Economics of Banking and Finance Markets
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Lecture - 25
Conflict of interest - I

Welcome to this session. The main objective of this session is to discuss the problem of Conflict of interest in finance markets.

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We are going to discuss the areas of conflict of interest in the finance market, and how does this the issue of conflict of interest adversely affect the efficient working of finance markets.

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Financial Institutions:

- Expertise in interpreting signals and collecting information
- Proving multiple services
- Collecting, producing and distributing information: **Economies of scale**
- Low cost of information production leads to: **Economies of scope**
- Institutions try to maximize profits
- This max profit process leads to conflict of interest

adversely affect financial system.

So, one of the features that we have seen in financial system is that the existence of large number of financial institutions. Financial institutions are prevalent in finance market mainly because they have expertise in interpreting signals and collecting information right. This we have discussed in length in one of the previous sessions.

We can also see that they have been providing multiple services in the market. These include, for example, you know because of providing multiple services, that is collecting, producing, and distributing information. So, look for example, banks, you know that banks collect information, and they produce this information, and to they distribute some of these information.

Similarly, rating agencies, you know that they also collect lots of information about the financial market or different firms, different stakeholders, and then they distribute this information. So, because of that when they collect, produce, and distribute information, sometimes they have economies of scale.

They often enjoy economies of scale. That is the volume of their activity incentivize them to engage more and more further different types of economic, different types of financial activities

The low cost of information production often leads to economies of scope as well.

The economic institution, that the financial institution, just like any other firms they try to maximize profit. So, while trying to maximize profit, they often rely on these economies of scale, they also make use of economies of scope to make maximize their profit.

And during the maximization of profit, the process leads to conflict of interest, this adversely affect, this would adversely affect the financial market, then adversely affect the financial system. So, before proceeding further, let us see, what is the concept called these economies of scale and economies of scope.

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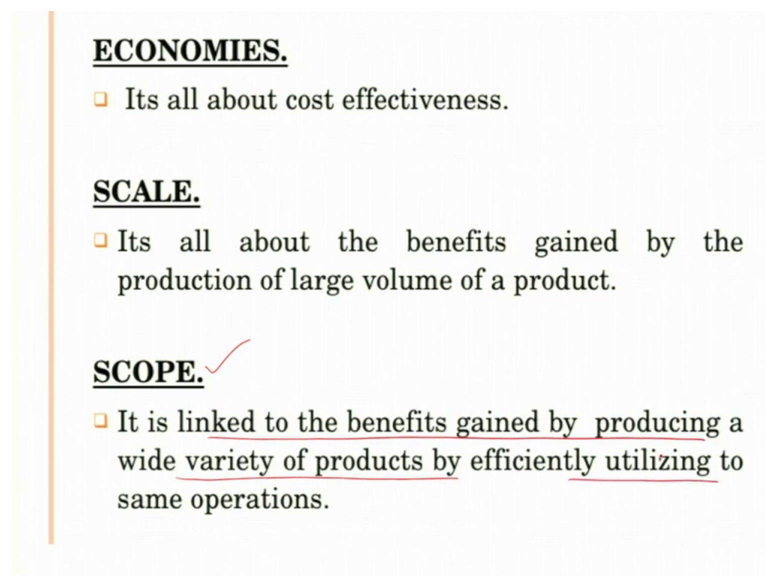

So, starting with first economies, it is all about cost effectiveness. Then, economies of scale means, it is all about the benefits gained by the production of large volume of a product. So, when you keep producing large amount, large volume of product, a mass production, then the unit cost, that the marginal cost of production decreases, decreases very fast. It diminishes at a faster rate.

Then, about the economies of scope, that means, instead of economies of scale where we talked about the volume, the economies of scope is linked to the diversity; that means, variety. You can see that is linked to the benefits gained by producing a wide variety of product by efficiently utilizing the same operation.

