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Challenges to Regional Initiatives Promoting Transnational Infrastructure Projects

*Paulina Beato, Juan Benavides, and Antonio Vives**

Two regional initiatives have recently been proposed to promote transnational infrastructure. They are the Initiative for the Regional Integration of South America (IIRSA in its Spanish acronym) and the Plan Puebla Panama (PPP) for Central America and Mexico. These Initiatives face significant challenges, most of which have not been properly taken into consideration. This

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Conflicts of Interest Facing Securities Research Analysts: Implications for Capital Markets

*Leslie Boni, Luis Alberto Giorgio, and Pietro Masci**

Securities research analysts are employed by banks and brokerage firms to provide investors with research reports and recommendations to buy or sell stocks. In the last year, they have been widely criticized by legislators, regulators, the press, academics, and investors in the United States. Specifically, do these analysts, who face a variety of potential conflicts of interest, always make recommendations that are in the best interest of the investor?

This article examines the academic evidence regarding the extent to which investors can profit from relying on analyst recommendations and discusses the potential conflicts of interest that analysts face. It also describes how these conflicts of interest may have contributed to the Enron debacle. Finally, it

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paper will identify these challenges and discuss their implications.

For the purpose of this article, transnational projects are those that incur costs and yield benefits in several countries. In general, transnational project benefits are related to trade or factor mobility across countries. The first consideration is the nature of the costs and benefits across countries. Transnational projects whose costs and benefits are distributed symmetrically across countries do not give rise to problems greater than those to be expected from pure national infrastructure projects. Problems arise when one country bears a disproportionate share of the costs or enjoys an extraordinary share of the benefits. In the latter case, while the project may be regionally desirable, it could be undesirable from the point of view of an individual country. In some cases, transnational projects are analyzed in a short-sighted way, as a collection of individual projects. This can lead to severe problems of underinvestment. The asymmetry feature of most transnational projects raises some issues related to the processes of gathering information, and selecting and distributing the costs of transnational projects.

Individual Country Decisions and Optimal Investment

Transnational projects generally present asymmetric costs and benefits across countries that make their implementation difficult. As a result, countries sometimes make individual decisions that may lead them to ignore or abandon some potentially efficient transnational projects. This does not mean that all transnational projects with asymmetric costs and benefits would not be undertaken. It only means that some efficient transnational projects would not be undertaken and, as a result, investments would be less than optimal. The combination of several factors makes the development of transnational projects difficult. First, it is difficult for one country to identify the benefits it would enjoy from a transnational projects when those benefits are spread across several countries. Second, countries are generally reluctant to pay for infrastructure assets located abroad. Third, there is a lack of socially acceptable mechanisms to distribute costs and benefits among countries.

The first factor refers to lack of information about the benefits of transnational investment for each individual country. Even when a country is able to identify the benefits that it would accrue, it lacks information on how its own investments may reduce costs or yield benefits in another country. In addition, countries lack incentives to attempt to identify third country benefits since doing so involves costs. Precise information on the benefits that a country would derive from an infrastructure project will increase the incentive for cooperation and agreements across countries. Moreover, to the extent that proper identification of third country benefits may results in contributions from that country to the project, cooperation and agreements promote better identification of the benefits of transnational projects.

The second stumbling block for transnational investment is that individual countries are willing to invest only in projects whose within country costs are smaller than the benefits, that is, they take a single country approach. Countries are also reluctant to bear the costs of projects located outside their borders even when in-country benefits are larger than costs. The reluctance to pay for infrastructure investments abroad is characteristic of transnational infrastructure.

Finally, the lack of socially and politically acceptable mechanisms to distribute costs and benefits among countries, even when countries agree on some sort of cost-benefit sharing, makes it virtually impossible to develop transnational projects with asymmetric benefits and costs across countries. However, asymmetry is common in most efficient transnational projects.

It takes a great deal of time for two countries to enter into a dialogue about a project with cost and/or benefits in both nations if they lack rules for cooperation and/or incentives to communicate with each other about the project's costs and benefits. For instance, after identifying the benefits to a second country, the government of the first country must persuade the government of the other country to contribute to the costs of infrastructure located in the first country. Once the second country accepts the notion of contributing to the cost of the infrastructure, the two countries must agree on the actual amount that the second country must pay the first country. The length and complexity of the process makes the implementation of transnational projects a frustrating task. Therefore, increasing transnational investment calls for Regional Initiatives that have the capacity to solve or mitigate the problems that lead to less-than-optimal levels of transnational investment.

Promoting Transnational Investment through Regional Initiatives

A Regional Initiative for promoting and developing transnational investment

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may be organized under different schemes. Its success will depend on its decision-making power [GDT1]and budgetary restrictions, among other things. In order to discuss the practices and guidelines that are appropriate for promoting regional infrastructure in Latin American, we first present some of the features that the Regional Initiative should have. First, the Initiative may not directly provide financing to transnational projects. Second, transnational projects can only be developed if they have the approval of the countries involved, i.e., there is no supranational authority capable of imposing projects on individual countries, this must be done by consensus. Third, the Initiative does not have the financial capacity to make side payments to compensate countries that are unwilling to accept a project. Fourth, the Regional Initiative has limited resources for promoting transnational projects. In other words, its operating budget for analyzing project costs and benefits are quite limited. The IIRSA and PPP initiatives mentioned above share these features. However, the discussion is not limited to them.

The success of Regional Initiatives to increase investment in transnational infrastructure is a function of their ability to remove the obstacles to transnational investment; namely, poor information, the reluctance of nations to pay for the cost of infrastructure assets that are located outside of their borders, and the lack of mechanisms to distribute costs and benefits. Two points apply here. First, better information provides incentives for countries to agree to cover costs in third countries. This is reinforced if socially acceptable mechanisms for distributing costs and benefits are in place. Second, credibility and stability of the regional initiative are necessary conditions to effectively increase investment in transnational infrastructure.

