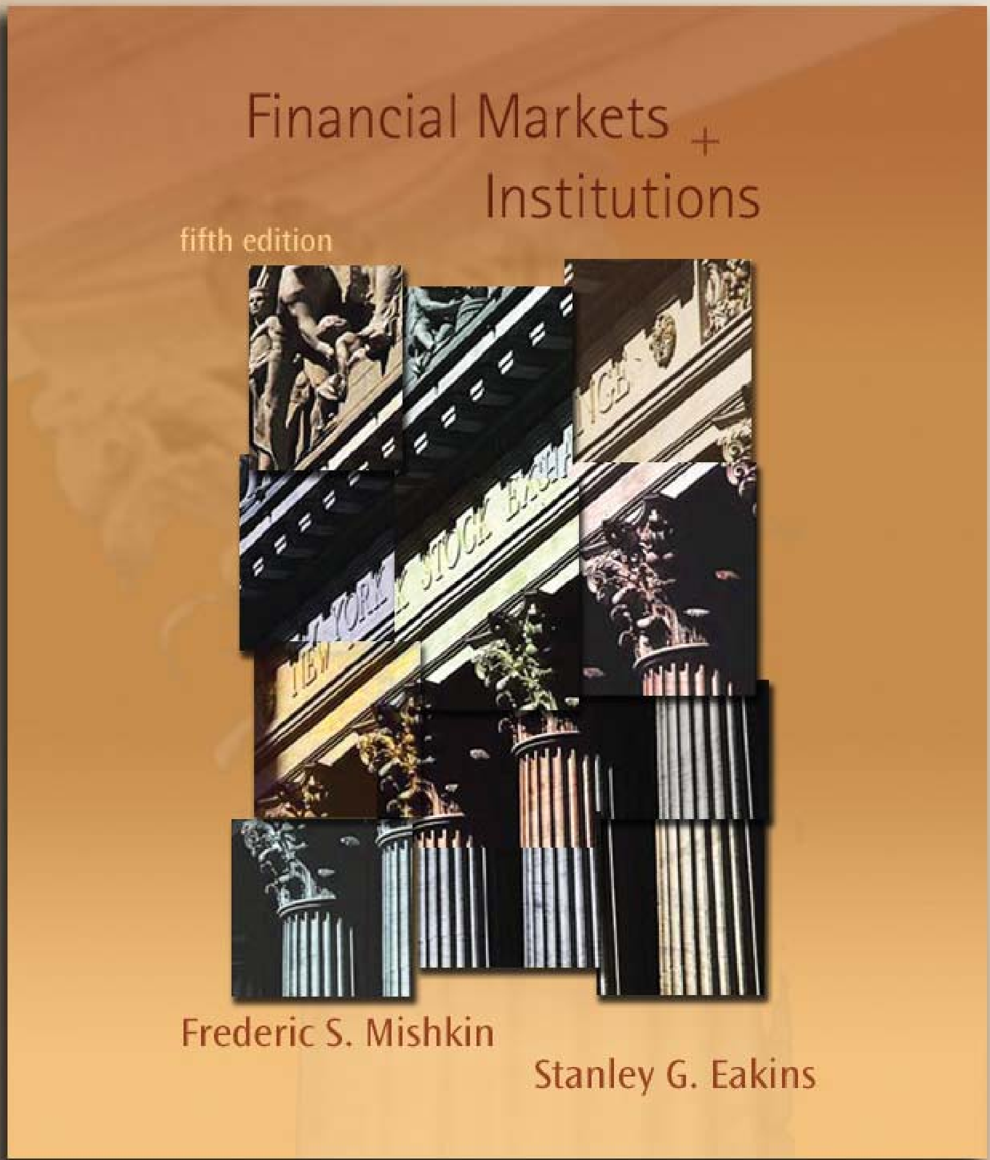


Class 7

Conflicts of interests and regulation

Conflicts of Interest

- Situation in which a party in a transaction can potentially gain by taking actions that adversely affect its counterparty
- FIs have better information than their clients
  - Incentives to provide false or misleading information
- FIs offer multiple services
  - These services compete, often at the expense of each other

