

Making Capital Markets Work Through Corporate Governance

Over the past few months, as banks, insurers and investment houses cut down their workforce, fears are mounting that conditions are set to deteriorate markedly in capital markets. Lehman Brothers warned recently that spreads on credit default swaps, which track the cost of insuring corporate debt against default, could soon spike beyond the levels seen at the time of the Bear Stearns rescue in March.

The complete loss of risk appetite either in equities or treasuries, the shorter queues at delicatessens and sandwich shops, the gloom-shrouded watering holes and the number of vacant floors in previously bustling buildings are stark reminders of the severest downturn since the crash of 1929.

Just a year ago, UK economy was on top of the world. Banks like Barclays, and stores like Marks and Spencer had generated record profits. Building Societies were flushed with money and touting public for mortgage bonanzas as if there was no tomorrow. The city was crowing about being the world's largest financial capital, thanks to the less stringent listing requirements of the London Stock Exchange. There was a revulsion against Sarbanes Oxley as if it were the kiss of death. It was decimating NYSE and SEC was making cacophonous noises how they were rolling it back. UK was priding itself on its pragmatic and pliable financial regulatory system "comply and explain".

All this has been silenced by the relentless news of doom and gloom everywhere. It all started with the run on the banks like Northern Rock spreading to the fears of crash of the housing market, stagflation and the weakening pound. A country that once stood proudly apart from the rest of Europe, trumpeting its "Third Way" to prosperity, is having serious doubts about its own policies and has started pillorying its own prime minister, at one stage regarded as the best ever British Chancellor of the Exchequer.

The current debacle of capital markets is fuelled by the greed of bankers, financiers institutions and the monied class. The shenanigans that followed the collapse of Bear Stearns showed crass behaviour of market manipulators that have spelt doom of the global free-market capitalism. This has made the debate about the 'overkill' of Sarbanes Oxley Act irrelevant. The irony is we have far too many regulators overlapping in roles and competing with each other to deregulate the financial system in a race to the bottom.

The unique spectacle of impending recession coupled with rising inflation produced by one of the most reckless manipulations of capital markets with the connivance of regulators has catastrophic implications. Billions of dollars in shareholder value has been wiped away. Stunned Bear Stearns shareholders have seen their investments virtually wiped out overnight. The takeover deal with J P Morgan Chase offered \$2.4 a share compared with Bear's \$159 stock price in last April. Questions abound on the buyout. Shareholders, law makers and public at large want answers on how the deal was arranged, and gained government approval and financing, all in a few hours, and seemingly without alternative bidders being canvassed.

While irresponsible subprime lending in the US stock market has played havoc in the global markets, it is the derivatives, a fast growing category of contracts whose value is derived from the underlying value of bonds, stocks and currency futures which has shaken the public confidence in the rising stock market in India. According to a recent survey, Indian companies may have suffered \$5 billion mark to market losses due to subprime and derivative crises.

That all this should happen despite the draconian Sarbanes Oxley Act points to the abyss reached by the free-market capitalism which displays flagrant disregard of all norms of corporate governance practices and risk management standards which Sarbanes Oxley Act was supposed to uphold.

Insider trading on Wall Street is starting to look as troubling as it was in the time of Ivan Boesky in the 1980s, the head of enforcement at the US Securities and Exchange Commission warned recently. Linda Chatman Thomsen, the SEC's director of enforcement, said she had been "quite dismayed" at the nature of the commission's recent insider dealing actions.

"The tippers and tippees have been in senior positions of trust and confidence," she said. "We are far from low-level employees or people on Main Street." Ms Thomsen expressed concern at the "multiple incidences" of insider trading and cases involving couples who were both professionals. Recently a former Ernst & Young partner was charged with allegedly passing insider trading information to an investment banker friend ahead of seven deals involving the accounting firm's clients. In one of the most high-profile cases recently, 13 people, including a Morgan Stanley compliance officer and a UBS executive director, were charged in relation to an insider trading scheme.

The rules of the game in the financial markets are set up solely to benefit the financiers whether in London, New York or Hong Kong. Globalisation today appears to be run in the interest of big monied class which has western governments in its thrall. As Will Hutton says in Guardian: "Interpol should make arrests in New York, London, Tokyo, Beijing, Frankfurt and Paris, starting with all the executives in the credit-rating agencies who blithely ranked the debt as creditworthy in exchange for fat fees and freebies from the very banks who were making the absurd loans. Governments should bring suits against the executives involved, the repository of vast personal wealth, to help repair the hole in private and public balance sheets."

