Discussion

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Overview

I will first discuss the importance of putting the bubble and fraud into perspective. I will then raise some questions about the corporate governance of financial service providers, and I will conclude by commenting on the paper's arguments and recommendations.

The Stock Market Bubble and Fraud in Perspective

One of the main points of the paper is the importance of addressing conflicts of interest in a way that will not reduce the information flow to financial markets. While a number of remedies are already in place, putting the bubble and fraud into a somewhat broader perspective, in order to avoid further remedies that might do more harm than good, could be worthwhile. Although one would not want to be seen as condoning the outcomes of conflicts of interest, the key lesson is that bubbles or manias, and particularly fraud, have been features of the economic landscape for a long time.

Charles Kindleberger was Chuck's thesis supervisor. It is fitting, therefore, that we draw from his *Manias, Panics, and Crashes* (1996, 66):

> Commercial and financial crises are intimately bound up with transactions that overstep the confines of law and morality, shadowy though those confines be. The propensities to swindle and be swindled run parallel to the propensity to speculate during a boom.

I want to focus on the "be swindled" part of the quote because Kindleberger suggests that fraud is cyclical and demand-determined. Greed is exploited. The coupling of a "new era" psychology and the cyclical peak in the economy provided fertile ground for the exploitation of conflicts of interest. As Kindleberger notes, virtually throughout his book, this pattern has been seen many, many times. And yet, overall, the economic system has worked well, generating higher standards of living over the centuries. Thus, we should have some confidence that market-based solutions will be sufficient to solve conflict of interest problems in many cases.

Corporate Governance of Financial Service Providers

While the paper acknowledges that it does not venture into the broad field of corporate governance, I believe there are some specific questions that it should address.

The author takes the view that the "extraordinary surge in the stock market created huge temporary rewards, permitting well-positioned analysts, underwriters, or audit firm partners to take advantage of the conflicts before incentives could be realigned. The reason these conflicts of interest are so dangerous is that they are not readily visible to the market and may not even be visible to the top management of the firm. In the most severe cases, opportunitistic individuals were able to capture the firm's reputational rents" (p. 227).

This seems much too benign with respect to the culpability of senior management. The culture of a firm—the incentive structure—has to be the responsibility of senior management. Would one not expect the senior management and the board of these firms to have identified these types of conflicts of interest as threatening the very existence of the firms, and to have put appropriate controls in place? If they did not, where were the internal and external auditors? One of the important roles of internal audit is to ensure that the appropriate control and risk-management processes are in place. How is it that these conflicts were not addressed?

I suspect that even the most junior analysts in these firms knew there was a problem. Moreover, these conflicts did not just burst onto the scene, but were created over time from the mid-1990s to 2001.

It may therefore be that incentives for the senior management could be as conflicting as those for the analysts and investment bankers. It is certainly well known that the behaviour arising from the conflicts of interest was, in fact, sanctioned by the executive group in some institutions. This would appear to be a significant issue that the paper should have explored.

The Arguments

I would like to raise a point about banks as delegated monitors. The argument in the paper is that financial intermediaries are not as subject to the free-rider problem, and they profit from the information they produce because they can make investments such as bank loans, which are often not traded.

There is evidence, however, that delegated monitoring by banks may be waning. Intermediation by banks in the United States has fallen sharply. In addition, there is an active secondary market in bank loans, which suggests reduced monitoring by the original bank loan syndicate members. Perhaps the most important development has been the increased use of credit derivatives, which can reduce or eliminate a bank's exposure to a particular firm without selling its loans, thereby diminishing the incentive to monitor. Increasingly, there are examples where bank lenders have effectively shorted the credit of their clients. Thus, the incentives for financial institutions to monitor are changing rapidly.

These changes are also affecting clients. They are becoming more concerned that financial institutions may use information that comes into their possession against client interests and, consequently, they are rethinking the nature of the relationship with their service providers and the information they give to them. This may result in less information being made available to banks.

I want to make two points regarding the paper's generic approaches for remedying conflicts of interest.

First, disclosure is a powerful tool and yet one observes a fair bit of resistance to mandated transparency, particularly from banks. Since the 1994 Fisher Report from the BIS that dealt with the disclosure and management of risks in financial institutions, for example, only limited progress towards more disclosure has occurred. And, even in the wake of LTCM, there was considerable reluctance to push hard on this front. Thus, a real effort will be required to increase transparency and to make it effective.

Second, the paper notes (see p. 233) that "rating agencies are largely insulated from conflicts of interest." However, the increasing importance of structured finance suggests that rating agencies may increasingly face conflicts of interest. The percentage of ratings revenues from this source at Moody's is approaching 50 per cent, and it is rising.

This suggests that the rating agencies may wish to be perceived favourably by companies in order to grow their structured finance rating business. There is no evidence that this conflict is creating a problem, and it may provide economies of scope, but the industry should deal with it in an open manner,

since the conflict does have some similarities to those faced by auditing firms. Indeed, the undermining of the "objective standard" for credit ratings assessments, given the paucity of firms involved in this business, might be even more devastating for market efficiency than the audit scandals.

The Recommendations

The paper asserts that auditors and most financial institutions operate in highly competitive markets, but rating agencies are protected from competition by high entry costs and the official sanction of their ratings from regulators.

One might argue, however, that the cost of entry into auditing and particularly into the financial intermediation business is also high. Official sanctions are provided. And, for example, requirements for the information, loan-making capacity, and capital to enter into the fixed-income underwriting business appear very high.

I see the question of how to enhance competitiveness when the cost of entry is high as very difficult, and one with broad relevance. I would urge the author to provide more suggestions for encouraging greater competition.

With regard to increasing disclosure, I think that investors need to have a sense of the scale or depth of an intermediary's relationship with an issuer. Merely disclosing a relationship does not provide investors with all the information they require. For example, investors should have a sense of the importance to the investment bank of the income from underwriting or other activities for an issuer.

Turning to the supervisory oversight over conflicts of interest, I come back to the question of where the internal auditors of the investment banks were. Supervisors should ensure that a strong framework is in place and that the role and independence of internal audit and compliance are well established.

Finally, on the socialization of information in the financial services industry, I agree with the author that this is not the way to go. In Canada, fortunately, this has gone a different route, which is good since the pool of analysts here is quite small. While direct compensation from a specific investment banking transaction is prohibited, Policy 11 of the Investment Dealers Association will permit analyst compensation from general investment banking revenues, but this must be disclosed in any research report. Numerous other types of prohibitions, disclosures, and guidelines are being put in place, but the socialization of research has not been proposed. One other significant difference is that Policy 11 would also apply to research

and recommendations related to fixed-income products, as well as disclosure of holdings of these products by the member firms.

I hope these comments are helpful. The paper is an excellent contribution to policy discussions about conflicts of interest in financial service providers.

References

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