Economics of Banking and Finance Markets
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Lecture - 27
Conflict of interest - III

Welcome to this session, let us continue our discussion about Conflict of Interest in Rating Agencies.

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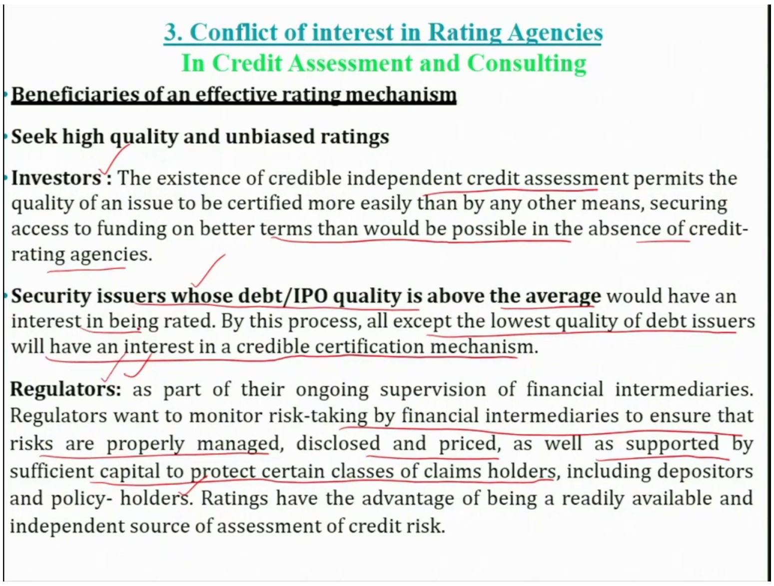

So, we have seen in the previous session that there are mainly 3 beneficiaries of an effective rating mechanism. One is investors, second is security issuers, and the third one is regulators.

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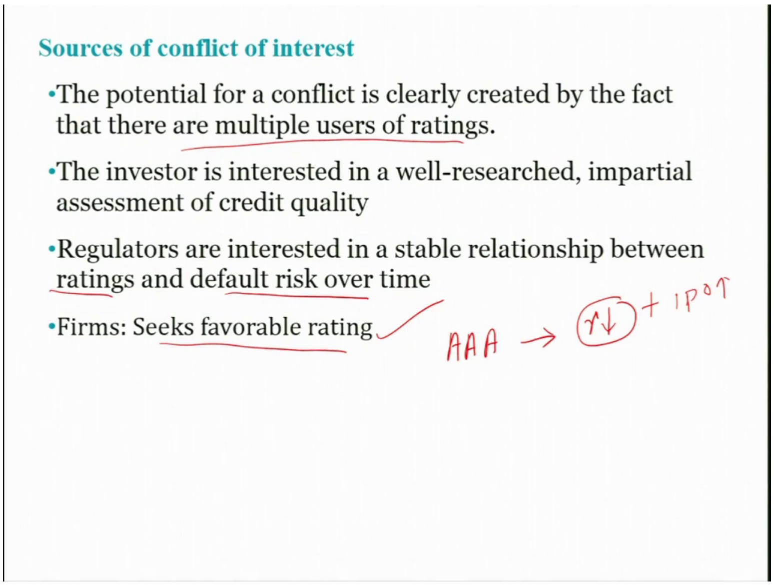

Let us examine what are the sources of conflict of interest for the rating agencies. The potential for a conflict is clearly created by the fact that there are multiple uses of ratings. That is foremost important source of reason by for the conflict of interest.

Then coming to the investors, you know that investor is interested in a well-researched impartial assessment of credit quality. So, you know that in the market because of information asymmetry, to distinguish between lemon and peach, you know that actually one of the main sources of information to do so is the credit rating, right.

The credit rating: that means, giving the rating for the company and their financial instruments. That is, an investor is interested in a well researched impartial assessment of credit quality. And coming to the regulators, regulators are interested in a stable relationship between the ratings and default risk over time. So, they want to see what the credit rating is received by a firm and its debt instruments. And then accordingly they also want to see that there is a high correlation between the ratings and the default risk over time.

So, that regulators if they see that, there is a robust relationship correlation between both, then they can ensure that the rating mechanism is more credible and impartial, right. And coming to firms, you know that firms obviously, they always seek favorable ratings.

