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Editorial

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Corruption in corporate sectors and high public offices is a menace that negates the growth story of India. Lots of government Initiatives in India today is mired in controversy and allegation of corruption. Many laudable social projects launched by the government are alleged to have resulted in massive financial corruption. Experts believe that inefficient bureaucracy and rent seeking behavior of the government are the two root causes of corruption in India. Media is at times complimented for doing a commendable job in unearthing stories on corruption and making public aware of it. The question that is raised now is how the economic institutions react to the news on corruption. The first article in this volume looks at the short-term reaction of the stock market on corruption. Surprisingly the article finds that the short-term reaction of the stock market is positive or neutral.

The second article highlights important findings of the book titled Scorecasting. The author uses the concept of 'home field bias', as described in the book, to suggest that banking regulation also shows symptoms of such bias. The author argues that regulators should come out of such bias while framing regulatory policies.

I hope you'll enjoy reading the newsletter. Please offer suggestions for further improvement to ashok@iimcal.ac.in

Editor

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Corruption and Stock Market

Prof. Ashok Banerjee

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During the last five years (June 2008 –May 2013), there were 964 news items on corruption in India- of which 58% were reported in last one year. During the same time corruption news reported of other BRIC countries was very few- in double digits. This clearly shows that India has, in recent years, attracted the attention of the press for wrong reasons. This may also mean that corruptions in other BRIC nations get largely under-reported due to government control or influence on the press. India is struggling to fight corruption for quite some time and there is yet no sign of a solution to end or minimise the menace. History tells us that this experience of India is nothing unique. Whenever any country is in a transition from an agrarian economy to industrial economy with sustained growth, corruption is bound to happen. It was the duty of the media and civil society of the affected nations to highlight the areas and enormity of corruption resulting in establishment of appropriate governance mechanism. Experts mention that the process of cleansing takes time. However, some critics mention that Indian public has short memory and therefore would not be able to maintain persistent pressure on government to eradicate corruption. Regulation always lags market practices and participants' behavior. Corruptions tend to flourish when institutions are weak and government policies generate economic rent. Bribes are one of the main tolls of corruption. A World Bank study has shown[1] that interestingly foreign direct investment may still flow to countries in which corruption is systematic but only if bribery is affordable and the results are predictable. Many regulatory bodies were set up after a major corruption (scam) incident or economic upheaval. The Securities and Exchange Commission in the United States was set up after great depression. In India, the capital market regulator, SEBI, was set up after Harshad Mehta scam.

The news on corruption was reported by several reliable national and international agencies (Table 1). The present article did not consider news on social media. There were a very few stories on corruption in India till 2009. Some of the popular news items on corruption during this period were on Commonwealth Games (held in Delhi) and on NREGA.

Table 1: Number of news on corruption in India during the last five years

Agency	Number of news
Press Trust of India	542
Washington Post	81
Bloomberg News	77
Financial Express	40
Financial Times	25
New York Times	51
Economist	7
Wall Street Journal	7
Telegraph (UK)	30
Others	104
Total	964

Source: Bloomberg

[1] www1.worldbank.org/publicsector/anticorrupt/corrupt/cor02.htm

Capital Market Reaction

How did the stock market react to news on corruption? The news flow is continuous whereas the stock market operates for a defined period of time during the day. Hence, the news items are divided into three segments- (a) news during market hours; (b) news in off-market hours; and (c) news on holidays (Table 2). It is observed that most of the news on corruption was reported in the off-market hours and hence market reaction could be gauged from the opening price of the next trading day. The reaction to off-market news is more reliable as the investors usually get more time to analyse those news and hence their trading behavior would capture their perception about the impact of corruption on general economy.

Table 2: News Timing

Time of the day	Number of news
Market hours	286
Off-market hours	506
Holidays	172
Total	964

Note: Bloomberg's reporting on corruption news has time stamps. The above classification is based on the news timestamp and day of the week information.

