

Rethinking investor protection

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From Hong Kong to UK

It is my pleasure to speak to you today as part of the International Distinguished Lecture series. The Distinguished Lecture series, as I see it, is distinguished as much for its audience as the speakers that have preceded me in this respected forum. I am sure this is true today.

I have chosen to speak on a topic that is central to the work of a financial market regulator – that of how we protect investors. This is a question that is being asked worldwide after the financial crisis. I know it is a question here in Australia following many product failures. It is certainly a question I am facing daily in Hong Kong – where protest marches have become the order of the day. And it is a public policy debate in the UK – where I shall soon be going to take up this question.

So I think it's a pertinent one for today. A forum like this provides a valuable

sounding board when regulatory reviews and reforms are in gestation. That is certainly the case currently in the UK, the US and many other parts of the world – though less so in Hong Kong as I shall explain later.

I looked at the content of previous speeches and I looked back on the remarks that John Fraser made at the third instalment of this Lecture series in November 2008. He observed that being a regulator in the environment then - when financial markets worldwide were spinning from the aftershocks of Lehman's collapse - was an incredibly difficult task. He said that the speed with which the financial sector grew, the globalisation of the industry and the remuneration packages have meant that regulators were struggling to retain people with the right expertise.

John further noted that good regulators - once they get on top of an issue - often get nabbed by the private sector. Well I'm not – I am moving from one regulator to another.

The crisis that followed the collapse of Lehman Brothers led to a lot of soul-searching. And the inevitable question was asked - by the media, politicians, the public – why hadn't the regulators seen this coming? And why wasn't more done to protect investors?

In retrospect of course there has been a wealth of analysis on the factors that led to the crisis. And with the benefit of hindsight, a wealth of indicators that did show something was amiss. But these were indicators that few people picked up at the time. Some analysts and economists did sound warnings of impending crisis.

Economists such as Nouriel Roubini and Kenneth Rogoff warned about US house prices and levels of debt; the historian Niall Ferguson analysed previous boom and bust periods. But the general mood of the period was to dismiss such warnings as

“extreme” and “out of touch”.

The world’s central bankers get together each year in Jackson Hole in the US to debate the global economy. They met in 2005 for what was to be Alan Greenspan’s last as Federal Reserve Board chairman. Most of this event in 2005 was dedicated to celebrating the “great moderation” that financial markets had achieved; the plentiful supply of credit that was now available and boosting global growth – but which had happened with “no greater risk in the system”.

Only one economist, Raghuram Rajan, dared question “Has financial development made the world riskier?” and he was roundly criticised as being out of touch. He argued that risk had not been as widely dispersed as was claimed; that the banking system itself could be at risk; that the bond market could freeze up and a full-blown crisis emerge.

Amongst regulators – the Financial Stability Forum (FSF) (the forerunner to the now more powerful Financial Stability Board) was charged with the task of reviewing risk build-up in the system. This role was given following the collapse of Long Term Capital Management (LTCM) – the hedge fund that whilst employing Nobel prize winning mathematicians came close to bringing down the financial system. Even as late as early 2007, the reports from the FSF were still saying that whilst risk appeared to be underpriced, the process of securitisation had left banks carrying a relatively small but manageable portion of that risk; that if a crisis were to emerge it would probably come from “the less regulated hedge fund sector”.

Despite a few lone voices, regulators generally failed to appreciate the scale of the crisis that would ensue.

The fall-out in each market was different. In Hong Kong, Lehman was not a particularly big player overall in the market. It had however packaged a complex product – known as a Minibond which I shall come back to later – which had been widely sold to retail customers via the banking system.

The challenge now being presented for regulators, policy-makers and supervisors is that we must ensure that “never again” do we face a crisis like this. The nature of financial markets is that they are about pricing risk, taking risk. And that inevitably means that failures whether at a product or entity level are a fact of life. To take risk out of the system would undermine the economy more widely. It is NOT never again to failure – BUT that any failure should not be allowed to impact in the way that this crisis has. A lot of this debate is about the “too big to fail” problem – how to ensure that financial institutions take less risk, hold more capital – and do not become a burden on the tax-payer.

The other part of the debate on “never again” is about products – complexity of products, suitability and the risks that they expose the holders to. It is this part of the debate that I shall focus on today - How to make sure that products are appropriate. It’s a subtle and difficult debate. Most products are neither inherently good or bad (unless they are fraudulent of course). But they have become very complex where the balance of risk and reward can be opaque – products unsuitable for some may be entirely appropriate for others. “Credit” as a product was widely packaged and sold in Hong Kong – it’s probably not appropriate for 100% of your investments but could be a diversification play in a broader portfolio.