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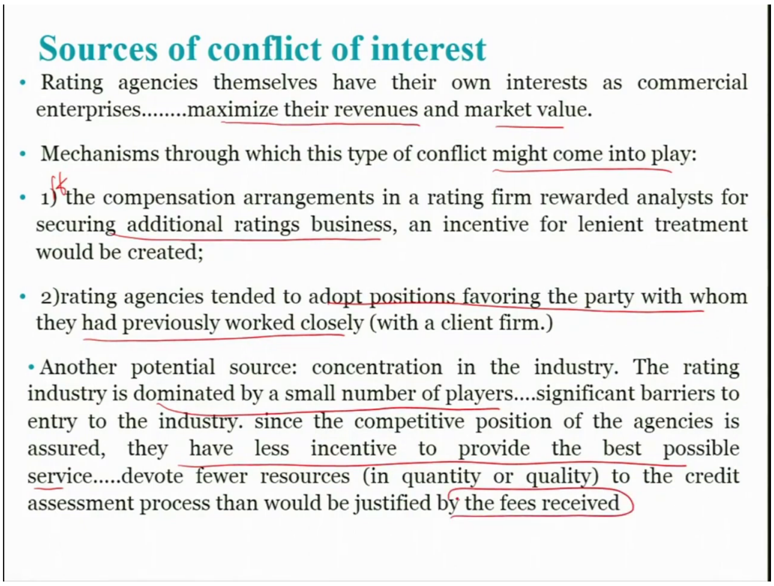

So, what is the advantage here? Favorable rating: obviously, you know that because of favorable ratings; that means, suppose somebody is getting triple A ratings, then you know that it will be considered as the prime rating, the high quality; that means, really a very low default risk.

That means, they will be able to borrow from the market at a low rate of interest, right. If they issue IPO, the unit price for the IPO also will be very high. So, in that way firms will be seeking favorable rating here.

Let us now elaborate the sources of conflict of interest. And because the rating agencies themselves have their own interest as commercial enterprises. So, they have their own interest as commercial enterprises. So, obviously, you know that they want to maximize their revenues and market value.

So, in this process they make best use of the advantage they are having, that the information advantage they are having in the markets. So, let us see the mechanism through which this type of conflict might come into play.

So, one is the compensation arrangements in ratings; rating firm reward analyst for securing additional rating business, an incentive for lenient treatment would be created. That means, if the compensation arrangements in a rating firm reward analyst for securing additional rating business, an incentive for lenient treatment would be created here.

And the second is that rating agencies tended to adopt positions favoring the party with whom they had previously worked closely. That means, with a client firm. So, that means, if they already work with the other firm, so they tend to adopt position favoring the party with whom they had previously worked closely. Because they are getting their business, right.

So, because when they are doing the rating, they are also getting the rating business for the future as well. So, since there is freedom that each firm can approach any of the rating agencies, as it is not necessary, they must stick to one rating agency. So, rating agencies to ensure to secure their business, and to retain their business, they always adopt a position favoring the party with whom they had worked closely.

Another potential source of vulnerability to conflict of interest could arise from the concentration in the industry. So, you know that the rating industry is a kind of oligopoly market; that means, dominated by a small number of players. So, because of that there is a significant barrier to entry to the industry.

Since the competitive position of the agencies is assured because there are only few players, they have less incentive to provide the best possible service. So, they devote fewer resources in quantity or in terms of quality to the credit assessment process than would be justified by the fees received.

So, that means, they will be looking more at the fee that they are getting. Maybe they will be spending a less resources, be it in quantity or in terms of quality for the credit assessment process.

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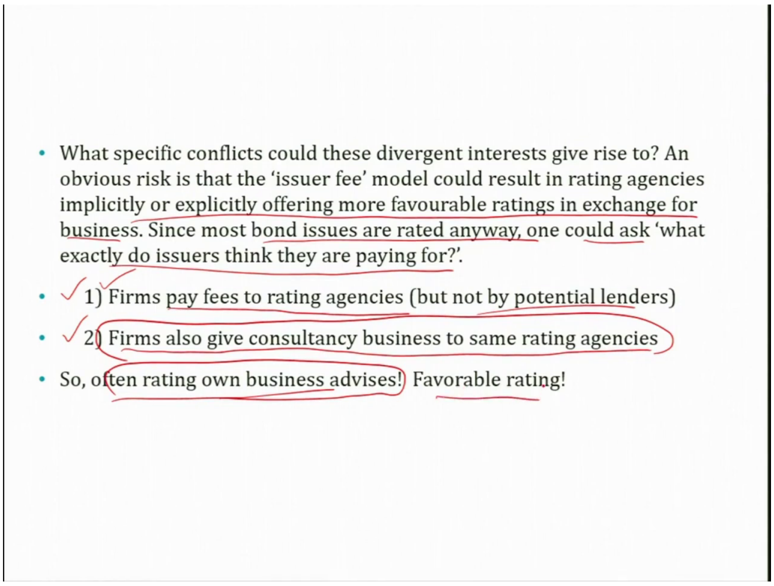

So, what specific conflict could this divergent interest give rise to? We can see here is that an obvious risk is that 'issuer fee' model could result in trading agencies implicitly or explicitly offering more favorable ratings in exchange for business. So, that means, suppose if you are the owner of the firm and you give me your rating business to me, I will be more lenient to you because the incentive mechanism.

