Economics of Banking and Finance Markets
Prof. Sukumar Vellakkal
Department of Economic Sciences
Indian Institute of Technology, Kanpur

Lecture - 26
Conflict of interest - II

Welcome to this session, in this session we will continue our discussion on Conflict of interest in investment banking. We have had a brief discussion in the previous session. That, investment banking often undertakes both tasks research and underwriting.

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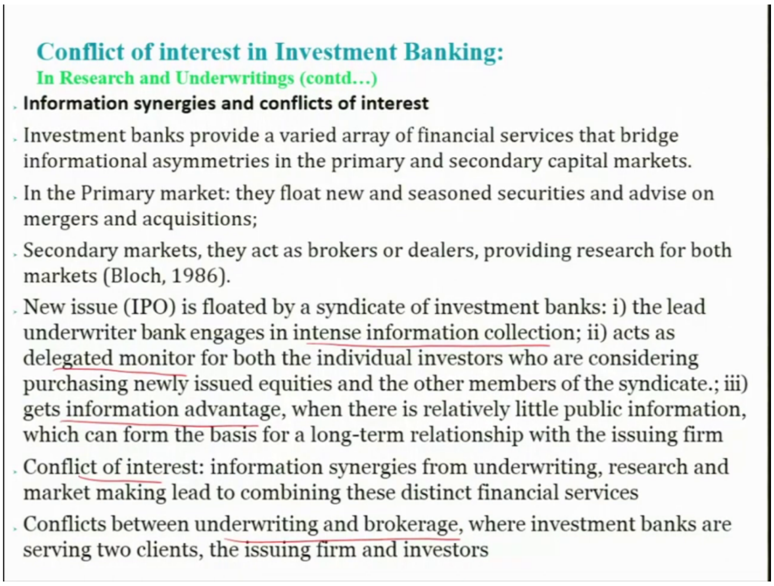

As a result, both activities would lead to conflict of interest, which would adversely affect the smooth working of financial market.

So, the information synergies and conflict of interest, how does it arise? Particularly coming to the information synergies, investment banks provide a varied array of financial services that bridge information asymmetries in the primary and secondary capital markets. So, when it comes to the primary market, they float new and seasoned securities and advice on mergers and acquisitions. So, coming to the secondary markets, they act as brokers or dealers, providing research for both markets.

These services have important complementarities in the collection and use of information that encourage their joint profession. So, let us see an IPO is issued; that means new issue is floated by a syndicate of investment banks. So, let us see how this process is done. There will be a lead underwriter bank engaging in intense information collection. So, that is the first one task, that is, the intense information collection by the lead underwriter from the syndicate of investment banks.

This lead underwriter act as delegator monitor for both the individual investors who are considering purchasing newly issued equities and the other members of the syndicate. And the lead delegator monitor, that is the lead underwriter bank, gets information advantage as compared to others; because when an IPO is issued or a new security is issued, there is relatively little public information about it, as you know.

This can form the basis for a long-term relationship with the issuing firm; that means their client, that the borrower or the equity issuing firm. Then you know that because of this, there is a kind of conflict of interest. Because information synergies from underwriting, research and market making lead to combining these distinct financial services; So, there is conflict between underwriting and brokerage, where investment banks are serving two clients, that is issuing firm and investors.

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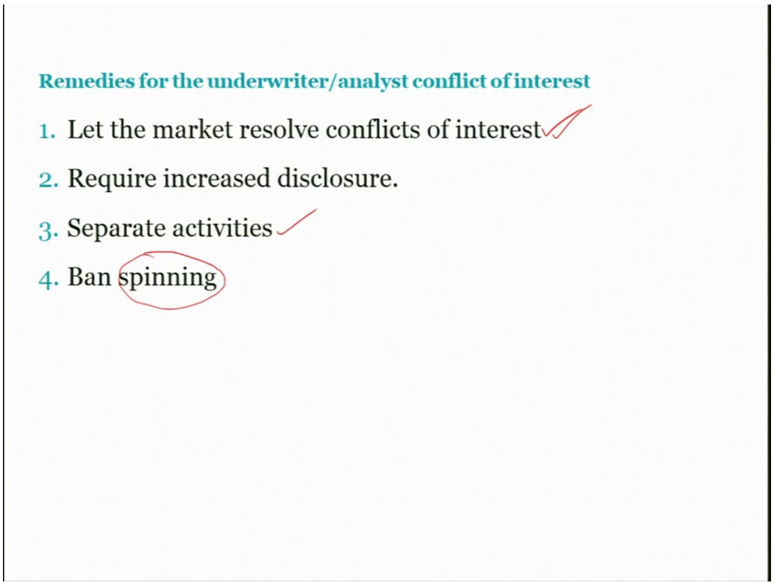