As I have mentioned earlier, investor protection is a fundamental part of the

responsibility of securities regulators. I have a perspective on this based both on the last six years regulating the Hong Kong market, and on my next job. I'm returning to the UK in September to help set up a new, purpose-built conduct regulator – the Financial Conduct Authority (FCA) - and to head it once the legislative process completes. I will therefore have the chance to help shape the creation and direction of the new body.

The FCA is one of the three new bodies to be created under the UK Government's current reforms of financial regulation, the other two being the Financial Policy Committee (FPC) to be set up in the Bank of England and the Prudential Regulation Authority (PRA).

From spaghetti approach to packaged solutions

I would categorise the regulatory response in the aftermath of the financial crisis the spaghetti approach – a vivid description of the strategy of throwing ideas against the wall to see what sticks.

Governments and regulators, placed under immense pressure to act, had brought out emergency rules only to be later reversed, creating further problems rather than eliminating them.

Just recall the assorted bans on short selling in different markets, which hurt rather than helped the markets by disallowing legitimate strategies, choking the much needed liquidity off the markets.

Crisis often opens a window of opportunities to forge ahead with necessary,

sometimes overdue reforms. I am hoping the relative calm at present, with markets on the mend from the damage sustained in 2008, will provide background for more rational, balanced debates and decision-making regarding regulatory issues.

When I was last in Australia for the ASIC Summer School this February, I had the chance to update myself on how the Twin Peaks model has served the Australian market. No market around the world escaped the crisis unscathed – but in a scenario where major financial institutions collapsed and billions of dollars of tax-payers' money was needed to shore up the system in some markets, the Australian Twin Peaks model has served the market well.

When, in late 2008, regulators in Hong Kong were tasked with producing a report to the government to suggest ways to improve the regulatory system, I found myself a proponent for Hong Kong to adopt the Twin Peaks model. After considerable deliberations, Hong Kong decided that it would not go so far as to dismantle the current regulatory structure to make way for two new regulators.

Instead, a package of measures to enhance investor protection have been introduced, covering both the products and the conduct and spanning the three key stages of an investment – pre-sale, sale and post-sale.

For example, we have mandated an easy-to-read product key facts statement to help investors understand the key risks and features of a product. Certain unlisted structured products must now offer a minimum cooling-off period so that investors have a chance to unwind the investment in a completed transaction.

On the other hand, the UK drew a different conclusion and resolved to follow

Australia's model to run in parallel a prudential and a conduct regulator. Where you have the ASIC and APRA here, the UK is in the process of creating the FCA alongside the Bank of England's FPC and the PRA: these will replace the current FSA integrated regulator approach.

While global regulatory structures may converge and diverge, the common, fundamental objectives remain the same - the protection of investors, and maintaining a safe and sound market. In the UK, the responsibilities of achieving these objectives fall squarely on the FCA and PRA.

Conventional wisdom about investor protection

Disclosure, premised on the belief that sufficient information enables sensible decisions, and conduct regulation, which imposes suitability requirements and addresses conflicts of interests issues, often go hand in hand in investor protection regimes.

A recent survey conducted by Fidelity International shows that 78% of Hong Kong investors think "investor protection" is to provide investors with the appropriate information before making an investment decision – fair enough and rather encouraging.

But in the same survey 59% said they would not read the prospectus and 64% said they would not read fact sheets or product brochure. It's a bit worrying as a regulator that puts an emphasis on disclosure – if most people don't read what you disclose.

Hong Kong is among the many markets that have beefed up conduct regulation in the light of mis-selling allegations. It means the sales process takes longer and is more intrusive. It requires the bank to have a better understanding of client needs – and to spend more time explaining product features. However, as the survey goes, to avoid additional selling process, 32% changed their investment from mutual funds to risky or riskier investment products that are less regulated. So the investor choice (or possibly the bank if I am really cynical) is to opt for the riskier products to avoid the time involved in extra regulation.

Loads of information, none the wiser

These perplexing, worrying findings have driven me to venture into consumer psychology. At the ASIC Summer School three months ago, Dr Paul Harrison of Deakin University had quoted Stephen Pinker, author of *How the Mind Works*, who sums up human behaviour rather well: “Humans are impatient, intelligent beings.”

Dr Harrison went on to explain that we are drawn towards information that is easily accessible, fits in with our current worldview, requires little cognitive resources, and is easy to understand.

If we are tired, stressed, confused or struggling, we are likely to use peripheral, emotional, social and impulsive cues, such as trust, inertia, or external stimuli (e.g. perceived relationship with the person selling a product to us) to assess whether we are making a good decision.

Provision of choice brings benefit insofar as decision complexity is manageable, otherwise too many options are likely to result in suboptimal decision making.

The toxic mix of mis-selling and mis-buying

The Fidelity survey has turned out another interesting finding: investors expect to achieve an average of 17.2% of return on investment per annum from their investment portfolios. This is a troubling figure if you want to stem both sides of the problem - mis-selling and mis-buying.