The stock market reaction to corruption news was surprisingly positive or neutral (Table 3). The market reaction was even more positive (or neutral) for the corruption news in the last one year. The results are quite perplexing! India has witnessed massive corruption in the last one year and there has been huge public outcry against such corruption (e.g., Anna Hazare movement). However, the capital market has seen no wrong in that news! Does the stock market believe that economic development and corruption coexist? Of course, there are examples of negative reaction of the market to Individual stocks whenever there were reports of corruption against the CEO or owners of a company. For example, the arrest of Shahid Balwa in the 2G scam has taken the stock of the company he was heading from Rs.400 levels to Rs.72. But these are exceptions- where the owners are prosecuted and the market believes that the owners are the key players for the companies. However, in majority of the cases, the corruption goes unpunished and hence the general short-term reaction of the market is not negative. The strong correlation between economic development and corruption does not appear to be an artifact of misplaced perceptions[2]. However, another study[3] shows that most important channel through which corruption affects economic growth is political instability. Consequently, corruption reduces the share of private investment.

Table 3: Stock Market Reaction

Last Five Years	Number of news	Positive or neutral Market reaction	Percentage
Market hours	286	195	68
Off-market hours	506	314	62
Holidays	172	126	73
Last One year			
Market hours	192	143	74
Off-market hours	253	175	69
Holidays	111	82	74

Note: Market reaction refers to change in the value of NIFTY immediately the day after the release of the news.

Stoic Stock Market

India has witnessed massive corruptions and scandals for the past twenty years- the period during which India had unleashed major economic reforms. Economic reforms in India have surely improved the

[2] http://economics.mit.edu/files/8777

[3] Pak Hung Mo, 2001, *Corruption and Economic Growth*, Journal of Comparative Economics **29**, 66-79

livelihood of a large section of the population. However, the stories on corruption prove that the economic fruits of reforms have been enjoyed more than proportionately by a section of the population. Skeptics believe that common people have become stoic and do not react any more on such news. People may have resigned to the fact that corruption is inevitable. What about the stock market? Has the market reacted in similar ways? If one looks at the cases where market reaction was neutral on release of news on corruption (Table 4), one may tend to agree that stock market reflects the sentiment of the people.

Table 4: Cases of Neutral reaction of the market

Last Five Years	**Number of news**	**Neutral Market reaction**	**Percentage**
Market hours	286	73	26
Off-market hours	506	124	25
Holidays	172	68	40
Last One year			
Market hours	192	53	28
Off-market hours	253	66	26
Holidays	111	45	41

Note: Market reaction refers to change in the value of NIFTY immediately the day after the release of the news.

One may note that the result of the above table is a subset of results of Table 3. More than quarter of the time the Indian stock market did not react at all to the corruption news. These reactions of the Indian capital market can be transient and should not be construed as the long-run reaction of the society. Empirical findings in other countries confirm that in the long run an increase in corruption index reduces economic development and more particularly human development index. Therefore, India's political establishment should realize soon this reality and make serious efforts to minimize corruption through setting up of truly independent regulatory and enforcing agencies.

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"Home Field Bias" in Sports and Banking Regulation: Some Recent Research

Prof. Partha Ray

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Scorecasting is a book that deals with the hidden influences behind how sports are played and games are won.[4] Written jointly by a Chicago Finance Professor, Tobias Moskowitz and a renowned U.S sports journalist, Jon Wertheim and published in 2011, the book became a national bestseller in the U.S. It has delved into enormous cases of wins and losses of various games – from baseball to soccer to basketball and tried to find out some statistical regularity. In doing so, they also arrived at the defective role that statistics could play in interpreting games and in a chapter titled, "Damned Statistics", they inferred that "four out of last five" almost would surely mean "four of six". Their broad messages can be summed up as follows:

- "That which is recognizable or apparent is often given too much credit, whereas the real answer often lies concealed".
- "Incentives are powerful motivators and predictors of how athletes, coaches, owners, and fans behave – sometimes with undesirable consequences".
- "Human biases and behavior play a pivotal role in almost every aspect of life, and sports are no exception."
- "The role of luck is underappreciated and often misunderstood."