Improving Information Gathering

Regional Initiatives have some advantages for gathering and preparing the information needed to assess the benefits and costs of transnational projects. For example, if a project presented to such an Initiative does not properly identify third-country benefits, the program may request additional information or use its own resources to gather that information. However, this advantage would be more significant if individual countries have incentives to study and make public the true benefits inside their borders of projects with investments elsewhere. Gathering information on the benefits of transnational projects without the support of the countries involved is expensive and time consuming. Moreover, cost distribution based on information gathered without the support of the countries affected would lack the consensus required for effectively implementing the project.

Reducing the Reluctance to Pay for Investments Located Abroad

The second obstacle, a country's reluctance to pay for infrastructure located abroad or to bear costs that do not yield domestic benefits, may be better dealt with on a regional basis for two main reasons. First, regional initiatives may reduce this reluctance if they can establish and enforce rules to ensure that the country will benefit in the long run. The more along the integration process is, the greater the potential for this to happen. For instance, the European Union has an established capacity for setting rules to harmonize regulatory frameworks that ensure access to all users on a nondiscriminatory basis. Regional Initiatives in Latin America may promote the establishment of these rules by making them a condition for the promotion of a given transnational project. Second, the Regional Initiative may reduce the reluctance of countries to undertake a project whose internal benefits are smaller than internal costs, but is efficient on a regional basis. The regional initiative may deal with this obstacle by undertaking a portfolio of transnational projects that balance costs and benefits for each country. In other words, although a particular country may face an imbalance between costs and benefits for a given project, costs and benefits would balance when taken as a whole because other projects would have an offsetting impact on the overall portfolio. As a result, it would be politically easier for the country in question to support the project. It should be stressed here that the capacity of a Regional Initiative to deal with this obstacle is a function of its credibility and ability to implement the portfolio over time and on time. In other words, countries should trust that the Regional Initiative will be able to ensure that the discrepancy between the costs and benefits of a particular transnational project will be balanced once the entire portfolio is implemented. Needless to say, that this long-term approach, even though feasible, places significant demands an all the parties involved.

Establishing Schemes for Distributing the Costs of Transnational Projects

Regional decision-making may be able to establish schemes for distributing the costs and benefits of transnational projects among countries, allowing for a balance between in-country benefits and costs and removing the constraints for taking account of the spillovers and externalities resulting from one country´s investment in another country. Two important potential problems should be taken into account when designing such mechanisms. First, it is easier for a country to assume the entire cost of an investment located within its borders, even when the benefits are weak, than it is for it to pay for an investment in another country, even if that investment will yield large benefits. Second, if costs are distributed across countries as a function of the benefits, then countries will have an incentive to understate benefits. This would jeopardize the ability of the Regional Initiative to gather data necessary to identify efficient transnational projects.

Mistakes in Establishing a Portfolio of Transnational Projects

Proper identification of mistakes that may occur in the selection phase is

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important for increasing effective transnational investment because a good selection process facilitates project implementation and a good implementing record provides incentives for countries to improve the identification of costs and benefits. Thus, the interaction between good project selection and implementation generates a virtuous circle that increases transnational investment.

Selecting Inefficient Transnational Projects

A common mistake of Regional Initiatives is the selection of an inefficient transnational project. Country authorities mistakenly see these initiatives as a mechanism for low-cost financing of projects. Their incentive is to submit as many projects as possible. If the regional initiative imposes restrictions on the cost-benefit relationship to ensure that only efficient projects will be presented, countries tend to overestimate expected benefits. Inefficient projects usually face serious problems during the implementation phase. The most common being the lack of private sector involvement and poor commitment by the countries. In addition, this reduces the ability of the regional initiative to analyze its own portfolio. The result is that only a few of the projects are implemented and the credibility of the regional initiative is jeopardized.

The risk of creating a large portfolio may be mitigated by advising stakeholders that declared benefits will be used for two purposes: to determine project efficiency and to perform cost/benefit distributions. Once countries know that project costs will be assigned as a portion of actual benefits, the incentive to overestimate benefits disappears. However, while reducing the risks of inefficient projects, this may raise other problems. For instance, it may lead to the selection of purely national projects, ignoring efficient transnational projects.

Taking Pure National Projects as Transnational Projects

Knowing that costs will be distributed as a function of benefits, countries that are reluctant to pay for infrastructure outside their borders will tend to request projects in which their benefits are similar to the costs of the portion of the infrastructure located within country borders. If all countries do this, only national projects would be considered. Clearly, managing a national project through an initiative for promoting transnational projects is not desirable. Doing so would not only absorb resources and structures designed for transnational projects, but would also restrict the capacity of the regional initiative to promote national structures. There is no simple solution to this problem. Nevertheless, studies of trade costs and trade creation due to a project may mitigate the problem. Although those studies are expensive and difficult, if prepared only for efficient projects that have a country commitment to support their costs, then the number of required studies becomes affordable.

Ignoring Efficient Transnational Projects

Creating a portfolio based on benefits declared and costs assumed by national stakeholders may preclude the identification and support of many efficient transnational projects. As pointed out before, a Regional Initiative may mitigate these risks trough schemes to reduce national reluctance to support investment abroad and establish mechanisms to compensate for asymmetries between benefits and costs.

A rewarding approach for regional initiatives at the early stages of regional integration is to promote full and nondiscriminatory access to regional infrastructure for all countries. Harmonization of country regulatory frameworks, free trade in infrastructure services and regional institutions to ensure fair treatment are needed to build confidence in the long-term advantages of infrastructure sited outside a particular nation's borders. At later stages, when countries are willing to pay for investments that take place outside their borders, the regional initiative may establish mechanisms for compensating countries that support more costs than the expected benefits and provide incentive to countries to identify the benefits of transnational projects. A discussion of actions to develop these two approaches is outside the scope of this article.