And then I will be giving more favorable ratings, and obviously, you know that if I give you a favorable rating and in the coming years also, coming days also, you will be approaching me as your prospective rater, right. So, that means since most bond issues are rated anyway, one could ask what exactly issuers think they are paying for.

One more thing you need to remember here, we need to highlight here, that means, to do the ratings the firms pay fees to rating agencies.

Suppose for getting rated for a firm or is a debt instruments (Refer Time: 07:05) securities you can see that firms pay fees to rating agencies, but not by any potential lenders. And we suppose if you are buying a bond or if you are buying an IPO, you are not paying for the rating. It is the firms are paying, the issuer firm of the security pays fees to the rating agencies. This is one, one source of conflict.

Then another motivating factor is that in addition firms also give consultancy business to same rating agencies. They will be giving lots of consultancy's services, various to the firm for developing its financial product.

So, who is going to rate it finally? The same firm who gave advice, the same firm is going to do the rating as well. So, that means, rating, often rating own businesses. Obviously, you know that they will be giving favorable ratings.

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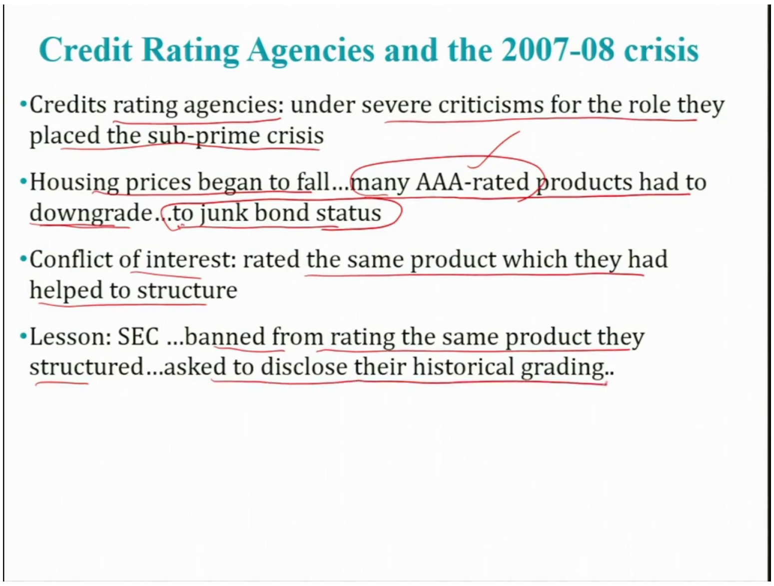

One more, we can see that this conflict of interest played a considerable role, major role in the 2007-08 crisis. You know the credit rating agencies in the 2007-08 crisis, they have been under severe criticism for the role they played in the subprime crisis.

And the rating given by the credit rating agencies was not impartial ratings. So, the when the housing prices begin to fall, many AAA rated products were downgraded. So, that means, AAA, AAA rated obviously, you know that low default risk with high-quality debt instrument, but once the 2007-08 crisis started, these products had to finally, get downgraded.

Many of these are bonds, many of these debt instrument who got high rating finally, they became speculative or junk bond, they got junk bond status, that is, speculative status. There what happened that because of the conflict of interest whatever we have discussed till now, you know because of the conflict of interest; one of the conflicts of interest is that because of all these they rated the same product which they had helped to structure.

So, the product they developed based on which it was developed, based on their advice, they rated the same product as well. So, because of that many of them got a high-quality rating, in real they did not deserve it, right. They did not deserve, but they got AAA or AA ratings. But at the end, we have seen that one had to finally downgrade to junk bond status.

So, what security exchange commission did as a solution, as a lesson from 2007-08 crisis, was that they banned from rating the same product they structured. And not only that they have been asked to disclose their historical grading as well.

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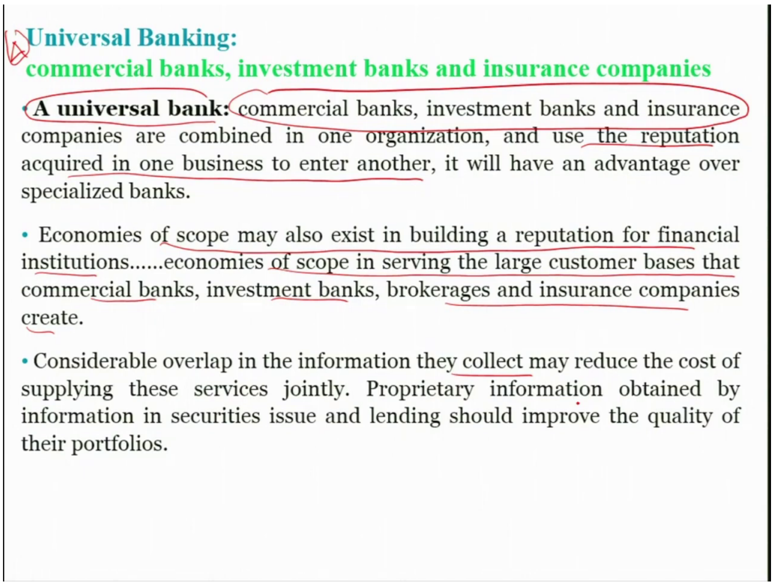

So, let us now move to another domain of conflict of interest, that is in universal banking. This is another area of conflict of interest in the financial sector. So, what is a universal banking means? A universal bank means here, universal banking means a firm doing all the businesses including commercial banks, investment banks, insurance companies. All are combined in one organization.

