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Comment: Hamid Rashid*

Information Asymmetry, Conflicts of Interest, and the Financial Crisis: Lessons Learned and the Way Forward

Information asymmetry is often the main cause of market failures, as Joe explains earlier in the chapter. Firms, especially financial firms, have incentives to exploit information asymmetries, hiding critical information about their incentives, behavior, and performance. Conflicts of interests—with information asymmetry hiding their existence—can allow financial firms to ignore, misprice, and under-report risks, triggering devastating market failures. This is what we saw in the run up to the financial crisis, the most significant market failure of our lifetime. One lesson from the crisis is that regulators, rating agencies, and investors largely failed to detect widespread conflicts of interest in the mortgage market, when some large banks commingled appraisal, origination, servicing, securitization, underwriting, and even rating functions. A bank originating a mortgage typically relies on an independent third party to appraise the value of the property and thus avoid potential conflicts of interest in the valuation. But this practice changed during the boom years before the financial crisis. If a bank stood to gain more from a higher valuation of the property—earning hefty commissions and fees, as we saw during the mortgage boom—it would use a complicit appraiser willing to inflate the property value. By 2006, 90 percent of the property appraisers felt pressured—often by the originating bank or its agents—to inflate home values.[1] The independent appraiser was supposed

*The views expressed here do not reflect the views of the United Nations or its Member States.

1. Financial Crisis Inquiry Commission (2011).

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to protect the lender (and by extension, the banks' depositors) against the risk of a mortgage default. But during the mortgage boom, the appraiser and mortgage originator worked together—a clear conflict of interest—to inflate property values and originate as many mortgages as quickly as possible, which exacerbated the risk of a crisis.

Conflicts of interest were also pervasive in transactions between the originator and the mortgage securitizer. Both often worked for the same bank, and the originator knew that the securitizer would buy whatever mortgages she would originate, without raising any question about the quality of the mortgages. In addition, the securitizer knew that he would be able to package any mortgage into AAA-rated securities and sell them to the investor clients of the same bank, then neither the originator nor the securitizer had an incentive to assess underlying risks accurately and price the mortgage-backed securities correctly. With all transactions taking place among related parties and no consequences for ignoring conflicts, due diligence became a waste of time for our banks.

During the mortgage boom, our banks routinely hid conflicts of interest and originated trillions of dollars of subprime mortgages that did not meet minimum underwriting standards. In a "issuer pays" rating model—with manifest conflicts of interest—more than 80 percent of subprime mortgage-backed securities received the highest-possible AAA ratings,[2] making many below-investment-grade securities highly attractive to investors. Had the investors been fully aware of the extent of the conflicts of interests—and how these conflicts contributed to the mispricing of mortgage-backed securities—the mortgage bubble that precipitated a global financial crisis might have been avoided.

It is surprising that the pervasive conflicts of interest that led us to the crisis did not attract the attention of our regulators, given that only 7 years earlier, the Enron scandal exposed widespread and harmful conflicts of interest in corporate America. Drawing on the Enron lessons, the US Congress passed the Sarbanes-Oxley Act in 2002, with the stated objective: "to protect investors by improving the accuracy and reliability of corporate disclosures." Title V of the Act deals with conflicts of interest, requiring a clear separation between the securities analysts and

2. Ashcraft, Goldsmith-Pinkham, and Vickery (2010).

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underwriting functions of a financial firm. Large banks blatantly disregarded the separation and exploited conflicts of interest in securitization deals. Yet no banker was charged for violating the Sarbanes-Oxley Act, although it contained provisions for holding senior management personally responsible for a breach.

As the issuers of billions of dollars of Alt-A and subprime private-label mortgage-backed securities, our largest banks were fully aware of the quality of underlying assets that backed the securities and yet hid that information from their investors. The banks put their own interests ahead of the interests of their investors to make a quick profit on risky bets. The sheer size and complexity of these banks—financial supermarkets—that combined mortgage, retail, and investment banking activities, allowed them to exploit conflicts of interest with impunity. Their status as "too big to supervise" allowed them to evade regulatory oversight, while being "too big to fail" meant they faced no consequences of a devastating financial crisis.