Conclusion

First, the levels of transnational investment undertaken by countries individually are less than optimal because of the interaction of three elements: poor information across countries about project costs and benefits, political and economic constraints to bearing the costs of infrastructure built in another country, and lack of schemes for distributing cost and benefits among countries.

Second, regional initiatives can raise transnational investment to optimal levels if they are capable to address these three problems. A credible and stable regional initiative is needed to successfully address these problems.

Third, Regional Initiatives that separate the process of evaluating benefits and assigning costs increase the likelihood of selecting inefficient projects because they would result in a larger initial portfolio that may not be properly managed and evaluated. Moreover, as the proportion of developed projects in the initial portfolio falls, the credibility of the initiative and its ability to promote transnational projects is jeopardized.

Fourth, screening projects according to the benefits and costs assigned to them by the national stakeholders may leave out efficient transnational projects and result in the selection of pure national projects because the willingness of countries to bear the costs of a project is likely proportional to its benefits. Therefore, additional screening is needed to eliminate pure national projects.

Fifth, advancing the integration processes and promoting the harmonization of regulatory frameworks can increase countries' confidence in the likelihood of reaping long-term benefits from projects that are sited abroad. This

is necessary to reduce countries' reluctance to support investment located outside their borders.

Increasing transnational infrastructure projects through regional initiatives is a slow process that requires simultaneous actions on many different fronts. Regional initiatives that lead nations to expect that many large transnational projects will be undertaken will likely generate frustration because expectations would not be fulfilled. The regional initiative's credibility and its ability to develop new programs would improve through a well-defined program with projects that are likely to be implemented. ■

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examines the actions being taken to address potential conflicts, and the implications of this controversy for capital markets development in United States and in Latin America and the Caribbean.

Can Investors Profit from Recommendations Made by Research Analysts?

Banks and brokerage firms in the United States employ more than 3,000 researchers in the field of securities analysis. Each researcher usually studies a dozen or so publicly traded companies in a particular industry sector. The analyst's research is typically presented as a detailed report, earnings forecast, or recommendation to buy or sell the company's stock. Analysts continually update their assessments of the information they collect by talking with the company's managers, suppliers, and customers, and revise their recommendations and earnings forecasts accordingly.

While historically analysts' research has been provided to investors by phone, fax, and mail, banks and brokerage firms now make analysts' reports, earnings forecasts, and recommendations available to their investor clients via web sites. The earnings forecasts and recommendations of many analysts are also available to the general public at Internet sites such as the Nasdaq market web site (www.nasdaq.com), CBS.MarketWatch.com, Yahoo! Finance, and Earnings.com. It is also commonplace for the high profile analysts at prominent banks and brokerage firms to make their stock recommendations public through television appearances, press interviews, and other media outlets.

Analysts' actions are expected to conform to the policies of the individual banks and brokerage firms that employ them. As discussed below, these policies vary from firm to firm. Analysts are also subject to rules imposed by the U.S. Securities and Exchange Commission (SEC) as well as by the self-regulatory arms of the National Association of Securities Dealers (NASD) and the New York Stock Exchange (NYSE). Few analysts are certified public accountants. Some, but not all, are certified financial analysts.

In the summer of 2001, the SEC's Office of Investor Education and Assistance issued an "Investor Alert" to educate investors about the potential conflicts of interest faced by analysts. The alert starts with an important first point; namely, that analysts "exert considerable influence in today's marketplace." It goes on to sate that "Analysts' recommendations or reports can influence the price of a company's stock-especially when the recommendations are widely disseminated through television appearances or through other electronic and print media. The mere mention of a company by a popular analyst can temporarily cause its stock to rise or fall-even when nothing about the company's prospects or fundamentals recently has changed."[1]

Academic researchers have shown that when analysts upgrade recommendations (from "hold" to "buy" for example) or downgrade recommendations (from "hold" to "sell" for example), stock prices typically react immediately and can continue to drift in the recommended direction for one to six months. Thus, analysts are at least, on average, temporarily good predictors of future stock prices. On average, stock prices drop by a greater percentage in response to analyst downgrades than they increase in response to analyst upgrades.[2] It is worth emphasizing several points about attempting to use analyst recommendations when choosing an investment strategy, however. First, the value to be gained from acting on analyst recommendations is short-lived in the sense that the largest gains on average are achieved by those investors who are able to respond most quickly to the analyst changes. Therefore, reacting to changes in analyst recommendations may be profitable for investors, but selecting a particular stock based on the average level of its (possibly stale) analyst recommendations is not necessarily a profitable approach. Second, not only are some analysts' recommendations better than others, but as discussed below, academic researchers have documented that the recommendations of some types of analysts, such as those associated with an initial public offering, typically underperform the recommendations of others. Finally, there have been some extremely important market downturns that most analysts failed to predict. For example, analysts have been widely criticized for failing to warn investors of the 60%-80% fall in stock prices of many U.S. technology compa-

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[1] See www.sec.gov/investor/pubs/analysts.htm, page 1.

[2] See Womack, Kent L. 1996. "Do Brokerage Analysts' Recommendations Have Investment Value?" Journal of Finance 51: 137-167.

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nies in the last few years. Most analyst recommendations performed particularly poorly in the year 2000.

