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Antagonism Of Interest And Market Discipline Among Financial Services Industry

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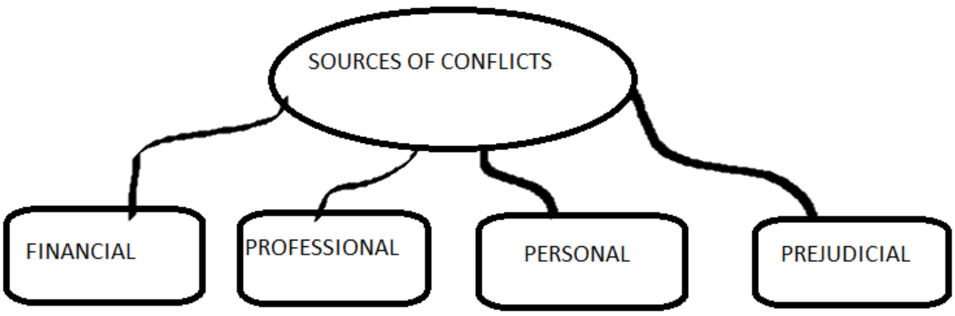
***Abstract**: Antagonism of interest, a type of moral hazard problem that occurs when a person or institution has multiple objectives or interests and as a result has feuds between them, may be responsible for the recent scandals. Firms can benefit from Conflict-Profiteering in the short term, to the extent that business margins are increased as a result but the reputation losses can cause serious damage, as demonstrated by repeated "accidents," and contribute to poor market valuations among the most exposed financial services firms with conflict-profiteering. The fact that such events repeat with some regularity suggests that market discipline is not a remedy for corporate ills – for reasons that include faults in corporate governance among financial services firms themselves. This report analyses what conflicts of interest are, explains why we care about them, and develops a framework for evaluating policies to remedy them.*
***Key Words**: Conflicts, Exploitation, framework, financial services, Interests.*

I. Introduction

Conflicts of interest may have played an important role in the subprime financial crisis of 2007–2008 by compromising the quality of credit ratings. In each case, people who were supposed to act in the investing public's best interests by providing investors with reliable information had incentives to deceive the public and thereby benefit both themselves and their corporate clients. What are these conflicts of interest, and how serious are they? Where do they occur, and why have they been the source of the recent woes in financial markets? What should, and can, we do about them? This chapter provides a framework for answering these questions. It first explains what conflicts of interest are, why we should care about them, and why they raise ethical issues. It then surveys the different types of conflicts of interest in the financial industry and discusses policies to remedy them.

Potential conflicts of interest are a fact of life in financial intermediation. Under perfect competition and in the absence of asymmetric information, exploitation of conflicts of interest cannot rationally take place. Consequently, the necessary and sufficient conditions for agency costs associated with conflict of interest exploitation center on market and information imperfections. Arguably, the bigger and broader the financial intermediaries, the greater the agency problems associated with conflict-of interest exploitation. It follows that efforts to address the issue through improve

We care about these conflicts of interest because if they sufficiently reduce the amount of information in financial markets, they increase asymmetric information and prevent financial markets from channeling funds to those with productive investment opportunities. There are clearly broader definitions of conflicts of interest than the one stated above, and many of these conflicts of interest are exploited to the detriment of individuals and the economy. However, this paper restricts itself to a narrower view, because conflicts of interest require public policy intervention only if they lead to less efficient financial markets



1.Misuse of fiduciary role ***2.Board interlocks*** ***3.Misuse of private information*** ***4.Client interest incompatibility*** ***5.Involuntary cross-selling*** ***6.Churning*** ***7.Inappropriate margin lending*** ***8.Market-timing and late-trading***

In order to understand why conflicts of interest are important, we need to step back a bit and think about the function of financial markets in the economy. Well-functioning financial markets perform the essential economic function of channeling funds from individuals and firms who lack productive investment opportunities to those who have such opportunities. By so doing, financial markets contribute to higher production and efficiency in the overall economy. Reliable information is the key to financial markets performing this function.

Moral hazard occurs because the receiver of funds has incentives to misallocate funds for personal use or to undertake investment in unprofitable projects that increase personal power or stature. As a result, many investors will decide that they would rather not provide firms with funds, so that investment will be at suboptimal levels. To minimize the moral-hazard problem, investors must have information so that they can monitor the activities of managers to ensure that they use the funds to maximize the value of the firm.