So, what are the solutions to resolve these problems? Some of the remedies suggested for resolving the conflict of interest is that, let the market resolve the conflict of interest. For the market to solve the conflict of interest, investors need to be able to identify and respond to inaccurate biased information. In the market normally the issuer firm, they will be giving more weightage to those firm who works more objectively and more credibly.

So, let the professional money managers discount the information. So, in the case of market resolving conflict of interest, especially about the institutional investors; for example, professional money managers, let them discount the recommendation and reports of analysts when there is an investment banking relationship between the bank and the company analyst.

So, whenever there is issue comes up that actually; that means the investment banking and the issuing firm. Suppose something the invest money market managers come to know that there is some relationship between them; then accordingly it has been said that let the investors discount this information.

However, this was fine for institutional investors; but when it comes to a individual investors, it needs lots of effort for this kind of individual investors to collect information. The issue here is that the institutional investors and money managers may understand the bias, but less sophisticated individuals may not.

So, the 2nd one is required increased disclosure. So, if the market does not provide sufficient disclosure, regulation may be necessary to cause firms to permit investors to observe whether there are any conflicts of interest behind the information provided by analyst. So, here one solution is mandatory disclosure of the relationship between the bank and its employees, and the issuing firms is the minimum information required. So, such information would include whether the firm was a client of the underwriting banks or other departments or any conflicts of interest for individual analyst.

And coming to the next remedy, this one is separate the activities; that means to increase the distance between analysis and underwriting by either strengthening firewalls within investment banks or forcing a complete separation. In the separation of activities, the difficulty here is that, although the potential conflicts of interest are reduced by this approach; the greater the degree of separation you know, the more potential synergies in information collection and use are lost.

Because we see that, though we talk about this conflict of interest, we can also see that when this, for example, an investment bank does underwrite and at the same time they do a research, consulting. So, they are getting more and more information; there are not only conflict, at the same time there are some synergies as well. Actually, by doing the separation, we also need to aware that this is one of the remedies to address conflict of interest; at the same time there is an opportunity cost of the potential synergies in information collection, which will be lost in this process.

The 4th one is ban spinning. So, we have seen in the previous session, we have discussed that one of the ways how investment banks pursue it, they bribe the managers or the executive of the firm to get their consultancy business by giving hot and underpriced IPO. Because of that, the managers will be biased in giving their consultancy business those investment banks who had given them spinning.

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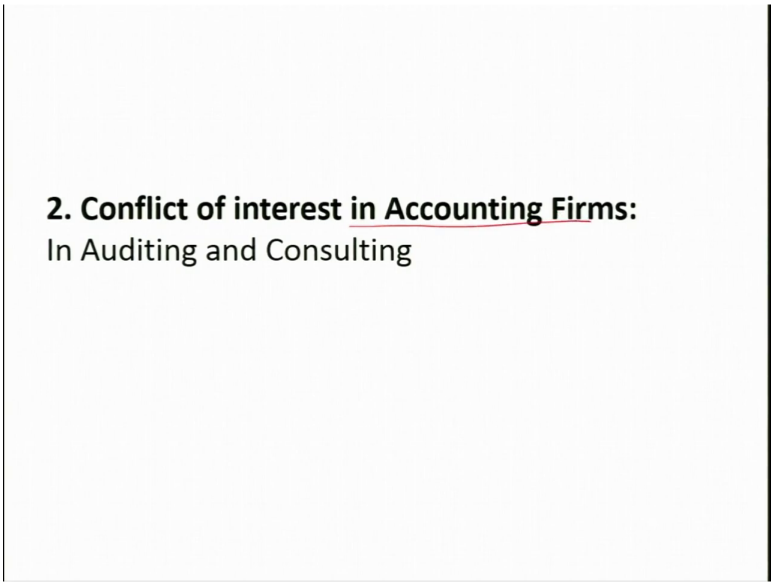

Let us now move to another area, another area of conflict of interest in the financial sector. So, that is with the conflict of interest in accounting firms; that means in auditing and consulting.

