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CRASHES, BAILOUTS, REGULATIONS

Foreword

With the recent stock market frauds in markets around the world such as the Madoff case in the U.S. and the recent Satyam fraud in India, no nation can hold its head high and claim to have good corporate governance. The reality is that the problems of fraud, faulty audits, misleading accounts, lack of transparency, conflicts of interest, criminal destruction of records and a long list of other corporate governance violations, are not limited to emerging markets but are very much in evidence in developed markets as well. Given recent events then, the importance of sound corporate governance is becoming increasingly apparent. International organizations like the OECD, the World Bank and the International Corporate Governance Network (ICGN), along with major fund managers, are formulating sets of codes and principles that can be applied globally. It is also clear, however, that governments have generally done a poor job of policing the complex world of finance and that the greater part of the task will be left to self-policing on the part of the participants.

There is no doubt about it: sound corporate governance pays. Several studies undertaken by various organizations have shown that: there is a direct relationship between good corporate governance and investment returns. The oversight that comes from transparency and accountability creates a structure where the managers are discouraged from mismanaging the company, be it though a lack of diligence or care, improper decision-making, or even intentioned unconscionable behavior.

Thus, good corporate governance results in better management and more prudent allocation of the company's resources resulting in better earnings. Hence, there could be a strong fundamental bond between good corporate governance and strong corporate performance. Needless to say, for these reasons, good corporate governance can also lead to increases in the demand for, and price of, company shares.

One study that appears to support this was made in 1994 by the pension consultant Wilshire Associates. This study was undertaken for the California pension

IFC International Finance Corporation World Bank Group

organization, CALPERS, which is well known for its active corporate governance policies in the U.S. The Wilshire Associates study focused on the effects of the pension fund's investments in 62 companies that had, in the five years prior to the making of the investments, lagged the S&P 500 index by an average of 85%. Five years after the pension fund had invested in these companies and influenced their management with their shareholder activism for good corporate governance, the share price of those same companies outperformed the S&P 500 index by an average of 33%. CALPERS have since estimated that the improvement in those 62 companies led to about US$150 million in added returns.

This causal relationship between good governance and strong corporate performance works to increase the attractiveness of investing in a company as illustrated by rising share prices. In fact, when a company's management is known to be better than its peers in its accountability to minority shareholders and in its competence (to deliver good earnings and returns for shareholders), a premium for that company's stock often develops.

Good corporate governance not only constitutes a moral imperative for shareholders to be treated fairly but it simply makes good economic and financial sense.

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CRASHES, BAILOUTS, REGULATIONS[1]

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This article is written at a time when global financial markets are passing through 'interesting times'—as the Chinese saying goes—which led Paul Volcker to comment that'…the bright new financial system—for all its talented participants, for all its rich rewards—has failed the test of the market place'. Financial institutions in the United States and Europe have either filed for bankruptcy, or made cosmetic changes in their business form to remain in financial services, or are choosing to be taken over by stronger institutions. In the US, the victims have been the financial institutions considered 'too big to fail'—Washington Mutual (the largest US savings and loans association), Wachovia (the sixth largest US bank), Lehman Brothers (founded in 1850; its history is said to have paralleled the growth of the US), AIG (set up in 1919 and went public in 1969), Merrill Lynch (founded in 1914), Goldman Sachs (founded in 1869), Morgan Stanley (founded in 1935), Bear Stearns (founded in 1923) and Ginnie Mae and Freddie Mac of a more recent vintage. In the United Kingdom, after Northern Rock and the acquisition of HBOS by Lloyds TSB, there was the bust and rescue of B&B and the Royal Bank of Scotland; in Belgium, Fortis had to rescued; in Germany, HRE, a major financial institution was also near-bust and in need of a government rescue. Japan's benchmark indices had the worst fall in two decades.

