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Diagnosis of Disarray in Investment Capital Markets

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Abstract: *Investment capital markets have been displaying signs of disarray and are significantly damaged. The operators are declining in number, contracting in scale and losing in asset base. The products are losing glitter and are shunned by investors. The monitors have lost creditably. And the regulators have failed at regulating. A diagnosis of damage incurred within the investment capital market and the possible projection of damage parameters within a conceptual and operational model is the focus of this article. The paper starts with a definition of the damage with an investment in capital markets, proceeds to relate damage to four forces, i.e. players, products, monitors and regulators and concludes with a conceptual and operational model for damage analysis. A diagnosis of investment capital market damage is analysed and an identification of several strains of this damage is made. Prime among the strains is malignant operator concentration, monitor misleading self-interest and product failure. The derived model provides a base for investment capital market damage level assessment and directions for policy and strategy response. The issue addressed is conceptually tackled within investment capital market analysis.*

I. Introduction

Investment capital markets have been displaying signs of disarray and are significantly damaged. Symptoms of this damage are visible. The operators are declining in number, contracting in scale and losing in asset base. The products are paling in colour and shunned by the very investors who were keen to hoard them. The monitors have lost creditability and are accused of blatant system misguidance. Even those who are supposed to regulate seem to have forgotten the finer mechanics of regulation. The article begins with a diagnosis of signs of disarray in an investment capital market. It assesses the specific-ness of this damage. Operator, product, monitor and regulator damage are diagnosed. A holistic conceptual and operational model follows. The model sets a framework for the measurement of the systems' damage. The article relies on current events within and analysis of investment capital markets.

In investment capital market context, damage is an event that undermines the continuity and the outcome of an organization. Organization disorganisation, client losses, revenue contraction and product failure are the prime manifestations of this damage. This can occur at the operator, product and monitor and regulator level. Focus is placed on investment banks, hedge funds, private equity and sovereign investment capital as the prime operators. This include considering structural finance instruments as the key contemporary product, rating agencies as the pivot of the rating process and the Securities and Exchange Board of India (SEBI) as the ultimate level of regulation.

II. Operator Damage

Malignant Concentration

The investment banking industry has become a very highly concentrated industry and it needs fundamental restructuring. This ratio, which measures the relationship between the combined business of most dominant firms and all business done by the entire industry, reflects the degree to which a few firms can influence and impact an industry as a whole. The most dominant firms concentration ratio is too much which would imply a high measure of industry dominance by those dominant firms. High investment banking industry concentration evolved from a modest level to the overbearing level. The deregulation drive and the ensuing structural changes in investment banking regulation, have affected investment banking concentration and concurrently adversely affected the dominant investment banking firms.

Reckless Culture

An exceptional high risk taking was observed among the leadership of dominant investment banking institutions. It seems as if this exceptional rush for risk taking has become an industry trait and one can consider it a failure at genuine leadership. This is an act that separated retail banking from investment banking and by

doing that delineated functional risks and protected ordinary depositors. The problems in one area of financial activity must not spread to another.

Deregulation

Deregulation has become an operating assumption in considerable segments of the investment capital industry. Investment vehicles, such as hedge funds and private equity operators, the so-called shadow investment capital market, were exempt from government and industry regulation. Those have grown over the past decade under the belief that "sophisticated investors" as pension funds and wealthy individuals are skilled enough to judge the inherent risk. Assets managed by the shadow banking industry exceed in comparison to assets managed by the conventional banking system. Meanwhile, a form of structural deregulation rules the market and predicting a period of tremendous instability.

III. Structured Product Damage

Structured products, the prime fund raising product innovation within investment capital markets, are complex, high risk instruments with fatal structural flaws that twisted marketing practices. Their flaws caught up with them and the result was a loss in product market viability. Structured products were unsecured debts marketed by investment banks whose self serving practices, and greed, projected a blurred image of product genuine benefits and concealed risk content. Investors ran a risk of losing their principal if the market value of the underlying asset diminished or the investor's demand for liquidity induced an early prematurity termination of the investment. They were priced not on a net-asset-value basis. Their prices were often too low and did not reflect their true risk exposure.

Innovation and learning involved in the development of the wide variety of structured finance products has deep roots in the investment banking industry. Many of those roots are malignant. They inflict considerable damage to the product innovation process and so a process of de-learning is essential. The absurd complexity of the product did not discourage the operators from extending it beyond household mortgages to commercial mortgages, corporate loans, high yield take over loans, emerging market loans and several others. They were packaged into collaterized loan obligations and marketed.