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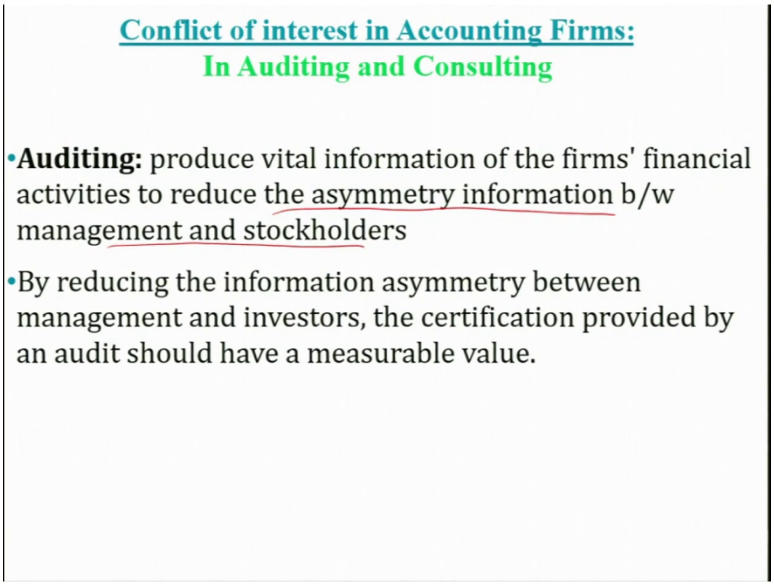

You know that auditing produces a vital information of the firms' financial activities to reduce the asymmetry information between management and stockholders.

So, by reducing the information asymmetry between the management and the investors, the certification provided by an audit should have a measurable value. So, the traditional role of an auditor has been to act as an efficient monitor of the quality of information produced by firms to reduce inevitable information asymmetry between firms' managers and other stakeholders especially its supplier of capital.

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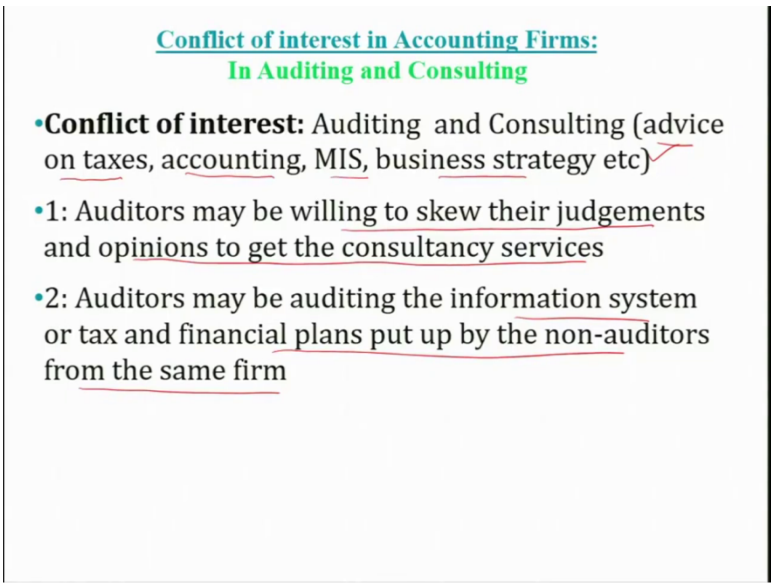

The conflict that has received the most attention lately occurs when an accounting firm as well as providing audit services also provide a non-audit consulting services like advice on taxes, tax advice, accounting, accounting management information system and business strategy; that is strategic advice, which is commonly referred to as management advisory services. So, that means, in addition to audit services, they also provide several consultancy services as well, as I mentioned just now here.

So, these multiple services enjoy economies of scale and scope, that is potential synergy that we can see; however, you know that it creates two potential sources of conflict of interest. The most discussed conflict is the potential to pressure auditors to bias their judgments and opinions to limit any loss of fees in other services; that means, auditors may be willing to skew their judgments and opinions to get the consultancy services.

And the second but more subtle conflict is that auditors often evaluate systems or tax and financial structure that were put in place by their non-audit counterparts within the firm; that means, in the same company the auditors may be auditing the information system or tax or financial plans put up by the known non-auditors, a department from the same firm, you know, that is, clearly a conflict of interest.