Home Field Advantage

A key message from *Scorecasting* is the phenomenon of "home field bias", whereby irrespective of the nature of the game the home team has a disproportionately larger chance of winning in home turf. Interestingly, the systemic study of many types of games by Moskowitz and Wertheim establishes the fact that home bias is *not* due to player performance, crowd support or intimate knowledge of the home field but due to "systemic biases of officials, referees and umpires". If Moskowitz and Wertheim were to be believed, such "home field advantage" is in no way indicative of corrupt officials *per se* but can be explained entirely in terms of social behavior of these officials. They went on saying that,

> "Despite fans' claim to the contrary, referees, are finally human. Psychology finds that social influence is a powerful force that can affect human behavior and decisions without the subjects even being aware of it. Psychologists call this influence conformity because it causes the subjects opinion to conform to a group's opinion".

Ineffective Banking Regulation: Is it an outcome of the "home bias"?

This monthly column in *Artha* is, admittedly, no place for a review of this book on sports. But this concept of "home field bias" has been used extensively in a recent book to explain the story of actual and potential regulatory failure in the U.S. [5] In plain vanilla terms, the regulator being part of the financial / banking sector tends to have an in-built social bias in favor of the regulated entities. This tendency

[4] Moskowitz, Tobias J., and L Jon Wertheim (2011): *Scorecasting*, New York: Crown Archetype.

[5] Barth, James., Gerard Caprio and Ross Levine (2012): *Guardian of Finance: Making Regulators Work for Us,* Cambridge, Massachusetts: MIT Press.

among the regulators has been examined in detail in Barth, Caprio and Levine (2012), who argue that, " …. regulatory bias has a natural human manifestation of the current institutional structure of financial regulation in which the financial services industry enjoys a decisive home field advantage". But how does such home bias get generated to begin with?

The Swinging Door Syndrome

In the financially advanced Western world, there is a large intersecting subset between the bankers and the regulators. In the U.S in particular, often the Treasury / Fed officials come from financial market place, where they tend to go back with a remarkable regularity. The table below highlighting the cases of a few individuals is purely illustrative in nature (Table 1).

Interestingly, this is not to mean or even to hint that there was any possible conflict of interest in these cases. Corporate governance practices in all these institutions ensure such implicit or explicit conflicts of interest are avoided scrupulously. For example, Paulson recounted in his autobiography[6], the detailed procedure he has adopted so that any case related to Goldman Sachs would not come to him when he was Treasury Secretary. He went on to say, "I had sold my shares in Goldman Sachs and severed ties with the firm when I became Treasury secretary. I had also signed an ethics agreement that precluded me from being involved in any government transaction particular to Goldman Sachs".

Table 1: Some Illustrations of "Swinging Door" Syndrome in the U.S

Individual	Before	During	After
Robert Rubin	Goldman Sachs (spent 26 years at Goldman Sachs since 1966, eventually serving as a member of the board, and co-chairman from 1990 to 1992)	Treasury Secretary (during January 1995 to July 1999 under President Clinton)	CitiGroup
Henry Paulson	CEO, Goldman Sachs	Treasury Secretary (during July 2006 to January 2009 under President Bush)	--
Gerald Corrigan	--	President, FED New York (Joined the New York Fed in 1968 where he remained for twenty-five years, becoming Vice President in 1976. He went on to serve as president of the Fed Minneapolis during 1980 to 1984 and President of the Fed New York during 1985 to 1993).	Goldman Sachs
William Dudley	Goldman Sachs (from 1986 to 2007, holding the position of chief economist for ten years)	President, New York Fed (since January 2009 till date)	--
David Mullins	Professor, Harvard Business School	Vice Chairman, Board of Governors, US Fed (during 1990-1994)	Long-term Capital Management (Following LTCM's collapse in 1998 and dissolution in 2000, Mullins left LTCM and worked for financial services companies)

Source: Compiled from the text of Barth & others (2012) and various biographical resources in the web.

[6] Paulson, Henry M (2010): *On the Brink*, New York: Business Plus.

