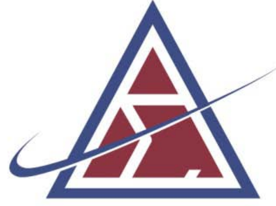

Institute of Actuaries of Australia

The Regulation of Retail Investors

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Presented to the Institute of Actuaries of Australia

Biennial Convention

10 - 13 April 2011

Sydney

This paper has been prepared for the Institute of Actuaries of Australia's (Institute) 2011 Biennial Convention.

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The Regulation of Retail investors

Purpose

I wanted to highlight some poor experiences of financial services (FS) regulation to justify an examination of the possibility of providing more ethical financial services products outside the current regulatory regime.

However, while struggling with the latter challenge it became obvious that my first goal should be reconsidered.

It is easy to see from the Treasurer's statements of expectations and the regulators' statements of intents that the regulators all share my thoughts about the importance of fairness, transparency, competitiveness and innovation in financial services markets. These market ideals are apparently 'supported by confident and informed investors and consumers'.[1] It follows that there was no point debating these issues despite the fact that the current FS world seemed far from an ideal one to me.

Of course, one needs to be careful about interpreting intents and expectations... and statements too! It seems clear to me that a regulator is not your friend (or protector) though it is reassuring to project them that way. They are hired to administer legislation and are basically amoral in their actions. It is possible that they might occasionally dare to daydream about saving us by prosecuting some of the less ethical players.

Fortuitously, there seem to be wider issues to discuss and not enough time to focus on the structural details of skirting the regulatory regime. Those have become a separate project. So for now, I will be focussing on the general problem of creating equity and efficiency in FS markets.

[1] ASIC

Part I: The Regulation of Retail Investors

The world is run by confident rather than competent people - equity is a casualty.

In a world with finite resources that is becoming far more openly amoral, there is a need for structures, and particularly FS structures, that are based on principles of equity and sustainability. Despite the plethora of speeches and mission statements that claim to embrace these simple aims, it seems that when pressed, the personal risk renders genuine action abhorrent to anyone with the means to drive meaningful change.

Is there a need to move from our bastardized capitalism towards a more conscious capitalism? That is, an economy based around the private ownership of ethical and sustainable corporations. This contrasts with the current system which sees government support for entrenched businesses and for popularity driven spending and consumption (which may not be sustainable and is likely to be immoral).

I think that the Institute of Actuaries should be involved in promoting positive change in the wider fields to further its stated 'strategic intent' (that is, enhance the brand, expand the mandate, add value). But this could mean moving beyond the safety zone of insurance, pensions and risk management and into the dirtier world of politics and perception – a place likely to be actuarially unpopular and far from the comfort of simply doing the numbers.

I have argued that actuaries are very well placed to use their strengths to create more equitable, productive and sustainable corporations[2]. Perhaps it would be easier to start by using our profession to promote a more efficient retail financial services sector?

Why pick retail financial services (RFS)?

Everyone has felt or read about inequity and inefficiency in RFS

Everyone has some idea about the principles of investment and the place for a RFS market. Most people are uncomfortable about investing and seek 'expert' advice to determine a strategy and suitable investments. Some of us have more understanding and confidence about investing but still need to pray that we are not caught in the next scandal. Most people understand that some investments might not perform well but not many understand why money in regulated schemes periodically disappears with everyone blaming each other and only the investors suffering.

There would appear to be room for improvements in the RFS market. Competition and innovation... or more precisely the absence of them would appear to provide an opportunity for more innovative businesses and structures. Regulation of RFS has evolved into regulation of retail investors by homogenising the platforms, processes, fees and products that are offered. It is stifling innovation and the opportunity to offer a fair proposition to retail investors except, perhaps, in very small schemes.