It is also worth emphasizing that ratings terminology varies from firm to firm. Some brokerage firms instruct their analysts to give a stock one of three possible ratings: "buy", "hold" or "sell". Other brokerage firms instruct their analysts to use almost a dozen rating levels, arguing that these differentiations are needed to communicate with different investors who have different investment objectives. As discussed in the following section, there are a number of potential conflicts of interest that can make analysts reluctant to issue "sell" recommendations. As a result, some brokerage firms have traditionally used "strong buy" to signal a buy recommendation, "buy" to signal a neutral recommendation, and "hold" to signal a sell recommendation. Although institutional investors claim to understand these signals, regulators have argued that less savvy individual investors may not be aware of these unwritten codes. In fact, analysts historically have issued many more "buy" than "sell" recommendations. The ratio of buy to sell recommendations increased from 8 to 1 in 1986-1995 to 39 to 1 for the year 2000.[3]

What Are the Potential Conflicts of Interest?

Analyst conflicts of interest result from incentives provided by their bank and brokerage firm employers, the companies they research, and perhaps even some of their institutional investor clients.

Conflicts Generated Within the Analyst's Firm

Brokerage firms primarily employ analysts to provide investment research to encourage their investor clients to undertake stocks and bonds transactions. The more transactions they facilitate, the greater the brokerage firm's commissions. "Buy" recommendations are more likely to generate investor transactions, thus resulting in greater brokerage commissions, than are "sell" recommendations. While the brokerage firm's sales force can contact any investor with a "buy" recommendation and encourage a trade, most investors are unwilling to sell stocks short. Thus, unless the client already owns the stock in his portfolio, "sell" recommendations are less likely to generate trading commissions. As a result, analysts may feel pressure to produce more positive research reports, earnings forecasts, and recommendations. Analysts may also be reluctant to downgrade or remove "buy" recommendations.

Another conflict may result from the fact that many banks and brokerage firms take speculative trading positions themselves. Analysts may feel pressure not to issue negative research, which could result in price declines, on companies in which their firms have taken substantial speculative positions. In addition, some banks and brokerage firms allow analysts to take personal trading positions in the stocks of the companies they cover. Analysts may be reluctant to downgrade recommendations or issue negative research on companies whose shares they own.

Perhaps the most profound conflict of interest may arise when analysts work for banks and brokerage firms that provide financing or banking services for corporations. Corporate financing activities include providing loans; making markets in or facilitating transactions of money market instruments, securities, foreign exchange, swaps, and derivatives; providing merger and acquisition advice; and assisting with initial public offerings (IPOs). Thus, the largest brokerage firms often represent corporate financing clients (who are largely borrowers) as well as investors (who are primarily lenders). Corporate clients may be less likely to give corporate financing business to banks and brokerage firms from whom they have received negative research coverage. As a result, analysts may feel pressure from the corporate financing and banking divisions within their firms to publish positive research on corporate clients. But while corporate financing clients are likely to prefer brokerage research analysts to be optimistic ("credible marketers"), investors would likely prefer independent and objective research ("truth telling").

In the 1990s, profits from corporate financing activities dwarfed profits from brokerage activities. Recently the SEC became particularly concerned about potential conflicts of interests that analysts face from the corporate financing side of the business. Based on interviews at a variety of banks and brokerage firms, the SEC found, for example, that executives in the corporate financing divisions have substantial input into how analysts are compensated. Also, many analysts are compensated in part on the extent to which they "bring in deals." In other words, the reputations of high-profile analysts, and their ability to issue influential positive research and recommendations, are important criteria used by start-up companies when selecting a firm to assist with IPOs. As a result, analysts may feel pressure to develop a reputation for issuing positive research.

"Optimism" biases in analyst recommendations have been documented following IPOs. When firms conduct IPOs for start-up companies, they commonly require the company's owners to refrain from selling their stock for a pre-agreed time ("lock-up" period) after the IPO. Otherwise, these sales might depress the stock's price. The SEC found that analysts typically issue positive research or recommendations following the expiration of these lock-up periods. Specifically, analysts of firms that have conducted IPOs may feel pressure to issue positive reports (sometimes referred to as "booster shots") to help support stock prices during the

[3] See Barber, Brad, Reuven Lehavy, Maureen McNichols, and Brett Trueman. 2001a. "Can Investors Profit from the Prophets? Security Analyst Recommendations and Stock Returns." Journal of Finance 56: 531-563; and Barber, Brad, Reuven Lehavy, Maureen McNichols, and Brett Trueman. 2001b. "Prophets and Losses: Reassessing the Returns to Analysts' Stock Recommendations." Unpublished paper. University of California, Davis (May).

post-lock-up period when the company's owners are finally allowed to sell their shares. Analysts may also feel pressure to issue positive research post-IPO if their firm acquired a pre-IPO stake in the company. Furthermore, the analysts themselves may have personally invested in pre-IPO shares. These potential conflicts of interest surrounding IPOs have important implications for interpreting recommendations made post-IPO by analysts of firms that conducted the company's IPO. Academic research by Michaely and Womack shows that, on average, recommendations for companies for which the analyst's employer conducts the IPO are "biased and, in the long run, inferior to recommendations" of unaffiliated analysts.[4] Analysts employed by firms conducting the IPOs issued 50% more buy recommendations than the other analysts. Michaely and Womack also find that for 12-month holding periods, firms recommended by IPO-affiliated analysts on average underperformed firms recommended by unaffiliated analysts by a wide margin (18.4%). Investors who used a strategy of buying stocks recommended post-IPO by the IPO-affiliated analysts would have a negative abnormal return of 5.3%.

Conflicts Generated by the Companies the Analyst Researches

One of the most important aspects of the analyst's job is the timely access to new information about the companies covered. Corporate management controls access to this vital information. In the 1990s, corporate boards increasingly tied their executives' compensation to stock prices. Company executives, therefore, have strong incentives to release good news to brokerage analysts and investors as quickly as possible and to put a positive spin on the company's prospects.

