Case Studies on

Financial Markets

Edited by

Chiradeep Chatterjee

Icfai Business School Case Development Centre

Icfai Books

71, Nagarjuna Hills, Punjagutta, Hyderabad – 500082

Icfai Books
71, Nagarjuna Hills,
Punjagutta, Hyderabad – 500082
Andhra Pradesh, INDIA
Phone: 91 - 40 - 23435387/91, Fax: 91 - 40 - 23435386
e-mail: icfaibooks@icfai.org, ibscdc@icfai.org
Website: www.icfaipress.org/books, www.ibscdc.org

© 2008 The Institute of Chartered Financial Analysts of India. All rights reserved.

No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means – electronic, mechanical, photocopying or otherwise – without prior permission in writing from The Institute of Chartered Financial Analysts of India.

While every care has been taken to avoid errors and omissions, this book is being sold on the condition and understanding that the information given in the book is merely for reference and must not be taken as having authority of or being binding in any way on the authors, editors, publisher or sellers.

Product or corporate names may be registered trademarks. These are used in the book only for the purpose of identification and explanation, without intent to infringe.

Case studies are intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation.

Copies of individual case studies are available for purchase from www.ibscdc.org

ISBN: 81-314-1209-6

Editorial Team: P. Sai Manohar and Radhika Nair M.K.

Visualiser: P. Damodara Siva Prasad
Designer: P. Damodara Siva Prasad

Case Title	Page No.
Section I: US Financial Markets	
International Finance Facility: The Global Marshall Plan	3
Greenspan's Economic Policies: Managing Through Booms and Busts	19
The Power of the US Dollar: The Waning Glory	33
US Junk Bond Bubble: Is History a Better Guide for the Present?	47
Long Term Capital Management Fund: What went wrong?	59
Hedge Funds: A Risky Trade-Off?	69
Fannie Mae: The US Mortgage Giant's Accounting Controversies	79
Morningstar Inc.: The US Fund Rating Leader's Credibility at Stake	93
Kroll Inc.: From Private Eye to Risk Management Specialist	103
Wilbur Ross: The Buyout King	115
Silver Lake, the US Private Equity Firm: Expansion Strategies in Europe	125
Section II: European Financial Markets	
The Chicago Exchanges vs Eurex US	139
Eurex Challenges	147
Private Equity Firms in Germany: Can they Change the Corporate Landscape?	157
Italian Corporate Bonds: Bella figura to Buconero	167
Deutsche Börse's Bid for London Stock Exchange: What's the Strategic Fit?	175
Section III: Asian Financial Markets	
Foreign Private Equity Funds in South Korean Banks	193
Southeast Asian Debt Restructuring Institutions: The Lessons	205
ICICI's CDO	217
Infrastructure Development Finance Corporation: The Controlling Battles	227

OVERVIEW

A remarkable aspect of the fallout of globalisation has been the increased relevance of financial markets to human society. This has been largely due to the spread of US-style capitalism to nations that had in the past detested it. This has obviously led to the study of financial markets with renewed interest. One area of interest has been how US macroeconomic policies affect the economies of other nations.

Effect of US Macroeconomic Policies on Other National Economies

Even after the demise of the Bretton Woods system, sovereign governments had accepted the dollar as the standard for international transactions. Of course due to the US's perennial influence on international politics – so much so that it can rattle other economies. This is the primary reason behind US macroeconomic policies affecting other national economies. It should be thus interesting for the reader to realise, how the rise or fall of the dollar influences other financial markets.

Changes in the domestic dollar value largely depend on the interest rate set by the Federal Bank in New York. This influences investment as well as borrowing decisions. We must remember that US-based investors as well as borrowers evaluate their decisions based on real interest rates that compensate for the risk of change in dollar value during the entire tenure of their transaction. A reduction in the nominal rate of the dollar by the US Federal bank leads to a fall in the real rate. If this fall is relative to rates prevalent abroad, it leads to shift by investors to foreign currency financial assets. However, borrowers turn to US markets from foreign markets with higher interest rates. The fall in dollar value also depends on factors like anticipated inflationary trends in the US economy and interest rate policies of the central banks in other nations. This intermingling of factors alters the demand/supply characteristics of financial markets across national economies.

Change in dollar value interestingly routes the flow of international goods and services. A fall in the federal rate ups the demand as well as prices of US goods and services. This creates increased demand for imported goods and services, as they are cheaper; in turn, creating a wider US trade deficit. But, if the reduction in nominal rate also leads to a fall in the real exchange value of the dollar, US goods and services will be cheaper than the foreign ones. This rather boosts US exports. Usually, a fall in the dollar value has an initial stimulating effect on foreign economies due to the growth in the US economy. However, in the long run, it is offset by the increased demand for US exports. In order to maintain a status-quo on their economies, sovereign governments can directly intervene into their economic systems through their ministries or their central banks, based on whether they have pegged or floating rate currencies.

Consolidation in Financial Markets

Governments can intervene in financial markets through state-controlled direct investment and fiscal subsidies to companies and households. Excess importance given to the quantity of financial sources, with little concern for the quality, usually weakens the economy's financial

status. Keynesian economics argues that low interest rates spur higher investment, and a higher level of investment in turn raises the output level. Conversely, the financial liberalisation approach posits that the second link may fall short when the state supplies financial investment against the market principles. This generally leads to overheating of the economy through a rise in inflation. Since financial capital has an opportunity cost, it must be allotted towards investment with the highest return, to gain maximum benefit.