II. Types Of Conflicts Of Interest

Banking System

Although commercial banks, investment banks, and insurance companies originally arose as distinct financial institutions, there were economies of scope that could be attained by their combination, thus leading to the development of universal banking in which all of these activities are combined in one organization. Yet, given that activities within a universal bank serve multiple clients, there are many potential conflicts of interest. If the potential revenues from one department surge, there will be an incentive for employees in that department to distort information to the advantage of their clients and the profit of their department. For example, issuers served by the underwriting department will benefit from aggressive sales to customers of the bank, while these customers are hoping to receive unbiased investment advice. A bank manager may push the affiliate's products to the disadvantage of the customer or limit losses from a poor public offering by placing them in the bank's managed trust accounts. A bank with a loan

Underwriting and research in investment banking

It is the responsibility of each underwriter to:

- Act promptly, while exercising sound, objective and consistent judgment, in making underwriting decisions.
- Follow established risk classification principles that differentiate fairly on the basis of sound actuarial principles and/or reasonable anticipated mortality or morbidity experience.
- Treat all underwriting information with the utmost confidentiality, and use it only for the express purpose of evaluating and classifying the risk.
- Comply with the letter and spirit of all insurance legislation and regulations, particularly as they apply to risk classification, privacy and disclosure.
- Avoid and underwriting action which is in conflict with the obligation to act independently and without bias.
- Act responsibly as an employee with scrupulous attention to the mutual trust required in an employer-employee relationship.
- Provide information and support to sales personnel to help them to fulfill their field underwriting responsibilities in selecting risks and submitting underwriting information.
- Strive to attain Fellowship in the Academy of Life Underwriting, maintain a high level of professional competency through continued education, and help promote the further education of all underwriters. 16 The Role of the Underwriter in Insurance
- Maintain the dignity and sound reputation of the Underwriting Profession.
- Increase the public's understanding of the underwriting by providing information about risk classification.

Auditing and consulting in accounting firms

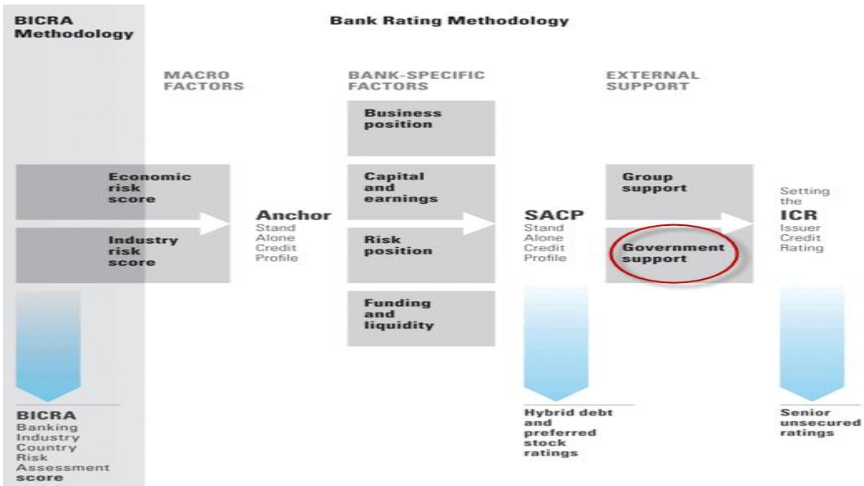
Accountants in public practice should be independent in fact and appearance when providing auditing and other attestation services. If you provide attestation or assurance services to clients, a conflict of interest

may prevent you from also providing investment advisory services.
AICPA rules state that an accountant's independence will be impaired if the accountant:

- makes investment decisions on behalf of audit clients or otherwise has discretionary authority over an audit client's investments.
- executes a transaction to buy or sell an audit client's investment.
- has custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.
- Accountants may provide certain advisory services to audit clients without impairing independence. Accountants can:
- recommend the allocation of funds that an audit client should invest in various asset classes, based on the client's risk tolerance and other factors.
- provide a comparative analysis of the audit client's investments to third-party benchmarks.
- review the manner in which the audit client's portfolio is being managed by investment managers.
- transmit an audit client's investment selection to a broker-dealer, provided the client has made the investment decision and has authorized the broker-dealer to execute the transaction.

Credit assessment and consulting in rating agencies

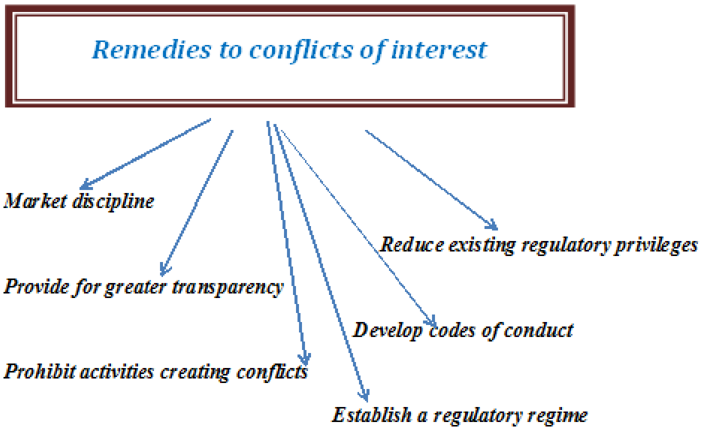
Ratings are widely used by investors as a guide to the creditworthiness of the issuers of debt, and in financial covenants. As such, they play a major role in the pricing of debt securities and in the regulatory process. Conflicts of interest can arise from the fact that there are multiple users of ratings; and, at least in the short term, their interests can diverge.