The global financial crisis is becoming more severe by the day, sucking countries into deep global recession. While the equity markets have crashed, bullion prices are rising to record highs (to gain on safe-haven interest) and the price of crude on the NYMEX has been falling after months of upward gyration. As stock market misdemeanours were not responsible for holding the financial system hostage, there is little that the securities market regulator can do to alleviate the situation. Governments and central banks have to play the principal role in pulling the system back on the rails. The US Federal Reserve, European Central Bank and several other central banks lowered interest rates in a coordinated effort to ease the economic effects of this global crisis. Governments have been providing rehabilitation packages and injecting equity. Markets which have proffered extreme forms of capitalism and private enterprise are being compelled to nationalise financial institutions. **But neither the short sales ban nor the expensive rehabilitation packages have so far been able to arrest the drop in stock prices**, though arresting the fall was not the avowed objective of these measures. Fear and uncertainty took a firm grip over the markets all over the world. When the short sales restrictions were removed and the unwinding of the credit derivative swaps of Lehman Brothers was just beginning to happen, everyone wanted to stay in cash and was hence selling out. The Dow fell over 10 per cent from its previous close on 9 October 2008, triggering the market-wide circuit filter. The US stock market was halted after several years. The ability of the US Congress and other national governments to support the stability and credibility of the financial system,

[1] This article was closed on October 16, 2008

protect ordinary savers, depositors, businesses and borrowers and safeguard the interest of tax payers, and restore the confidence in the financial system remains to be seen. Since the damage has been severe, we should not get carried away or be misled by the leavening of stock markets as an authentic signal of recovery, though many would have us believe so.

In India, foreign institutional investors (FIIs) withdrew $11 billion till October this year, of which $2 billion was in September and $3 billion in the first half of October alone (till 16 October). The BSE's Sensex and NSE's Nifty as well as the broader indices have been on a decline. In an unprecedented move, the Reserve Bank of India (RBI) lowered the CRR limit by 150 basis points to tide over the liquidity crisis. In September, the Index of Industrial Production was 1.1 per cent, the lowest thus far, exacerbating selling pressure on the securities market on stock exchanges and heightening fears of domestic recession. In a policy reversal, restrictions on Participatory Notes for the FIIs were relaxed by the Securities and Exchange Board of India (Sebi). The underlying expectation was that this move would prevent the flight of FII investment from Indian stock exchanges, thus maintaining India's attractiveness as an investment destination at a time when institutional investors were pulling out of all global equity markets. The validity of this flawed assumption has been tested by the market. The restrictions on Participatory Notes were put in place last year to help check the surge in FII investments into India as they were making foreign exchange management difficult for the RBI, as also on account of the apprehension about the sources of funds and concerns about the KYC ("know your client") norms. Both these considerations remain valid even now, raising questions about the imposition of these restrictions in the first instance. We have to wait to evaluate the impact of these policy reversals.

To write an article on the subject of the securities market and regulatory issues in India in the midst of the ongoing turmoil is a challenge by itself, but to choose a title for the article was a greater challenge. The article could be titled 'The Future of the Securities Market in India'. But that would be Delphic in nature, especially at this point of time. Financial globalisation, technology and complex financial products have strengthened the coupling between international financial markets and, by doing so, heightened the contagion risks and increased the frequency and intensity of global market collapses. We cannot say with conviction now that any market, unless it is exclusive to the Andaman and Nicobar Islands or for the deeper Congo Basin, is free of contagion risks. Predicting the future is generally a difficult task; under current conditions it has got even more difficult in the case of financial markets. Nouriel Roubini of Stern Business School was the one person who was able to read the future without the crystal ball. On 7 September 2006, when Roubini addressed the economists of the International Monetary Fund, he painted a lugubrious picture of an impending financial crisis engulfing the US which, he said, would ultimately lead the country to a deep recession. The audience was naturally sceptical, even dismissive, and not without rea-

son. Economists like validation of truth through numbers and mathematical models. Roubini had offered none.

Though weak due to rising oil prices and a softening housing market, the US economy was still growing and unemployment and inflation remained low. At the end of the Roubini's talk, one economist was reported to have dismissed his hunches as those of a career naysayer. Recounting the incident, a *New York Times* columnist (Stephen Mihm, 15 August 2008) wrote: '[When] Roubini stepped down from the lectern after his talk, the moderator of the event quipped, "I think perhaps we will need a stiff drink after that."… Roubini was known to be a perpetual pessimist, what economists call a "permabear".'

Neither could the title of the article be 'The Second (or third, fourth, fifth) Generation of Reforms in the Securities Market in India', though the cognoscenti in India is in habit of classifying economic reforms by generations. Economic reforms, of which the financial reforms are an integral part, are usually continuous and carefully sequenced—one reform converging into the next. It is quite unclear how a 'generation' of economic reforms are identified and distinguished from the preceding ones and what is the appropriate length of time between two generations of economic reforms.

