Connecting the dots - by Reaz Islam

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The recent crisis was caused by multiple factors including unabated risk layering in the financial system that led to the bubble. We can debate forever if the bubble was created by random events, policy errors, mismanagement, speculative investment or outright corruption. Most, if not all, financial crises around the world include all the above to some extent and it is only fair to accept that the recent crisis was not any different. In order to diagnose the main issues let us try and connect the dots that are more obvious.

The liquidity spigot was open

Generally, Bangladesh Bank (the primary liquidity provider) has managed to keep the banking sector reasonably insulated from systemic risks. Unfortunately it was not full proof, and at least to some extent the lack of timely enforcement of some of the existing rules and oversight of warning signs as loans to individuals and corporates ended up leaking into the over-priced capital markets. Obviously this was not intentional, but I believe played a role in inflating the initial bubble. In addition, allowing black money into the capital markets and the absence of capital gain taxation of share investment also played some role in setting the initial stage for layering of risks that was building and provided the environment for manipulation and speculation. Finally, I suspect actual margin in the system provided by some merchant banks and brokerage was to some extent uncontrolled and not adequately monitored. The brokerage fees and other transaction-based fees in some cases took priority and superseded the long-term interest of the investors or the institution itself that was providing leverage.

Easy money often has unintended consequences

When we have easy money it always ends up in a bubble, and bubbles often deflate very painfully both financially and, even most importantly, physiologically which is even harder to recover from. In addition, easy money in a less transparent market (uneven disclosure practices) also has unintended consequences, and creates abuse and manipulation by opportunists who prey on disadvantaged retail investors. Unfortunately we cannot eliminate the presence of such activities that may have contributed to the creation and to some extent deflation of the bubble upon their exit. Even in developed and matured markets, easy money policy was largely responsible for global recession in 2008-09.

Blinds leading the blinds

Banks, non-bank financial institutions, merchant banks, even brokerage firms provided leverage to the overpriced markets and I suspect in many instances to retail investors who are either uninformed, unsophisticated or outright speculators who had un-sustainable return expectations engaged in “share business” and not share investing. Excess return over a risk-free rate (deposit rate) involves risks whereby higher returns come with the potential for higher risk of loss. Those of us who are in the

markets have encountered rumors that XYZ stock will reach double the existing price, and that “Players” are behind it, without any regard to fundamentals. Unfortunately the retail investors were the collateral damage or left without the chair when the music stopped due to misinformation combined with poor advice, lack of research and, most importantly, aggressive margin loans provided by financial intermediaries. Unfortunately most banks, non-bank financials, merchant banks, even brokerage firms rarely have resources that can evaluate markets. This is probably also due to the fact that we do not have any fiduciary burden on these market intermediaries.

Uneven disclosure and lack of accountability

Beyond banks, NBFI and selected companies, financial reporting and disclosures of publicly listed companies are substandard. Issuers, auditors, and, most importantly, regulators must take this seriously. All publicly listed companies must improve financial disclosure. The requirement of tightening regulation to protect investors is long overdue. Quarterly conference calls with investors and analysts should be mandatory. In addition, we must determine what the obligation of the merchant banker or the broker is when it allows a client to invest or provide leverage to a client. If we do not have some fiduciary burden placed on the financial intermediaries, this problem will be repeated.

You are only as good as your weakest link

We have a serious shortage of qualified human resources and accountability in the financial markets including the regulators (SEC), banks, merchant banks, and brokerage that I believe played a role in the creation of the bubble in the first place. We are already more or less aware of the much talked about malpractices cited by different quarters as the reasons behind the recent crisis - manipulation of the well intended "Book Building" process that lead to overpriced initial public offerings, uninformed and unsophisticated investors incentivised and gamed to join the herd based on rumors and speculations, uncontrolled leverage disbursed by financial institutions in the overpriced market and many more. May be some intentional wrongdoing has taken place but I suspect this was largely due to the lack of adequate professional resources, systems, controls at regulatory agencies as well as financial intermediaries.

Excess liquidity and misinformation

Certain practices in capital markets have also contributed to create confusion among already uninformed investors. Following are a few glaring examples of such practices:

First, the concept of bonus shares that are sometimes expressed as issuance of 50 percent, 75 percent and 100 percent stock dividend. In most markets as opposed to Bangladesh, dividend, even if it is in the form of shares, is translated in dividend yield, i.e. the ratio of the realisable value of the cash plus the bonus shares once liquidated (numerator) over the most recent stock market price (denominator), calculated as a percent per share. Expressions like 50 percent, 75 percent and 100 percent stock

dividend in isolation, in my view, distort reality and are often misused in an immature market as Bangladesh.

Second, the face value of stocks is irrelevant for any valuation, and a perception exists that lowering face value is correlated with appreciating stock price regardless of fundamentals. This obviously played a role in creating the bubble since many were attracted to the overpriced market due to this gimmick. Although the intention was to create uniformity, it was unintentionally fuelling the speculative bubble, and aggravated the situation further.

Third, uninformed investors often misconstrue the revaluation of real estate as a fundamental change in a company's business prospects. Yes an investment in Real Estate can be marked to market and even liquidated to create value, however, if the company relies on cash flow directly or indirectly generated from real estate as a going concern, such practice may provide false expectations about the outlook of the company. It is imperative to realise that a company's real value lies in the expected future cash flow from core and continuing operations and not from onetime (non-recurring) sale/revaluation/mark-to-market of fixed assets unless real estate sales from inventory are an integral part of the company's core operations.

All industry professionals, regulators even print media are equally responsible for this illusion that is not only harmful but in some cases fraudulent, and provides opportunities for rumor mongers to inflate prices over intrinsic values based upon misleading or incomplete information.

No free lunch

The stance of "Blame the unsophisticated investors" is unfair, however all investors and financial intermediaries must take responsibility for their actions, otherwise we do not have a properly functioning capital market. Breaking windows and cars is not the solution. The government's intervention to support the market only makes this problem worse and creates unsustainable moral hazard that is an even more dangerous problem to deal with. The intervention should be the last resort and when used must be properly prescribed and managed only to the extent the support is required. Otherwise these interventions are not only ineffective but also harmful for the economy at a minimum and may also provide another opportunity to be exploited by manipulators.

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