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How damaged are investment capital markets today?

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Abstract

Purpose – Investment capital markets have been displaying signs of disarray and are significantly damaged. This is especially manifest in the case of the USA and some countries in Europe. Symptoms of this damage are visible. 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. This is the focus of the following article. An analysis of damage incurred within the investment capital market and the possible projection of damage parameters within a conceptual and operational model. The paper aims to discuss these issues.

Design/methodology/approach – The paper starts with a definition of the damage concept, 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. The paper is eclectic relying on finance, macro-economic and strategic management analytically frameworks.

Findings – A definition of investment capital market damage is proposed 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 damage concept could be contained within a conceptual and operational model.

Practical implications – The derived model could provide a base for countrywide investment capital market damage level assessment and directions for policy and strategy response especially for organizations as the World Bank and the IMF.

Originality/value – The issue addressed is possibly never conceptually tackled within investment capital market analysis.

Keywords Deregulation, Market failure, Credit rating, Capital market damage

Paper type Research paper

The problem

Investment capital markets have been displaying signs of disarray and are significantly damaged. This is especially manifest in the case of the USA and some countries in Europe. Symptoms of this damage are visible to the naked eye. The operators are declining in number, contracting in scale, losing in asset base, shrinking in prowess and losing some of their *raison d étre*. The products are paling in color 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 finer mechanics of regulation. Some, according to some claims, have given ideological bias precedence over sound judgment.

The article begins with a definition of what constitutes, within an investment capital context, damage. It then assesses the specific-ness of this damage. Operator, product, monitor and regulator damage are explored. A holistic conceptual and

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operational model follows. The model sets a framework for the measurement of countrywide system damage.

The article relies heavily on current events within and analysis of investment capital markets primarily in the USA.

What damage and where?

Damage within an investment capital market context, is an event that undermines the continuity and/or the outcome of an organization. Organization entropy, client losses, revenue contraction and product failure are the prime manifestations of this damage.

This can occur at the operator, product and monitor and/or regulator level.

Focus will be placed, for the purpose of the following analysis, on investment banks, hedge funds, private equity and sovereign investment capital as the prime operators. This will also include considering structural finance instruments as the key contemporary product, rating agencies as the pivot of the rating process and Federal Reserve as the ultimate level of regulation. The US investment capital market provides the broad framework.

Operator damage

Malignant concentration

The investment banking industry has become a very highly concentrated industry bearing all the marks of an industry in need of fundamental restructuring.

A four firm concentration ratio for the investment banking and securities dealing industry amounted, according to The US Census Bureau's Economic Census, to 51.7 percent in 2007. An eight firm ratio amounted to 76.6 percent in the same year (US Census Bureau's Economic Census, 2012). This was before the demise of industry leaders as Lehman Brothers and Bear Stern which could very likely increase concentration. This ratio, which is essentially a measure of the relationship between the combined business of the four or eight 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. A four firm ratio in excess of 40 percent or a four firm concentration ratio in excess of 70 percent would imply a high measure of industry dominance by those few firms and the degree to which the industry is oligopolistic.

High investment banking industry concentration evolved from a modest level in the 1990s (in 1997) to the overbearing level referred to above. One can speculate that Reagan's deregulation drive of the early 1980s and the ensuing structural changes in investment banking regulation, including the repeal of the 1933 Glass-Steagall Act, have delivered present day investment banking concentration levels and concurrently the emergence of the too big to fail phenomenon and the air of structural impunity that went with it.

Reckless culture

A high measure of what may be termed "exceptional high risk taking" was observed among the leadership of investment banking institutions such as Lehman Brothers and Bear Stern. It seems, at times, as if this exceptional rush for risk taking has become an industry trait and one can consider it a failure at genuine leadership (El Namaki, 2010a, b, c, d).

Roots of this behavior can be found in political measures as, for instance, the US Congress's 1999 repeal of the 1933 Glass-Steagall Act. This is an act that separated retail banking from investment banking and by doing that delineated functional risks

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and protected ordinary depositors. The Act saw to it that problems in one area of financial activity did not spread to another. The successor, the Financial Services Modernization Act of 1999, did not only bury the Glass-Steagall Act, but encouraged reckless risk taking with what is presumed to be low risk deposits.