Types of Conflicts of Interest

- Underwriting and research in investment banking
- Auditing and consulting in accounting firms
- Credit assessment and consulting in credit-rating agencies
- Universal banking
- Mutual funds
- Brokers

Underwriting and Research in Investment Banking

- Some investment banks both **underwrite** newly issued securities and provide **research** to investors. They have an incentive to withhold bad information (give *favorable* recommendation) about the issue to secure underwriting fees
  - Banks paid $15 bln to settle lawsuits related to Enron and WorldCom
  - Banks arranged structured finance deals designed to conceal huge losses of these firms

Underwriting and Research in Investment Banking

- IB has an incentive to underprice the IPO to make sure that the issue goes on
  - Same for M&A valuation if the fee depends on the eventual outcome of the deal
- **Spinning**: when underwriters of equity IPOs direct the new shares to their best clients. Since most IPOs are underpriced, these shares may be immediately sold for a profit.
- IBs often recommend to their clients more complicated (and expensive) products, without proper explanation of the associated risks

Auditing and Consulting in Accounting Firms

- Auditors should provide an unbiased view of the financial reports to reduce asymmetric information between the firm's management and investors.
- By also providing **management advisory services**, the auditor has an incentive to fudge the audit if the fees from other services are substantial.
- Auditors also have a conflict of interest since they are paid by the firm they audit.
  - If the auditor gives an unfavorable audit report, the auditor may lose the auditing business as well.
- E.g., Arthur Andersen's audit of Enron.

Credit Assessment and Consulting in Credit-Rating Agencies

- Bond investors rely on credit-rating agency assessment of firm's debt (debt ratings).
- However, ratings are only provided when the firm pays the agency. Agencies have an incentive provide "better" ratings to attract business.
- Rating agencies have also started providing firms with other services, and have the same conflicts as auditors.

Universal Banking

- Combination of commercial banking, investment banking, and insurance services
  – Glass-Steagall prohibited this in the U.S. as of 1933. However, in 1999, Congress repealed this act, allowing for some form of universal banks in the U.S.
- A bank can help a borrower to sell securities to repay its loan
- Bank managers may push investing products of its affiliates, even if they aren't in customer's best interest.

Mutual Funds

- Late trading:
  - Allowing trades after 4pm to trade at today's 4pm NAV instead of tomorrow's price
  - This is illegal under SEC regulations.
- Market timing:
  - Taking advantage of time zone differences for determination of NAV.
  - This is not illegal under SEC rulings.
- Allowing short-term trades to some clients
  - E.g., brokers (in exchange for a crate of wine)

Brokers

- Directed brokerage
  - A mutual fund directs trades to a broker, while he sells the fund's shares
- Pre-emptive trading
  - Brokers made own trades before executing their clients' orders
  - December 2004: 5 top NYSE market-makers paid $240 mln to settle

When Are Conflicts of Interest a Serious Problem?

- When they increase asymmetry of information
- However, *potential* conflicts do not always materialize:
  - Agencies' debt ratings are unbiased, despite being paid by the firms.
  - Many US banks in the 1920s spun-off their IB activities.
  - Investors "discount" recommendations made by the underwriter's analysts.
- When temporary rewards are high (e.g., in the late 1990s), "trusted" firms may extract **reputational rents** from investors by seeking short-term gains at the expense of their future reputation.

Remedies for the Conflicts of Interest

- Sarbanes-Oxley Act of 2002
  – Passed following the public outcry over corporate scandals
- Global Legal Settlement of 2002
  – Reached between the New York Attorney General and several large U.S. investment banks
- Tougher Regulation of Mutual Funds

Sarbanes-Oxley Act of 2002

- Establishing the Public Company Accounting Oversight Board to supervise accounting firms.
- Public accounting firms are prohibited from engaging in non-audit services to the clients under audit.
- Members of the board's audit committee must be independent. CEO and CFO must certify the reports.
- Material off-balance sheet activities must be reported.
- More resources for the SEC
- Increasing the charges for white-collar crimes and obstruction.