One could, then, have titled the paper 'Securities Market: The Way Forward' a variant of the first title. A paper so titled could have begun with a critique of the present regulatory architecture for financial markets in India and the arcane ways of Indian financial regulators, proceeding then to enumerate the complete 'things to do' list (with full convertibility at the head of the list). But such a title would have been apt for a consultant's report, and would have seemed to be an advisory of sorts for the securities market regulator. Having worked in the regulatory body for nearly two decades, one realises that the temptation to pontificate without the responsibility of execution and accountability can often be irresistible.

What then is this paper all about? It is about the issues and concerns relating to the securities market and market regulations in India in the perspective of the current world scenario. Rather than a menu of advice and suggestions, it is in the nature of peregrinations of thought through the capital market in India.

Owing to globalisation and advances in technology, global financial crises are increasing in their intensity and frequency: on securities markets on an average, they have been occurring at a frequency of 4.5 years in recent times. This is alarming by itself. But what is more alarming, is that the present one should have happened post-Enron and the Asian financial crisis. After these two cataclysmic events, central banks and securities market regulators set up a powerful international forum for regulatory coordination—the Financial Stability Forum (something like our own High-Level Committee for Capital and Financial Markets)—and adopted a series of measures to avoid contagion

risks, as if such risks can be avoided in a globally integrated market place. Obviously, these measures have not yielded much result. And now, with the talk of overhauling the regulatory system, there is the possibility of the pendulum swinging in the other direction. Furthermore, **despite the enormous increase of disclosures and stringent risk management systems in the US post the Sarbanes Oxley Act (SOX), the inability of the system to read the early signs of the impending disaster and willingness to take corrective action raised the question of what more does one need to do**. Finally, the sheer size of the financial mess at a 'fair value' of over a trillion dollars (aggregate of all the rescue packages till now) seriously questions the ability, competency and robustness of the present regulatory architecture for the financial markets faced as it is with unbridled greed and failure to impose punitive action for symmetrical losses.

Financial crises usually provide a good opportunity for introspection on the functioning of financial markets and the regulatory architecture. These times invariably expose the shortcomings and vulnerabilities of the system. The present crisis, with its widespread ramifications on global markets and economies, is one such great opportunity to reassess the existing views on financial markets, the role of financial institutions, market structure, financial products and, above all, on the regulatory architecture. It would be worthwhile to debate some possibilities relevant in the Indian context. But while reviewing and reassessing the present, extremes of regulatory action need to be avoided.

First, global financial markets have become far too complex, fast moving and integrated for the global regulatory architecture (which has so far helped supervision and regulation) to work any longer. This will be true for India as well, even though complex derivative products are not yet available in our market. Financial crises have never put an end to financial innovation or brinksmanship and it remains likely that we will see new and complex products emerge in our market too, out of necessity (though this may not happen immediately). The regulatory architecture in India needs to be geared to deal with such outcomes.

Second, the present financial crisis has made irrelevant the debate between libertarianism and authoritarianism in the area of market regulation. The fountainhead of the present global financial crisis—the one-to-one transactions in the derivatives markets for mortgage-backed securities and structured products—were all private. These were only lightly and indirectly regulated, perhaps following the philosophy of Friedrich von Hayek.[2] Besides, the transactions were opaque in terms of legal obligations and risks. There was both an incentive to hide overall credit risk from the markets and an ability to take such risks without proper due diligence. AIG, which avoided collapse with a $85 billion rescue package, is an example of this approach. Whether lighter regula-

[2] Friedrich von Hayek was a proponent of *classical liberalism* and *free-market capitalism*. He is considered to be one of the most important economists and political philosophers of the twentieth century.

tion, with greater reliance on self regulation and private counterparty surveillance, is a preferred regulatory model, or whether a single regulator is better than a multiple regulator model, or whether a principle-based regulatory regime is more effective than a rule-based one—all these are questions which have befuddled all shades of opinions. Financial markets in Europe, the US and Japan, all now in trouble, have experimented with all these models and there is no evidence to suggest that one country has been better off than the other.

There is a lesson in this for our home-grown, laissez faire, freelance advisors. It would serve little purpose for us to adopt a model or architecture or to change an existing one merely because it works elsewhere. The choice of a regulatory model and the architecture should be a function of a country's own ethos and legal system. What is important is that the system adopted should have the agility to read the early warning signals of a brewing crisis and take corrective measures, rather than be lulled into complacency by rising asset prices (as has generally been the case).