And use the reputation occurred in one business to enter another. And it will have an advantage over specialized banks. So, as compared to any specialized bank who is only doing commercial banking or only doing, for example, agriculture banking as compared to a universal bank will be combining all these activities together. And from this, they will be making use of the economics of scale and economic scope and maximizing their profit. However, this process involves conflict of interest.

So, the economies of scope may also exist in building a reputation for financial institutions. Economics of scope in serving the large customer bases that commercial banks, investment banks, brokerage, and insurance companies create. So, this considerable overlap in the information they collect may reduce the cost of supplying these services jointly, because of the economic scope.

So, proprietary information in securities issue and lending should improve the quality of their portfolio. So, universal banking also increases the point of contact, a bank has with a firm, expanding the number of services and improving information acquisition, and monitoring.

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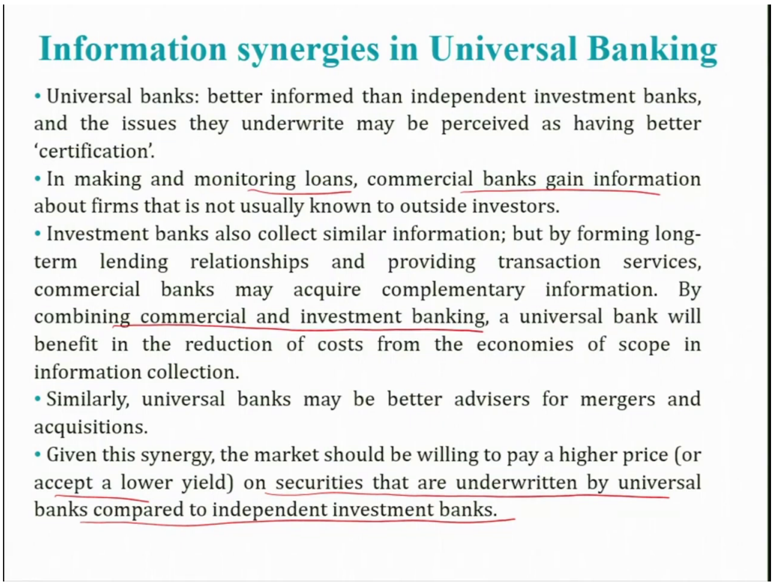

So, coming to the information synergies in universal banking, let us first discuss what are the information synergies that could happen in universal banking. Then, let us link these to the conflict of interest. So, the universal banks you know that they are better informed than independent investment banks. Similarly, universal banks may be better addresses for mergers and acquisitions. So, in making and monitoring of loans, for example, commercial banks gain information about firms that is not usually known to outside investors. That is one.

And investment bank also collects similar information, but by forming long-term lending relationships and providing transaction services, commercial banks may acquire complementary information as well. You know, by combining commercial and investment banking, a universal bank will benefit in the reduction of cost from the economics of scope in information collection.

Similarly, as I mentioned here before, universal banks may be better equipped for mergers and acquisitions. So, given this synergy the market should be willing to pay a higher price; that means, I accept a lower yield on their securities, on securities that are underwritten by universal banks compared to independent investment banks.

That is, the public, the investors, that means, the market would be willing to pay a higher price for that. Because they think that the securities underwritten by universal banks as compared to independent investment banks will be more credible because of the synergy, the information synergy they are having.

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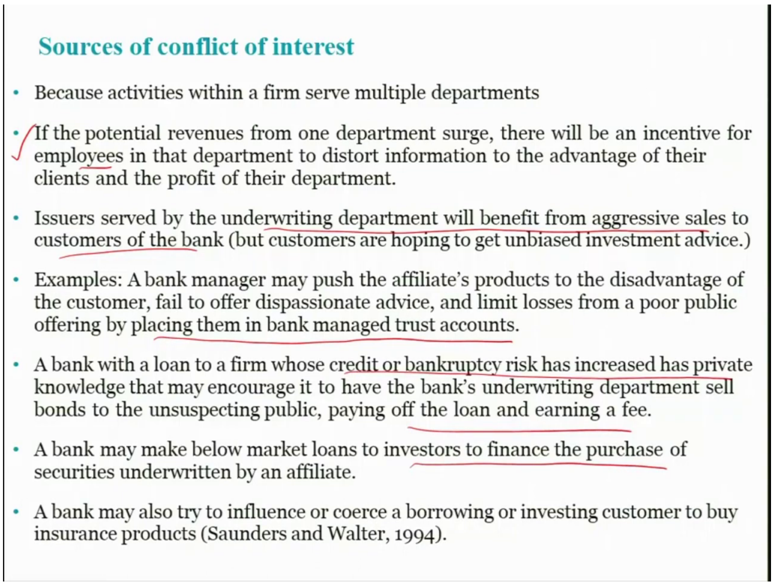