So, both conflicts may lead to biased audits. So, the investors are looking at the audit report of balance sheet of a company: the assets of the company, the liabilities of the company; so the individual investors and institutional investors will be looking for the unbiased auditing. They will be trusting the auditing firm; they will be thinking that the auditing done by this firm is more unbiased and more credible. But what happened that because most individual investors and sometimes institutional investors as well, they may not be aware of this kind of conflict of interest, and they will be trusting this the audit given by the audit firm.

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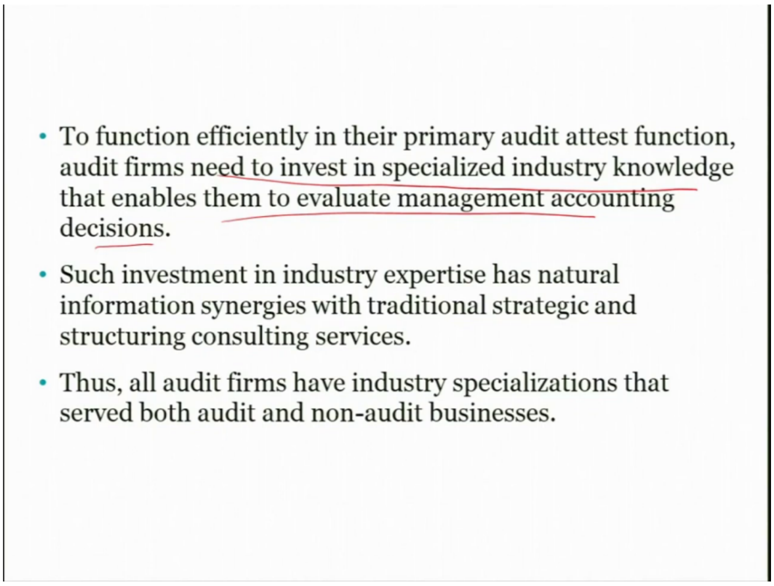

So, by reducing information asymmetry between the management and investors, the certification provided by an audit should have a measurable value. So, to function efficiently in the primary audit function, audit firms need to invest in specialized industry knowledge that enables them to evaluate a management accounting decision. So, such investment in industry expertise has natural information synergies within traditional strategic and structural consulting services.

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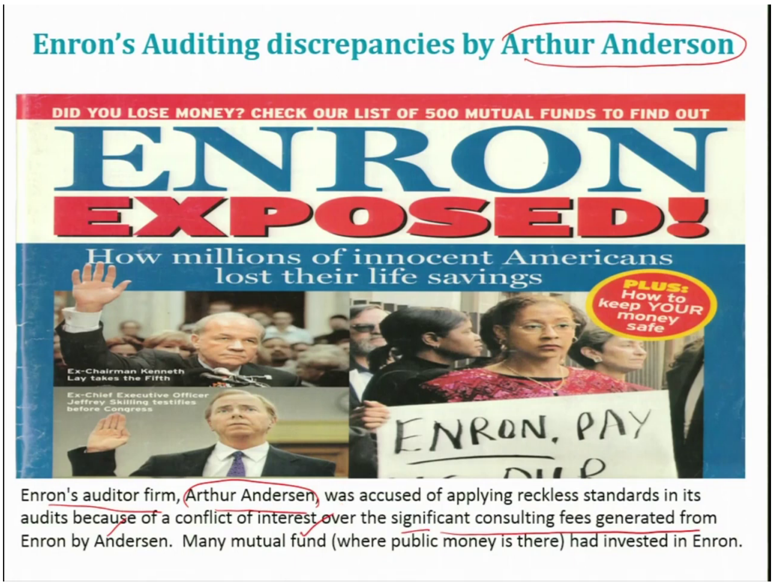

And one of the classic examples for this is the Enron's auditing discrepancy by Arthur Andersen. For example, Arthur Andersen is an audit firm; Arthur Andersen was one of the 5 largest audit firm in the US, Arthur Anderson had a long-standing expertise in oil and gas and related energy businesses in the auditing, which made it an obvious choice for Enron. Enron is also, as you may know, it was an energy firm with headquarters in Houston, the hub of the US energy industry.