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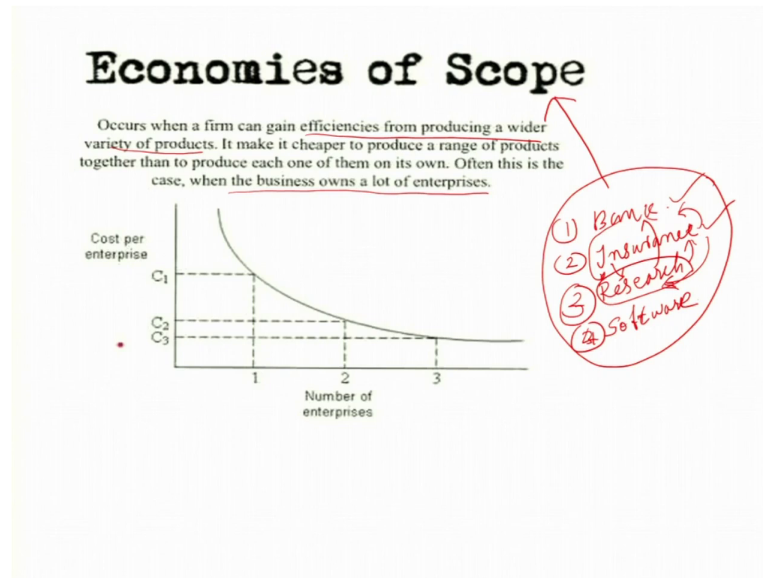

So, coming to the first part, the economies of scale occurs when a firm gains efficiency from producing a large volume of products, but the economies of scope is attained with a wider variety of products. It is cheaper to produce a range of products together than to produce each one of them on its own. Often this is the case when business own a lot of enterprises.

So, for example, you can see that a bank, suppose a large bank, and banking is one of their main business, right. So, in the case of bank you know that because they have the several branches across the country, and they have the strong economic and managerial technical capacities.

So, because of that you can also see that banks will be starting insurance business. The same bank will be entering insurance industry as well. You know why? Because they already have all this expertise, for example, the infrastructure the premises across the country. So, they have the wide network; and because of that it is easier for them to start an insurance firm as well.

Moreover, the bank will be having large number of customers. So, it will be easy for them to sell insurance product to them as well, with less unit cost. So, you can look at for example, State Bank of India. State Bank of India also has insurance business. Example is SBI life insurance.

In addition, what they will do that, since they have access to lots of information the same bank will engage in research. They will do consulting. So, because initially the research it will be helping them, it will be helping their insurance industry, and it will be helping their banking industry. To do the research they will be getting data from this bank and insurance as well.

Plus, you know that they will be making use of the online facilities, online banking facilities, online insurance facilities, most of the online facilities, it will also facilitate from them to do better research.

So, this is called diversity or variety. This is nothing but economies of scope. And what we are going to see that, because of economies of scope, it sometime leads to conflict of interest. It often leads to conflict of interest, that going to affect the working of financial system.

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Definitions and measurement

- Economies of scale
  - defined as change in outputs for a given change in inputs
  - can be measured by inverse of % change in costs from 1% change in outputs
    - > 1 = economies of scale
    - < 1 = diseconomies of scale
- Economies of scope
  - exist if joint production of multiple outputs costs less than separate production
    - sharing of indivisible inputs across different "products"

Economies of scale, which I forgot to elaborate; so, economies of scale are related to change in output for a given change in inputs. So, you can see that when they produce large quantity of the goods, when they keep on increasing the quantity, and obviously, you know that their cost of production will decline.

So, for example, look at for example, a mobile phone production, maybe we are for example getting a mobile phone for 10,000 for example, but you know that if a firm wants to produce only 100 units of mobile for example, then you know that the unit cost is going to be very

high. Because by just to produce 100 units they need large investment and then the unit cost will be high.