So, however, there are lots of sources of conflict of interest because of activities within a firm serve multiple departments. What we can see here is that if the potential revenues from one department will be an incentive for employees in that department to distort information to the advantage of their clients and the profit of their department.

And issues served by the underwriting department will benefit from aggressive sales to customers of the bank, but you know the customers are hoping to get unbiased investment advice here, right. But what is happening here is that the issuer is served by the underwriting department will benefit from aggressive sales to the customers of the bank.

So, let us take some examples for that. A bank manager may push the affiliates products to the disadvantage of the customer, fail to offer passionate advice and limit losses from a poor public offering by placing them in bank managed trust accounts. That is one.

A bank with a loan to a firm whose credit or bankruptcy risk has increased has private knowledge that may encourage it to how the bank's underwriting department sell bonds to the unsuspecting public, paying of the loan and earning a fee. So, that means, these are kind of key things, right. So, you can also see that bank may also make below market loans, may make below market loans to investors to finance the per case of securities underwritten by an affiliate.

A bank may also try to influence the borrowings or investing customers to buy insurance products as well because the universal banking who is having commercial, bank investment, banks insurance. You know that by commercial bank they are having access to lots of customers, the financial information of lots of customers.

And obviously, they will be knowing their financial activities through the bank. And similarly, underwriter as an investment bank that also make them lots of information and plus as an insurer. What they will do that information based on one business, they try to get the other business, and based on that they will be getting try to get the business in the other department.

So, all these things at the end, the objective of this firm is to maximize their profit, and the universal bank will engage in some manipulative activities because of this conflict of interest.

Let us see in what are the remedies that can be used to reduce this conflict of interest.

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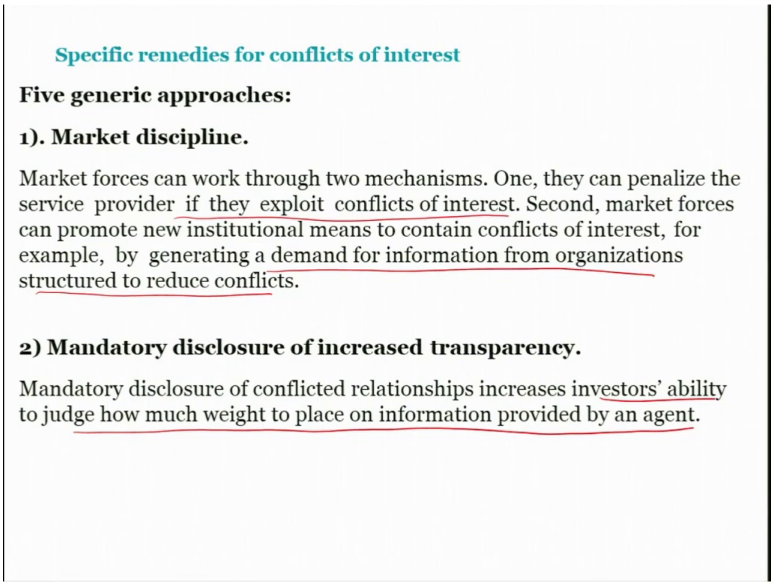

There have been 5 generic approaches, that are in fact more than that. Let us discuss the main 5 generic approaches.

One is market discipline. Market discipline means market forces can work through two mechanisms, one they can penalize the service provider if they exploit conflict of interest, the demand and supply forces. You know that somebody is giving manipulated information, obviously their reputation will be affected and finally, over time they will be out of the market, right. The market forces can promote new institutional means to contain conflict of interest. For example, by generating a demand for information from organization structure to reduce conflicts.

Second one is a mandatory disclosure for increased transparency. That means, you make it mandatory disclosure of conflicted relationship increases investor's ability to judge how much weight to place on information provided by an agent.

That means, if there is an investment banking if they are engaged in consultancy business, they also need to clearly disclose who are their clients, what kind of products they endorse, and make all this information in the public domain.