The problem is that western governments playing hostage to the big financiers fail to regulate them despite warnings. Markets became jittery only because following the subprime lending crisis nobody knew who had lost what. Market valuation of CDOs (Collateral Debt Obligations) and CLOs (Collateralized Loan Obligations) are presumptive. The exposures are not objectively validated. Banks behind the subprime loans had sold the debt to other banks and specialized funds known as CLOs and hedge funds exposing them to billions of dollars of debt when mortgages defaulted.

It is therefore, naïve to suggest that self-regulation can work in the markets. In an interview to Wall Street Journal, Eliot Spitzer, the much defamed former Attorney General of New York, said: "The honour code among CEOs didn't work. Board oversight didn't work. Self-regulation was a failure". Even a staunch defender of free capital markets as Joseph Ackerman, Chief Executive of Deutsche Bank says " I no longer believe in the market's self-healing powers."

It is good news that the Bush administration has finally woken up and recognized the crisis that Alan Greenspan calls the "most wrenching since the end of the second world war". The Treasury department is trying to undo the damage by confronting the credit crisis and putting brakes on free for all market. It is proposing wholesale changes in the US financial systems and bringing back financial regulation which it had discarded due to the pressure from greedy financiers. Under the current hodgepodge, institutions that take deposits and are federally insured face multiple regulatory bodies. By contrasts, hedge funds, private equity firms and investment banks endure substantially less regulation. The new regulation seeks to make sense of the mishmash of overlapping oversight in which an alphabet-soup roster of agencies regulates banks, thrifts and credit unions.

Hank Paulson, the Treasury Secretary is contemplating new powers to the Federal Reserve so that the central bank serves as the system's overarching protector of stability & shareholders interest. The proposals would abolish agencies such as the Office of Thrift Supervision and the Commodity Futures Trading Commission, shifting their responsibilities to other federal institutions. These changes will represent the most sweeping overhaul of financial regulation since the Great Depression of the 1930s. Soon the Draghi Commission within the Financial Stability Forum will report its conclusions and proposals for reform of the financial system to the G7 Finance Ministers.

We need to question the performance of the financial system against the time honoured principles of corporate governance of accountability, equity, integrity, transparency and responsibility. The crucial question in these financial failures is the lack of accountability. The system of compensation of bankers and operators in the financial system itself is flawed. According to Nouriel Roubini, Economics Professor at the New York University's Stern Business School, the compensation system is a source of moral hazard in the form of gambling for redemption. He enumerates ten fundamental issues that led to the melt down.

Since a large fraction of executive compensation is in the form of bonuses tied to short-term profits and since such bonuses are one-sided (positive in good times and, at most zero, when returns are poor) managers/bankers/traders have a huge incentive to take larger risks than warranted by the goal of shareholders' value maximisation. The potential solutions to this gambling for redemption bias can be changed by restricting the sale for a number of years and tying it up with the individual's quality of lending/investment decisions.

Such is the power of human greed and the complexity of capital markets that this restriction on sale did not prevent Bear Stearns, 30% of which is owned by its own employees, from making reckless investment that eventually made it insolvent.

It has become fashionable for most regulatory and supervisory regimes to move in the direction of emphasizing self-regulation and market discipline rather than rigid regulations. One of the arguments in favor of this market discipline approach is that financial innovation is always one or more steps ahead of regulation; thus, one needs to design a regime that does not rely on rigid rules that would kill financial innovation. But experience has shown that markets cannot be relied upon in a world where bankers are improperly compensated, where agency problems lead to poor monitoring of lending, where a flawed transfer of credit risk to those least able to understand it and manage it occurred, and where regulatory arbitrage was widespread and rampant. It is because of this that even Paul Volker, a doyen of central bankers commends tighter regulation in the interest of the industry itself.

The current securitisation model is packed with greed, opacity and irresponsibility. It reduces the incentive for the originator of the claims to monitor the creditworthiness of the borrower. Every intermediary in the chain is interested only in its fee and eventually transfers the credit risk to those least able to understand it and bear it.

The mortgage broker, the home appraiser, the bank originating the mortgages and repackaging them into MBSs (Market Backed Securities), the investment bank repackaging the MBSs into CDOs, CDOs of CDOs and even CDOcubed, the credit rating agencies giving their AAA blessing to such toxic instruments: each of these intermediaries was earning income from charging fees for their step of the mortgage intermediation process and transferring the credit risk down the line to lay investors. In this maze of CDOs no one knew the level of risk at each stage.