Third, rise in asset prices makes people happy as wealth is created. Nobody wants to know the reason for the price rise or if the price rise securities market is warranted or the returns abnormal. Rise in asset prices attracts new investors to the market, creates new demand and feeds into the price rise, making the owners of the assets happier. This is almost an eternal verity. We have seen this during the present crisis; we have seen this in India. The rise in equity prices (with the Sensex soaring beyond 20,000) as well as property prices led to the extraordinary popular delusion that asset prices can only move in one direction—upwards. Many of us facetiously regarded the rise in indices as a vindication of economic policies; we forgot that there are many indicators of economic growth and the stock market index is just one of them. We forgot that in an imperfect market—and the Indian stock market remains imperfect in many ways—the indicators would necessarily be imperfect. There is no discounting the fact that India's economic performance has been stellar by all major parameters of macroeconomic performance, leading to the 'India story'. But we forgot to ask if the story was being blown out of proportion. On the one hand, we reassured ourselves that contagion risks would not affect our system and hoped that the FIIs would show a preference for our market, but we were happy when our stock market indices rose phenomenally on days when the global markets also rose. We did not enquire if the rise was on account of significant FII investments on those days compared to other days. It is important that authorities ask the right questions at the right time. In the case of Enron, nobody, whether inside or outside the company, asked why. Similarly, with Bear Stearns and other investment banks; nobody critically examined their rise (when money was being made by individuals and the firms, and when phenomenal bonuses were earned), till they failed. It is important to question any abnormal return, any abnormal profit, especially when a 'specious association between money and intelligence' is witnessed.

Fourth, there is a wild animism inherent in financial markets, a kind of natural impulse which is displayed through speculation and through market volatility. When this urge becomes widespread, speculative excesses occur. Speculation then creates its own reality. Though libertarianism is the best and most desirable concept for market regulation, it is, for the reasons just cited, only an ideal one, more so when the market is under a speculative spell. This leads to the need to strike a balance; while leaving everything to market discipline does not work (as Mr. Greenspan discovered to his dismay), a completely fettered future would also prove to be futile as it would stifle innovation. Striking this balance is the most difficult part of financial regulation. For example, the much-maligned instrument of credit default swaps (CDS) has been in place for quite some time. In 2004, the estimated notional value was $6 billion according to the Bank for International Settlements. Between 1998 and 2001, these instruments were used to spread risk of $1 trillion in loans to the rapidly-expanding telecom network. Even though a large proportion of these ventures defaulted during the tech bust, not a single major financial institution ran into trouble. The losses were borne by highly capitalised institutions—insurers, pension funds and the like—who were the major suppliers of credit default protection. By 2006, the notional value rapidly rose to $20 trillion. Was the financial instrument the problem or its rapid growth?

Fifth, financial crises have, by and large, exhibited a repetitive pattern, demonstrating the inability, or unwillingness, of financial market participants to learn. Charles Mackay, in his book *Extraordinary Popular Delusions and the Madness of the Crowds,* says that while episodes of panic and disasters have their own distinctive features, they exhibit a common feature—that they are all preceded by a period of apparent prosperity when it is possible to rapidly acquire fortunes 'otherwise than by the road of plodding'. In their study of 18 financial crises in the US, economists Carmen Reinhart and Kenneth Rogoff of Harvard Business School found that there were 'stunning qualitative and quantitative parallels across a number of standard financial crisis indicators'. Ahead of each big financial shock, house prices rose rapidly, as did equity prices; current account deficits ballooned; and capital inflows accelerated. Isn't there an uncanny resemblance with the situation at home? Wasn't there a fairly long period of abnormal increase in property prices and stock prices? Little has been done to enquire into the behaviour of the property and stock markets, perhaps fearing that such actions could spook the rise in asset prices.

Sixth, financial crises do not play favourites, and no institutions are spared. But it begins with the actions of large institutions, which become too big to fail. There cannot be anything wrong in growing aggressively but the strategy adopted is very critical as this is often where the dangers lie. Financial services firms which are known to grow aggressively need to be carefully watched. Timely regulatory action always helps, whether in global markets or in India, even if such action may seem to spoil the party. More often than not, the pursuit of growth leads institutions to adopt sharp practices.