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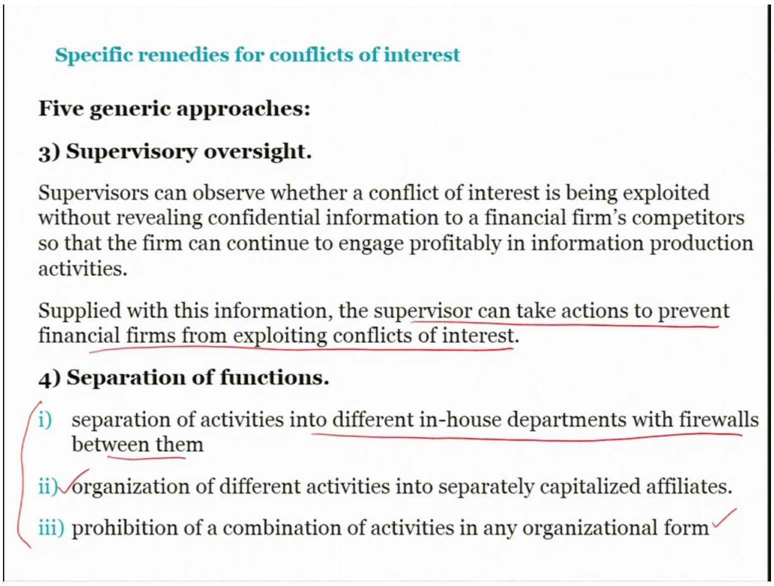

And third one is supervisory oversight; that means, firms can appoint, supervisors in their respective areas, so that supervisors can observe whether a conflict of interest is being exploited without revealing confidential information to a financial firm's competitors. So that the firm can continue to engage profitably in information production activities. So, supply with this information, the supervisors can take actions to prevent financial firm from exploiting conflicts of interest.

And the fourth one is separation of functions; that means, first, separation of function means separation of activities into different in-house departments with firewalls between them. Second is organization of different activities into separately capitalized affiliates. And third one is a prohibition of combination of activities into in any organizational form.

And however, though these are remedies at the same time we need to remember that separation of functions which also adversely affect the synergies in information collection, that is an opportunity cost anyway.

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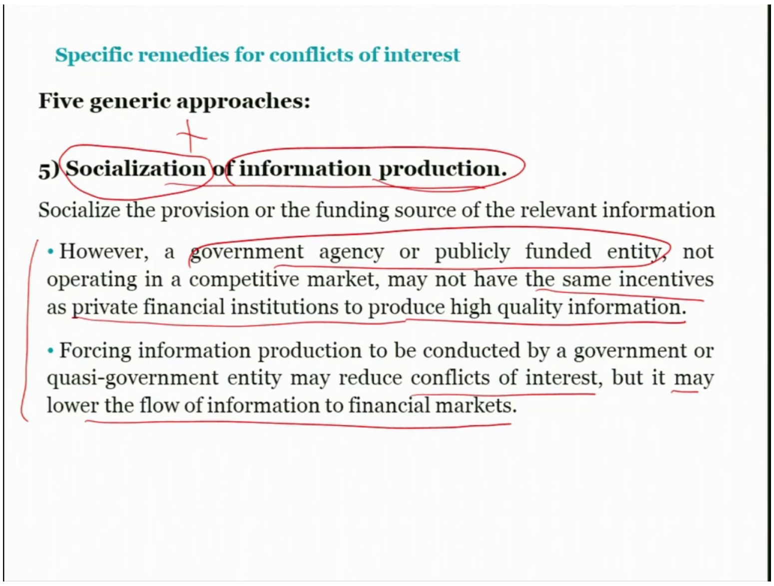

The last one is socialization of information production. Socialize the funding source of the relevant information. So, you know however, government agency or public funded entity not operating in a competitive market, may not have the same incentive as private financial institutions to produce high quality information.

So, socialization of information protection; that means, mandating a government agency or a public funded entity to collect information. That is one solution. However, we also need to remember that they may not have the same incentive to use as private financial institutions to produce a high-quality information.

Not only that, forcing information production to be conducted by a government or quasi government entity may reduce conflicts of interest, but it may lower the flow of information to financial markets. You know that sometime, on the one side you know that government agencies would not be that much insane device.

Second one, market, but that the firms may not be willing to share all this information to a credit rating, so into a public agency, government agency. So, all this would sometime affect the information production. So, though we recommend that socialization is one of the solutions, but at the same time socialization of information production has sometime has its own cons as well. That means, the flow of information to financial markets may not be that robust or sound enough. So, these are the 5 remedies that we just now discussed here.