So, Enron's what the Enron's auditing firm, Arthur Anderson the auditing firm, did here is that, was accused of applying reckless standards in its audits, because of a conflict of interest over significant consulting fee generated from Enron by Anderson. So, in another words, Anderson not only provided auditing services to Enron, but also provided consultancy services as well. So, you know that many mutual funds, mutual fund obviously you know that this is the where the public money lies, had invested in Enron.

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So, just to give an overview what is Enron scandal, you may be aware of it; Enron is a Houston based commodities energy and service cooperation; mostly they work in energy sector. And shareholders lost nearly in 74 billion dollar and thousands of employees and investors lost their retirement accounts and many employees lost their job. So, coming to the investor's part, you know that many people had put their money, may be in mutual fund, and many mutual funds had invested in this company Enron, they are the shareholders of Enron as well.

So, many people lost their jobs as well. These are the main players. And what they did, what was the scandal is all about? So, we said that it is all about the auditing; it is a discrepancy in the auditing, which was done by the Anderson, the auditing firm Anderson. What they did was? You know on the asset side and liability side; on the liability side they kept huge debts off the balance sheet, it was not reported in the balance sheet.

So, obviously you know that the net worth; net worth is equal to assets minus liability. So, you know that when the debt was hidden, it was not reported in the balance sheet; obviously you know that the net worth will be increasing and obviously, further impact of this also you know that when the net worth increases, and not only that you also see here is that their dividend also will be increasing.

They are not because of the economic fundamentals; because they have hidden the liability, that the debt, from the balance sheet and as a result you know that the dividend increases, obviously you know that stock price also increases. So, when the stock price increases, you know that the asset value, overall, the asset value of the company net worth will be increasing.

So, obviously they will be able to raise more and more funds through the IPO channel as well; because that also we discussed in one of the previous sessions that the primary market, the price in the primary market and secondary markets are closely interrelated.

So, finally, the thing is that how they caught, because there was a whistle blower and blower is Sherron Watkins; so mainly because the high stock prices fueled suspicion. You know the high stock prices because of these facts. So, at the same time there are some fun facts as well. So, you know, this Fortune Magazine named Enron as America's most innovative company for six years in a row prior to this scandal.

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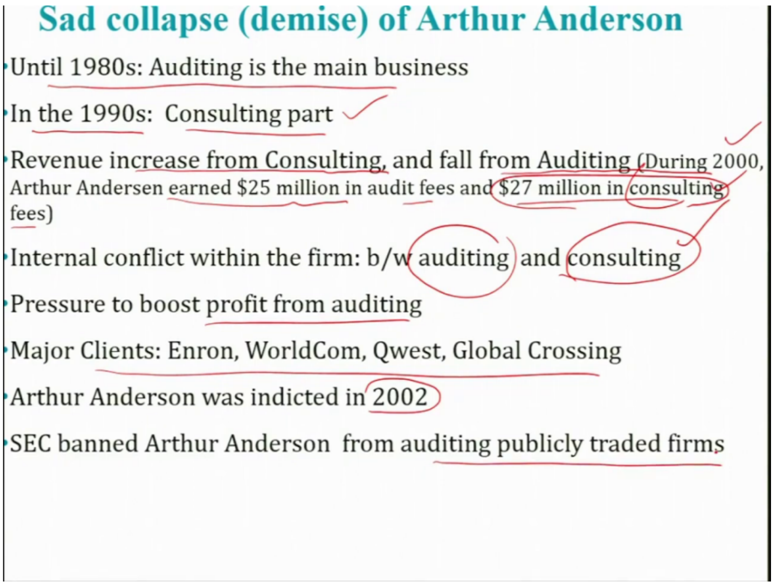

So, coming to Arthur Anderson, you know this is the audit firm who did both business, that is, the auditing and consultancy part and was major actor in this scandal. You know until 1980s, auditing was their main business; it was originally an auditing company until 1980s. But what happened that? Because of the competition and growth of the financial sector in the 1990s, consulting became another important component of this company.

There was a huge increase in revenue from consulting and a fall of revenue from auditing business; for example, during 2000 Arthur Andersen earned 25 million in audit fees and 27 million in consulting fee. And mostly in its branch in Houston, where this Enron companies headquartered; the Arthur Andersen's Houston branch started earning more and more in consulting business.

