

The Lack of Market Liquidity and Credit Crunch is Because of Lack of Transparency

Madhav Mehra

We have just experienced one of the most reckless periods of lending and deal making in recent history. Unbridled individual greed of the market manipulators in the form of financial innovations such as derivatives, MBS, CDOs ostensibly intended to spread the risk has destroyed credibility and trust to such an extent that even the banks have stopped lending to each other. With central banks bailing out the banks, ordinary tax payers are underwriting the excesses of monied people whose take home packages are reported to be in millions of dollars with bonuses.

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 said 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 repositories of vast personal wealth, to help repair the hole in private and public balance sheets.”

All this has happened despite calls for transparency which the World Council for Corporate Governance has given ever since the collapse in September 1998 of Long Term Capital Management, a giant hedge fund. Hedge funds and derivatives are financial innovations supposed to protect the market shocks while letting the financial system get on with its job. But they cannot function effectively if they act like a black box nurturing an environment of confusion and concealment.

Global markets in the recent months have seen highly aggressive private equity takeover deals financed by debt provided by banks. These debts are structured the same way as subprime mortgages. When the subprime markets collapses the private equity funds will be unable to sell the debt to CLO and hedge funds thus triggering an all around panic.

The problem was that western governments themselves play hostage to the big financiers and are scared of regulating them lest they move their assets to lightly regulated territories. This is precisely what happened to Wall Street and New York Stock Exchange. Scared of the draconian effect of Sarbanes Oxley Act many companies who delisted from the New York Stock Exchange were coaxed by the London Stock Exchange saying they did not believe in such draconian regulation and UK corporate

governance laws did not make the regulation binding and gave the opportunity to the firm to explain why they could not comply with a particular regulation. There was as such a race to the bottom by regulating authorities to invite investment.

It is the rolling back of regulation that added opacity in the markets and allowed hedge funds to act aggressively and irresponsibly. 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 (Collateralised Loan Obligations) are presumptive. The exposures are not objectively validated. Banks behind the subprime loans had sold the debt to other banks and specialised funds known as CLOs and hedge funds exposing them to billions of dollars of debt when mortgagees defaulted.

It is therefore naïve to suggest that self-regulation can work in the markets. In an interview to Wall St. Journal, Eliot Spitzer, the 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". The situation today shows no change.

The biggest challenge for the corporations, therefore, is how to replace greed as a driver of corporate agenda with something more substantial and subliminal. How to restructure remuneration and securitization processes that reward performance and not individual greed. That requires independent and effective boards. How to make boards who draw salary and perks from the same tainted management effective and independent? This may call for a 180 degrees shift in corporate attitudes from focusing on "how not to get caught" to "how to make a difference?". We have to change our metaphors of success "winner takes all" and "success at all costs" and develop a value system that prides in ethics, morality, equity, legitimacy, transparency, value dissent and diversity. Transparency implies courage to admit you were wrong and say: "We are sorry we made a mistake".

The good news is that studies reveal that transparency is a competitive differentiator as it restores both investor and customer confidence and creates value for the business. Bailout of the banks by lavish public investments are unlikely to succeed in restoring market confidence unless we can improve transparency in capital markets and increase board oversight, board effectiveness ie accountability of the management to a board constituted not only by independent directors but directors of independent mind.

Dr Madhav Mehra is the President of the World Council for Corporate Governance based in UK