Global Legal Settlement of 2002

- Firms must severe the link between underwriting and research activities.
- Spinning is banned.
- Firms must make public analyst recommendations and target prices.
- Brokerage firms required to obtain third-party, independent research for their clients.
- $1.4 billion in fines.

Tougher Regulation of Mutual Funds

- Require more independent directors
- Hardening the 4pm valuation rule: this addresses the late trading problem, but not market timing.
- Additional fees for short-term redemptions to discourage market timing.
- Increased transparency
  - Operating practices, directors, investment managers, compensation arrangements with brokers

Approaches to Remedying Conflicts of Interest

- Leave It to the Market:
  - Rely on market forces, even though the market has a "short" memory for past problems
- Regulate for Transparency:
  - Regulate mandatory disclosure, even if it is more costly than the information provided.
- Supervisory Oversight:
  - Force firms to provide private information to a supervisor, who can act on it if necessary.

Approaches to Remedying Conflicts of Interest

- Separation of Functions:
  - Separate functions that create conflicts, either within firms or (in extreme cases) by not allowing those functions within the same firm.
- Socialization of Information Production:
  - Look to public funding for information providers, such as credit agencies.

Regulators in the US and Russia

- FRS / ЦБРФ
  - Bank regulation
    - In the US, also Office of the Comptroller of the Currency
  - Monetary policy
- FDIC / АСВ
  - Deposit insurance
- SEC / ФСФР
  - Securities operations

The Securities and Exchange Commission

- The primary mission is "…to protect investors and maintain the integrity of the securities markets"
  – Corporate Finance Division: collects, reviews, and makes available all documents filed by corporations and individuals
  – Market Regulation Division: establishes and maintains rules for orderly and efficient markets
  – Investment Management Division: oversees and regulates the investment management industry
  – Enforcement Division: investigates violations of the rules and regulations established by other divisions

Bank Regulation

- Deposit Insurance and the FDIC
- Restrictions on Asset Holdings and Bank Capital Requirements
- Bank Supervision: Chartering and Examination
- Assessment of Risk Management

Reason for Deposit Insurance

- Prior to FDIC insurance, bank failures meant depositors lost money, and had to wait until the bank was liquidated to receive anything.
  - This meant that "good" banks needed to separate themselves from "bad" banks.
- The inability of depositors to assess the quality of a bank's assets can lead to panics.
  - If depositors fear that some banks may fail, their best policy is to withdraw all deposits, leading to a bank run, even for "good" banks.
- Major panics in the US: 1819, 1837, 1857, 1873, 1884, 1907, and 1930-1933.

How Deposit Insurance Works

- With a safety net, depositors will not flee the banking system at the first sign of trouble.
  - Indeed, between 1934 and 1981, fewer than 15 banks failed each year.
- The FDIC handles failed banks in one of two ways:
  - The **payoff method**: the bank is permitted to fail
  - The **purchase and assumption method**: the failed bank is folded into another bank
- Implicit insurance is available in some countries where no explicit insurance organization exists.

Problems Created by Deposit Insurance

- **Moral hazard** incentives for banks to take on greater risk than they otherwise would because of the lack of "market discipline" by depositors
- "**Too Big to Fail**" issue:
  - – Regulators are reluctant to let the largest banks fail because of the potential impact on the entire system
  - – 1984: bail out of Continental Illinois Bank, one of the largest US banks. FDIC recovered $1.1 bln of the $2.8 bln troubled loans it bought from CIB

Restrictions on Asset Holdings and Bank Capital Requirements

- Limit on the type of assets banks may hold as assets.
  - E.g., banks may not hold common equity.
- Capital requirements: banks are required to hold a certain level of capital (book equity) that depends on the type of assets that the bank holds.
  - **Leverage ratio** must exceed 5% to avoid restrictions
  - Capital must exceed 8% of the banks **risk-weighted assets and off-balance sheet activities**
  - Basel Accords: advanced method of risk measurement

Bank Supervision: Chartering and Examination

- Reduces the adverse selection problem of banks to engage in highly speculative activities.
  - Charters may simply not be granted.
- Examinations assign a CAMEL rating to a bank, which can be used to justify *cease and desist orders* for risky activities.
- Period reporting (call reports) and frequent (sometimes unannounced) examinations allow regulators to address risky / questionable practices in a prompt fashion.

