BUILDING TRUST IN INVESTMENT BANKS

WHAT ARE THE ISSUES?

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In a widely reviewed recent book, Phillip Augur group managing director of Schroeder’s has called investment bankers ‘greed merchants’ and argued that the integrated investment banking model is inherently flawed since it seeks “an irreconcilable reconciliation between a plethora of inbuilt conflicts of interest”. (2005, p10).

These conflicts of interests arise from the role of the investment bank as advisor to both buyer and seller in a single financial transaction. Augur argues also that this combination of execution and advice functions creates immense market power enabling investment banks to manipulate the market to serve their own interests. In the post Sarbene-Oxley world regulatory measures have not been developed to address these basic flaws of the integrated investment banking model.

In capital market operations the same investment bank advises the issuer and arranges distribution of stock through its brokerage subsidiaries. Investment banks thus have the potential to effectively run a new issues cartel. This capability leads to an unjustifiable increase in the cost of new issues—surely a matter which ought to be of serious concern in Pakistan, where new issues have been scarce. Investment banks have also been accused of encouraging take over and merger activity as a means for increasing their own profits. It has been SBP policy under Ishrat Hussain to encourage financial sector concentration of assets but there is no evidence that this has yielded any benefit to the smaller investor or deposit holder in Pakistan (Meenai and Ansari 2004. Chap 11).

Analysts of deals in mature financial markets have often complained of rip offs in fund management transactions and of exorbitantly high profits charged by investment banks on structured derivatives.

Many analysts (for example Bodie and Merton 2001) have accused investment banks of lacking an ethical framework. This amounts to the charge that the allocation of investment funds as mediated through investment banks does not lead to an optimally efficient utilization of society’s total resources—i.e to a maximization of aggregate profit / well being. However, achieving an optimum allocation of financial resources is in the long run interest of the investment banks themselves. It is therefore rational for investment banks to use their considerable regenerative and innovative capabilities for identifying synergies between their strategies for profit maximization and strategies crafted by national policy makers for realizing the full economic potential of Pakistan. Authors such as Augur believe that the function of originator and distributor of funds must be separated—investment banks must not be allowed to own brokerage subsidiaries—if this is to be achieved.

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Taking account of national objectives in developing corporate strategies is supposed to have gone out of fashion. Are we not living in the era of globalized capitalism where the nation state is supposed to be withering away and national policy is becoming a matter of accepting the wishes of the dominant players in world financial and commodities markets and accepting the dominance of regulatory regimes designed by the international bureaucrats of the WTO, the IMF, the BIS and the EU.

The overwhelming rejection by the French and Dutch electorate of the European constitution has exposed the fictitious character of this myth. The continuing victories of the mujahideen in Iraq and Afghanistan and America’s inability to create stable client regimes in these countries also illustrates the continuing salience of national power. Liberal democratic order—global or national—cannot be produced or sustained anywhere in the Muslim and as Fareed Zakaria foresaw (2003) free and fair elections will produce anti-imperialist Islamic governments from Morocco to Indonesia—as they have done in Iran in 2005 through the triumph of the Ulema of Islam. Globalization is an American project in the specific sense that ultimately it is American coercive force and American coercive force alone, which guarantees the dominance of global market and state governance processes. But America is a power in decline—its share of global GDP measured in purchasing power parity terms has fallen from over 50 percent at the end of the Second World War to less than 22 percent today. (WDR 2005 Appendix Tables). During the previous decade America’s trend rate of growth has been half that of China and American factor productivity growth has stagnated. The burgeoning budget and current account deficits and a rapidly aging populations are making global hegemonic projects—such as seeking regime change in Iran, North Korea, Venezuela, Cuba and Zimbabwe—increasingly unviable. American client states in Europe and North Asia are facing serious economic stagnation and decline and are in no position to bolster American global hegemony.

Global financial order is also threatened by intensifying rivalry between America and China. The Chinese Communist Party remains in effective control of the Chinese economy and society and the American ‘split China’ strategy, initiated in the Thiamin riots of 1989 has collapsed. China has shown how protection of domestic markets and industries can be maintained while formal compliance with the global liberal regulatory regime is instituted. America has failed to dismantle the Chinese foreign exchange regime and its momentary policy. By imposing quotas on textiles America has initiated a trade war against China. which threatens to escalate. If the Communist Party has to remain in command China has no option but to challenge American systemic hegemony and its associated global public order.