IV. Regulators Damage

Regulation of investment capital market processes and institutions has been hazy and sometimes nonexistent. This led to the emergence of largely unregulated "shadow banking" institutions and processes. This has inflicted damage to the regulation process. The government provided funds to stabilize unstable financial institutions, gave guarantees to bond holders, and extended tax breaks to investment institutions. It also purchased some risky assets. But it did not get much in return. Regulators did not regulate by demanding the far reaching financial institution restructuring that the situation required. The regulation process continues to be very fragmented, with different agencies responsible for different aspects of banking operations. The Consumer Financial Protection, the Deposit Insurance Corporation and the Securities and Exchange Board each regulate some aspect or another of bank activities. The process is fragmented and, at times, contradictory. Regulation institutions as the Security and Exchange Board of India have declined in terms of effective control over events. It is suffice to say that the mismanagement of monetary policy has had dire consequences.

V. Monitors Damage

Significant judgmental failure at providing a realistic rating for structured products has led to serious reputation damage to investment players and credit rating industry itself. Recent histories reveal that there are structured product types and structured product features that should have been avoided because they damage investor's interests. Relatively stable and solidly founded equity markets should give the rating process and players an easy ride. Violent market shifts are inducing shockwaves of unprecedented resonance in the credit rating industry. These shockwaves are increasing investor risk and augmenting investor loss. Today, market turmoil has left many investors exposed, especially those who seek safety as they approach retirement and are in search of relatively secure high yielding investment. Rating of structured products could provide paramount systemic risk. The challenge of this rating of structured products lies in their extreme sensitivity to estimation errors – that even modest imprecision in estimating underlying risks is magnified disproportionately when securities are pooled and trenched.

Research suggests that rating agencies are more prone to inflate ratings when there is a larger fraction of naive investors in the market. The research also suggests that the unlikelihood of fraud exposure and the level of risk assessment also impact blurred ratings.

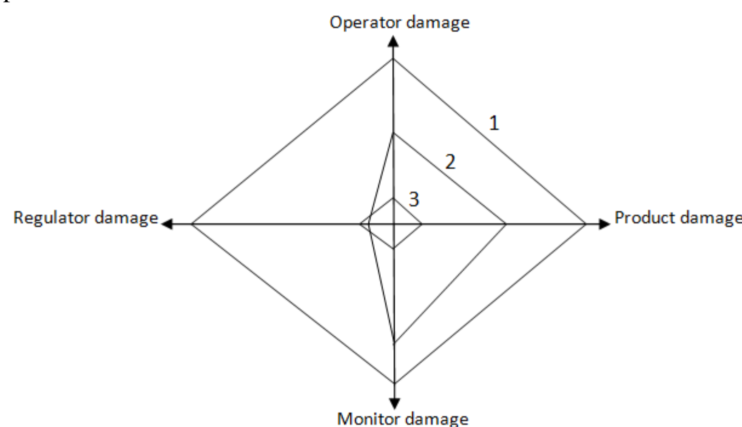
There is enough evidence to support the notion that the credit rating industry has misjudged the quality of many of the products that it did rate. Many structured products were assigned AAA ratings and subsequently

lost the rating. The industry ignored the fact that many structured finance products consisted of lower quality "BBB" rated loans that were assigned an AAA rating.

VI. A Concepyual And Operational Model

Analysis provided could lead to the question of whether a conceptual and operational model could contain the issue and provide a tool for further research. It is an instrument for the measurement of the damage on a system wide level. There are four dimensions, each representing one of the four damage strains. The scale allows from zero damage to maximum damage. The scale also reflects an assessment of the incidence of damage and, possibly, a quantification of the impact of each of the four strains.

The author has attempted a judgmental assessment of a few investment capital market situations. The first situation emerges as a market with extreme values for all four damage strains. The second moderate damage situation projects the other extreme or a market with relatively low attributes of all four strains, an outcome of a protected capital market. The third limited damage situation emerges as an in-between situation with tangible institutional and product damage but intact regulator and monitor profile. The operational model could have a policy guidance impact if change in investment capital market remedies are sought and measures for change are to be explored.



(A conceptual and operational investment capital damage projection and measurement model)
(1) Maximum damage situation (2) Moderate damage situation (3) Limited damage situation

VII. Summary And Conclusion

Investment capital markets have been displaying signs of disarray and are significantly damaged. The products are paling in colour and shunned by the very investors who were keen to hoard them a few years ago. The monitors have lost creditability and are accused of blatant system misguidance. Even those who are supposed to regulate seem to have forgotten the fine mechanics of regulation. Some have given ideological bias precedence over sound judgment.

A conceptual and operational instrument for the measurement of the damage on a system wide level is suggested. There are four dimensions, each representing one of the four damage strains. First situations were judgmentally projected with an extreme damage situation, second with moderate damage situation and the third with a limited damaged situation. The model may have a policy guidance impact if change in investment capital market remedies are to be sought and measured for change are explored for corrective action to overcome the three different situations.

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