Assessment of Risk Management

- Past examinations focused primarily on the quality of assets. A new trend has been to focus on whether the bank may take excessive risk in the near future.
- Four elements of risk management and control:
  - Quality of board and senior management oversight
  - Adequacy of policies limiting risk activity
  - Quality of risk measurement and monitoring
  - Adequacy of internal controls to prevent fraud

Other Regulations

- Disclosure Requirements
  - Better information reduces both moral hazard and adverse selection problems
- Restrictions on Competition
  - McFadden, 1927: interstate branching restrictions
  - Glass-Steagall, 1933: separation of banking and securities industries

TABLE 1 *Major Banking Legislation in the United States in the Twentieth Century*

Federal Reserve Act (1913)
Created the Federal Reserve System

McFadden Act of 1927
Put national and state banks on equal footing regarding branching
Effectively prohibited banks from branching across state lines

Banking Acts of 1933 (Glass-Steagall) and 1935
Created the FDIC
Separated commercial banking from the securities industry
Prohibited interest on checkable deposits and restricted such deposits to commercial banks
Put interest-rate ceilings on other deposits

Bank Holding Company Act (1956) and Douglas Amendment (1970)
Clarified the status of bank holding companies (BHCs)
Gave the Federal Reserve regulatory responsibility for BHCs

Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980
Gave thrift institutions wider latitude in activities
Approved NOW and ATS accounts nationwide
Phased out interest-rate ceilings on deposits
Imposed uniform reserve requirements on depository institutions
Eliminated usury ceilings on loans
Increased deposit insurance to $100,000 per account

Depository Institutions Act of 1982 (Garn-St Germain)
Gave the FDIC and the FSLIC emergency powers to merge banks and thrifts across state lines
Allowed depository institutions to offer money market deposit accounts (MMDAs)
Granted thrifts wider latitude in commercial and consumer lending

Competitive Equality in Banking Act (CEBA) of 1987
Provided $10.8 billion to the FSLIC
Made provisions for regulatory forbearance in depressed areas

Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989
Provided funds to resolve S&L failures
Eliminated the FSLIC and the Federal Home Loan Bank Board
Created the Office of Thrift Supervision to regulate thrifts
Created the Resolution Trust Corporation to resolve insolvent thrifts
Raised deposit insurance premiums
Reimposed restrictions on S&L activities

Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991
Recapitalized the FDIC
Limited brokered deposits and the too-big-to-fail policy
Set provisions for prompt corrective action
Instructed the FDIC to establish risk-based premiums
Increased examinations, capital requirements, and reporting requirements
Included the Foreign Bank Supervision Enhancement Act (FBSEA), which strengthened the Fed's authority to supervise foreign banks

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994
Overturned prohibition of interstate banking
Allowed branching across state lines

Gramm-Leach-Bliley Financial Services Modernization Act of 1999
Repeals Glass-Steagall separation of the banking and securities industry
Allows security firms and insurance companies to purchase banks
Allows banks to underwrite securities and insurance and engage in real estate activities

TABLE 2 ***The Cost of Rescuing Banks in Several Countries***

Date	Country	Cost as a Percentage of GDP
1980–1982	Argentina	55
1997–	Indonesia	50–55
1981–1983	Chile	41
1997–	Thailand	33
1997–	South Korea	27
1997–	Malaysia	21
1994–ongoing	Venezuela	20+
1995	Mexico	20
1990's	Japan	12+
1989–ongoing	Czech Republic	12+
1991–1994	Finland	11
1991–1995	Hungary	10
1994–1995	Brazil	5–10
1987–1993	Norway	8
1998	Russia	5–7
1991–1994	Sweden	4
1984–1991	United States	3

Source: Gerard Caprio Jr. and Daniela Klingbiel, "Episodes of Systemic and Borderline Financial Crises" mimeograph, World Bank, October 1999.