Aiming to address the root causes of the financial crisis, the US Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. The Act was intended to mitigate, among other issues, the inherent conflicts of interests in securitization. Section 621 of the Act, for example, prohibits any transaction that could create a conflict of interest with an investor in a securitization transaction. The subsequent rule issued by the Securities and Exchange Commission (SEC) included a negative list of conflicts of interest in securitization that is laden with exceptions and loopholes. For example, the rule provided that a securitization transaction would not represent a conflict of interest if it is for hedging, market-making, or for providing liquidity. This leaves room for subjective interpretation, requiring the regulator to differentiate ex ante between hedging and speculation. There is a growing recognition that it is hard, if not impossible, to detect conflicts of interest in securitization, especially when it involves many parts of a large and complex financial firm.

The Dodd-Frank Act, even if implemented fully, is unlikely to mitigate conflicts of interest in securitization, largely because of its reliance on a narrow set of rules and a long list of exceptions. Instead of prohibiting a limited number of activities, the Dodd-Frank Act needed to effectively address the structural causes of the crisis, such as the "too big to fail" criterion or stock-option based executive compensations, which incentivize banks to hide conflicts of interests and take excessive risks. Conflicts of

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interest—material, perceived, or potential—are often unobservable until their adverse effects become apparent. But organizational structures, such as bank size and compensation packages of senior executives, are clearly observable. The regulators need to target and regulate the observables instead of trying to regulate unobservable behavior. The Federal Reserve Board, for example, recently imposed a limit on the growth of the assets of a large bank that engaged in inappropriate behavior.[3] This is clearly a bold step in the right direction.

For nearly 70 years, the Glass-Steagall Act managed to keep conflicts of interest under control by enforcing a clear and structural separation between commercial and investment banking activities and making sure—albeit indirectly—that banks were not too big to supervise and regulate. Unlike the Dodd-Frank Act, it incorporated specific measures to address the problems of information asymmetry and conflicts of interest in the financial sector. Although Dodd-Frank recognizes the "too big to fail" problem, it has not prevented the growth of our largest banks. The large banks have since become even larger. In fact, the market share of the top 10 or 15 largest banks has increased relative to the pre-crisis level (figure 3.1). The largest bank in the United States was 57 percent larger in 2014 than it was in 2007.

Dodd-Frank also does not adequately address the problems of incentive structures in large banks. The stock-option based compensation schemes create a conflict of interest, as they encourage managers to act more like investors or speculators and to take excessive risks that boost short-term stock price of the firm, even if doing so undermines the financial stability and interests of the firm. In the run-up to the crisis, large financial firms offered significant amounts of stock options to their senior managers, ostensibly to incentivize best performance. Stock-based compensation also contributes to the "too big to fail" problem, encouraging top managers to aggressively increase size and market share. Although Dodd-Frank introduces certain prohibitions, time-limits, and claw-back provisions, stock-based compensation remains as pervasive as it was before the crisis. If this practice continues unabated, financial firms will continue to find ways to

3. See https://www.reuters.com/article/us-usa-wells-fargo-fed/fed-orders-wells-fargo-to-halt-growth-over-compliance-issues-idUSKBN1FM2V9.