In her testimony to the U.S. House of Representatives hearings on "Analyzing the Analysts" last summer, Laura Unger, then-Acting Chairman of the SEC, discussed potential pressures from company management: "The management of companies an analyst follows may pressure him/her to issue favorable reports and recommendations. Less than favorable recommendations may not be well received by management and issuers may threaten to cut off an analyst's access to its management if the analyst issues a negative report on the company. This could cause the analyst to issue a more favorable report than his/her analysis would suggest."[5]

Although analysts have been widely criticized for failing to be independent or objective in their research, one of the real problems may lie with the corporation executives if they strategically dole out the most valuable information only to those who "cooperate" by telling the story they want to tell.

Conflicts Generated by Institutional Investor Clients

Institutional investors (for example, mutual funds, pension funds, and insurance companies) can generate substantial brokerage commissions for firms. In her testimony to the House of Representatives Acting SEC Chairman Unger discussed the pressures that these investors can exert on analysts: "Institutional investors, such as mutual funds, that are clients of the analyst's firm may have a significant position in the security of a company covered by the analyst. An analyst may be inhibited from issuing a rating downgrade that would adversely affect the performance of an institutional client's portfolio for fear that the client would take its brokerage business elsewhere."[6] Ironically, despite their public outcries for independent research, institutional investors reportedly sing a different tune when the stocks in question are those in their own portfolios.

Analysts may be particularly sensitive to pressure from institutional investors because they can affect their own compensation through the publication Institutional Investor. This publication conducts an annual poll that asks investment managers to rank analysts by industry. The winning analysts are named to an "All-America Research Team." Institutional Investor also tallies up the winning analysts' to rank brokerage firms, as a result, top-ranked analysts can typically command higher compensation.

Research Analysts and the Enron Debacle

In December 2001, Enron Corp., once the seventh largest company in the United States, filed for Chapter 11 protection from creditors under the U.S. Bankruptcy Code. The filing followed large losses in the prior quarter, repeated restatements of earnings, revelations of partnerships that kept debt off balance sheet, and inquiries from the SEC. With the fall of the company's stock to pennies a share from $50 per share just six months earlier, many Enron workers and retirees have had their life savings wiped out. The company is currently under investigation by the U.S. Justice Department, and the U.S. Congress is holding hearings to probe the company's collapse.

The Enron saga provides a case study of the potential conflicts of interest facing analysts, who have been criticized for failing to ferret out Enron's accounting problems and for continuing to recommend Enron's stock as prices plummeted. As of Friday, October 26, 15 of 17 brokerage analysts maintained a "buy" or "strong buy" recommendation on Enron stock. Enron's stock price had fallen more than 50% in the previous several weeks, and Enron bonds had begun to trade at non-investment-grade yields. Despite these warning signals, only brokerage firm had downgraded the stock to a "sell." Four days later, Moody's Investors Service Inc., also criticized for doing too little too late, low-

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[4] See Michaely, Roni, and Kent L. Womack. 1999. "Conflict of Interest and the Credibility of Underwriter Analyst Recommendations." Review of Financial Studies Special 1999 (12): 653-686.

[5] www.house.gov/financialservices/073101wl.htm.

[6] www.house.gov/financialservices/073101wl.htm.

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ered its credit rating on Enron's senior unsecured debt and put the company under review for possible further downgrades. Particularly disturbing is the fact that brokerage analysts admitted that although Enron made a practice of minimal disclosure and opaque financial reporting, they continued to maintain buy ratings for the company. They say they were willing to accept Enron management's "Trust Me" story.[7]

One of the most striking conflicts of interest of this case is the extent of corporate financing services that some of the largest banks and brokerage firms provided Enron. For example, one large bank, whose analyst maintained a buy recommendation on Enron stock last fall, made loans to Enron, provided Enron with advice on mergers and acquisitions, traded bonds, currencies, and derivatives with Enron, and had an asset-management group that invested in Enron stock. The bank also maintained an offshore operation that typically made energy purchases just prior to year-end, then delivered the natural gas and oil back to their trading counterparties through complicated derivative contracts. For about 60% of the transactions, Enron was the counterparty[8]

One of the largest brokerage firms in the United States also provided corporate financing to Enron. The firm raised almost $400 million from institutional and individual investors (along with $22 million within the firm itself) to set up one of the Enron partnerships that enabled the company to keep debt off - the balance sheet. Among the other investors in the partnership were some of the most prominent providers of brokerage research on Wall Street. More generally, the list of banks and brokerage firms that employ brokerage analysts and underwrote for, lent money to, traded derivatives with, or provided merger or acquisition advice to Enron includes the largest and most influential banks and brokerage firms in the United States.[9]

Some banks and brokerage firms claim to maintain "Chinese firewalls," or virtual separations within their firms to prevent their research analysts from being influenced by their corporate financing activities. However, one prominent brokerage firm apparently has a policy of just the opposite: last fall while simultaneously advising Dynergy on a potential merger with Enron and seeking a $179 million repayment from Enron under a derivatives contract, the firm's energy research analyst, Richard Gross, recommended Enron stock to investors with a "strong buy." The brokerage firm told the Wall Street Journal "it has a policy that freezes analysts' stock ratings once the firm becomes involved in merger talks."[10]

Enron appears to have been a master at "managing" the information given to analysts. Analysts say Enron executives threatened to freeze them out of conferences and analyst meetings when they asked tough questions. They say they were made to feel stupid if they could not understand Enron's business model or financial statements. During an April 2001 conference call orchestrated by Enron with brokerage analysts to discuss its quarterly earnings, Enron's chief executive officer reportedly resorted to name-calling in response to criticism from an analyst that the company had not provided them with a balance sheet. Recently, Enron employees have come forth with stories that they were asked in 1998 to go to an empty Enron trading floor just prior to a visit from 150 brokerage analysts in town for a convention. The employees said they were told to pretend to trade energy contracts. Employees say Ken Lay, then Enron chairman and chief executive, along with other Enron executives, then gave the analysts a tour of the trading floor and returned later to praise employees on their efforts. Kim Garcia, then an administrative assistant for Enron, told the Wall Street Journal: "I think a bunch of us asked him why did we just do this, and he [Mr. Lay] said the analysts needed to see a bunch of warm bodies working so Enron could get a good credit rating." [11]