Mini-case: Bank Runs in Russia

- The Bank of Russia revoked the banking license from Sodbiznesbank, threatened several other banks including Guta-bank
- Guta-bank:
  - June 2004: depositors withdrew R10 bln, more than 1/3 of its liabilities
  - July 6: stopped the payments
  - July 19: bought for R1mln by Vneshtorgbank, which received $700 mln from the Bank of Russia

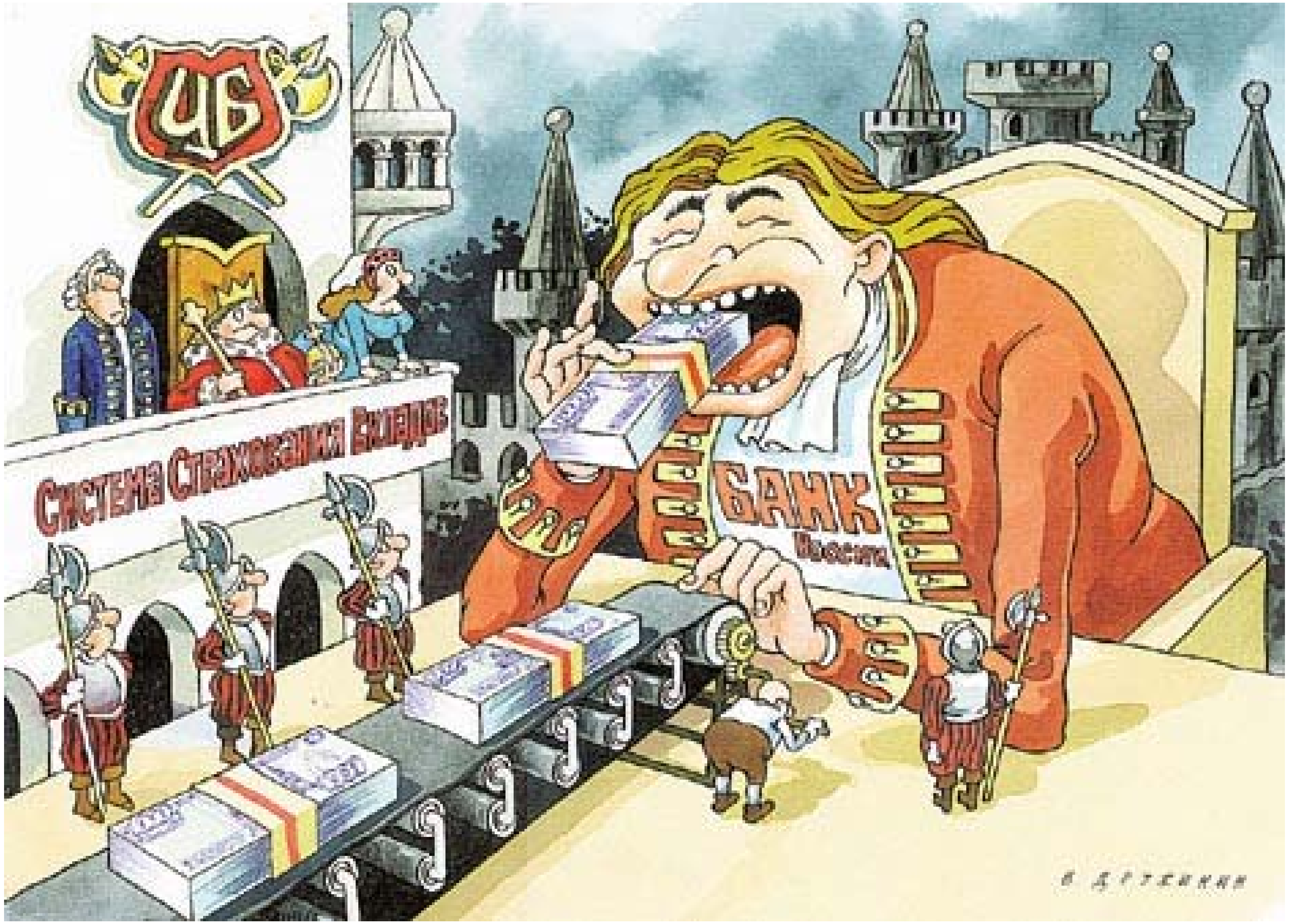
Mini-case: Bank Runs in Russia

- Alfa-bank:
  - The first week of June: depositors withdrew \$200 mln
  - July 8: the bank introduced 10% commission for the premature redemption (removed in July 19)
  - The owners provided \$700 mln support
- The consequences of the banking crisis
  - Winners: state and foreign banks
  - Losers: major private retail banks