Source: Standard & Poor's

III. The Panacea For All Corporate Ills

The information view of conflicts of interest proposed here also provides a framework for evaluating whether they require public policy actions to eliminate or reduce them. Some combination of financial service activities may result in incentives for agents to conceal information, but they may also result in synergies that make it easier to produce information. Thus, pre-venting the combination of activities to eliminate the conflicts of interest may actually make financial markets less efficient. This reasoning suggests that there are two propositions that are critical to evaluating what should be done.



The fact that a conflict of interest exists does not mean that it will have serious adverse consequences. Even if incentives to exploit conflicts of interest remain strong, elimi-nating the conflict of interest may be harmful if doing so destroys economies of scope, thereby reducing information flows

(i) Increase disclosure for investment analysts, credit rating analysts, and auditors to reveal any interests they have in the firms they analyze
(ii) Improve corporate governance
(iii) Supervisory oversight.
(iv) Socialization of information production.
(v) Establish codes of conduct developed by industry participants in co-operation with supervisors.
(vi) Increase supervisory oversight.
(vii) Provide adequate resources to supervisors.
(viii) Enhance competitiveness in the rating agency industry.
(ix) Prevent the co-option of information-producing agents by regulators and supervisors.
(x) Avoid forced separation of financial service activities except in unusual circumstances.
(xi) Do not socialize information for the financial service industry.

IV. Recent Scandals

The Brazilian oil company's financial scandal began at the beginning of 2015. Over 80 people, which includes former executives and senior politicians, were charged with money laundering and bribery. The scandal was given the name 'Operation Car Wash'. Prosecutors began investigating allegations back in 2014. The company was accused of taking billions of dollars and using it for personal use or to illegally donate to politicians.

Fourteen FIFA officials were indicted on 47 counts of money laundering, racketeering and wire fraud. Racketeering is considered to be the worst of the three crimes because according to the U.S. Attorney General, that meant the officials were turning the sport 'into a criminal enterprise.' This isn't the first time FIFA has been in trouble, but this is the first time the charges came from the U.S. Department of Justice.

July 2015, president and chief executive of Toshiba, Hisao Tanaka, resigned from the company because he was being investigated for being aware that the company was inflating profits for years. Since 2008, the company had been overstating operating profits by $1.22 billion in total. Two of Tanaka's predecessors were implicated in the report and also had to step down from the company.In April 2015, 'The Wall Street Journal' and 'The New York Times' published articles that linked the Clinton foundation with undisclosed donations for selling United States uranium production to a government agency in Russia. Reuters also revealed that the Clinton foundation misreported the amount of money from foreign governments by the tens of millions.

Akebono is a car part manufacturer expected to lose $58 million in the fiscal year ending in March 2016. According to a recent statement, the company inflated its profits and sales. They did this by saying their distributors had more inventory than they did. Following the Toshiba scandal, this is the second big financial scandal Japan has seen within the last few months.India's second biggest state owned bank called Bank of Baroda is at the center of a $1 billion money laundering scandal. The branch under investigation is located in a neighborhood called Ashok Vihar in New Delhi, the capital of India. The branch allegedly participated in the illegal foreign exchange transaction worth $922 million. The areas impacted by this are spread between Latin America and the Middle East.

V. Conclusion

Market discipline, working through the need for agencies to retain their reputational capital, has been instrumental in maintaining this situation. Nevertheless, there are troublesome aspects of the way in which the industry has developed, and the potential exists for conflicts to assume greater significance in the future. To guard against this, we believe it is important to ensure that market disciplines are provided with full scope to work in their intended way. This means an emphasis on transparency, and possibly supervisory oversight of new activities being developed by the agencies; a reduction in the scope of regulatory recognitions granted to approved ratings; and a diminution of barriers to entry of qualified new entrants to the industry.
Conflicts of interest may be constrained, they are more difficult to eliminate. It is easier for the market to identify a potential conflict of interest than it is to observe if it is being exploited because the ability to exploit conflicts depends on the hard-to-monitor internal controls and compensation mechanisms within financial service firms.

Radical solutions to conflict of interest problems that socialize information or stringently separate financial service activities are likely to do far more harm than good. We believe that with increased disclosure of information and supervisory oversight plus additional reforms of the rules governing audit opinions and official use and sanction of ratings, the problems created by conflicts of interest can be minimized. More radical approaches have the potential to reduce, rather than increase, the quality of information in financial markets, with the result that channeling funds to productive investments, which is so crucial to strong economic growth, could be severely compromised. While conflicts of interest may be constrained, they are more difficult to eliminate. It is easier for the market to identify a potential conflict of interest than it is to observe if it is being exploited because the ability to exploit conflicts depends on the hard-to-monitor internal controls and compensation mechanisms within financial service firms.

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