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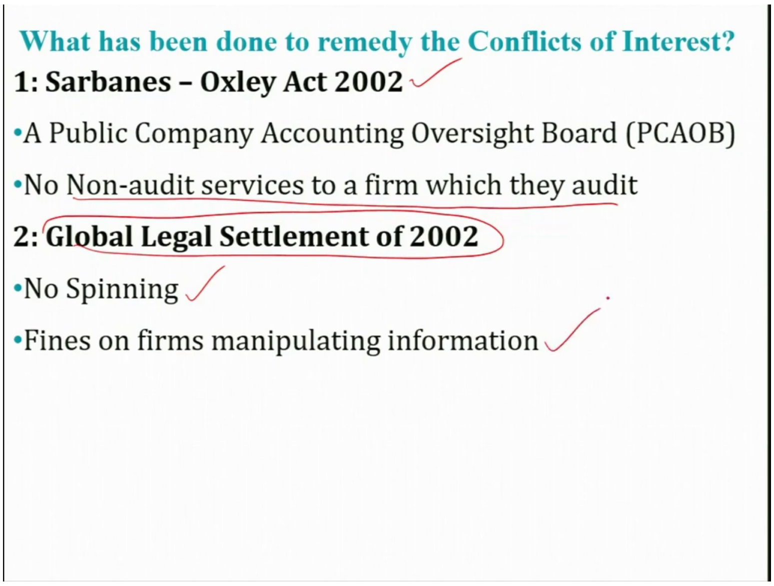

And there have been several policy initiatives to overcome this conflict of interest, especially from the US context you can see that this act in 2002, what the act mandated that a Public Company Accounting Oversight Board was set up, and it was also made that no non-audit services to a firm which they audit.

Then, the global legal settlement of 2002 here, no spinning was allowed. Spinning was banned. So, fines on firms manipulating information, that also agreed. This was such a global legal settlement by not only US government agencies, US agencies, but from other countries as well. So, they agreed for no (Refer Time: 22:55) spinning and fines on firms manipulating information.

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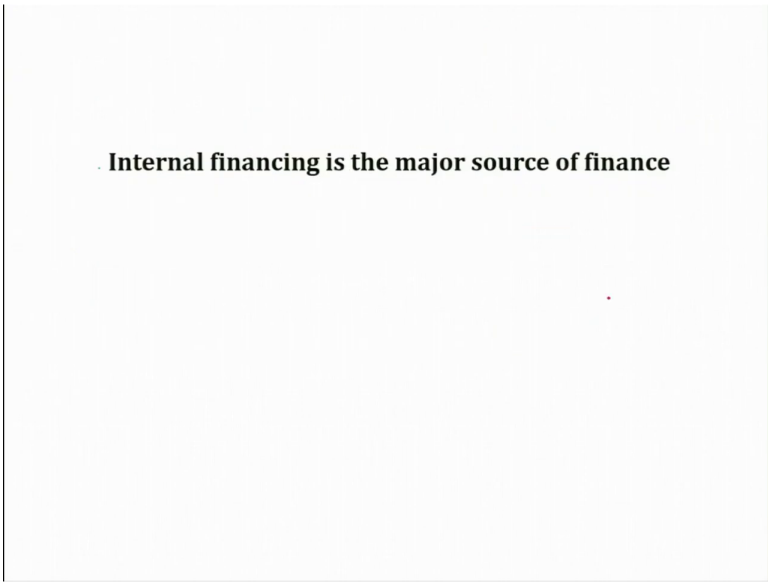

So, you know because of this conflict of interest what we have seen that the conflict of interest adversely affects the efficient working of financial market, the different areas. For instance, we have seen 4 main areas or where we can see the conflict of interest.

So, because of that, overall, what we can see that, the efficiency of the market will be distorted mainly because the asymmetric information which we expect that it will be reduced, but because of conflict of interest the asymmetric information increases in the market. And the efficiency of the market getting adversely get affected. And you know it would lead to adverse selection and moral hazard problem. And as a result, you know that, over time, that is one reason by internal financing is the major source of finance for many companies.

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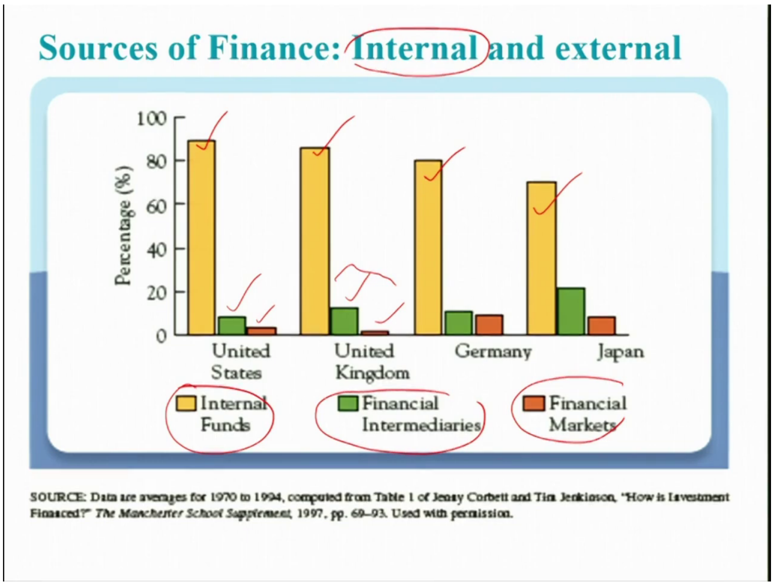

So, look at these 4 countries. What are the major sources of finance? So, you can see that internal finance, that internal finance is the major forces of finance for all these 4 countries. So, you look at for example, the US is nearly 85 percentage, more than 85 percentage and say almost similar for United Kingdom and Germany and Japan.