James Chanos, president and money manager for Kynikos Associates Ltd., which has about a billion dollars under management, suggests warning signs foreshadowing Enron's problems were there for anyone willing to dig into the company's financial reports. Among the red flags he noticed a year prior to Enron's collapse was the fact that the company had too low a return on invested capital given its cost of capital and its position as a leader in the energy sector. In addition, while Enron had pipelines and utilities businesses, its growth came largely from energy trading operations. In that sense, Mr. Chanos argues, Enron was essentially a hedge fund, much like the ill-fated Long-Term Capital Management, but without the returns for investors that the risk of a hedge fund warranted. In addition, there were a number of insider stock sales made in second half 2000. Mr. Chanos began shorting Enron stock in November of 2000. Securities research analysts, who may provide research on several dozens of companies, reportedly have claimed as a defense that they simply do not have the time to do the in-depth analysis that Mr. Chanos performed.[12]

At least one securities research analyst did advise investors to sell Enron securities. After issuing a research report on August 23, 2001, lowering his

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[7] Wall Street Journal, "Debt Is Downgraded by Moody's", October 30, 2001, page A4, and Wall Street Journal, "Most Analysts Remain Plugged in to Enron", October 26, 2001, page C1.

[8] Wall Street Journal, "Trading Charges: Lawsuit Spotlights J.P. Morgan's Ties to the Enron Debacle", January 25, 2002, page A1.

[9] Wall Street Journal, "How Wall Street Greased Enron's Money Engine", January 14, 2002, page C1.

[10] Wall Street Journal, "Enron's Collapse Roils Insiders and Wall Street - Lehman Faced Possible Conflict as Merger Failed", December 5, 2001, page C1.

[11] Wall Street Journal, "En-Ruse? Workers at Enron Say They Posed as Busy Traders to Impress Visiting Analysts", February 7, 2002, page C1.

[12] Wall Street Journal, "What Enron's Financial Reports Did - and Didn't -- Reveal", November 5, 2001, page C1.

recommendation on Enron from "buy" to "neutral," Daniel Scotto, then a bond analyst for a prominent bank, told investors in a taped conference call that Enron securities "should be sold at all costs and sold now." Given Enron's stock price, trading between $30 and $40 per share at the time, Scotto provided investors with a good opportunity to cut their losses. Several days later, the bank demoted Scotto and told, "we don't think it was a good recommendation or a reasonable one." Scotto was put on family leave and terminated on December 5, 2001.[13]

Actions Being Taken and Implications for Capital Markets in the U.S. and Latin America

During the summer of 2001, the U.S. House of Representatives held hearings to investigate the extent of analyst conflicts of interest. A variety of actions were considered by U.S. legislators, the SEC, the NASD, the NYSE, the Securities Industry Association, and individual banks and brokerage firms. In the months following the September 11 terrorist attacks, it appeared that legislators and regulators would focus their attention on anti-terrorist issues and delegate resolution of analysts' conflicts to the banks and brokerage firms. Within the last few months, however, the Enron debacle has again focused criticism on securities research analysts.

On February 7, 2002, the NASD and NYSE announced proposed rules to address analysts' conflicts of interest.[14] These proposals would strengthen NYSE's Rule 472 and NASD's Rule 2210 that are currently on the books to provide for various disclosures of analysts' conflicts of interest, such as whether the analyst's firm makes a market in the recommended stock and whether it has recently underwritten a public offering for the company. The proposed NASD rule (SR-NASD-2002-21) can be obtained at www.nasdr.com/analyst_guide.htm.

In addition to the rules proposed by regulators, the SEC and NASD recognize the need for increased awareness by investors. The SEC and NASD currently provide information via their web sites to educate investors about analyst conflicts of interest and are included in the "Recommended Reading" at the end of this article.

Banks and brokerage firms have already taken actions individually to address perceived conflicts of interest. Several firms have changed their policies on analysts' ownership of the stock of the companies they research. Other firms have changed their recommendation terminology and encouraged their analysts to increase their usage of "sell" recommendations.

In response to the Enron debacle, some banks and brokerage firms are also taking steps toward improving how their analysts conduct research. For example, one of the largest U.S. brokerage firms recently announced that it is telling its analysts to more closely scrutinize financial performance, not simply rely on the pro-forma numbers provided by the companies themselves. Pro-forma numbers, such as cash earnings or operating earnings, although legal, do not necessarily conform to generally accepted accounting principles, are not standardized, and may exclude important expenses.[15]

Finally, what implications does this controversy surrounding Wall Street research and conflicts of interest have for capital markets? U.S. banks and brokerage firms boast that they are the world's leaders in raising capital for new and ongoing businesses. As the recent controversy highlights, the fact that banks and brokerage firms represent the borrowers as well as the investors potentially creates a profound conflict of interest. However, it is precisely because banks and brokerage firms represent both borrowers and lenders that they can raise large amounts of capital for corporations and provide investors with the opportunities they demand. Apparently investors are happy to accept dual representation of corporate and investor interests until they lose money. In fact, Wall Street conflicts of interest have been documented for many years, but media attacks, Congressional hearings, and regulator concerns rose to a head only following the burst of the U.S. technology bubble in the year 2000.