For example, Bear Stearns was known for its notoriously freewheeling—some would say maverick—culture. Bear had pledged to fork out more than $3 billion the previous summer to bail out one of its two hedge funds that had bet heavily on sub-prime loans. This itself should have sounded loud alarm bells.

The organisational culture, dependent as it is on the tone on the top, is crucial. For example, at 'Phi Kappa Wall Street, the image of Bear Stearns was that of tough-guy loner, scrawny, wearing its beat-up leather jacket and nursing a cigar, and who disdained secret handshakes and towel snapping in favour of an extended middle finger toward pretty much everyone.' It was said that in Bear Stearns, unlike in Goldman and Morgan, your pedigree mattered little. What mattered was whether you could make money on the trading floor, and sufficiently. Its long-time chairman Alan 'Ace' Greenberg even coined a name for his motley hires: PSDs, for 'poor, smart, and a deep desire to get rich'. Time and again, such institutions have won accolades and plaudits from the market and authorities to the total exclusion of adverse opinion or criticism. But later, it was discovered that what was considered to be 'unusual acuity of returns [was] only a fortuitous and unfortunate association of assets'. This is true for all institutions and individuals who are now under a cloud in the global market.

In India too, there are a number of financial institutions who have grown aggressively and their businesses now straddle various financial services as well as the real estate sector. They employed phalanxes of very smart people, people trained under Mametesque pressure-cooker conditions to create new products, and to sell them with utter disregard for ethics. These institutions need to be cautioned. In financial services, it is the attitude and approach of the foot soldiers and the frontline staff towards ethics which would signal the tone at the top. It would be useful to watch out for such early warning signals.

Seventh, the genesis of market misconduct and financial crises on a big scale usually lie in areas which are either unregulated or lightly regulated and which operate by leveraging to the hilt. Unregulated banker's receipts used in the latter part of the 1980s by Harshad Mehta are an example. Credit default swaps, mortgage-backed securities and other collateralised debt obligations were lightly and indirectly regulated. Enron operated in the borderland while complying with the disclosure standards and governance norms on paper. It is important to identify such institutions and instruments and appropriately ring a fence around them. In India, non-banking finance companies (NBFCs), private equity players and private sector banks are three such institutions. While all these institutions are crucial for our markets, we should not become oblivious to the risks they carry. Several of these institutions have been included in the category of Systemically Important Financial Institutions by the RBI. But is that enough? Such institutions should usually always be kept under careful scrutiny, which should go beyond off-site inspection and periodic reports.

Not only should their CEOs be interviewed periodically by the regulators, but their annual reports and periodic financial statements should also be analysed. Financial statements are places where one can easily detect frauds. A hands-off regulatory approach does not work with such institutions.

Eighth, financial crises, either global or domestic, transform 'something close to universal trust into something akin to universal suspicion' as Galbraith remarked in his book The Great Depression. Under these conditions, it becomes difficult for regulators and legislators to make the wisest decisions or take the best measures. Regulations originating in a crisis tend to be extreme and such measures often lead to expensive regulation. The Sarbanes Oxley Act is one such example. The question is: if the financial crisis could not be detected despite the expensive disclosures and risk management requirements of this act and NYSE rules, are such rules serving the purpose? The recent banning of short sales in the US, Europe and Australia is another example. Banning of short sales is an extreme securities market measure which has not worked in any market. It does little to arrest the decline in prices; on the contrary, when the ban is removed, a flood of pent up sales push the market down further. This was tried in India too on a couple of occasions, and with little effect. We ought to refrain from taking any quick-fix regulatory measure—either as a precautionary or prophylactic step or for lifting the market sentiment. Market sentiments cannot be talked up or down and when fear grips the market it would be futile to try and impact the prices by comforting statements. For example, the famous Greenspan speak of 'irrational exuberance' had affected markets only for half a day. Markets are known to respond to the casual market-reviving measures only casually, as they did to the recent Participatory Note related policy changes. What works are measures that ensure that liquidity never dries up. That is the responsibility of the central banker.