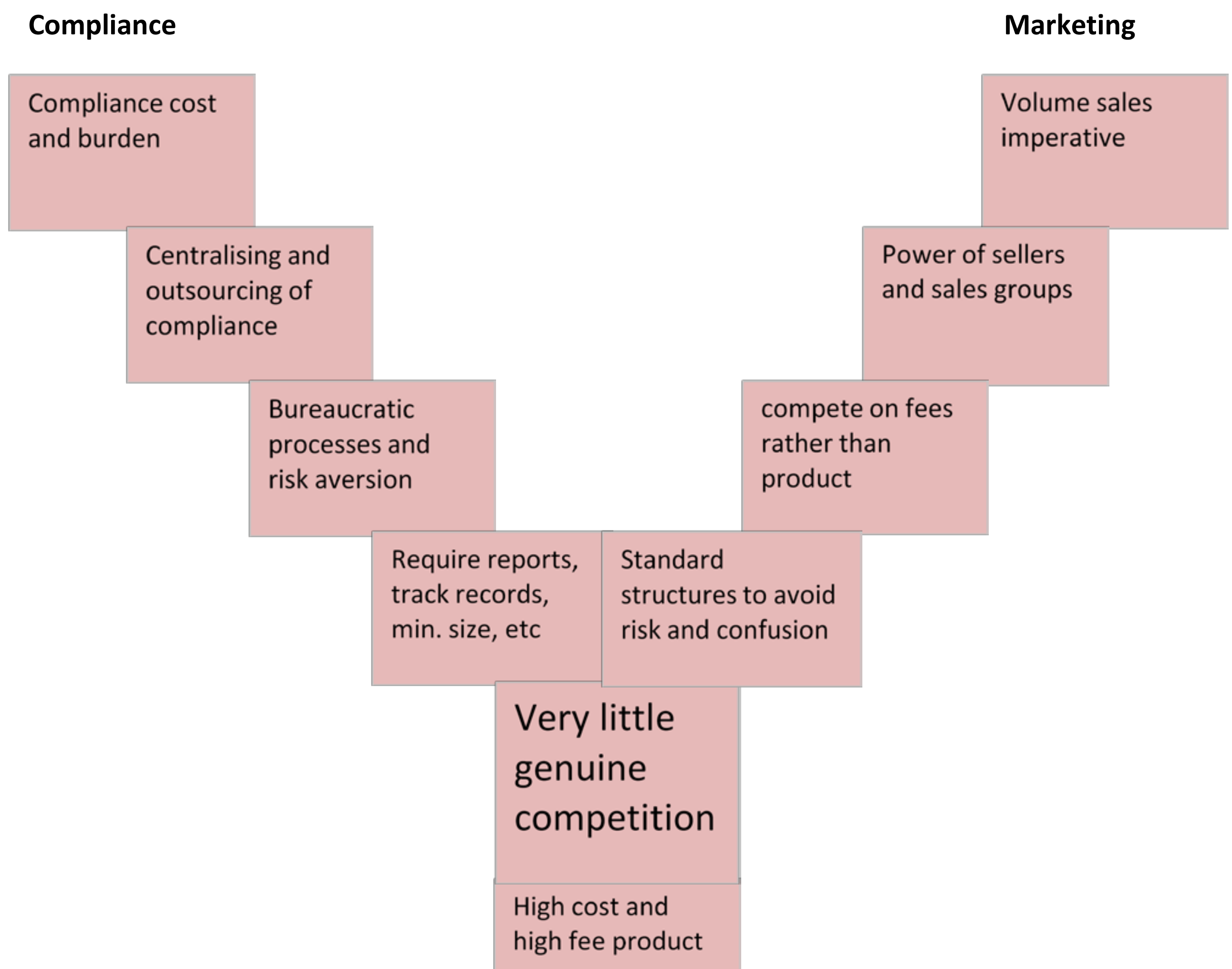
There is plenty of demand for cash in the current environment. Even the banks are competing much harder for retail savings with attractive term deposit rates. Meanwhile savers looking to invest in real assets are often more comfortable with the risks of direct real estate investments than the risks

[2] Equity Driven Productivity 2009

of retail fund issues. At the same time it appears that the great long term returns provided by equities and property will be difficult to maintain in the near future without some serious inflation.

There are good reasons for trying to protect less sophisticated investors but it would seem that restricting them to high cost products in a low return environment is not the ideal outcome. At the same time, regulation is costly and there are still frequent financial catastrophes that regulation could not stop or do much about. So is the high cost of regulation justified?

