Стоянка Петкова Петкова – Георгиева
д.э.н.,доцент, доцент кафедры
„Индустриални технологии и менеджмент",
Университет „Проф.Д-р Асен Златаров"-Бургас, БЪЛГАРИЯ

INNOVATIONAL MANAGEMENT PROBLEMS ON BULGARIAN MASS EQUITIES MARKETS

Introduction. This paper looks at some longstanding underpinnings of some innovational management problems in Bulgarian mass equities markets: factors that helped turn the recent lapses of bankers, rating agencies, and mortgage brokers into a crisis of extraordinary proportions and scope. Finance, I will argue, has been on the wrong trajectory for more than half a century. Its defects derive from academic theories and regulatory for more than half a century. Its defects derive from academic theories and regulatory structures whose origins date from 1970s, which encouraged financiers to rely on blind diversification as a substitute for due diligence and ongoing relationships.

Paper exposition. Unfortunately, there's a catch to the rules that sustain stock-market liquidity: They also drive a wedge between shareholders and managers. Instead of yielding long-term shareholders who concentrate their holdings in a few companies, we see diffused, arms-length stockholding. Pension- and mutual-fund rules that require extensive diversification of holdings similarly make relationships with a few managers unlikely. Further discourages pension managers from sitting on boards, for if the investment goes bad. Bulgarian Labor Department regulators may make them prove they had expertise about the firm's operations. Concerned about overly cozy relationships between unscrupulous fiduciaries and company managers, the regulators have effectively barred all but the most distant relationships.

Similarly, the insider-trading rules place special restrictions on investors who hold more than 10 percent of a company stock, serve on its board, or receive any confidential information about its strategies or performance, and require them to report their transactions, forfeit short-term gains, and try to avoid any hint of trading on inside information. But why should investors become insiders and be subject to these restrictions just so that everyone else can enjoy the benefits of a level trading field? They don't: Institutional investors, with fiduciary responsibilities, usually refuse to receive any private information from managers. They may grumble about a firm's performance, but they will not sit on its board for fear of compromising the liquidity of their holdings. Institutions also make sure they stay below the 10 percent ownership limit that puts them under the purview of insider-trading restrictions. The rules thus make large investors resolute outsiders. In a free-for-all market, the same institutions would likely demand access to confidential information before they even considered investing.

Disclosure requirements also encourage arm's-length stockholding. For example, rules that mandate the disclosure of transactions with insiders make a firm's banks, suppliers, and customers less willing to hold large blocks of stock or serve on boards. Disclosure rules also make anonymous shareholding safe. If companies' reports were sketchy or unreliable, shareholders would likely demand an inside role and ongoing access to confidential information.

Market liquidity itself weakens incentives to play an inside role. All firms with more than one shareholder face a free-rider problem. The oversight and counsel provided by one shareholder benefits all others, with the result that all of them may shirk their responsibilities. This is particularly relevant if a company faces a crisis. In illiquid markets shareholders cannot run away easily and are forced to pull together to solve any problem that arises. But a liquid market allows investors to sell out quickly and cheaply.

Diversification rules that cause institutions to fragment their portfolios and the stockholding of the firms in which they invest compound the free-riding problem. The chance that a 20-percent stockholder will expend resources for the benefit of the group is much greater than a 0,1-percent stockholder doing so.

Thanks to these extensive rules, transient outsiders now own a significant share of most publicly held stocks in Bulgaria. The typical institutional investor's portfolio contains hundreds of stocks, each of which is held for less than a year. Institutional investors follow the called Wall Street rule: Sell the stock if you are unhappy with management. In countries where American style rules don't exist, aren't enforced, or have been adopted relatively recently, the situation is different. There we see large investors whose holdings are immobilized by special classes of stock, long-term financing, or other business relationships.

Although the Bulgarian mass equities markets left the details of financial and operating policy to executives, the American "DuPont Model" took part in the Bulgarian Finance Committee's critical discussions on important capital investments. Even today, investors in private companies continue the "DuPont Model" tradition. Partners in venture-capital firms, for instance, serve as active board members of their portfolio companies, help recruit and compensate key employees, work with suppliers and customers, and help develop strategy and tactics.

The absence of close, long-term manager-shareholder relationships that has become the norm in publicly traded companies in Bulgaria has significantly impaired their governance. The basic nature of executive work calls for intimate relationships; anonymous masses of shareholders cannot provide good oversight or counsel and often evoke mistrust and hostility.