Ninth, derivatives are useful financial instruments. Just as financial markets cannot function without speculation, derivatives too are necessary for market efficiency. However, it is important that authorities understand the nature of the beast. Derivatives feed on leverage, and leverage feeds on greed. A combination of these leads to complexities in derivatives. When Bear Stearns ideated credit derivative swaps it may not have imagined its destructive potential. It saw the market in credit derivatives swaps as a place to make money. The instrument became so complex that, at one point, few understood who was taking the credit risk and this lead to a mispricing of risk. But complex derivatives helped make more money and puff up the bottom line, and earn more bonuses. No one could object. No one did. As yet in India we do not have complex derivatives or complex structured products based on securitisation. Nor has the securitisation market picked up. But there are a variety of derivative instruments in the stock market (index-based and stock-based futures and options) and exchange-traded currency futures have been introduced in the currency market. But even these simple derivatives could cause severe risk-management problems unless

one is careful. Though currency futures have the potential to adversely impact the exchange rate, there is already a demand from market participants to dilute some of the safeguards which, they contend, are making the market inefficient.

In equity derivatives, for example, one could question why stock futures have gained popularity (even with FIIs) in our market in comparison to anywhere else in the world. It could be that stock futures closely resemble the erstwhile carry-forward system which the market is familiar with; and it is possible that brokers and clients have found a way of using stock futures in a manner similar to the carry-forward system. This large market for stock futures could also be the reason why the short selling has not picked up in India. It may be useful to understand why the number of stocks eligible for stock futures far exceeds the number of securities eligible for carry forward and how it would benefit the stock exchanges to increase the list. It would be interesting to enquire why the volumes in stock futures are often multiples of the cash market, or if stock futures and index futures contribute to the phenomenal increases in market capitalisation, or market volatility, or why the open interests remain very high in stock futures, even when the stock market falls. It would also be worthwhile to find out if management and promoters of companies are using stock futures in the same way as they used the carry-forward system to help increase the valuation of their stocks and influencing the index. But no one has tried to find out the hows and whys. At least the stock exchanges did not.

Tenth, the growth in the size, role and complexity of the stock market makes its regulation more difficult than ever before. There needs to be a sharing of regulatory burden between the stock exchanges and the central regulator in India. The stock exchanges—the BSE (Bombay Stock Exchange) and the NSE (National Stock Exchange)—have two functions. One, is to provide a trading platform and, two, to perform the regulatory function of disciplining its members. Stock exchanges have done an excellent job with the former but have not particularly distinguished themselves in the latter and it may now be time to segregate the two functions. The regulatory function could be spun off into a separate body common to both stock exchanges, which would report to the central regulator and oversee the monitoring and supervision of the stock exchanges and the members. It will allow the regulator to devote greater time and resources to policy and overall market supervision.

Eleventh, related to the regulatory model just outlined is the adoption of the concept of the self-regulatory organisation (SRO). If this is to be adopted, it must be done with reference to its relevance to India. Given the way our market has grown, it may not be easy for all our intermediaries to form SROs keeping in mind that taking action against fellow members is not an easy task, at least in India. Under the circumstances it might be easier to work with the association of NSE members—ANMI—which has now converted itself into a national body. If ANMI is nudged into being an effective and efficient SRO over the next one year, it might serve a very important function for the securities market.

Twelfth, competition is important among stock exchanges. But to compete efficiently, they must have products which differ in features and benefits or, even if these parameters are the same, they must be distinguishable in service quality. Without any product differentiation, the market gets segmented, leading to efficiency losses when the same product is traded on more than one exchange. The BSE and NSE are now trading identical products in equity; even arbitrage gains between the two are insignificant. Unless one is trading in very large volumes, arbitrage gains remain small. Other 19 stock exchanges have been de-mutualised and are in existence without any business. In the past, when account period settlement was prevalent, the dates of the settlement varied from exchange to exchange. It was this variation in settlement cycles, complemented by the availability of carry-forward trading, which made product differentiation possible even if the same security was traded in multiple stock exchanges. The issues that need to be debated are: one, is there any purpose in having two stock exchanges that trade the same product with indistinguishable features and benefits? Two, is it politically incorrect to merge the 125-year-old BSE with the NSE to gain advantages of size, liquidity and depth? Three, would it be a loss, financial or national, if the non-functioning exchanges were closed down and the companies wound up under the Companies Act? Four, with one stock exchange, would the overarching regulation and governance structures need to be strengthened?

