GLOBAL TRENDS IN FINANCIAL REGULATON

Synopsis of speech by Tony Neoh on behalf of CFA Societies Australia

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[Slide 2 /3]

Major financial institutions were fined to the tune of nearly USD60 billion in 2014.

The big one last year was Bank of America, which paid USD17 billion for a settlement agreed with the Justice Department in the United States. Around $10 billion of that money was paid to the Federal Housing Finance Agency ("Agency") and various other Federal and State Authorities, $7 billion of which was put into a trust fund to help house owners whose mortgages were terminated or foreclosed.

[Slide 4 /5]

In another case where judgment was rendered last week by the Southern District of New York, the Agency sued Nomura and RBS in relation to the asset backed securities they sold prior to the financial crisis. The prospectus contained a description of the securities which later turned out to be false.

This is what Judge Denise Coat said about the prospectus: "This case is complex from almost every angle but at its core there is a single, simple question. Did the defendants accurately describe the home mortgages in the Offering Documents for the securities they sold that were backed by those mortgage? Following the trial, the answer to that question is clear. The Offering Documents did not correctly describe the mortgage loans. The magnitude of falsity, conservatively measured, is enormous."

Nomura and RBS decided to fight it out in court. Other banks have decided to settle, including the Bank of America. While the amount of fines and compensation has fallen significantly in 2015, it has already increased by another billion just because of this judgment. There will be more cases because settlements have not yet been reached by some banks.

[Slide 6]

I was in Hong Kong last week speaking at the Annual General Meeting of the Pacific Bar Association and one of the members of my panel (a well known real estate developer) said “something is wrong if major financial institutions have to be fined billions of dollars”.

So why did this happen?

One reason is this: since 2009, financial regulation has ascended to the top of the political agenda. Most changes to financial regulation made and the enforcement actions taken since that time have been the result of the political agenda since then.

The global financial regulation agenda is co-ordinated by the G20 countries. The finance ministers and central bank governors now attend every G20 meeting. Since 2008, they have formed a group called the Financial Stability Board, which has been creating a worldwide agenda on financial regulation, the likes of which haven’t been seen before.

The most important point here is that this worldwide political agenda is leading to a convergence of financial regulatory concepts. Asset managers, commercial bankers, investment bankers, investment advisers, insurance companies or securities brokers; as the purveyors of services are perceived to affect the stability to the financial systems, and so, everyone is thrown into the one “financial services” bucket and one universal regulatory template.

While we still have different regulators enforcing the rules in the United States, the United Kingdom and here, they all work to the same template and the same objective: that is the stability of the financial system.

[Slide 7]

The term ‘too big to fail’ came about as the result the intervention of United States, United Kingdom and European governments to keep major financial institutions afloat using taxpayer money.

To show taxpayer money was not being wasted, President Obama promised “we’re eventually going to get these people who have done the wrong thing” as a counterweight to the funds he received from Congress for this purpose.

Hence, the rise in number of fines in the years since 2009.

Obama actually drove this with powers vested in the Federal Government under the Financial Investment Reform and Recovery Act (FIRREA), which requires to the Government to look at all types of financial misdoings and to then make recoveries and establish reform.

These recoveries do not go back to investors. Instead, in the United States they go to the Federal Government or to the State government, if it’s a state matter. New York State has more or less recovered a very substantial part its budget through fines in the past two years.

Politics is therefore driving the regulatory agenda today.

[Slide 8 - 12]

By financial institutions putting out their hands to the government saying “we are too big to fail; give us money or everyone else goes down with us”, they were in effect holding governments to ransom not only in the United States but also in the United Kingdom and in Europe.

“Too big to fail” has now entered the agenda of the Financial Stability Board where the view has been formed that any institution who can impact the stability of the system should not be allowed to hold out their hand for funding.

The agenda has been to do two things: all banks need to have enough capital to deal with the potential losses they could generate from the types of business model that they follow and they should not be allowed to infect the domestic and global financial system in the manner that occurred during the last Global Financial Crisis. The regulatory template calls this ‘loss absorption ability’.

This term is used around the world, including by the Financial Stability Board; it was also used in the Financial Systems Inquiry in Australia.

The question it then raises is this: what is the return to investors if institutions are loaded up with capital? It means equity is very high, revenue doesn't change significantly and return on equity is much lower than before.

If that's the case, what's the impact on the real economy if big institutions' capital levels are increased to a point where their capital is laying useless?