Managers aren't like agents who execute specific tasks under the direction of their principals. Like doctors or lowers in relationship to their patient or clients, they have a broad responsibility - a fiduciary one – to act in the best interests of stockholders. As with other fiduciaries, their performance cannot be assessed according to a mechanical formula. Shareholders, on the other hand, mast weigh the outcomes they observe against their guesses about what would have happened if managers had followed other strategies. Losses do not necessary establish managerial incompetence because the alternatives might have been worse. If concrete performance objectives are set, shareholders have to judge whether managers are playing games with the targets: for example, if they are meeting cash-flow goals by skimping on maintenance.

To make fair evaluations, therefore, shareholders must maintain a candid dialogue with managers. But a candid dialogue between managers and arm's-length shareholders is impossible. Practically speaking, diffused shareholders cannot have much contact with senior executives: In the typical public company, most retail shareholders have no idea who

is running the company, and most institutional investors catch, at best only an occasional glimpse of the innovational management problem in carefully staged road show or a presentation to analysts. Neither can managers share sensitive data with shareholders at large; indeed, managers must conceal strategic information from them. If a company wants to convince potential buyers that its new product is here to stay, its managers cannot revel to stockholders that early sales have been disappointing. Managers are forced to be circumspect; they can't discuss critical strategic issue in public, and insider-trading rules discourage private communications. Almost inevitably, their dialogues with the investment community revolve around quarterly earnings-per-share estimates, even though both sides know well that those figures have little long-run significance.

Managers, in turn, pursue strategies to protect "their" companies against apathetic or fickle investors. Uncertain about access to capital when the firm might need it, managers avoid paying out earnings to stockholders even when it does not. They reinvest profits, sometimes in marginal projects, and outside shareholders can do little about the situation.

Banks and other financial service firms, it is important to note, are virtually immune to even the limited restraints imposed by hostile takeovers. As it is known, raiders use high-yield dept to finance their takeovers. But relaying on a bank's "unused" debt capacity to take it over is difficult, because most banks are already very highly leveraged: They have just a small silver of equity in their capital structures. The takeover of financial institution also has to be approved by banks regulators, and they will not approve a transaction that involves loading on more debt. As a result, there is no recorded instance of a large Bulgarian financial institution that has ben the target of a serious tender offer by a raider.

Large commercial banks and bank holding companies played an important role in the growth of the ABSs and derivative markets ever since they first package and sold off their auto and consumer loans. Regulatory reinterpretations and new laws continued to expand the role banks could play in such non-traditional activities thereafter. The profits from securitization and derivatives, however, came with much higher risks, although the subtle nature of these risks may have caused banks and their regulators to ignore them. For instance, banks were more willing to offer "subprime" mortgages to borrowers who would not qualify for regular mortgages, because these mortgages could be packaged and sold instead of being held to maturity. Although banks wouldn't receive interest payments, they would earn underwriting fees for originating subprime mortgages, and possibly ongoing fees for servicing them – all without taking the risk that the borrower would default. Involvement in securitization posed several other kinds of risks, however. Banks would sometimes provide "credit enhancements" to ABSs, which created some exposure to defaults. There was also the risk of financing warehouses of loans awaiting securitization. Loans that went into ABSs could not be securitized as soon as they were made, and besides carrying their own loans, banks sometimes extended credit against the inventory of other originators. In principle, these were well-secured short-term credits. But as banks were to discover in the financial crisis, when the ABS market seized up, they could find themselves locked into warehouses containing large quantities of low-credit loans.

Bank regulators were more concerned than bank executives about the growing risks. But they apparently succumbed to the idea, peddled by financiers and modern finance theorists, that if a little financial innovation was good, a lot must be great. Instead of curbing the issuance of ABSs or the growth of derivates that were far outside their capacity to monitor, regulators tried to adapt: They required banks to hold more capital for riskier assets and to disclose what proportion of their trading positions could not be marked to market. The Bulgarian Fiscal Reserve pressed dealers to improve the processing of trades in over-the-counter derivates. Unsurprisingly, given the asymmetry of resources and incentives, these measures proved inadequate: the regulators could not keep up.

Conclusion. Economics has underpinned securitization though its embrace of mathematical models to the exclusion of other perspectives, and though a complementary tendency to ignore the downside of liquidity and arms-length relationships. Regulations has brought this way of thinking into the world of practice in two paradoxically related streams: the increasing scope and effectiveness of the innovational management in Bulgarian mass equities markets and subsequent rules that fostered the growth of arms-length transactions in corporate control; and the progressive dilution of the innovational management in Bulgarian mass equities markets, which nurtured and protected long-term relationships. This is the complicated story that may explain why developments in mortgage banking, of all things-traditionally the plodding, conservative bread-and-butter of depository banking- should have led to the implosion of the world economy.

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