Capital Markets as Instruments of Social Inclusion

We are living in one of the most inequitable world in history posing a palpable threat to global security. The richest 1100 own wealth, double of half the world's population. Our greatest challenge is to bridge this widening gap. Capital markets are the best human innovation and our only hope to achieve our goal of an equitable society. But like parachutes they can only function when open.

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 Sarbanes Oxley Act irrelevant. Far too many regulators with overlapping roles are 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 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 all governments play hostage to the big financiers and are reluctant to regulate them despite warnings. It is 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."

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.

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.

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 CDO cubed, 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.

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.

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. Where exactly were the boards & the independent directors of financial giants such as Citibank, Bear Stearn, Freddie Mac, Fanny Mae, Merryl Lynch, Lehman Brothers & Morgan Stanley etc when all this was happening? This is the question being increasingly asked by shareholders and employees and the public at large whose lives have been destroyed by these market manipulatorsis. We are tasked today to find out the answers, not only for improving the quality of capital markets but also to ensure world security.

IOD is a revolution, a silent revolution that began 20 years ago with a conviction that if this silent revolution to reform the capital market does not succeed it will make a violent revolution inevitable.

*The above is the Presidential address delivered by Dr Madhav Mehra at the 19th IOD Foundation Day on 02 August 2008 in New Delhi