But what if they produce millions of units, millions of unit different models and all then because of that there are economies of scale and then the unit cost will be reducing. So, that means, the percentage change in cost from percentage change in outputs, you can see that if it is greater than 1, you can see there is economies of scale, right. So, because there is 1, then the economy of scale is 1, that would often further lead to economies of scope as well. Then, let us connect this one to our financial market context.

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What are Conflicts of interest?

- Conflicts of interest arise when a financial service provider, or an agent within such a service provider, has multiple interests which create incentives to act in such a way as to misuse or conceal information needed for the effective functioning of financial markets.
- when an institution provides multiple financial services, thereby creating an opportunity for exploiting the synergies or economies of scope by inappropriately diverting some of their benefits.

So, then the question here is that how it leads to conflict of interest, how economies of scope lead to conflict of interest. And let us see what conflict of interest is. Before we were discussing that in detail what kind of conflicts of interest prevalent in financial market, let us see what conflict of interest is here.

So, conflict of interest arises, it arises when a financial service provider or an agent within such a service provider has multiple interest, which create incentives to act in such a way as to misuse or conceal information needed for the effective functioning of financial market.

So, that means, concealing information or misusing the information which they are aware, and engaging in malpractice, maybe they are incentivized to do that that would often lead to adversely affect the effective functioning of financial markets. And that will deepen, that will

further aggravate the problem of asymmetric information, that will aggravate the problem of asymmetric information.

So, when an institution provides multiple financial services, thereby creating an opportunity for exploiting, the synergies, or economies of scope by inappropriately diverting some of their benefits, this would then adversely affect the working of the finance market.

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What are Conflicts of interest?

- Multiple Objectives
- Conflicts b/w these objectives
- Multiple services: potentially competing interests
- May lead to conceal information or disseminate misleading information

Why do we care Conflicts of Interest?

- Reducing in quality in information in Finance Market.
- Asymmetric information...prevent channeling funds into the most productive uses

So, because of the multiple objectives which I mentioned for example, same firm starting multiple business. Bank for example, starting insurance firm, starting its own consultancy businesses. and sometimes many banks join, and they start setting up a rating agency.

This would lead to a situation of rating some of the products of its own. That means, the rating agencies will be rating their own products, their parent companies' products. So, that all going to adversely affects the efficient working of the financial market.

So, because of these multiple objectives, conflict between these objectives happen, right. For example, credit rating agency, that they have the credit rating agency, at the same time they are also in the investment banking; they are also in the consultancy business. So, because of these multiple objectives, there is going to be a conflict.

So, when multiple services they provide, there is potentially competing interest. And you know that ultimately, they want to maximize this profit because they are all firms, at the end of the day they are all firms, they want to maximize their profit and they must satisfy their

shareholders and accordingly they will be working. So, all these, as I had mentioned just previously, may lead to concealed information, or disseminate misleading information in the financial market.

So, why do we care conflict of interest? Then, you know that this will reduce the quality of information in finance market. This will aggravate the problem of asymmetric information. Then, ultimately what is going to happen? That the concept that we discussed in the session, previous session; that means, asymmetric information will create adverse selection problem and that all would prevent efficient channelizing funds into the most productive uses.

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Sources of Conflicts of interest?

Broadly, 4 areas of financial activities with combination of other activities

1. **Investment Banking:** Research and Underwritings
2. **Auditing Firms:** Auditing and Consulting
3. **Rating Agencies:** Credit Assessment and Consulting
4. **Universal Banking:** commercial banks, investment banks and insurance companies

Let us now discuss what are the major sources of conflict of interest in the finance markets; so, there are large number of, several areas of financial activities with the combination of other activities, which all lead to conflict of interest. However, for the sake of simplicity and to manage our discussion, let us classify all these into, broadly into, 4 areas of financial activities. These are more prominent in the financial market and let us discuss these one by one.