As a result, an internal conflict within the firm began to arise here. So, between auditing and consulting and there was a pressure to boost profit from auditing at the same time; because the competition is now mainly coming from the consulting department within the firm, that means this section is outperforming and there was a pressure on auditing department to boost their revenue.

So, the major clients of this Arthur Andersen were these companies, you know these are all well reputed, well-known companies. So, finally, Anderson was indicted in 2002 and the security exchange commission banned Arthur Anderson from auditing publicly traded firms afterwards.

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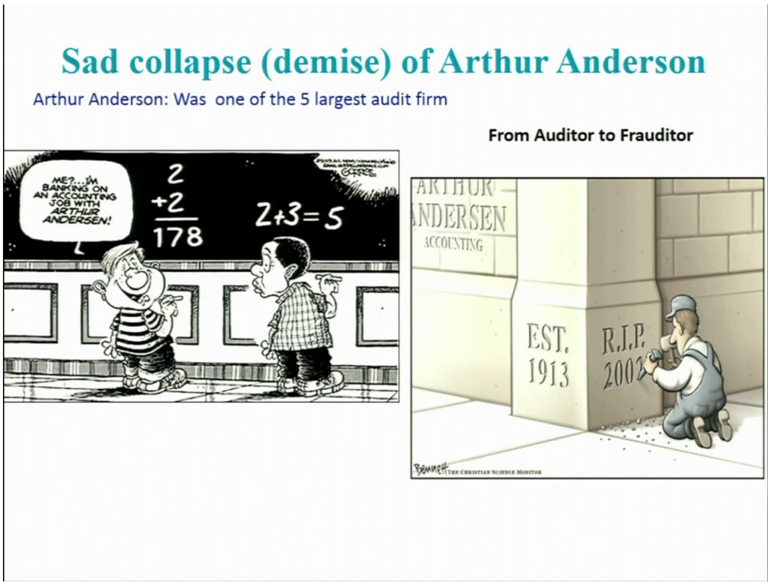

So, this is just a graphics I am just showing here, just to show that how they cheated because of the conflict of interest, how they contributed to the increase in information asymmetry and related problems in the financial sector.

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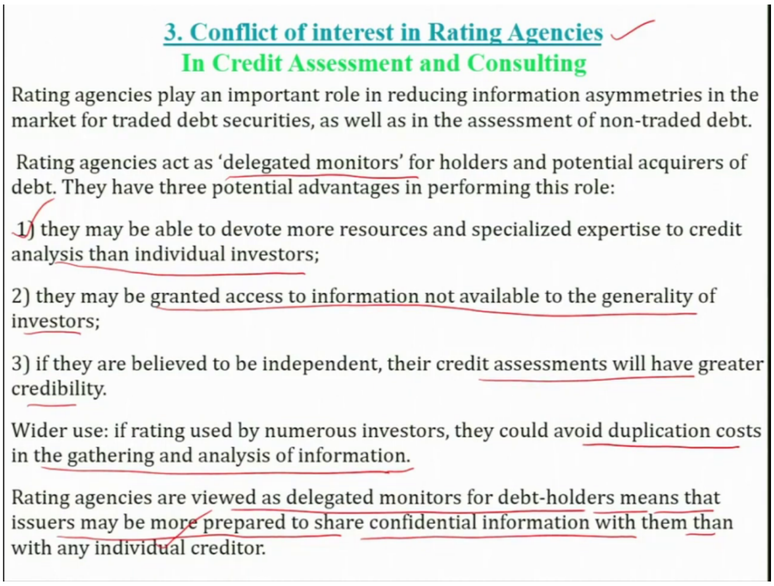

Let us now move to the 3rd area of conflict of interest. So, this area is conflict of interest in rating agencies, in credit assessment and consulting business. So, rating agencies play an important role in reducing information asymmetries in the market for traded debt securities, as well as in the assessment of non-traded debt.

So, these asymmetries arise, because potential purchases of debt instruments lacked information or the capacity to assess accurately the credit worthiness of issuers. The issuers are aware of the true characteristics of the securities they issue, that is what we said that the information asymmetry; that means the issues of the security, that is the firm who issue the security, they are aware of the true characteristics of the security that they issue, whether there is a scope for adverse selection, but are unwilling or unable to communicate this information credibly to potential lenders.