Mini-case: Bank Runs in Russia

- The anti-crisis measures by the Bank of Russia
  - Reduced the reserve requirements from 7% to 3.5%
  - $700 mln loan for state-owned Vneshtorgbank
  - Deposit insurance up to 100,000 rubles
    - For most of the banks

Deposit insurance



Decline in Traditional Banking in the US

- Tough regulation
  - Deposit rate ceilings
  - Branching restrictions (across the states)
- Money market mutual funds
- Competition from foreign banks
- Development of securities markets

Latest Developments in Banking

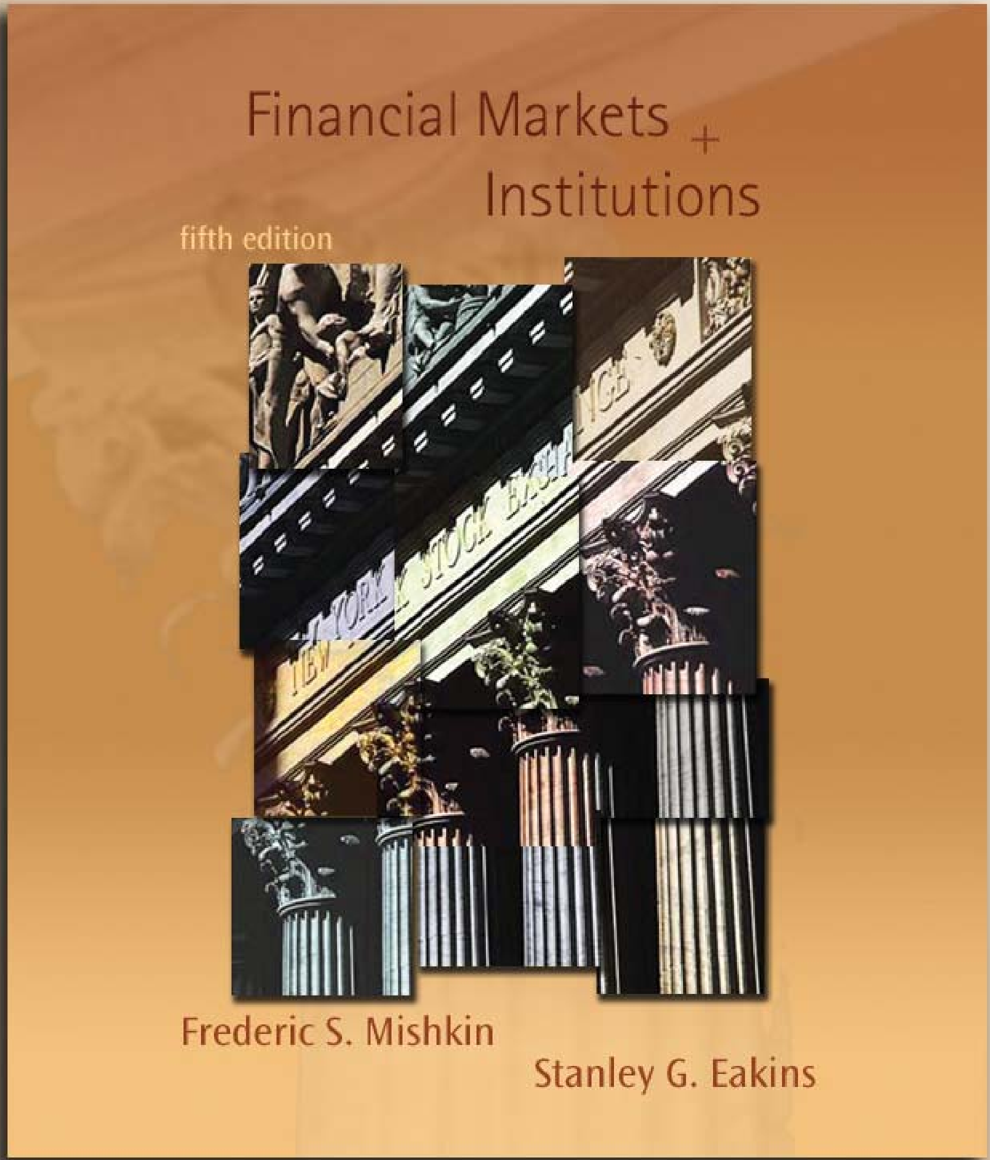
- Expand lending into riskier areas (e.g., real estate)
- Expand into off-balance sheet activities
  - Creates problems for U.S. regulatory system
- Bank consolidation and globalization