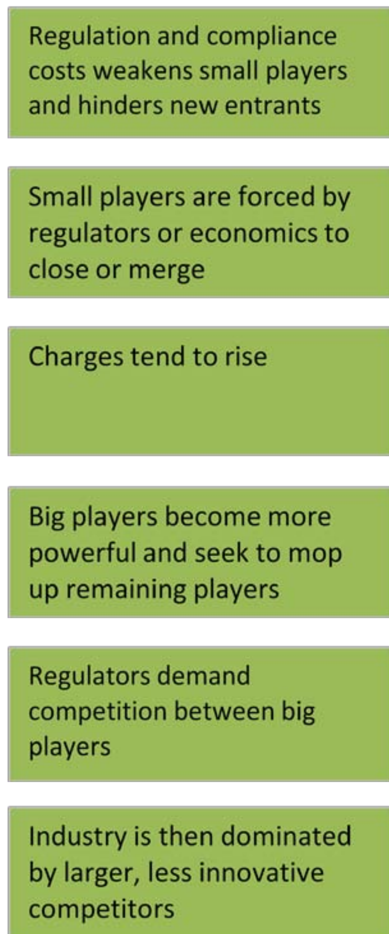
It is interesting to discuss how RFS markets are driven. I have tried to show some views in the graphic below.



Real Competition and Innovation

Do not get side-tracked by the competition argument!

Competition can lead to innovation if it is free and fair. However regulation seems to be, perhaps unintentionally, killing real innovative competition. Competition policies are aimed at avoiding monopolies at the big end of town by requiring that there exists more than one significant competitor. The issue of collusion supersedes the issue of homogeneity. So the regulator is happy with independent competitors even if products, pricing and fees are the same. The graphic below shows how I see the current regulatory framework undermining real innovative competition.



Nowhere are the problems more evident than in **banking in Australia** where**;**

- The barriers to entry are extremely high.
- The regulator is pushing small players, notably credit unions, to merge or close.
- Big banks are keen to add to market share by buying smaller rivals.
- Regulations prevent mergers of big four to encourage ‘competition’.
- Government gets its feedback from big banks and focuses on their health.
- Regulations and policy focuses on competition between the main players and shuts out new players and innovation.

I also refer to the retail mortgage business – the cornerstone of Australian banking – to show the perverse outcomes as the Government attempts to promote competition.

The credit crisis (GFC) severely weakened the position of the innovative non-bank mortgage sector (NBMS) that relied on capital markets and had become a big part of the mortgage market in Australia. The government support for the banks then entrenched or further weakened the weak position of the NBMS relative to the banks.

Later the government set aside around $15bn to support the alternative mortgage lending sector. I understand that size was an important selection factor used in the allocation process and most of this money helped to support various banks' mortgage businesses, again at the expense of the NBMS. There are now proposals to ban exit fees (for competition reasons – so people can switch between large banks more easily) and this will likely bury the once thriving NBMS. This is because the industry needs to cover the mortgage set-up costs – banks can rely on the persistence of a mortgage book but the NBMS funders (capital markets) will not.

The road to poverty is paved with good intentions

Where did we go wrong?

So with a few simple misconceptions in mind, for example:

- law means justice,
- regulation means protection,
- big means safe,
- fees hinder competition,
- competition promotes innovation

it is easy to see how policy might become counterproductive even if individual components are justified in isolation. Of course less benevolent intentions (by regulators or policy makers) and a focus on maximising short term profits may not help outcomes either. In any case, we cannot sensibly rely on an ideal, or even a positive, environment to foster efficient and productive business structures.

In theory, more efficient and productive structures will dominate if they can get established. In practice, market domination eventually tends toward inefficiency and predatory pricing.

'Evil will always triumph over good, because good is dumb'[3].

However, history suggests that once established, greater efficiency and productivity will prosper for long enough to make a positive difference so the challenge is to identify and promote such structures.

[3] Spaceballs – A Mel Brooks movie

Part II – FS Structures and Regulation

Where to from here?

By splitting my notes, I am hoping to avoid the distraction provided by the detail of model FS structures and regulation during the discussion in Part I. However, it is fair to ask what improvements can realistically be made? And perhaps more importantly if these can be successfully promoted?

Retail investors would like to think that they had broadly equal access to investment opportunities. I believe that they would generally be satisfied if they knew that their returns would reflect the performance of the assets that they invested in. Also that they would be much happier with fees and bonuses that were paid from good performance rather than fees and bonuses taken out up-front or regardless of performance. The key ingredients are:

- A **suitable structure** where:
  - Conflicts of interest are avoided
  - Most of the classic catastrophes are avoided
  - Investments are held beyond the control of the promoters and managers
  - Clear and efficient structure, documents and related party agreements exist that are readily available; and
- **Alignment of interests** between the investors, promoters and servicers.

There are some challenges in these but a considered and well promoted model fund structure could lead to much lower charges, less (and less costly) compliance requirements and less losses. And even more 'confident and informed investors and consumers'.