It is therefore unwise for investment bankers to ignore national interests and to accept American hegemony and the dominance of global market players as natural and eternal. In 2005 global financial order faces several serious threats. Growth rates have been scaled down in every major capitalist country. Unemployment has risen Asset distributional inequity is reaching unprecedently high levels and stagflation is re-emerging as a serious policy concern.

Furthermore, the expectation that self regulation can replace state regulation as a modus vivendi for ensuring financial market stability is being questioned. Alan Greenspan has warned that rapid growth of credit derivatives has created considerable uncertainty about how financial markets may react to economic shocks (FT 6/5/2005). The complexity of derivatives transactions and the monopolization of financial markets has made risk assessment more and more difficult for both regulators and participants. This is paradoxical since derivatives are supposed to spread risk among multiple investors and thus
increase the resilience of the banking system. The woeful inadequacy of the existing international regulatory regime to prevent or mitigate crises has been emphasized by Greenspan who has frequently acknowledged that the Federal Reserve simply does not know the size of the global financial market, the degree of leverage of key players within it or the balance of risk sharing between investors. The regulatory regime cannot address risk management issues raised by the explosive growth of the collateralized debt obligation (CDO) industry. The US regulatory regime measures CDO transactions in terms of their book value and not their risk but a 2005 Morgan Stanley study has shown that during 2003-2004 the book value of CDO transactions represented only about 40 percent of their risk adjusted value Greenspan warns that “understanding the credit risk profile of CDO tranches poses challenges to even the most sophisticated market participant” (FT 6/5/2005). CDOs are seen as having created a false sense of security among investors. They have the potential to act as mechanisms for crisis transmission—investment banks, insurance companies, hedge funds and pension funds have large CDO holdings—and the regulatory regime is not equipped to deal with such a situation. This is becoming an increasingly important concern as interest rates rise in the mature capitalist economies and tighter monetary policy is used to deal with the impending threat of stagflation.

CDO growth since the mid 1990s has been fuelled by the erosion of margins in many of the traditional avenues of investment bank operations—such as bond underwriting—and the search for higher yields. Higher yield requirements have led investment banks to create ever more complex products whose risk profile cannot easily be assessed and the dizzying rate of product innovation since 2002 complicates regulation and risk assessment enormously. Instances of sponsor seller deception have occurred. Thus in February 2005 Barclays Capital (an investment bank) had to accept an out of court settlement with a German regional bank which claimed that Barclays had miss sold CDO tranches Bank of America faces similar charges from an Italian bank (FT 17/4/5). Similar cases of deception are likely to become more common and the riskiest CDO tranches are carried by investment banks and hedge funds.

The proliferation of hedge funds is another source of worry. They are highly opaque, highly leveraged and have the potential to rush out of the market at a moment’s notice. Greenspan sees them “as subject to considerable funding pressure” in 2005 (FT 8/5/5) and increasingly risky. Once again this is paradoxical for hedge funds are supposed to hedge against risk and to correct stock market distortions. The opacity of their operations arises from “their fiduciary obligation to investors. If a short position became public this could undermine the reason for making it “says a leading hedge fund CEO. (Moley 2005): This necessary transactional secretiveness has created market jitters over their potential exposure as returns have fallen from conventional strategies such as convertible arbitrages in 2004 and 2005. An increase in the riskiness of hedge funds investment portfolio is a major worry for they regularly account from a quarter to a third of equity traded in the New York Stock Exchange. Since 2002 hedge funds have become one of the biggest and most profitable customers for investment banks. No effective regulatory mechanism exists to ensure that hedge funds do not take on “excessive” risk and exposure. American and global regulators expect investment banks to ensure that hedge fund risk exposure is not excessive. Concern with lapses on hedge funds regulation date from the collapse of Long Term Capital Management (LTCM) in 1998. Huge hedge fund losses have been recorded in the US, Germany, The Netherlands and Singapore in 2005.