Thirteenth, India has a fledgling mutual funds sector wherein funds have chosen the easy growth path by approaching the corporate sector for investments rather than tapping individual investors by developing a large network across the country. The Association of Mutual Funds of India has done precious little in diversifying the sector or contributing to its growth. If efforts were made to encourage individual investors (across the urban and rural landscape) and wean them away from competing investment opportunities, a strong countervailing institutional mechanism may have been available. Countervailing forces are essential in stock markets and the greater the diversity of investor classes in a market, the greater the possibility of competition (as diverse investor classes will have different horizons) and the greater the market efficiency.

Fourteenth, the present crisis did not originate in India. To a large extent, we are facing the consequences of events beyond our shores. It is a great tribute to the cautious and judicious policies of the RBI and the government that we do not have the kind of runaway laissez faire economics which has allowed global financial markets to indulge in products which were exciting and exotic at the time of launch but carried in them the seeds of destruction. The present global financial crisis is not an account of market misconduct but the result of deliberate leveraging, mispricing of risk and asset bubbles. Although several confidence-building measures have been

taken, we may not have come to the end of the tunnel. Fears of a US as well as global recession will not die down so soon. It is important that this is understood and we should not get carried away merely by the performance of the stock market or the housing asset bubble and parade them as indicators of prosperity. It is equally important that we take a deep dive to clean up our own house by taking deeper systemic measures.

This article has deliberately not touched upon new products that need to be introduced in our stock market. The job of identifying and developing such products should be left to stock exchanges and market participants, rather than the regulator. The latter should be tasked with managing the products through appropriate regulations. This paper does not touch upon the process simplification measures to improve market efficiency as the central regulator is doing a commendable job. It also does not talk about the debt market because there are volumes of reports on the subject and if the latest securities market comprehensive report is implemented, the debt market in India would have a new face. All this apart, the report on how to make Mumbai an international financial centre seems to have included every conceivable financial instrument and policy change that needs to be Introduced in India to magically transform a city with crumbling infrastructure into an international financial centre.

Finally, my pet peeve. ***The stock market is ruled by powerful emotions and desires—greed, fear, hope, uncertainty and hubris—which control the behaviour of stock markets and investors. Various theories and economic models rationalise these emotions and desires.*** 'Fear is an automatic response in all of us to threats to our deepest inbred propensities. It is also the basis of many of our economic responses. It is difficult for investors to imagine when markets veer from rational to irrational, from euphoria to fear and back again' (Alan Greenspan, *The Age of Turbulence*). Behind the CDSs, CDOs and MBSs and the widely-used 'originate and distribute' model of securitisation lies the real originator of the sub-prime problem—inordinate greed. This is reflected in the flawed system of executive compensation by way of bonuses tied to short-term profits for the bankers, heralded as the proud pennants of free market and capitalism. **All of these concerns fall squarely in the domain of ethics and corporate governance, the role and responsibility of the Boards,** especially those of financial institutions.

The sub-prime crisis originated in highly professional financial enterprises, served by highly knowledgeable and competent boards, complemented by a talent pool drawn from the best business schools, extensive disclosure requirement, and an elaborate risk management system. Compare this to Mohammed Yunus' Grameen Bank which was set up in 1976 to lend microcredit to the impoverished without requiring collateral: it has a borrower base of over 8 million and an outstanding loan portfolio of $313 billion (as of October 2007) and has a loan recovery rate of 98 per cent. We

may analyse and attribute the success to the business model, we may determine that that model would not be relevant and appropriate in a world where it is customary to wear pinstripe dark Versace with a pink shirt and tie but, in reality, the Grameen Bank is in the financial service business and is not a charitable institution. The only difference is that there is absence of greed, high standards of governance and high degree of accountability. **Markets and regulators need to look at the entire subject of ethical business conduct and governance standards afresh**, especially in financial services firms. In India, corporate governance and ethical business conduct are areas which need careful attention, by the regulators, the stock exchanges and the government. This would mean that there is a need to go beyond box-ticking compliance and make it a part of business strategy. This is yet to happen in a big way in India. For example, banks, even the listed entities, have their own corporate governance and ownerships standards which are different from what has been prescribed in Clause 49. Public sector companies which are listed on the exchange have to necessarily follow government policies, and have to address societal needs, even if such needs are at variance with shareholder interests. Private sector companies are governed by the legal framework of the Companies Act and the listing agreement for corporate governance; more often than not these two provisions are contradictory rather than complementary. This does not make sense. It is important that regulators work towards a uniform and harmonious governance standard which addresses issues of governance comprehensively and is applicable to all listed companies, irrespective of the regulatory jurisdiction.