But it was not just retail investors who got entangled in disputes over complex financial products. Nor did they happen in isolated markets.

As many as half a dozen Italian municipalities have been embroiled in law suits with investment banks over swap contracts that had turned sour. Derivatives losses sustained by Italian local governments, by one account, were up to some 1.2 billion euros.

Plausibly, one might argue, all these massive failures have to do with the fact that retail investors and municipal governments lack the sophistication to handle increasingly complex financial products.

But corporations have also got their fingers burned in derivatives transactions.

In a lawsuit between a German corporation and its bank over interest-rate swap transaction, the court ruled that the bank had not adequately explained the risks to the firm. The presiding judge mused that "If you are able to read the words of a poem, you haven't necessarily also understood its meaning."

It is also wrong to think that these failures afflicting individuals, governments and corporations, were the collateral damage of the global financial crisis. This is not a

recent phenomenon. Just look at this case which happened in the mid-1990s.

Bankers Trust, the name associated with pioneering of derivatives trading, was sued by a number of major corporate clients which ran sophisticated treasury departments, including Procter & Gamble.

Have creative product design and selling gone one step too far? Were these isolated shenanigans pulled off by rogue, greedy sales?

Disclosure, conduct, and beyond

With the basic belief in free markets, most regulators have so far kept away from direct intervention. We know merit-based regulation is a murky territory, and could potentially create moral hazard. In a merit-based system the regulator would approve products. Once approved does that mean they are safe? Safe for all consumers in all conditions?

Product intervention may take the form of rules placing requirements on products and product features; mandating minimum product standards, and restricting sale of a product to a certain class of consumers.

In Hong Kong, we have published a consolidated product handbook, which includes a new product code for unlisted structured investment products.

But intervention can go further than that.

It is also possible for the regulator to go in before the problem occurs, trying to spot any potential build-up of risk and risky products before they cause any

damage.

Acting before damage has occurred is not easy or straightforward. It is quite a challenge which requires judgement calls to be made about what's good and what's bad in markets.

Ideally, a large part of the intervention work should fall on the proactive scrutiny of the products market. However, the regulator must also stand ready to act in order to stop major problems in its tracks.

Many investment products have become excessively complex, and doubts are cast as to whether they make any meaningful economic sense. In some cases, due diligence is not only beyond investors; it is probably safe to assume that intermediaries selling these products or advising their clients on these products find it impossible to grasp the structure of these products.

In a 2009 speech, Andrew Haldane of the Bank of England reckoned that an investor in a CDO squared – synthetic collateralised debt obligation squared - would need to read in excess of one billion pages to fully understand the ingredients.

When comprehension of a product is lacking even among the professionals, it is hard to put forward a convincing case of how the product can benefit the investor.

As inflation is now creeping into most economies with interest rates failing to catch up, investors would be attracted by the higher return investment markets to preserve their wealth. This could be a recipe for another bubble to form.

An added pillar, a more balanced approach

Knowing that the flip side of intervention is the potential risk of moral hazards, any regulatory framework that provides for intervention must at the same time highlight the importance of consumers' responsibilities for their own choices.

Intervention is a fundamentally different approach in the way most regulatory regimes have operated to mitigate risk of financial services.

Regulators may proactively intervene earlier in a product's life cycle, and exercise greater scrutiny of firms' product design and product governance. A more proactive, interventionist approach will also require a greater use of judgement.

This is done to complement, not to supersede, the traditional focus on sales and marketing, and the disclosure of information.

But financial markets are primarily about the management and pricing of risk, not its removal. It is therefore imperative that intervention does not make for a zero-failure regime, and that investors are not removed of the responsibility for their own decisions.

Conclusions

The interventionist approach is a challenge and a novelty. There will be a need to road-test the rules and we may even have to allow for a few false starts.

A problem averted may be visible to only the few who saw it coming. But a problem that happens on the watch of an intervening regulator could be taken as

proof of a deficient system.

Using the rear-view mirror alone in regulating the market means the market will always get ahead of regulations. As product complexity is growing at an ever faster pace, investor protection work calls for the exercise of foresight, the power to act pre-emptively.

These powers are tools that come together as a package, with each pillar buttressing the effectiveness of the others. We are also careful that the new power to intervene does not distort the incentives or create moral hazard. Vigilance is the responsibility of both the regulator and investors.

Before the advent of complex structured products, regulatory attention was appropriately targeted at conduct issues, mainly in the selling process. But with investment banks continuing to recruit droves of mathematicians and financial engineers each year, we can expect more complex products to come on stream.

If the intention is not to throw the baby out with the bath water, then we need to make room for market development and product innovation. Accordingly, regulatory resources should be appropriately deployed to ensure dangerous build-up of risks on the product side would not be off the regulator's radar screen.

Thank you.