It is unlikely that the recent controversy surrounding research analyst conflicts of interest will substantially change how the well-developed U.S. capital market functions. U.S. banks and brokerage firms will continue to raise capital for corporations and provide investment opportunities for institutional and individual investors. The controversy may well result in more knowledgeable investors, however. If passed, the NASD proposed rules should go a long way toward making potential analyst conflicts of interest more transparent to investors. When potential conflicts of interest are disclosed to investors, banks and brokerage firms will have increased incentives to reduce and eliminate perceived conflicts. Investors can then "vote with their feet," taking their business to banks and brokerage firms that best convince investors that despite the potential for conflicts, their research analysts represent the best interests of their investor clients. Perhaps the most important implication from the recent controversy is that it highlights the continued need for regulatory oversight of disclosure and information transparency, even in well-developed capital markets.

The efficiency of the U.S. capital market stems from the level of transparency and disclosure and corporate governance as well as the checks and balances from various players and allows the United States to enjoy great advantages over emerging countries.

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[13] Wall Street Journal, "The Analyst Who Warned About Enron", January 29, 2002, page C1.

[14] The Association for Investment Management and Research (AIMR) requires that its members, the Chartered Financial Analysts, abide by the Standards of Practice Handbook which covers, among other ethical aspects of the investment profession, issues related to conflict of interest (see www.aimr.org).

[15] Wall Street Journal, "Merrill Instructs Stock Analysts: Pro Forma Doesn't Cut It", March 6, 2002, page C1.

◀ p.9 ***Conflicts of Interest***

Transparency and disclosure permit the companies listed in the U.S. market to obtain a discount in the cost of capital of up to 50% compared to financial markets in emerging economies. The events surrounding Enron's demise as well as questions related to Tyco International, and other companies highlights some issues about the development of capital markets particularly in Latin American and Caribbean.

The Enron debacle shows a malfunction in the U.S. capital market in several areas; e.g., transparency, accounting, auditing, self regulation, investors' education, and the role of the financial analyst. However, the Enron case has prompted no rescue attempt with public money, which has so often occurred in other developed as well as emerging countries. More importantly, Enron has provoked an important debate among all the stakeholders in the wellbeing of the current health of the U.S. financial market, focusing on the necessary changes to avoid another Enron. At the end of this process (which boils down to the perpetual dilemma: market or regulation) there should be a number of adjustments made, which will almost certainly be based on various compromises. Clearer rules against conflict of interests (e.g., research analysts who work for banks that provide financing to the corporation subject to the scrutiny of the analyst; auditor firms that also provide consulting activities), better and more transparent corporate governance and manager's compensation, more effective protection of investors and pension fund beneficiaries are likely to be introduced. Presumably the U.S. financial market will emerge stronger and more efficient. Some years from now, we may remember Enron as a "blip" and an opportunity to make corrections to the system and, in all likelihood, investor confidence will have rebounded.

Other considerations apply to financial markets in emerging countries and, in particular, to Latin America and the Caribbean. The Enron case may prompt a redirection of investments toward emerging economies. The reasoning is that emerging market stocks have been excessively penalized because of the lack of accounting, auditing and governance standards.

Along that vein, the Enron experience may also lead to a delay in the introduction and effective implementation of accounting and auditing standards as well as the rules of corporate governance. In fact, there are groups in emerging countries that see financial standards as an imposition of developed countries, which, as the Enron case shows, does not resolve the problems caused by inefficiency, cronyism, fraud and corruption. In fact, the example of Enron illustrates how smart executives can manipulate shareholders even in the face of trendy and sophisticated standards, which can do anything to improve transparency.

If this ends up being the effect of the Enron demise in Latin America and the Caribbean, it will be very damaging in the long run. In fact, the lesson of Enron is that a relatively healthy and coordinated financial system gives rise to various and disparate stakeholders and groups that are ultimately interested in its efficiency and generates the incentives, antibodies as it were, to defeat diseases such as Enron. As of now, the region is far from such a system whose various interest groups see the health of the financial system as their ultimate goal. For example, in Latin America and the Caribbean trading is influenced by non-institutional arrangements in markets with a limited number of listed companies and scant liquidity. The function of the research analyst is still considered a somewhat foreign concept and extremely few companies provide research for the use of investors. Under these circumstances, the problems raised in this article become magnified. There is a very limited pool of skilled professionals, that is research analysts, who perform the fundamental task of finding, and evaluating public available information and doing so to ensure a properly functioning market.[16] Against this backdrop, as the U.S. financial system moves toward tighter rules and a more stringent application of standards (and other developed markets follow suit), the lack of progress in emerging markets, and in Latin American and the Caribbean in particular, will make them unacceptably risky for many international and local investors. Moreover, the expected reforms and improvements in the U.S. financial system will make investors demand more transparency, market regulation, and liquidity in other markets. If the countries of Latin American and Caribbean do not reform their financial systems to reflect these requirements, the gap will widen, as will the premium paid over the cost of capital. Recent publications on competitiveness indicate that the development of capital markets in Latin American and Caribbean (as measured by stock market capitalization and stock market trades as a percent of GDP) lags developed as well many emerging countries. If anything, Enron should teach the countries of Latin American and Caribbean that they have to actively pursue reforms. This should be seen as an opportunity to accelerate the introduction of more transparency and disclosure, which will in time help to create a coordinated system of stakeholders whose concern is the health of the financial system. ■

[16] In recent years the program for the Chartered Financial Analysts of the AIMR has attracted an increased number of candidates from outside the US and Canada and a significant share of them comes from the Latin American and Caribbean region.

Book Reviews, Articles & Papers:

Financial Structure and Economic Growth: A Cross-Country Comparison of Banks, Markets, and Development, *edited by Asli Demirguc-Kunt and Ross Levine.* The MIT Press, Cambridge, Massachusetts, London, England.