Globalisation, in the recent years, has involved the integration of financial markets worldwide. Far from its traditional meaning – cross-border transactions of goods and services – globalisation now extends to international capital flows, supported by advances in technology. Internet has made the process easier. The payment and settlement systems, vital for the financial markets, minimise the systemic risk by influencing the speed, financial risk, reliability and the cost of overall transactions. Technological advances affect all the above factors positively, thus improving the depth and liquidity of various segments in the financial markets.

Globalisation widened its scope, due to the emergence of worldwide financial markets and the prospects of profiting from external financing. Capital account liberalisation is now a vital ingredient for economic growth, akin to the notion of downing the barriers on international trade of goods and services.

For instance, introduction of financial reforms in India since the early 1990s, made it possible for the integration of its domestic financial markets achieving greater depth and liquidity. In China, during the 1980s, reforms shifted the allocation of financial resources from the government to the local bodies. Investment by foreigners was allowed from 1992 and FDI is a major factor in the high investment levels in China. China's WTO entry led to further financial reforms and opening up of the financial markets. Robust growth in India and China may further lead to higher integration of these economies into the world economy.

But capital account liberalisation is not without its own risks. The financial markets tend to follow boom and bust cycles, where capital flows expand and contract. Also, it leads to obscuring a clear demarcation between different kinds of borrowers. These risks if not properly handled, result in abnormalities as experienced during the 1997 Asian financial crisis.

Vibrant Asian Financial Markets

Before the 1997 crisis, the Asian financial sector was distorted in many ways. These included relationship banking, biased credit by state-owned banks and preferential lending rates for targeted borrowers.[1] This has apparently led to a surge in the levels of non-performing loans.

The Economist had pointed out that a mix of factors – weak financial systems, hasty opening of economies to foreign capital and pegging local currencies to the dollar –led to the crisis. It was also said that the crisis was different as East Asia had lower inflation levels, balanced budgets and a growth record of almost 8% over three decades.[2]

[1] "Financial Reforms in Asia since 1997: Lessons and Responses", http://www.gdnet.org/pdf2/gdn_library/annual_conferences/fifth_annual_conference/mundle_paper.pdf

[2] "Gold from the storm", http://economist.com/finance/displaystory.cfm?story_id=9401752

But 10 years after the crisis, the economies are brimming again. For the past three years till 2007, the Asian economies have been growing at an average of 8%. The IMF bail-outs have helped restore confidence, backed by reforms, to restructure and strengthen the banking sector. Since 1997, Thailand, Korea and Malaysia have introduced reforms in banking and capital markets, as part of the IMF-led adjustment programme. The Asian Development Bank and the World Bank have also helped by way of adjustment loans concentrating on capital markets and the banking sector respectively. Malaysia, China and India buzzed with their own reform programmes.

Most countries have tightened the regulation systems in the capital markets: improving long-term debt market and innovative financial instruments, and reforming the insurance and pension structures. On the banking side, greater transparency and improved risk management have emerged as a result of heightened regulation and supervision. Banks have also strived to attain better capital-adequacy norms. Bankruptcy and foreclosure laws also have been reformed.

While the above essay may help the reader to get a feel of the trends that are apparent in today's financial markets, deeper insights are needed to understand the actual nuances of the functioning of financial markets. Readers can get them through specific real-time case studies like those given in the following table:

Sl.No.	Name of the Case Study	Core Theoretical Concept
	Section I: US Financial Markets	
1.	International Finance Facility: The Global Marshall Plan	Role of international finance in poverty alleviation in third world countries
2.	Greenspan's Economic Policies: Managing through Booms and Busts	Role of US macroeconomic policies on business cycles
3.	The Power of the US Dollar: The Waning Glory	Role of US macroeconomic policy on the exchange value of the dollar
4.	US Junk Bond Bubble: Is History a Better Guide for the Present?	Innovation in financial markets
5.	Long Term Capital Management Fund: What went wrong?	Innovation in financial markets
6.	Hedge Funds: A Risky Trade-Off?	Innovation in financial markets
7.	Fannie Mae: The US Mortgage Giant's Accounting Controversies	Accounting principles
8.	Morningstar Inc.: The US Fund Rating Leader's Credibility at Stake	Audit principles
		Contd...

9.	Kroll Inc.: From Private Eye to Risk Management Specialist	Risk consultancy
10.	Wilbur Ross: The Buyout King	Private Equity in the US
11.	Silver Lake, the US Private Equity Firm: Expansion Strategies in Europe	Obstacles to Private Equity in Europe
Section II: European Financial Markets		
12.	The Chicago Exchanges vs Eurex US	Role of technology in financial markets
13.	Eurex Challenges	Financial market integration
14.	Private Equity Firms in Germany: Can they Change the Corporate Landscape?	Changing perception of Private Equity in Europe
15.	Italian Corporate Bonds: Bella figura to Buconero	Financial market regulation
16.	Deutsche Börse's Bid for London Stock Exchange: What's the Strategic Fit?	Financial market integration
Section III: Asian Financial Markets		
17.	Foreign Private Equity Funds in South Korean Banks	Financial restructuring of Southeast Asian financial institutions
18.	Southeast Asian Debt Restructuring Institutions: The Lessons	Financial restructuring of Southeast Asian financial institutions
19.	ICICI's CDO	Innovation in financial markets
20.	Infrastructure Development Finance Corporation: The Controlling Battles	Governmental interference in financial institutions

The first 11 cases (cases 1 – 11) are on US financial markets, the next 5 (cases 12 – 16) focus on European financial markets, and the rest (cases 17 – 20) are about Asian financial markets. Each case focuses on a financial market issue from a distinct angle, to help readers get the necessary outlook to understand the shades in financial markets.