There are fundamental accounting issues on how to value securities, especially in periods of market volatility and illiquidity when the fundamental long term value of the asset differs from its market price. The current "fair value" approach to valuation stresses the use of mark-to-market valuation where, as much as possible, market prices should be used to value assets, whether they are illiquid or not. Financial markets have become less transparent and more opaque in many different dimensions. The development of news exotic and illiquid financial instruments that are hard to value and price; the development of increasingly complex derivative instruments; the fact that many of these instruments trade over the counter rather than in an exchange; the fact that there is little information and disclosure about such instruments and who is holding them; the fact that many new financial institutions are opaque and with little or no regulation (hedge funds, private equity, SIV and other off-balance sheet special purpose vehicles) have all contributed to a lack of financial market transparency and increased opacity of such markets.

The absolute lack of supervision on the non-banking financial institutions like Bear Stearns and hedge funds has the real cause of the havoc. By their very nature the banks borrow in the short term and in liquid ways whereas they lend in the long term and in illiquid ways. There is therefore need for proper tab on their

lending. In the case of banks the risk of runs is significantly prevented by the existence of deposit insurance and by the lender of last resort support that the central bank can provide to depository institutions. Publicly provided deposit insurance is generally not warranted for non-bank financial institutions as the protection of small investors/depositors - who don't have the expertise to monitor the lending/investment decisions of banks - is not generally an issue for such non banks. But as the recent Bear Stearns episode as well as the run on and collapse of other members of the shadow financial system suggest bank like runs on non-banks can occur and are likely to occur more often if such institutions do not properly. The absolute lack of supervision on the non-banking financial institutions like Bear Stearns and hedge funds has proved to be the primary cause of the havoc.

The Fed's action to bail out Bear Stearns at a cost of \$30 billion shows the importance of these non-banking financial entities. How could they be allowed to run amok without controls in the first place? It is all the more reason that they should be exposed to at least the same level scrutiny as the banks. Such firms should be asked to fully disclose to their supervisors and investors the liquidity and other risks that it is undertaking and required to reduce its liquidity risk with a variety of tools that ensure a greater liquidity buffer.

Basel II agreement has shown its serious flaws: capital adequacy ratios that are pro-cyclical and thus inducing credit booms in good times and credit busts in bad times; low emphasis on the importance of liquidity risk management; excessively low capital requirements given the serious financial risks faced by banks; excessive reliance on internal risk management models; excessive role given to the rating agencies and their ratings. These are serious shortcomings of the new capital regime for large internationally active banks and depository institutions. When a crisis of confidence of the dimensions we have witnessed takes place, what is crucial is how fast we can extinguish the fire. In this context UK's model of having an FSA, where all financial policies – for banks, securities firms, other financial institutions, insurance companies, etc. – are under one umbrella, is considered superior to an increasing number of regulators at the federal and state level as in US.

Finally in a world of financial mobility, mobile capital, instant transferability, globalization and financial intermediation, capital will always have a tendency to move to more lightly regulated shore. Reforms of financial regulation and supervision cannot be effectively carried out only at the national level. Indeed, the recent US debate on reforming capital markets was driven – before the current market turmoil – by the concerns that a tighter regulatory approach in the U.S. (say the Sarbanes-Oxley legislation) was leading to a competitive slippage of New York relative to London in the provision of financial services. There is therefore a need to encourage cross-national fora and develop a global financial monitoring system for stronger coordination to avoid a race to the bottom of financial regulation.

The above points based on an excellent research paper of Professor Nouriel Roubini's Ten Fundamental Issues in Reforming Financial Regulation and Supervision in a World of Financial Innovation and Globalisation show how the current crisis is primarily due to the failure of corporate governance in the financial system. It begs the question how could the boards of these institutions, supposed to monitor performances, missed such egregious failures? Charles Elson, who sits on several boards and heads the Corporate Governance Centre at the University of Delaware asks: "Where exactly were they when all this was going on?" The question is beginning to be asked by shareholders and employees whose lives have been destroyed by these market manipulators.

At the heart of the matter is whether the corporate governance infrastructure, built over the decades to provide checks and balances to ever more powerful chief executives, has been exposed as woefully inadequate by recent events. As one former senior Wall Street executive puts it: "If, as it appears clear, boards were asleep at the switch, then there is something fundamentally wrong with the system of controls we have." Hence the the theme of the forthcoming 9th International Conference on Corporate Governance scheduled in London on 18/19 September is aptly chosen as "Making Capital Markets Work Through Corporate Governance."

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