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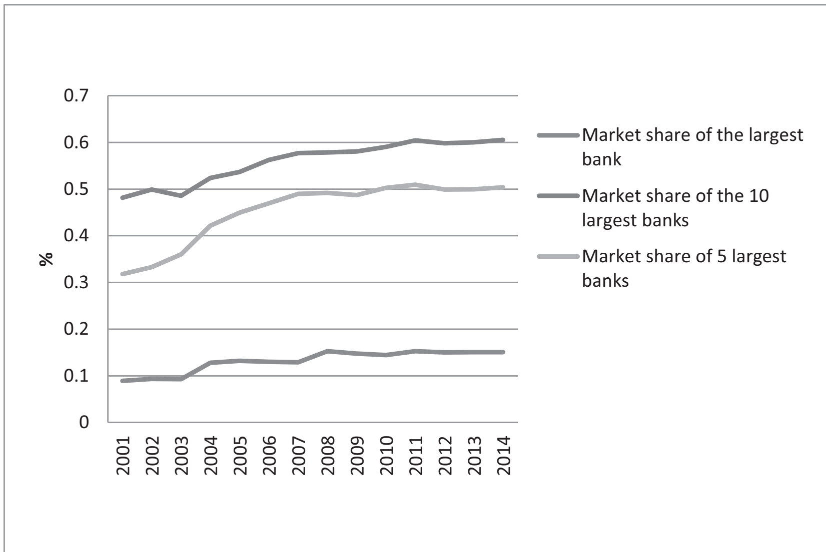

Figure 3.1
Market share of large US banks: 2001–2014
Percentage of total assets of banks with more than $300 million in assets
Source: Author's compilation of data from https://www.federalreserve.gov/releases/lbr/.

make risky bets and boost short-term profits and market valuation. This also perhaps explains the spectacular growth of the market valuation of US financial firms since the crisis, increasing from $2.8 trillion in 2008 to $7.3 trillion in 2015 (figure 3.2).

The financial crisis is a sad testimony to the failure of the revolution in information economics that Joe spearheaded, which should have fostered and enabled effective regulation of our financial sector, where information asymmetry matters the most. The advances in our thinking and understanding of how information shapes market behavior and the scope and intensity of financial regulations have moved in the opposite direction during the past few decades. We now see a starker, and more disconcerting, disconnect between the lessons of information economics and the state of financial regulation. Financial regulation of the past few decades has relied on the imaginary narrative of perfectly competitive financial markets with perfect information. The Dodd-Frank Act is no exception. The revolution

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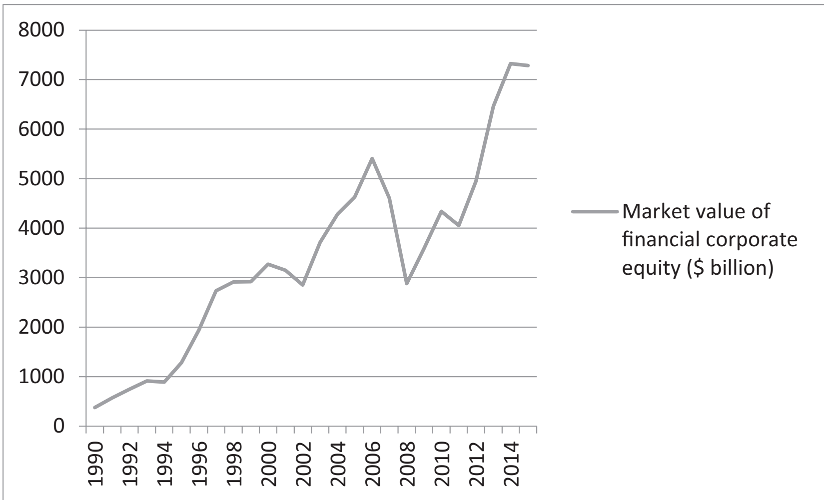

Figure 3.2
Market value of US financial corporate equity ($ billion)
Source: US financial accounts, https://www.federalreserve.gov/releases/Z1/Current/data.htm.

in information economics will remain incomplete until the economics of information guides and shapes financial regulation. Unless we bridge the gap between what we know and how we regulate financial markets, another financial crisis is just around the corner.

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The State of Economics, the State of the World

Edited by: Kaushik Basu, David Rosenblatt, Claudia Sepúlveda

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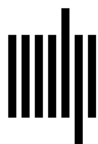

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