So, one area is with the investment banking. When they engage in both research and underwriting, then these lead to conflict of interest. And the 2nd is auditing firms, because we have seen that most government, to ensure a sound financial system, in order to reduce the asymmetric problem, most government asks the firms to get their balance sheet audited by independent firms.

And, however, the auditing firms sometimes they also have consulting business as well. So, auditing firms, because of the economies of scope, they also engage in consulting as well. So, this creates further conflict of interest.

Then, the 3rd one is rating agencies, the credit rating agencies their primary duty is to do credit assessment, but they also do consulting. How? Why they do? Because they have lots of information. How do they do credit rating credit assessment? Because they collect lots of information about the default risk, about the economic fundamentals of each firm whom, they are going to do the credit assessment.

So, during that process, they are getting lots of information. They are investing lots of technical and managerial expertise. Based on that they also engage in consulting as well.

Then, the next area is universal banking, what if the same bank engages in commercial banking activity, investment activity, and insurance company. They set up the, say one bank, the parent bank set up, they have the commercial bank, investment bank and insurance companies.

So, what they are going to do? See here that because of all these, there is conflict of interest, this would lead to financial crisis and the 2007-08 financial crisis is one of the classic examples of how a conflict of interest led to this financial crisis of 2007-08.

When we study 2007-08 crisis, we are going to review all these points that we are going to discuss here. That means, each of that the conflict of interest played a major role in the 2007-08 financial crisis.

Let us now discuss one by one what are the areas of conflict of interest, and how does it affect, what are the possible way it would affect the working of financial system.

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Conflict of interest in Investment Banking: In Research and Underwritings

Investment Banks: 2 tasks

1: Research companies issuing securities

2: Underwrite these securities

Underwriting: an individual or an institution undertakes the risk associated with a venture, an investment, or a loan in lieu of a premium.

In the securities market, underwriting involves determining the risk and price of a particular security. It is a process seen most during IPOs, wherein investment banks first buy or underwrite the securities of the issuing entity and then sell them in the market. This ensures that the issuers of the security can raise the full amount of capital while earning the underwriters a premium in return for the service.

Combine both tasks b/c of information synergies

Information produced for one task may also be useful for the other

Brokerage Vs Underwriter

So, one area of a conflict of interest is in investment banking; what if when investment banker engages in both research and underwriting. So, investment banks, because of their huge vast managerial and technical expertise, often engage in two tasks. One is research to companies issuing securities. That is, one research, we can also call it as consultancy. The 2nd one is underwrite these securities.

So, the information synergies from underwriting and research provide a rationale for combining these distinct financial services; this combination of activities leads to conflict of interest, however. So, the conflict of interest that raises the greatest concern occurs between underwriting and brokerage where investment banks are serving two client groups, one is issuing firms and the other one is investors.

There are two client groups, both are on the opposite side of the market. One is issuing these securities and the other one is giving services to the investors.

The issuers benefit from optimistic research. So, the firm who is issuing a security is expected to benefit from the research output that they are getting from their client, that the client, that means, from the research companies, while investors expect unbiased research.

So, if the incentives for these two activities are not properly, appropriately, aligned and there will be a temptation for employees on one side of the firm to distort information to the

advantage of their clients and they profit their department. So, you can see here that when the same firm, the investment bank, underwrite.

What is underwriting means? Underwriting means an individual or an institution undertakes the risk associated with a vendor. That means an investment or a loan in lieu of a premium. So, in the securities market, for example, underwriting involves determining the risk and price of a particular security, that is, it is a process seen most during IPOs, wherein investment banks first buy or underwrite securities of the issuing entity, then sell them in the market.

So, this ensure that the issuers of the security can raise the full amount of capital while earning the underwriters a premium in return for the services. So, this is, because as I mentioned here, when they are doing underwriting at the same time, we also see that they provide research services, and they combine both task because of information synergies.

So, in this case, what is going to happen. So, the information produced for one task may also be useful for the other, that is the economies of scope, right. So, the research the output they are having, they also will be using it for underwriting these securities.