But is this "swinging door syndrome" something new? Readers may perhaps remember that in the context of promoting unbridled capital account convertibility, Professor Jagdish Bhagwati as early as 1998, spoke against its facile theoretical foundation. To rationalize the bogey of thought favoring capital account convertibility, he talked of the "Wall Street Treasury Complex" in the U.S, whereby, "Wall Street has exceptional clout with Washington for the simple reason that there is, in the sense of a power elite ..., a definite networking of like-minded luminaries among the powerful institutions - Wall Street, the Treasury Department, the State Department, the IMF, and the World Bank most prominent among them" (Bhagwati, 1998; p. 11).[7] In a world of caricatured polar opposites, Bhagwati is indeed seen as a neo-classical mainstream right wing economist, and hence his contentions cannot be brushed aside as some fringe attack on financial globalization. Bhagwati too went to give his own list of the Wall Street Treasury complex and remarked, "Secretary Rubin comes from Wall Street; Altman went from Wall Street to the Treasury and back; Nicholas Brady, President Bush's Secretary of the Treasury, is back in finance as well; Ernest Stern, who has served as acting president of the World Bank, is now managing director of J.R Morgan; James Wolfensohn, an investment banker, is now president of the World Bank" (Bhagwati, 1998; p. 12).

Group-Think and Regulatory Capture

Presence of such home-field bias often leads to groupthink among regulators and helps the market participants towards a regulatory capture. People within a tribe start to think alike, almost like clones – and any challenge to the groupthink is nipped in the bud. I will give two illustrations.

The first illustration is related to the inability of the International Monetary Fund (IMF) to predict the current financial crisis. In the aftermath of the financial crisis, the IMF's Independent Evaluation Office (IEO) published a report.[8] Moises Schwartz, Director, Independent Evaluation Office in summing up the report observed, "the IMF's ability to identify the mounting risks was hindered by a number of factors, including a high degree of groupthink; intellectual capture; and a general mindset that a major financial crisis in large advanced economies was unlikely. Governance impediments and an institutional culture that discourages contrarian views also played important roles". The report also pointed out that often IMF's diagnosis tended to suffer from a confirmation bias that refers to cognitive bias reflecting the tendency of people to only notice information consistent with their own expectations and to ignore information that is inconsistent with them.

The other interesting illustration is the case of shelving regulation of over-the-counter derivatives in the U.S. This has been brought to the limelight in recent research on banking regulation.[9] Brooksley Born was the Chair of the Commodities Futures Trading Commission (CEFT). During 1998-2000, Ms Born put forward a proposal to regulate the ever increasing OTC derivatives. The proposal was jointly blocked and vehemently criticized by Alan Greenspan (Fed Chairman), Arthur Levitt (Chairman of the Securities and Exchange Commission) and Robert Rubin (Treasury Secretary). On May 7, 1998 when Born's concept release was published, on the same day a joint statement was issued by Rubin, Greenspan and Levitt, categorically stating that, "we are very concerned about reports that the CFTC's action may increase the legal uncertainty concerning certain types of OTC derivatives".[10] Effectively the regulatory initiatives of CEFT have been killed at that point of time.

Is the regulatory capture beyond "Home Field Bias"?

But the extent of regulatory capture could go beyond the peer pressure culminating into home field bias. Recent research also puts a stamp of authority to the phenomenon that was informally known

[7] Bhagwati, Jagdish (1998): "The Capital Myth: The Difference between Trade in Widgets and Dollars", *Foreign Affairs*, Vol. 77, No. 3 (May - Jun., 1998), pp. 7-12

[8] Independent Evaluation Office (IEO), IMF (2011): "IMF Performance in the Run-Up to the Financial and Economic Crisis: IMF Surveillance in 2004–07", available at http://www.ieo-imf.org/ieo

[9] Johnson, Simon and James Kwak (2010): *13 Bankers*, New York: Pantheon Books.