Then comes financial intermediaries. Second place goes to inter financial intermediaries. You know that financial intermediaries they can reduce information asymmetries. They can also reduce the transaction cost and because of the managerial and technical efficiency, they are having, they can reduce the transaction cost and they can also reduce the information asymmetry.

And as a result, the problem of adverse selection and moral hazard can be minimized. You can see that a (Refer Time: 25:01) share of company's finance is coming through internal finance.

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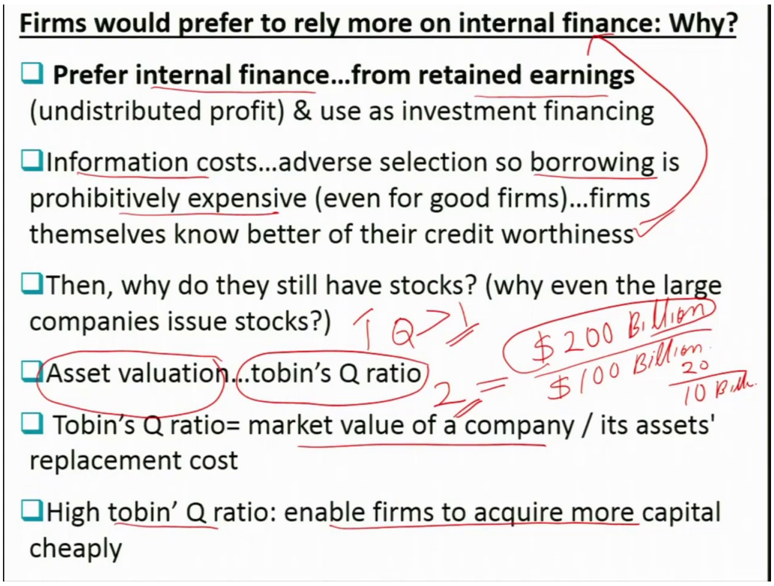

You know, why firms would prefer to rely more on internal finance? You know the one reason may be prefer internal finance from retained earnings because they prefer internal financing, mostly from their own retained earnings that the undistributed profit and use it as investment financing.

And why? Because the information cost you know that well-functioning, well performing company with a high rate of profit and very high net worth and with a strong balance sheet but you know that they're the credit worthiness or the efficiency of that firm may not be communicated to the market because of the information asymmetry and the conflict of interest that we discuss here.

And because of that, they may not be able to borrow at a cheap rate. That means, sometimes they also must pay high interest rate, if they want to borrow from the market because of the asymmetric information. So, because of this adverse selection, the borrowing is prohibitively expensive even for good quality firms.

So, firms themselves know better of their credit worthiness. So, what they will do that if some firms if they think that their credit worthiness is much better, that is, higher than the market average, they will prefer to go for internal finance because they know that it is expensive for them to borrow from the market.

Then, why do they still issue stocks? Even the large companies issue stocks. So, one of the reasons is that is asset valuation. So, the asset valuation, the public with the valuation, the market valuation of a company will happen through the stock price, right. Any company's net worth is calculated through the stock price, the stock value.

So, here one of the measures is Tobin's Q ratio, Tobin's Q ratio means the market value of a company divided by is asset replacement cost. Suppose the market value of a company, because the economic fundamentals are strong of a company, suppose is a good firm with a high profit. And then, suppose the market value of this firm for example, 200 billion suppose, suppose 200 billion is the market valuation of this firm.

But you know that to replace all these assets, suppose it is a factory in all these factories that in machines and all these premises, suppose the replacement cost of this factory is for example, 100 billion suppose. So, then you know that to replace all the equipments of this company, all these assets, machines, and tools, premises and all a complete replacement it needs only 100 billion.

But because of the future, because of the economic fundamentals of this company, expected profit as well and because of all these things, market is willing to value them 200 billion. So, here the Tobin's Q ratio is 2, right. That means, market is valuing more than its actual cost, the actual replacement cost. That means, is 2; that means, any Tobin's Q ratio, if it is greater than 1 itself, means next time they can raise more and more capital, right.

If they buy a new 10 billion machines and tools, so immediately you know that market will be valuing it for 20. Ahigh Tobin's Q ratio enables firms to acquire more capital cheaply.

What we discussed here in this session is that we discussed conflict of interest in 4 domains in the finance market. And then we said that this affects the efficient working of the finance market. And one of the reasons why firms rely on internal finance may be because of the conflict of interest and resulting distortion in markets.

Thank you.

Keywords: asymmetric information, universal banking, conflict of interest, information synergies, internal finance, Tobin's Q ratio