However, the brokerage that they are getting, the brokerage that they will be getting by providing research and consultancy services to the companies, at the same time as a underwriter; what is the benefit that they are getting.

Sometime one area will be benefiting more, there the return from brokerage may be large as compared to underwriter or maybe they sometimes feel that an underwriter, as an underwriter, sometimes they have the incentive to little bit to manipulate the price. That means, for example, while issuing IPO, sometimes they have some incentive to bias the unit price of the IPO

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Conflict of interest in Investment Banking: In Research and Underwritings (contd…)

Brokerage Vs Underwriter

What if potential revenue from underwriting is greater than brokerage commission?

Strong incentive to alter information in favor of issuer of securities

So, brokerage versus underwriting, what if potential revenue from underwriting is greater than the brokerage commission? So, because if this happen you know that there is strong incentive to alter information in favor of issuer of securities; so, they have strong incentive to alter information in favor of issuer of securities.

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Conflict of interest in Investment Banking: In Research and Underwritings (contd…)

- **Spinning:** Investment bank may allocate the hot but underpriced IPOs to the executives of other firms, so to persuade them get their firms consulting business
- Executives of the firms: Biased business...this may not be right investment bank for their firm...may raise the cost of borrowing...diminish the efficiency of capital market
- Without Spinning: An efficient firm (investment banker) might have fetched a high value for the IPOs of issuing company

Then, this also, you see this will be they are doing it in a biased way. The securities price what we expect that the price of securities, for example, the price of securities, it should

primarily be reflecting the economic fundamentals of that firm, not based on any other aspects.

The investment banks, to get the underwriting and consultancy business of firms, they engage in some other malpractices, to say, for example, spinning. Spinning means investment bank may allocate the hot, but underpriced IPOs to the executives of other firms, so to persuade them to get their firms consulting and underwriting business.

To get their consulting business, when this investment bank when they are underwriting any new security or IPO of another firm, they will be giving some hot IPO; that means, newly issued share, to the executive of the other firms; that means, it is kind of bribing indirectly.

So, that the managers of that firm another firm who got these IPOs have an incentive to hand over their consulting businesses, of their firm, to this investment bank who gave them this IPOs. Why it is called hot, but underpriced IPOs? You know that when you get an IPO, within 1 or 2 weeks it will be listed in a stock exchange, then obviously, most often it happened that IPOs price will increase at par with the price in the secondary market.

But, obviously, sometime when you get the IPO, it will be little bit underpriced and you will get a higher price within 1 or 2 weeks when the IPOs, these securities are listed in the stock market. So, this is in a way, that spinning, they are bribing the executives of the other firms to get their consulting business.

So, because of this, you know, the executive of the firms, will be doing a biased business, they will be approaching this investment banker because they got benefited from them by getting underpriced IPOs, on a personal basis. So, this may not be right investment bank for the firm. So, the biased business, they will be giving this consulting business of this firm to the investment.

So, this may not be the right investment bank for their firm, and this may raise the cost of borrowing and it diminish the efficiency of capital market. And maybe the same managers will be approaching the same investment bank for next time for underwriting when they want to issue an IPO.

So, that means, they shortlist or identify an investment bank not because of their any economic consideration, but because of they have been benefited because of spinning. So,

without spinning what I want to say here is that an efficient investment banker might have fetched a high value for the IPO of the issuing company. So, this will affect the efficient working of the finance market.

Another area of conflict of interest is in the areas of accounting firms. What if an accounting firm engage in both auditing and consulting business?

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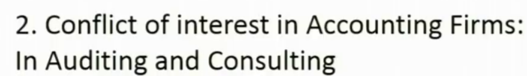

Let us discuss this in detail in the next session.

Thank you.

Keywords: conflict of interest, economies of scale, economies of scope, investment banking, research, and consultancy, rating agencies, underwriting, spinning