[10] Joint Statement By Treasury Secretary Robert E. Rubin, Federal Reserve Board Chairman Alan Greenspan And Securities And Exchange Commission Chairman Arthur Levitt

always. Admati and Hellwig (2013) commented, "firms in the industry influence politicians and administrators by lobbying and by providing money, particularly for election campaign".[11] Apart from the various formal channels there are various informal channels. Illustratively, there are reports that Jamie Dimon, the head of JPMorgan Chase cultivated number of big business relation – so much so that Mr. Dimon went on to comment that he tended to get a decent return from his company's "seventh line of business", viz., government relation.[12]

Home Field bias, Group think, sleazy world of Washington Lobbyists – these allegations are emanating from fairly recent mainstream research with reasonably credible documentation or theoretical foundation. With all these, the future of banking reform may not look too bright. In this backdrop, we need to do some soul searching so as to assess the progress of banking reform in the aftermath of the global crisis. But that is another story.

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[11] Admati, Anat and Martin Hellwig (2013): ***The Bankers' New Clothes: What's Wrong with Banking and What to Do About It*****, Princeton:** *Princeton University Press.*

[12] New York Times, "In Washington, One Bank Chief Still Holds Sway", July 18, 2009.

The Financial Sector Legislative Reforms Commission and its direction for Debt Market*

Dr. Golaka C. Nath

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The Financial Sector Legislative Reforms Commission (FSLRC) report is significant as it tries to address some of the major issues faced by financial markets – specifically jurisdictional overlap and regulatory gap existing today. The FSLRC had a broad mandate to review the institutional arrangements in Indian financial sector regulations. Its report advocates a sweeping reorganization of the country's financial regulation architecture and proposes the by consolidation of regulation to be managed in the form of Unified Financial Authority (UFA).

FSLRC proposes to create a resolution corporation to deal with "too big to fail" problems. It also proposes an independent public debt management agency. The current debt management functions are vested with the Reserve Bank of India (RBI). On earlier occasions, this issue was debated in various forums. The report suggests that RBI should concentrate on monetary policy issues and debt management should be handled by a separate agency. In 2010, a debt mid-office was opened as a cell in Ministry of Finance, New Delhi as a starting point to shift the debt management functions from RBI to a new proposed agency called National Treasury Management Authority (NTMA). This was envisaged in the Report of the Internal Working Group on Debt Management (Ministry of Finance) dated 31-Oct-2008 – commonly known as Jehangir Aziz Committee (who headed the said committee). However, the shifting of the debt management role could not take place as the Government had to grapple with huge borrowings on account of global financial crisis. It was believed that a new agency would find it difficult to manage such huge borrowing programme and hence it was consider prudent to leave the debt management arrangement with RBI.

The proposal has again surfaced in the new report possibly the Committee considered the views of the earlier Internal Report relevant in the changing context. However, given the current situation of high borrowings, serious debate need to be initiated to understand what a new debt management office can do which cannot be done by RBI in its present role as a Merchant Banker for the Government.

The report proposes to streamline the country's system of capital controls that would allow restrictions of capital flows in narrowly defined instances. It proposes that the Central Government would promulgate 'rules' governing capital inflows while the RBI would promulgate 'regulations' governing outflows. It also proposes a clean-up of certain matters related to financial contracts and market infrastructure.

FSLRC recommends for institutional arrangements to deal with future financial crises. This is going to be a big challenge. The report recognizes the need to have clear financial regulations to suit the current

** Personal views of the author only and not the views of his organization*

business environment rather than continuing with the current varying polices of depending on sectors and unnecessary complexity. It may be reasonable to have investment limits to vary by industry sector and conditions have been attached to individual licenses for reasons which many find inconsistent. FSLRC's arrangements would provide unified treatment of financial firms for prudential reasons. FSLRC's recommendations would create specialized administrative courts to review violations of financial regulations which is a very important step and provide a leg up to the financial markets.

The Committee tries to downsize the central bank and this may not be a good idea in the long run. The Commission's recommendations would rewrite the rules of engagement in economic policy in favor of government. This may bring serious problems given the coalition structure of the Governments in recent years.

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