the European Union, as well as towards a peaceful and just settlement of the political problem that has troubled Cyprus for many years. Cyprus remains divided to this date following the invasion of Turkish troops in July 1974 that still occupy the northern part of the island. Cypriots hold a great hope that the momentum of Cyprus' imminent accession to the European Union now creates the conditions for the resolution of the problem through the UN-sponsored negotiations. They aspire to the achievement of a just, peaceful and lasting solution that will lead to the reunification of the country in the context of a federal state so that all Cypriots will enjoy in peace all fundamental freedoms enjoyed by all European citizens.

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The 31<sup>st</sup> EWGFM Meeting is organized by the “HERMES Center on Computational Finance and Economics”, of the University of Cyprus. This HERMES Center was recognized as a Center of Excellence by the European Commission in 2000 and it receives financial support from the European Commission. The Center’s faculty and research staff pursue state-of-the-art research on current topics in finance and economics (e.g., enterprise-wide risk management, real options, efficiency and quality in the provision of financial services, capital markets research, analysis of household portfolios, etc.) The HERMES Center has hosted several visitors and has organized several international conferences and workshops in the last couple of years. It sponsors a seminar series on macroeconomic and financial research and it maintains a working paper series. Faculty affiliated with the Center have authored or edited several books and special issues of scientific journals. Information on the Center’s activities is posted on the web site: [www.hermes.ucy.ac.cy](http://www.hermes.ucy.ac.cy). We always look to explore prospects of further collaboration with European academic and research institutions. We would be interested to discuss any suggestions you may have along these lines.

I hope that the 31<sup>st</sup> Meeting of the EWGFM will be both enjoyable and productive for all the participants. I look forward to welcoming you to Cyprus and giving you a taste of traditional Cypriot hospitality.

Hercules Vladimirov  
University of Cyprus

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## Call for papers EJOR

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Thusfar, the European Journal of Operational Research has published a number of special issues on Financial Modelling:  
Issue 74/2, edited by T. Martikainen, I Virtanen and P. Yli-Olli;  
Issue 91/2, edited by E. Castagnoli and J. Spronk. In 1998, the European Journal of Operational Research together with the EURO Working Group on Financial Modelling decided to start a more regular series of feature issues.

A feature issue on financial modelling is an issue of EJOR partly or wholly devoted to financial modelling. The intended frequency of these feature issues on financial modelling is once or twice per year.

Papers on financial modelling are solicited that help to solve financial-economic decision problems in practice. Papers may relate to new insights, both theoretical and empirical, into the environment in which decision makers operate, new tools available to the decision makers and to the integration of these tools within frameworks for financial-economic decision making. Papers that stimulate and strengthen the interaction between financial economic theory and the practice of financial decision making, will be especially welcome.

The first feature issue was published as Issue Volume 114, Number 2, April 16, 1999, and edited by J. Spronk. This was followed by a stream of issues, some of which have been published and the others will follow soon.

Authors who want to submit to the upcoming feature issue are kindly invited to submit four copies of their paper to the Guest Editor Financial Modelling:

Nico van der Wijst  
The Norwegian University of Science & Techn.  
Dept. of Managerial Economics &  
Techn. Management  
Alfred Getz vei 1  
N-7034 Trondheim  
NORWAY  
Tel. + 47.73.597712  
Fax + 47.73.593603  
E-mail: [Wijst@iot.ntnu.no](mailto:Wijst@iot.ntnu.no)

With respect to format and other requirements of submitted work, the authors are kindly referred to the Instructions to Authors, that can be found in every issue of EJOR. For the feature papers there is a separate board of editors, consisting of

**Wolfgang Bühler**, University of Mannheim, Germany

**Erio A. Castagnoli**, Università Luigi Bocconi, Italy

**Michael A.H. Dempster**, University of Cambridge, UK

**Winfried G. Hallerbach**, Erasmus University Rotterdam, The Netherlands

**L. Peter Jennergren**, Stockholm School of Economics, Sweden

**Bjarne A. Jensen**, Copenhagen Business School, Denmark

**Jonathan S.H. Kornbluth**, Hebrew University, Israel

**John M. Mulvey**, Princeton University, USA

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**Lorenzo Peccati**, Università Luigi Bocconi, Milano, Italy

**Matti Viren**, University of Turku, Finland

**Stavros A. Zenios**, University of Cyprus, Cyprus

**William T. Ziemba**, University of British Columbia, Canada

**Constantin Zopounidis**, Technical University of Crete, Greece

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## Cyprus 7-9 November 2002

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### Program

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The Program of this meeting and other information can be found on the internet site:

<http://www.hermes.ucy.ac.cy/conferences/ewgfm/>

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### Information

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This meeting is a.o. organized by:

**Stavros Zenios and Hercules Vladimirou**

For further information please contact:

**Hercules Vladimirou**  
**Department of Public and Business**  
**Administration**  
**University of Cyprus**  
**75, Kallipoleos Str. PO Box 20537**  
**CY-1678 Nicosia, CYPRUS**  
**Tel. +357 22 892463**  
**Fax. +357 22 892460**  
**Email: [zenioss@ucy.ac.cy](mailto:zenioss@ucy.ac.cy)**  
**or [hercules@ucy.ac.cy](mailto:hercules@ucy.ac.cy)**

More information about this meeting can be found on the internet site

<http://www.hermes.ucy.ac.cy/conferences/ewgfm/>

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## Next meeting(s)

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The Autumn 2003 meeting will probably be held in Monaco.

Offers to organise the Spring 2004 meeting, or one of the future meetings, are welcome.

For more information about organising a meeting, please contact Jaap Spronk ([spronk@few.eur.nl](mailto:spronk@few.eur.nl)) or H el ene Molenaar ([molenaar@few.eur.nl](mailto:molenaar@few.eur.nl))

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## 32<sup>nd</sup> EWG Meeting

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The 32<sup>nd</sup> meeting will be held in London, U.K., from 24-26 April 2003.

This meeting will be organized by:

**Chris Adcock and Nigel Meade**

For further information please contact the organizing committee at:

**Email: [c.j.adcock@sheffield.ac.uk](mailto:c.j.adcock@sheffield.ac.uk)**

The information about the 32<sup>nd</sup> meeting is still subject to discussion

More information about this meeting can be found on the internet site, which is being set up at the moment. It will be regularly updated as information becomes available. Calls for papers, venue information, registration instructions, etc. will be posted on this webpage.

As soon as this website is available, it will be announced on:

<http://www.eur.nl/topics/finance/research/euowgr.htm>

so please check this site on a regular basis.

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## News

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The first EURO/INFORMS joint International Meeting of the new millenium will be in:

**ISTANBUL**

**July 6-10, 2003**

For more information you can visit the website:

[www.istanbul2003.org](http://www.istanbul2003.org)

The intention is to organize 4 sessions on Financial Modelling during this Conference.

If you want to organize one of the sessions, please contact Jaap Spronk during the Cyprus-meeting, or by email: [spronk@few.eur.nl](mailto:spronk@few.eur.nl)

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## Working Papers

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You can find publications of the Erasmus Research Institute of Management (ERIM) on the following website:

<http://www.fbk.eur.nl/ERIM>

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## Working Papers

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From the *Rotterdam Institute for Business Economic Studies* (RIBES), Erasmus University Rotterdam, Room H15-28, P.O. Box 1738, 3000 DR Rotterdam, The Netherlands, the following papers can be ordered:

- |        |   |          |  |
|--------|---|----------|--|
| 9401/F | Hallerbach, W.G., Duration and bond return approximation, The quaso-convexity effect, January 1994.   | 9615/O/F | Bruining, J., A.C.C. Herst and D. Citron, Loan covenance relationship banking and MBO's in default: a comparative study of the UK and Holland. |
| 9405/F | Smit, J.T.J., The flexibility value of strategic investments under competition, March 1994.   | 9616/F   | Soppe, A.B.M., De rol van rente, geld en vermogen in het wereld economisch proces: een ethische beschouwing.                                   |
| 9414/F | Spronk, Jaap and Erik M. Vermeulen, Interfirm performance evaluation under uncertainty: A multi-dimensional framework, September 1994.                              | 9707/F   | Post, Th. and J. Spronk, Bank performance bench-marking in stochastic environments using log-linear mean-variance data envelopment analysis.   |
| 9422/F | Brouwer, Frank, Paul C. van Aalst and Nico L. van der Sar, Investment risk and risk management revisited, November 1994.  | 9711/F   | Groenendijk, A.A. and J. Spronk, Portfolio performance through the eyes of monkeys.  |
| 9426/F | Hallerbach, Winfried G., A simple approximation to the normal distribution function with an application to the Black & Scholes option pricing model, December 1994. | 9713/F   | Spronk, J. and E.M. Vermeulen, Interfirm performance evaluation under uncertainty.   |
| 9502/F | Higson, Chris and Jamie Elliott, Post-takeovers returns - The UK evidence, March 1995.  | 9719/F   | Meulen, J. van der and J. van der Voort, Er valt wat te zeggen voor passief beleggen.  |
| 9503/F | Groenendijk, A.A. and E.E. Hagen, Solving the capital structure puzzle: The government as a stakeholder in the firm, March 1995.                                    | 9721     | Post, G.T., Transconcave Data Envelopment Analysis   |
| 9504/F | Vermeulen, Erik M., Jaap Spronk and Nico van der Wijst, Analysing risk and performance using the multi-factor concept, april 1995.                                  | 9822     | Kouwenberg, R., Dynamic Portfolio Insurance: A Stochastic Programming Approach   |
| 9505/F | Vermeulen, Erik M., Jaap Spronk and Nico van der Wijst, A Framework for conditional failure prediction, April 1995.   | 9824     | Soppe, A., Capital, Interest and Ethics: Some Empirical Explorations of an Ethical Approach of economic growth                                 |
| 9508/F | Brännback, M. and J. Spronk, A multidimensional framework for strategic decisions, June 1995  | 9847     | Post, G.T., Estimating non-convex production sets using transconcave DEA   |
| 9509/F | Hallerbach, W.G. and J.Spronk, Portfolio management for the non-average investor, June 1995.  | 9905     | Post, G.T., Nonparametric efficiency estimation in stochastic environments   |
| 9520/F | Soppe A., De duurzaamheid van het internationale geld en bankstelsel: Een ethische beschouwing, September 1995.   | 9911     | Kuosmanen, T. and G.T. Post, Robust Efficiency Measurement. Dealing with outliers in Data Envelopment Analysis                                 |
| 9526/F | Groenendijk, A.A., Investeren, kasstroomprojectie en ondernemingswaarde, December 1995.   | 9913     | Hallerbach, W.G. and J. Spronk, A Multicriteria Framework for Risk Analysis  |
| 9606/F | Greco S, The splitting property of fuzzy financial laws, September 1996.  | 9922     | Spronk, J. and W.G. Hallerbach, Het "redelijk rendement" voor ondernemingsactiviteiten vanuit financieel-economisch perspectief                |
| 9612/F | Post, T. and J. Spronk, Interactive data envelopment analysis, September 1996.  | 9933     | Post, G.T. and J. Spronk, Evaluating productive performance under uncertainty  |
|        |   | 9934     | Kuosmanen, T. and G.T. Post, Measuring economic efficiency with incomplete price information.  |

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## Working Papers

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From the *Erasmus Center for Financial Research* (ECFR), Erasmus University Rotterdam, Room H11-01, P.O. Box 1738, 3000 DR Rotterdam, The Netherlands, the following papers can be ordered:

For more information:

<http://www.few.eur.nl/few/research/ecfr/publications/>

9901	Dick van Dijk, Philip Hans Franses, André Lucas and Nick Taylor, SETS, arbitrage activity, and stock price dynamics.	2005	Arjan Berkelaar and Roy Kouwenberg, Retirement Saving with Contribution Payments and Labor Income as a Benchmark for Investments.
9902	Jan Annaert and Marc J.K. de Ceuster, The big mac: more than a junk asset allocator?	2006	Arjan Berkelaar and Roy Kouwenberg, Dynamic Asset Allocation and Downside-Risk Aversion.
9903	Philip Hans Franses and Patrick J.F. Groenen, Visualizing time-varying correlations across stock markets.	2007	Yulia Veld-Merkoulova, Price Limits in Futures Markets: Effect on the Price Discovery Process and Volatility.
9904	Pauline Bod, David Blitz, Philip Hans Franses and Roy Kluitman, An unbiased variance estimator for overlapping returns.	2001/1	Winfried G. Hallerbach, Enhanced Bond Return Approximations: Using Duration, Convexity and Quasi-Convexity.
9905	Martin Martens and Ser-Huang Poon, Correlation dynamics between international stock markets using synchronous data.	2001/2	Pieter Bouwknecht and Antoon Pelsser, Market Value of Insurance Contracts with Profit Sharing.
9906	Jaap Hoek, Patrick Houweling and Frank Kleiberger, The joint estimation of term structures and credit spreads.	2001/3	Frank de Jong, Joost Driessen and Antoon Pelsser, Libor Market Models versus Swap Market Models for Pricing Interest Rate Derivatives: An Empirical Analysis.
9907	Winfried Hallerbach and Bert Menkveld, Value at risk as a diagnostic tool for corporates: the airline industry.	2001/4	Antoon Pelsser, Mathematical Foundation of Convexity Correction
9908	Ser-Huang Poon and Peter F. Pope, Tests of option market efficiency: a high frequency data and common volatility component approach.	2001/5	Thierry Post, Stochastic Dominance in Case of Portfolio Diversification: Linear-Programming Tests.
9909	Jacek Gondzio, Roy Kouwenberg and Ton Vorst, Hedging options under transaction costs and stochastic volatility.	2001/6	Albert J. Menkveld, Splitting Orders in Fragmented Markets, Evidence from Cross-Listed Stocks.
9910	Jon Danielsson, Bjorn N. Jorgensen and Casper G. de Vries, VoF or VAR? Firm Value and Risk Management.	2001/7	Reimer Beder and Ton Vorst, Options on Dividend Paying Stocks.
2001	Ton Vorst, Optimal Portfolios under a Value at Risk Constraint.	2001/8	Chris Veld and Yulia V. Veld-Merkoulova, Do Spin-Offs Really Create Value? The European Case.
2002	Bert Menkveld and Ton Vorst, A Pricing Model for American Options with Stochastic Interest Rates.	2001/9	Namwon Hyung and Casper G. de Vries, Portfolio Diversification Effects and Regular Variation in Financial Data.
2003	Henk Grootveld and Winfried G. Hallerbach, Upgrading Value-at-Risk from Diagnostic Metric to Decision Variable.	2001/10	Jón Danielson, Bjørn N. Jorgensen, Casper G. de Vries and Xiaoguang Yang, Optimal Portfolio Allocation under a Probabilistic Risk Constraint and the Incentives for Financial Innovation
2004	Philip Hans Franses and Roy Kluitman, Unbiased Variance Estimators for overlapping Returns when the Returns have First-Order Dynamics.	2001/11	P. Hartmann, S. Straetmans, C.G. de Vries, Asset Market Linkages in Crisis Periods

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# EURO Working Group on Financial Modelling

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The EURO Working Group on Financial Modelling was founded in September 1986 in Lisbon. The primary field of interest for the Working Group can be described as “financial models that help to solve problems faced by financial decision makers in the firm, intermediaries and the investment community. From this the following objectives of the Working Group are distinguished:

- providing an international forum for exchange of information and experience on financial modelling;
- encouraging research in financial modelling (new techniques, methodologies, empirical studies, software, etc.);
- stimulating and strengthening the interaction between financial economic theory and the practice of financial decision making;
- cooperating and exchanging information with other universities and financial institutions throughout Europe.

It can be stated safely that the Working Group has become an established one. To give an idea: over 400 members, 30 international meetings and an own newsletter (*NEWSFLOW*) are three examples of the success until now.

## *Meetings*

The meetings of the Working Group are organized twice a year, in April/May and in October/November. Earlier meetings were held in Belgium, Curaçao, Cyprus, Finland, France, Hungary, Italy, Lithuania, the Netherlands, United Kingdom, Germany, Greece, Croatia, Poland and Spain. There are now members in 34 countries spread over 4 continents. The meetings are attended by 80-100 members on average, most of them scientists but also representatives from the financial institutions, and are usually organized on Thursday, Friday and Saturday morning. The organizers are expected to schedule three types of sessions: a round table session with invited speaker(s), regular sessions with the presentation of refereed papers and balloon sessions in which unrefereed papers, new topics and ‘loose’ ideas can be discussed.

## *Newsletter*

*NEWSFLOW*, the newsletter of the Working Group is published twice a year, about one month before each meeting. Newsflow is also published on the internet site <http://www.eur.nl/topics/finance/research/eurowgr.htm>

It contains general information about the Working Group and the next meeting(s), letters from readers, announcements of financial seminars, calls for papers, a list of working papers, etc. For information about *NEWSFLOW* or for publication of your contributions please contact the editor: Hélène Molenaar, address below.

## *Membership*

For information about membership of the EURO Working Group on Financial Modelling, you may write to:

Hélène Molenaar  
Erasmus University Rotterdam  
Dept. of Finance and Investments, Room H14-01  
P.O. Box 1738  
3000 DR Rotterdam  
The Netherlands  
Phone: +31.10.4081282  
Fax: +31.10.4089165  
E-mail: [molenaar@few.eur.nl](mailto:molenaar@few.eur.nl)