Executives responsible for this reckless risk taking appeared, moreover, to be immune from legal action or persecution. CEOs of institutions such as Lehman Brothers and Bear Stern did leave the organization but were largely not subjected to criminal or juridical persecution. Some of them, as the CEO of RBS of Britain, went on to receive generous retirement awards. It seems, at times, and when one looks at more recent events such as JCP Morgan Chase, as if awarding mismanagement has become a common practice within the industry and as if managerial mediocrity has been institutionalized!

Lost controls

Deregulation has become an operating assumption in considerable segments of the investment capital industry with loose and, at times, no control. Investment vehicles, such as hedge funds and private equity operators, the so-called shadow investment capital market, were, and until very recently still are, 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, today, those managed by the conventional banking system.

Regulation is demanded and is explored but is taking time to emerge. Proposals put forward in Britain spell out a separation of retail and investment banking, while the USA "Volcker rule" curtails the ability of banks to trade for their own profit. The US Dodd-Frank Act was intended to restructure the regulatory framework for the US financial system, with broad and deep implications for the financial services industry where the crisis started. But this seems to be a long road. Meanwhile, a form of structural un-regulation rules the market and a period of tremendous instability (*The Economist*, 2012).

Product damage

Dangerous innovation

Structured products, the prime fund raising product innovation within investment capital markets, were complex, high risk instruments with fatal structural flaws and twisted marketing practices. Their flaws caught up with them and the result was a loss in product market viability (El Namaki, 2010a, b, c, d).

Structured products were unsecured debts marketed by an investment bank (or 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 or assets diminished or the investor's demand for liquidity induced an early prematurity termination of the investment. They were priced on a matrix, essentially a best guess approach, and not a net-asset-value basis. Their prices were often too low and did not reflect their true risk exposure.

The regulatory framework of structured products, in the USA in the first place and Europe in the second, was, moreover hazy (*The Financial Times*, 2008). Several governments have taken the unusual step of either restraining the marketing of structured finance products or banning them altogether. Britain s Financial Services Authority put the squeeze on firms marketing structured products to retail investors

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(*The Financial Times*, 2010). The government of the UAE brought to a halt the marketing of structured finance instruments in September 2009.

Product innovation de-learning

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.

At the heart of the process lies the skewed product development learning process that took hold of the US investment capital industry in the 1980s. This was based on fundamentally new information technology software, as well as complex mathematics. The by now well-known process led to the emergence of the first product or the collaterized mortgage obligations (CMO), the 1983 mathematical "invention", that provided the core of the securitization industry. The at times 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 (CLOs) and marketed globally. New classes of derivatives, purportedly protecting banks against loan default, made investors climb higher and higher on the risk curve.

For nearly 20 years this has become the traditional learning curve of the investment banking industry. The shock of 2008 and beyond has compelled a radical rethinking of the curve and left the industry with a desperate search for an alternative learning process. Worse still, it has led to the onset of what we may term a "de-learning process" or a process that reverses the malignant practices of those 20 years (Morris, 2008).

Regulators' damage

Failure of the regulation process

Regulation of investment capital market processes and institutions was, for decades, hazy and at times nonexistent. This led to the emergence of largely unregulated "shadow banking" institutions and processes. Attempts at remedy came late and faced considerable resistance. This has inflicted damage to the regulation process.

Events of the 2008 TARP are a case in point. The US 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 institutions continued as going concerns.

The regulation process continues to be very fragmented, with different agencies responsible for different aspects of banking operations. The Commodity Futures Trading Corporation, the Consumer Financial Protection Bureau, the Federal Deposit Insurance Corporation, the Federal Reserve, the National Credit Union Association, the Office of the Comptroller of the Currency, the Securities and Exchange Commission, and the Treasury Department each regulate some aspect or another of bank activities. The process is fragmented and, at times, contradictory. Some agencies, for instance, give priority to bank survival at the expense of client interests. Dodd-Frank's design and implementation is constrained, to put it mildly (*The New York Times*, 2012).

Decline of regulation institutions
Typical functional regulation institutions as the Federal Reserve and the Security and Exchange Commission in the USA and the Central Bank and the Financial Services Facility (FSA) in Britain have declined in terms of effective control over events and the steering of the system towards the nearest thing to equilibrium.