Do Banks Have a Future?

- Only the largest firms have access to bond markets
  - Tough information requirements
- Large companies rely on syndicated bank loans to finance large projects
  - Info requirement / greater control
- Banks are well-suited for the transfer of the control from shareholders
  - Banks restructure and recapitalize firms in financial distress
- Banks provide sophisticated financial products

Is More Competition Always Good?

- Recent trends in banking:
  - EU: integration and cross-country competition
  - USA: lifting restrictions on universal banking
  - Russia: allowing entry of foreign banks?
- Intensified competition in banking regarded with suspicion:
  - Lower rents => excessive risk taking and failures
  - Higher systemic risks



Class 7

Trends and perspectives

Financial Innovations

- Innovation is the result of search for profits
- Response to Changes in Demand Conditions
  - Major change: higher interest-rate volatility from 1960s
  - Banks also started using derivates to hedge risk
- Response to Changes in Supply Conditions: mostly due to improvement in IT
  - Increases ability to collect information
  - Lowers transactions costs

Examples of Financial Innovations

- Credit and Debit Cards
  - Many store credit cards existed long before WWII.
  - Improved technology in the late 1960s reduced transaction costs making nationwide credit card programs profitable.
  - The success of credit cards led to the development of debit cards for direct access to checkable funds.

Examples of Financial Innovations

- Electronic Banking
  - Automatic Teller Machines (ATMs) were the first innovation on this front. Today, over 250,000 ATMs service the U.S. alone.
  - Automated Banking Machines combine ATMs, the internet, and telephone technology to provide "complete" service.
  - Virtual banks now exist where access is only possible via the internet.

Examples of Financial Innovations

- Electronic Payments
  - Technology has made electronic payments of bills more cost-effective than paper checks or money.
  - The U.S. is still far behind some European countries in the use of this technology.
- E-Money
  - Electronic money only exists in electronic form. It is accessed via a stored-value card or a smart card.
  - E-cash is an account on the internet used to make purchases.

Examples of Financial Innovations

- Securitization
  - Transformation of illiquid assets into marketable capital market instruments.
  - Almost any type of private debt: home mortgages, credit card debt, student loans, car loans, etc.
- Structured products
  - Synthetic instruments created to meet specific needs
  - Often, a pre-packaged investment strategy based on derivatives, which features protection of principal if held to maturity

New Financial Order (by Robert Shiller)

- Insurance to cover long-term economic risks
  - Livelihood / home equity insurance
- Macro markets
  - For long-term claims on national / industry / real estate incomes
- Income-linked loans
  - Like selling shares in future income