Hedge funds have been accused of “short termism” and transactional opacity. In 2005 many hedge funds suffered losses because they were taking huge risks by buying risky CDO tranches and selling short less risky ones and buying corporate debt while selling the equity of the same company short. These trading strategies were seriously hurt earlier
this year when Standard and Poor downgraded GM and Ford stock to junk status. This shows that many hedge funds do not adopt strategies for correcting market distortions. Quite the contrary they are momentum traders—“herders” following market trends creating mini bubbles and accentuating market distortions.

Enhanced riskiness of financial markets has been an unintended consequence of the growth of instruments such as CDOs and hedge funds specifically designed to diversify risk. This illustrates that capitalist markets cannot regulate themselves—that belief in the optimality of corporate self regulation is belief in not only a false but also a dangerous myth. This realization has induced even countries such as South Korea, which want to become a regional financial hub to tighten up the foreign investment regulatory regime. In April 2005 seven American private equity funds were being investigate for alleged tax fraud. New policy guidelines have been developed to regulate take over and mergers in South Korea. More stringent requirements for disclosure of source of funds by foreign investors have been enacted and tighter control of portfolio investment is also envisaged (FT 7/5/2005).

As global credit markets tighten, global equity markets brace for interest rate shocks, metropolitan country growth rates plummet (as recently forecast by such leading analysts as Merrill Lynch, Jordine Fleming, Goldman Sachs, the IMF and the OECD) conflict between China and the US intensifies and America prepares for abandoning its allies in Asia, investment banks need to turn inwards and take national interests seriously. All banks are by definition public institutions—share holder’s equity is of necessity a small fraction of total capital employed. The banks are custodians of the public’s money and as financial markets segmentation is eroded this is as true of investment as it is of commercial banks. Investment bank strategy should not merely be focused on maximizing share holders value. It should seek to address issues concerning the impact of financial sector profit maximization strategies on the structural transformation of the national economy.

In other words we must explicitly reject the view that appropriate macro structural transformation is an inevitable, unintended consequence of micro level financial sector profit maximization strategies. There is overwhelming empirical evidence which shows that this is not the case. Market strategy must explicitly take account of national structural weaknesses and national economic interests. Perhaps the most important structural weakness of the national economy is the investment strike which has continued even in the high growth years of FY 2003 to FY 2005. As the Economic Survey (2005) shows both total investment and fixed investment declined as a ratio of GDP in 2004-2005. Public investment as a ratio of GDP has fallen significantly and private sector investment has stagnated paradoxically despite the phenomenal growth of private sector credit and the sporadic capital market surges. The domestic savings performance is so abysmal that it does not rate a mention in the executive summary of the 2005 survey released to the press.

Pakistan is experiencing consumption fuelled growth and the bourgeoning trade deficit indicates increased import dependence of both consumption and investment growth. We are seriously under-investing in capital goods sectors and several UNIDO studies (2003, 2004) have shown that Pakistan’s technological competitiveness has been declining in global markets. In terms of technological capability. Pakistan ranked 79th out of 118 countries in 2000—more than 30 ranks below India (UNIDO 2004). The growth that we have been experiencing is detechnologizing growth.

It is also immiserising growth : while per capita income exceeds $ 730 according to government estimates the majority of labor market participants have a monthly wage of
less than Rs 4000 and average family size is still six. This means that Pakistan has one of the world’s most unequal patterns of income and asset distribution. The rapid growth of the financial sector means nothing to the bulk of the population. The vast majority of the people have no contact with the formal money and capital markets. Pakistan is among the few countries in the world where the bank branch to population ratio has declined during the past two decades. During 1985-2005 population has almost doubled but the number of bank branches has fallen by almost twenty percent (Meenai and Ansari 2004, Chap 11). Similarly while advance accounts in excess of Rs. 10 million account for less than 0.4 percent of the total number of advance accounts at scheduled banks in Pakistan almost 70 percent of total bank advances are extended to them (Meenai and Ansari 2004, Table 11.1). Our banks—commercial, investment and NBFCs are apparently not interested in creating investment products targeting the common man.  