The problematic performance of the Federal Reserve is well documented and suffice it to say that the frequently stated mis-management of monetary policy has had dire consequences. It, according to some, has "[. . .] fed asset bubbles, fueled a bread and circuses consumer binge, floated Wall Streeters into financial stratosphere, and perhaps, irrevocably debased the dollar" (Meyer, 2008).

Discussing regulation cannot be complete without a reference to the role of the Chairman of the Federal Reserve, Alan Greenspan. He is given the credit, by several, of undermining the very process of regulation through a personal anti-regulation belief and an obsession with the efficacy of the market. Greenspan ignored corrective intervention at times when intervention was due. He lavished praise on the new credit technologies for their role in laying off all the risk of highly leveraged institutions. "Alan Greenspan deserves full blame for his feckless money creation through most of the 2000s" (Meyer, 2008).

Monitors damage

Reputation damage
Significant judgmental failure at providing a realistic rating for structured products has led to serious reputation damage to investment players and to the US 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. The ratings should have revealed that, but they failed to do so (El Namaki, *The Financial Times*).

Relatively stable and solidly founded equity markets should give the rating process and players an easy ride. Violent market shifts, of the type we saw for nearly three years, 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 (*The Wall Street Journal*, 2008).

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 (Hanna, 2009).

Client deception
Research suggests that rating agencies are more prone to inflate ratings when there is a larger fraction of naive investors in the market or when expected reputational costs are lower (Bolton *et al.*, 2009). The same research also suggests an association of boom times, the unlikelihood of fraud exposure and the level of risk assessment also impact blurred ratings (Skreta and Veldkamp, 2008).

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. It is common knowledge,

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today, that many structured products were assigned AAA ratings, then subsequently lost the rating or even defaulted. The industry ignored the fact that many structured finance products consisted of lower quality "BBB" rated loans that became invisible when bundled into CDOs and were assigned an AAA rating. The industry failed to understand that rating structured finance products is different from rating of corporate bonds! (Bolton *et al.*, 2009).

The ultimate outcome was a culture of client deception.

A conceptual and operational model

Analysis provided above could lead to the question of whether a conceptual and operational model could contain the issue and provide a tool for further research. The following is an attempt at doing that. 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 referred to above. The scale allows for a graduation 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. It goes without saying that conversion of the scales into quantified data will require further analysis.

The author has attempted a judgmental assessment of a few investment capital market situations. One of those was for the USA and the other two were for Switzerland and China. Those country situations are projected in Figure 1. The USA emerges as a market with extreme values for all four damage strains. China projects the other extreme or a market with relatively low attributes of all four strains, an outcome of a protected capital market. Switzerland 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.

Summary and conclusion

Investment capital markets have been displaying signs of disarray and are significantly damaged. This is especially manifest in the case of the USA and some countries in Europe.

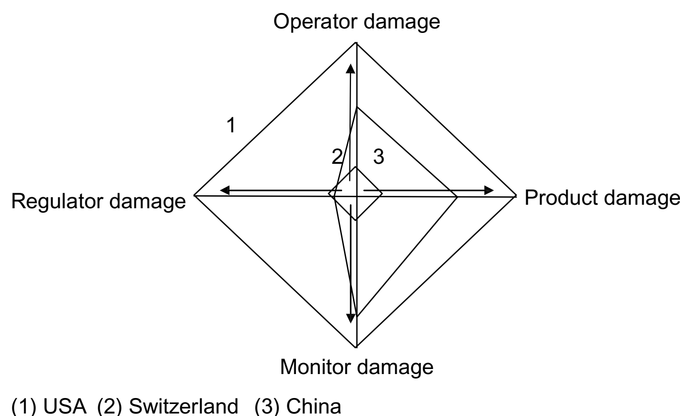

Figure 1.
A conceptual and operational investment capital damage projection and measurement model

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Symptoms of this damage are visible to the naked eye. The operators are declining in number, contracting in scale, losing in asset base, shrinking in prowess and losing some of their *raison d étre*. The products are paling in color 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, according to some claims, have given ideological bias precedence over sound judgment.

The article begins with a definition of what constitutes, within an investment capital context, damage. It then assesses the specificity of this damage. Operator, product, monitor and regulator damage are explored. A holistic conceptual and operational model follows.

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 referred to above. Three country situations were judgmentally projected with the USA representing an extreme damage case and China a limited damage case. The model could have a policy guidance impact if change is investment capital market remedies are sought and measures for change are explored.

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