So, the rating agencies here act as delegated monitors for holders and potential acquires of debt. So, here they have three potential advantages in performing this role.

One is they may be able to devote more resources and specialized expertise to credit analysis than individual investors.

2nd one is they may be granted access to information, not available to the generality of investors.

And the 3rd one is that if they are believed to be independent, their credit assessments will have a greater credibility.

So, what we can see here is that because the rating agencies are used by numerous investors, you can see that they could avoid duplication cost in the gathering and analysis of information, right.

The rating is used by numerous investors. For example, many investors, be it individual or institutional, if they have been using this one; so they do not need to directly go and collect this information, because already specializing firm is there. So, they avoid duplication costs in gathering and analysis of information.

So, here the rating agencies assessment of credit worthiness has always been resource intensive right; to collect information about the economic fundamentals or project activities of a firm needs lots of resources to get the information about a firm and its credit instruments. So, here the fact is that rating agencies are viewed as delegated monitors for debt holders, which means that issuers may be more prepared to share confidential information with them than with any individual creditor.

So, in other words what we can see that, since the rating agencies are considered as a a delegator monitors for debt holders; the firm who is issuing for example bond or IPO, you know that they are willing to share a confidential information with this rating agency, because these are the rating agency who come and rate them, right. So, because of that you know that they will be willing to provide more and more confidential information as well with them. So, it will make the credit rating agencies having more informational advantage in the market.

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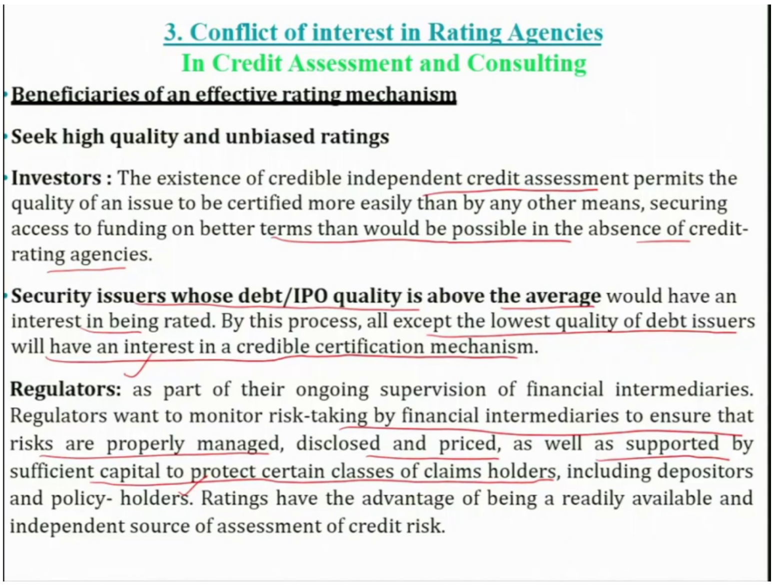

So, coming to the beneficiaries of an effective credit rating mechanism, you know that credit rating agencies have always been viewed as an important instrument in the hands of investors to help get their investment decisions. So, one of the beneficiaries of credit rating is the investors; because the existence of credible independent credit assessment permits quality, permits the quality of an issue to be certified more easily than by any other means.

So, securing access to funding on better terms would be impossible in the absence of credit rating agencies. Another group of stakeholders who will be benefiting out of this rating is that the security issuers whose debt, IPO quality is above the average; that means peach, not lemon.

They will be more interested in the credit rating agencies ratings; because for them they anticipate that their credit worthiness is communicated to the potential investors in a credible way through their rating score. So, they have huge incentive there. So, by this process, all, except the low quality of debt issuers, will have an interest in a credible certification mechanism.

The last one here, the third group of stakeholders who will be more interested is regulators; regulators means as part of their on-going supervision of financial intermediaries. Regulators want to monitor risk taking by financial intermediaries to ensure that risk are properly managed, disclosed and priced as well as supported by sufficient capital to protect certain classes of claims holders, including depositors and policyholders.

So, in this way, ratings have the advantage of being a readily available and independent source of assessment of the credit risk. And in the next session, we will continue this discussion and we will see what the potential sources of conflict of interest in rating industry are and see how it affects the efficient working of financial system.

Thank you.

Keywords: conflict of interest, auditing, consultancy, biased audit reports, Arthur Anderson, Enron scandal