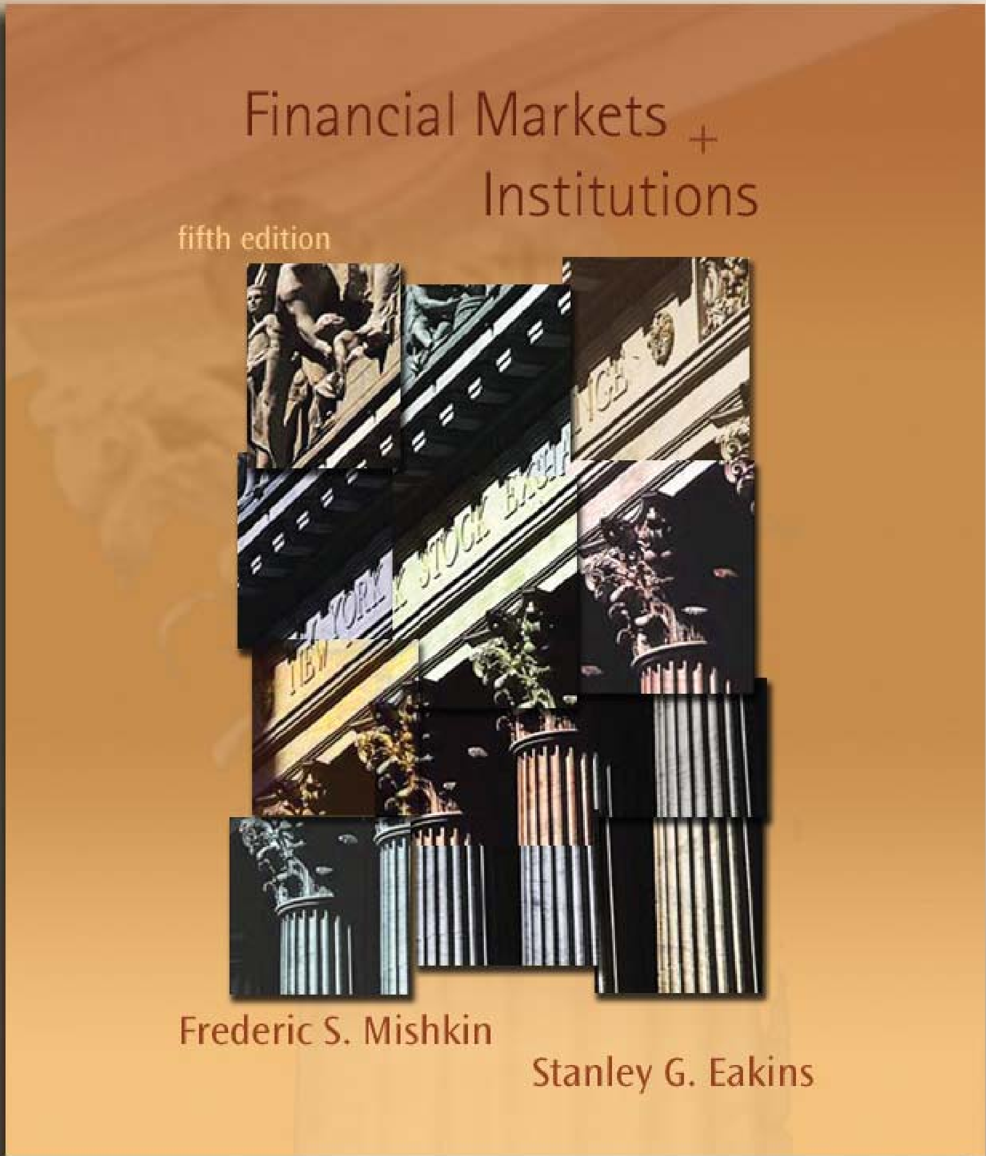
New Financial Order (by Robert Shiller)

- Inequality insurance
  – Reframing the progressive income tax structure to fix the amount of inequality
- Intergenerational social security
  – A social insurance system sharing risks across generations
- International agreements
  – Spreading the risks across the nations

New Financial Order (by Robert Shiller)

New information infrastructure:

- GRIDs: global risk information databases
  - Detailed and precise information for the risk management
- Indexed units of account
  - New units of measurement and e-money for better negotiating risks



Discussion topic

What is the most promising segment of the Russian financial market?