The book presents a broad cross-country assessment of the ties between financial structure and economic growth. It contains recently acquired cross-country data from almost 150 countries, including information on the size, efficiency, and activity of banks, insurance companies, pension and mutual funds, finance companies, and stock and bond markets. It also incorporates information on each country's political, economic, and social environment.

The articles tackle three broad questions: 1. What happens to national financial systems as countries develop? 2. Does overall financial development influence economic growth and firm performance? 3. Does the structure of the financial system (bank-based or market-based) influence economic growth and firm performance?

The findings of the book can be summarized as follows: Overall financial development matters for economic success, but financial structure per se does not seem to matter much. Thus, policymakers may achieve greater returns by focusing less on the extent to which their country's market is bank-based or market-based and more on legal, regulatory, and policy reforms that boost the functioning of markets and banks.

Suggested Web Sites:

www.iaisweb.org

The International Association for Insurance (IAIS) issues global insurance principles, standards and guidance on issues related to insurance supervision. The site includes information about these principles and standards, publication and activities of the association.

www.assalweb.org

This is the web site of the Association of Superintendents of Insurance of Latin America (ASSAL). It provides valuable information on the regional insurance industry. It includes statistical information and publications provided by all insurance industry supervisory entities of Latin America, Spain, and Portugal.

www.bis.org/bcbs/index.htm

The Basel Committee on Banking Supervision, established by the central bank governors of the Group of Ten countries at the end of 1974, meet regularly four times a year. It has about thirty technical working groups and task forces, which also meets regularly. The site contains information and publications produced by these working groups.

www.asbaweb.org

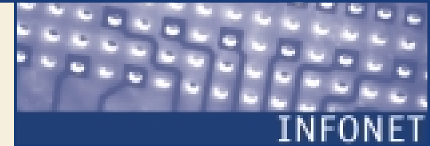
The site presents information produced by the Association of Supervisors for Banks of the Americas (ASBA), which maintains close links with many international forums, such as the Basel Committee on Banking Supervision, and with different regional group of supervisors.

www.iosco.org

The International Organization of Securities Commissions produces standards and principles, documents, press releases, resolutions and memoranda of understanding concerning the development of securities markets. This site contains information regarding IOSCO activities and publications.

www.cvm.gov.br/ingl/inter/Cosra/inter.asp

The Council of Securities



Regulators of the Americas (COSRA) provides a forum for mutual cooperation and communication to enhance the efforts of each country in the region to develop and foster growth of sound securities markets. Contents include documents on principles and best practices on different aspect of capital markets.

Events:

Workshop: Sustainability of Power Sector Reform in Latin America and the Caribbean

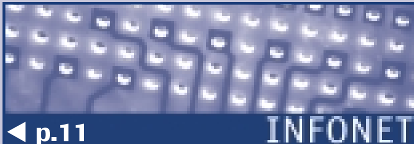
May 20, 2002

The Infrastructure and Financial Markets Division, and the Multilateral Investment Fund will host a one-day workshop focusing on critical issues for the sustainability of power sector reform in the region. Experts in this field from the countries, private sector and international organizations will present and analyze the main issues surrounding power sector reform, particularly reform in small markets. In addition, country studies for Honduras, Guatemala, Colombia, and Brazil will be presented and an agenda for IDB support for the sustainability of power sector reform will be discussed.

The event will take place at IDB headquarters, 1300 New York Avenue, Washington, D.C., Andrés Bello Auditorium. For more information please contact Cynthia Nuques at cynthian@iadb.org.

Regional Financial Sector Forum

A meeting was held on February 22 at Bank headquarters to evaluate the creation of a Regional Financial Sector Forum. The meeting was



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attended by: Burke Dillon, EVP/IDB; Álvaro Clarke, Superintendencia Valores y Seguros de Chile; Félix Delgado, Consejo Nacional de Supervisión del Sistema Financiero de Costa Rica; Winston Dookeran, Central Bank of Trinidad and Tobago; Graciela Kaminsky, George Washington University; Moisés Schwartz, Secretaría de Hacienda, Mexico; Jacques Trigo, Ministerio de Hacienda, Bolivia; Carlos M. Jarque, SDS/IDB; Antonio Vives, SDS/IDB; Pietro Masci, SDS/IFM; Kurt Focke, RE2/FI2; Hunt Howell, RE3/FI3; Luis Giorgio, SDS/IFM; Edgardo Demaestri, SDS/IFM; Kenroy Dowers, SDS/IFM; and Diego Sourrouille, SDS/IFM.

The participants concurred on the need to establish a forum to provide an appropriate environment for the discussion, dissemination and promotion of financial policies that are geared to ensuring financial stability in the region and to support the design and implementation of policies that contribute to this objective.

The Forum would focus on issues directly related to the design and implementation of public policies. Moreover, it would identify recommendations of policies to develop and disseminate best practices, based on prior successful experiences and the constraints derived from the specific political situation of the countries in the region.

Regarding the members and structure of the Forum, it was suggested that one or two participants from each Latin American and Caribbean member country of the IDB would participate in the meetings. These permanent participants should be policy makers with general responsibility for the financial system. However, it would be optional and the choice of the country to include a specialist working on the subject to be discussed in a particular meeting of the Forum. Given that the institutional structures and arrangements vary by country, each country would select the appropriate representative(s) to the Forum.

The Infrastructure and Financial Markets Division invites you to visit our Website

www.iadb.org/sds/ifm/

The Infrastructure and Financial Markets Division of the Sustainable Development Department provides technical and advisory support, research and dissemination within the IDB group. This mission is accomplished through the development of policies and strategies, training programs, and dissemination of best practices.

Inter-American Development Bank

Sustainable Development Department
Infrastructure and Financial Markets Division