If the increased profitability of the investment banks is to serve as a vehicle for strengthening the national development effort and stimulating desired structural transformation investment bank strategy must focus on the following issues.

- Developing risk management instruments and institutional frameworks for insulating the national financial sector from adverse global market shocks and increasing its resilience. The banks must develop a capacity to assess the political risks of exclusive reliance on American support. The State Bank’s unreserved and unqualified commitment to subordinating Pakistan’s financial structure to global markets must be abandoned “Learn from Beijing” must be our motto in this regard for China has shown how subordination can be avoided while benefiting from global opportunities. Unless national resilience to global financial shocks is augmented we may become victims of the type of financial Tsunami that was imposed upon South Korea, Thailand, Malaysia and Indonesia in 1997 and 1998.

- Secondly asset management and portfolio management strategies have to be crafted to reduce the volatility of the capital market. Reducing “short termism” lengthening the time profile of investment planning periods and promoting structural linkages between physical and financial investment must be major investment bank strategic concerns. The collapse of the DFIs has decimated project financing. All major infrastructure projects in Pakistan are imperialist funded. This exacerbates our global subordination and makes the pursuit of national economic policy objectives more and more difficult. Investment banks should seek to revitalize investor interest at the long end of the market. Both China and Iran have shown how ambitious project financing can be undertaken without subordination of national development priorities to global capital. Investment banks should therefore play a pivotal role in promoting joint ventures with China and Iran.

- Thirdly the business strategy of the investment banks must address the issue of exacerbation of asset distributional inequalities. Two major initiatives are required in this context. On the one hand a range of investment products must be developed for the small real sector investor—the shopkeeper, the repair and maintenance business; the small producer of agricultural tools and equipment, the school owner in the peri urban centers. The micro enterprise financing schemes have all but collapsed because they do not address the question of increasing the productivity of the small manufacturer and businessman. Neither micro banks nor mutual funds can address this issue. Investment banks must develop financial products which promote linkages between large and small enterprises. Such production distributional and technological linkage has played a major role in
enhancing the productivity of China’s Town and Village Enterprises and in reducing unit costs for the country’s major exporting firms (UNIDO 2001).

- Finally investment banks must pay close attention to ethical management. Building trust is the key to successful long term profit maximization by financial institutions: Ethical management systems have been institutionalized by many leading financial institutions in global markets. These systems structure organizational practices to ensure that ethical risks and opportunities created by specific transactions are identified. They develop a framework for promoting ethical consciousness and ethical behavior by employees and they create structures for involving key strategic stakeholders (specially customers and regulators) in assessment of organizational performance. An effective ethical management system can demonstrate how an investment bank is taking account of the social and developmental impact of its business strategy. It can show that the investment bank is concerned to articulate a business strategy which is beneficial for society as a while.

We have argued that investment banks are social institutions. They are custodians and trustees of the public’s money and promoting national interests—strengthening the sovereignty of our state, technological upgradation and reduction of asset distributional inequities—must be explicit objectives of their business strategy. These objectives will not be unintentionally, automatically achieved by profit maximization. A strategy has to be crafted which deliberately synthesis financial viability and profitability concerns with the concern for safeguarding national sovereignty and promoting national development.
NOTES

1. In capitalist order the maximization of profit and social well being are seen to be the same thing (Ansari, Naeem and Zubairi 2005 Chap 2)
2. As it is in the interest of all other forms of capital property (Nayyar 2003)
3. The split India’ strategy—launched by America through the ongoing Kashmir initiative—is however likely to be more successful.
4. America’s client states in the European Union will also do so in the near future.
5. This is specially the case in the euro region.
7. As against this consumer financing products targeting lower middle income groups have proliferated during Ishrat Hussain’s governance. Banks are thus serving as a conduit for transferring savings from the poor to the rich and thus accentuating asset distributional inequalities.
8. On the other hand India is not a suitable partner both for geo strategic reasons (reflected in Indian obstinacy on dam projects in Occupied Kashmir) and because global capital dominates major project financing deals in India.
9. These have been described in detail in Roussouw (2004) Chap 15.
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