To date, nobody has been able to work that one out.

The counter question to that is if these banks don't increase capital levels and they create more risk in the future, who will trust the financial system?

[Slide 13]

So there's now a trade-off between the two.

The Basel Committee on Banking Supervision is now saying that capital adequacy for globally significant institutions should be around 17.5 per cent; compare this to the standard 8 per cent in 1988.

[Slide 14 - 17]

Most other changes to the regulatory regime in recent years have been around financial reporting and corporate governance.

In the United Kingdom as an example, there is a recommendation before the Parliamentary Select Committee saying that any financial institution directors found to have been grossly negligent in assuring there are adequate risk management systems should be criminally liable together with management.

There is also a view that regulators are now also expected to be more accountable to their political masters as well as to the legislatures.

One change that hasn't happened and should happen is to establish objective metrics to assess the performance of financial regulators. I note the Financial Systems Inquiry Report made a recommendation to establish an Assessment Board for this purpose. The challenge here is to find the correct objective assessment in a quantitative and qualitative sense.

This has been the topic of discussion between governments, regulators and the institutions that regulators have been handing out fines to. Unfortunately, these discussions haven't included the very consumers and investors in financial services who the regulations are meant to protect and, in my view, the focus on financial stability has meant not enough attention is being paid to their protection and needs.

With the global template, regulation means this: better coordination, much deeper prudential regulation and stricter market regulation.

In terms of prudential regulation, this just doesn't mean capital it also means liquidity and liquidity deemed by the regulator as high quality liquid assets. There are also stronger governance requirements such as the competence of directors in terms of fit and proper and ensuring they are aware of all the risks. In China, the regulators now sit at all board and committee meetings of major institutions for this purpose.

The other area is stricter business and market regulation rules. One of the big issues in the global financial crisis was the purveying of complex financial instruments to the general public.

[Slide 18]

A Lehmann mini bond was sold to thousands of retail investors in Hong Kong before 2009. I was in fact the leading counsel on the case suing one of the banks selling these bonds. The bond was sold to my clients as equivalent to a bank deposit.

Despite our more than thirty years of experience in the financial markets, my market consultant and I took ten days to begin to understand the prospectus and the relevant contractual documents associated with the product, in order to understand the product and prepare the statement of claim. Imagine retail investors asking advice of a bank they are supposed to be able to trust and being told it was equivalent to a bank deposit!

This was the problem with a number of the financial instruments sold before 2009 in places like the United States, United Kingdom, Europe, Singapore and Hong Kong.

[Slide 19 - 22]

There has been a sea change in the attitude of regulators towards selling instruments or financial assets to the general public. Unfortunately, they have attacked this in a mechanical way.

In the US, there is a Self Regulatory Organisation (a regulatory agency with delegated authority under Federal legislation to regulate members of the securities industry) called FINRA, which regulates financial advisers and business managers who sell products to investors as persons having fiduciary responsibilities. They have gone into a lot of what I call 'box ticking'; bright line specific rules which they now have to follow. Anyone who walks into a bank now has to be first advised of the rules before any product can be sold, and they are read a lot of "boiler plate" warnings. It has in fact gone the other way in that not sufficient thought is being given to the client's needs because the banks are now scared of going beyond the bright lines of the rules and the fines and prefer to stick to them mechanically.

There has to be some kind of happy medium which has not been struck at this stage.

[Slide 23 - 24]

And you have to ask, who is this all being done for? Regulators would say this is being done for investors; institutions would say this is being done for the benefit of the regulators and not the investors. But this is the wrong question and thus, the wrong answers emerge.

[Slide 25 - 29]

The correct question is: what is being done to fulfill the needs of the people who are investing with us? That's the question we haven't been asking and that is the reason why regulation has become so mechanical. The investor protection regulations are only for the benefit of what regulators 'think' investors need but they, the investors, haven't actually been asked.

The CFA Institute has actually developed a paper about what needs to be done in financial reporting that is responsive to the needs of investors. It puts institutions in the shoes of investors and asks them to decide what they need to know from the financial reports. The report says there needs to be a change of mindset with institutions, one which gives investors a voice.

The investors themselves don't have a big voice and this is where organizations like the CFA, whose core agenda is one of consumer advocacy and market integrity, has a vital role in becoming that voice for investors.

A video of Tony Neoh's speech and presentation is available on the CFA website.