This crisis has shown that organisations, especially in financial services sector, need to be founded on an ethical value system if they are to be successful in the long run. **No regulatory ring-fencing, no funds injection by national governments, no confidence-building will work unless governments, central banks, regulators and financial services companies realise that the success of laissez faire economics is predicated on a system of values and ethics.**

About the Author

Mr. Pratip Kar is currently the Dean of Finance and Corporate Governance at the Tata Management Training Centre (TMTC) in Pune. He joined TMTC in September 2006. He designs and delivers programmes in finance, financial regulations, ethics and corporate governance at TMTC.

Mr Kar holds a MBA degree from INSEAD, a Certificate in Banking from the Indian Institute of Bankers, and a Post graduate in solid state physics with a year's post- MSc experience in nuclear physics from the Calcutta University. He is proficient in French language.

He is a Member Board of Governors, National Institute of Securities Market, set up by the Securities and Exchange Board of India, Member CII National Council on Corporate Governance and a Member of the India Advisory Council of the Global Corporate Governance Forum—an IFC multi donor trust fund facility.

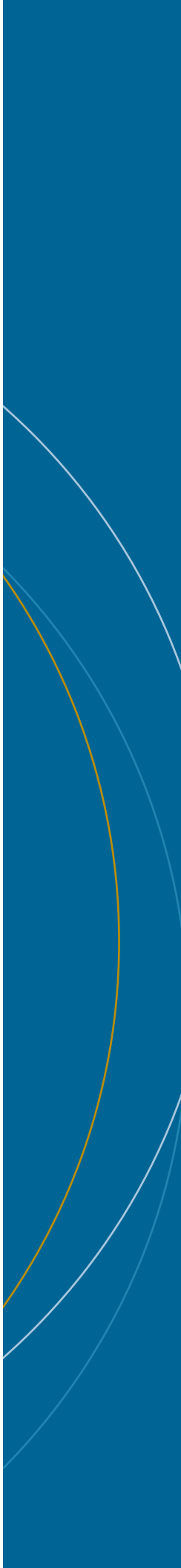
He has been in the financial sector in India for nearly three decades, of which ten years (1977–88) was in development banking and project finance with the Industrial Finance Corporation of India and Industrial Development Bank of India and twenty years with the capital market.

He joined the Securities and Exchange Board of India (SEBI) when it was set up in 1988, and was with it till September 2006. He became the Executive Director of SEBI in 1992. During his 18 years tenure in SEBI, he was closely involved with the economic reforms in the country and with the reform of the Indian securities market. He helped frame the regulatory framework and policy for the securities market, and implement the regulations relating to primary issues, disclosure norms, accounting standards, corporate governance, takeovers and substantial acquisition of shares, foreign institutional investment, mutual funds, automation and modernisaton of the stock exchanges, regulations of the stock exchanges, demutualisation of stock exchanges, regulation of the equity, bond and derivative markets, risk management, dematerialisation of securities, clearing and settlement systems, surveillance and investigations and policy research. He also drafted the SEBI reports on Corporate Governance and framed the Clause 49 of the listing agreement which lays down the requirements of corporate governance in India.

He also has a rich experience in international securities market regulations and has been a regular participant at the meetings of the International Organisation of Securities Commissions (IOSCO) as well as the Organisation of Economic Cooperation and Development (OECD) and the World Bank in the areas of securities market and corporate governance. He has been a member of several high powered committees and working groups set up by the Government of India, the Reserve Bank of India,

SEBI, the OECD and the World Bank. He also has several publications to his credit in the field of capital markets.

His areas of specialization are: corporate governance, domestic and international regulatory framework for capital markets, compliance, risk management and internal controls, mutual funds, derivatives, foreign portfolio investment, mergers and acquisitions, raising of capital in domestic and international markets.



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Established in 1999, the Global Corporate Governance Forum is an IFC multi-donor trust fund facility located within IFC Advisory Services. Through its activities, the Forum aims to promote the private sector as an engine of growth, reduce the vulnerability of developing and transition economies to financial crises, and provide incentives to corporations to invest and perform efficiently in a socially responsible manner.

The Forum sponsors regional and local initiatives that address the corporate governance weaknesses of middle- and low-income countries in the context of broader national or regional economic reform programs.

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