Financial regulators 'asking the wrong question'

World-renowned financial markets specialist calls for more emphasis on the needs of investors rather than 'mechanical' response to their protection

Sydney, 21 May 2015: The focus on financial stability above all else may be leading governments and regulators to lose sight of what regulation should really be about, namely protecting investors and consumers, according to a leading global investment expert.

Speaking yesterday at a breakfast organised by the CFA Institute as part of its 'Putting Investors First' (PIF) month, Mr Anthony Neoh QC, SC, who is on the international advisory committee of the China Securities spoke about global trends in financial regulation, outlining a number of successful global initiatives, but also highlighting oversights by regulators that have become apparent since the global financial crisis (GFC).

According to Mr Neoh, regulators in Australia, the United States and the United Kingdom may have different rules, but ultimately they are all working to the same template and agenda, that of the stability of the financial system.

"Ever since a number of major financial institutions held governments to ransom by calling for taxpayer-funded bailouts on the basis that they were 'too big to fail', regulators have been focusing on ways of ensuring this never happens again.

"In essence, their solution boils down to two things; that banks should have enough capital on hand to deal with potential losses, and that they should not be allowed to infect the domestic and global financial system in the way they did during the GFC.

"Regulators call this the institution's 'loss absorption ability'", Mr Neoh explained.

Mr Neoh acknowledged that some banks clearly need to hold higher levels of capital, but pointed to the possible unintended adverse consequence of more stringent capital adequacy ratios. In some cases the ratio could be as high as 17.5%, if an institution is deemed to be globally significant. This is more than double the 8% standard in 1988.

"If banks are made to hold very high levels of what is essentially useless capital, there will be an impact on the economy, and on investors. If equity is high and revenue doesn't change significantly, then clearly return on equity is going to be much lower than before," Mr Neoh said.

Mr Neoh then spoke about another major issue to come out of the GFC, namely the purveying of complex financial instruments to the general public. In many cases it became clear after a number of highly risky instruments had been sold to investors as low risk, but they were not understood by those buying them.

"Regulators have made significant efforts to enforce stricter business and market regulation rules to deal with this, but in my view, they have approached the problem in a very 'mechanical', or what I would describe as 'box ticking' way.

"By this I mean that a great many standard warnings and rules must now be presented to investors, and the problem is that the rules are so rigid, and the banks so terrified of contravening them, that they stick to them mechanically," he said.

Despite improvements in regulation, Mr Neoh said that the big question of who really benefits from all the changes being made, remains. Regulators say they are for investors, whereas institutions say they are for the benefit of the regulators, and not for investors at all.

"In my view, the question of who it is all being done for is not in fact the right question. The right question is what is being done to fulfil the needs of the people who are investing? That question hasn't been asked. Regulators say they are acting for the benefit of investors, but the investors haven't actually been asked," he said.

Mr Neoh finished by highlighting the vital role that groups like the CFA Institute play in advocating for investor rights, and contributing to initiatives like the Financial System Inquiry. In fact, the CFA Institute has recently developed a paper which hones in on what should be done in financial reporting to be responsive to the needs of investors. It calls for a change in mindset within institutions, one which gives investors a voice.

"There's no question regulators have taken significant steps to address many of the systemic problems in global financial systems which the GFC brought to a head. And the fact that major financial institutions were fined nearly USD60 billion in 2014 is evidence that governments are more than willing to enforce their new rules.

"At the same time, it's important not to lose sight of the ultimate objective in all of this, which is to create stable and transparent financial markets which investors trust."