Australia-New Zealand Shadow Financial Regulatory Committee

Responding to Failures in Retail Investment Markets

Statement No. 3
Melbourne, September 25, 2007

Summary

In this statement the Australia-New Zealand Shadow Financial Regulatory Committee (ANZSFRC)

- Emphasises that the prudential safety net should be limited in extent. This means that regulatory proposals such as those being considered to protect investors in financial products need to take care not to blur the boundary line of the safety net.
- Repeats its December 2006 call to the Australian and New Zealand authorities to speedily finalise and implement their proposals regarding failure management arrangements, which would help to clearly delineate the safety net boundary.
- Recommends that proposals for new disclosure requirements should be "road tested" with consumers as part of the required regulatory impact assessment.
- Suggests that regulators review whether increasing (or retaining) the role of mandatory trustees for debenture or deposit-like securities is appropriate, given the availability of alternative, possibly superior, approaches to fulfilling their current investor protection role.
- Argues that the authorities should promote the development of secondary markets for such securities as a complement to other measures which have been proposed for improving information (and exit mechanisms) for retail investors.
- Questions whether the application of an "If Not Why Not" approach to disclosing whether benchmark financial indicators have been met, as proposed by the Australian Securities and Investments Commission (ASIC), is effectively equivalent to compulsion, and calls for more detailed consideration of the benchmarks proposed.

Both Australia and New Zealand have recently experienced a number of high-profile failures of non-prudentially-regulated finance companies and property development financiers. While retail investors in debenture or deposit-like products issued by these borrowers have incurred significant losses, the stability of the financial system at large has not been under threat. Nevertheless, the losses have grabbed headlines and prompted both Australian and New Zealand authorities to develop proposals for strengthening investor protection.

In New Zealand, these proposals include licensing all "deposit-takers" (which, unlike Australia, includes finance companies), imposing requirements for minimum capital, capital adequacy and restrictions on lending to related parties, as well as stricter requirements for disclosure and formal credit ratings. In Australia, ASIC has proposed a set of minimum "benchmark" conditions on capital, liquidity, lending arrangements and other matters (including credit ratings), that borrowers would be required to disclose whether or not they are met, and if not, to explain why not. ASIC has also suggested increasing the threshold value (currently $50,000) above which promissory notes are not regulated under the Corporations Act.

The ANZSFRC urges authorities in both Australia and New Zealand to proceed carefully in regulating suppliers of riskier investment products. Failure of financial institutions and the attendant losses must be expected as part of the normal operation of efficient and innovative financial systems. Risk taking, risk transformation and risk management are core parts of the business of financial intermediation. By its very nature, risk involves the prospect of loss as well as gain, and losses must occasionally occur. When investors knowingly accept exposure to high-risk financial assets in the expectation of improving their returns, they should bear the consequences of failure. Furthermore, if governments protect investors from the adverse consequences of their informed decisions, moral hazard can arise to distort the efficient working of the financial system. Ensuring that retail investors are appropriately informed about investment risk is, of course, an important policy challenge.

Historically, Australia and New Zealand have adopted different approaches to prudential supervision, with New Zealand relying more on disclosure requirements and market discipline rather than formal regulation. Indeed, it is somewhat ironic that New Zealand authorities propose to intervene more heavily in response to recent developments than their counterparts in Australia. But in both countries there is a spectrum of deposit or debt instruments available to retail investors, ranging from minimal to high default risk. At the low-risk end of the spectrum are deposits of banks and other deposit-taking institutions. At the higher-risk end are claims on non-prudentially-regulated borrowers, including finance companies and property development financiers.

Investors who seek higher returns must stray beyond the prudentially regulated sector, and in so doing accept a higher risk of default. They should not be prevented from doing so. Balancing the safety of individual investors and the system as a whole against the need for efficiency and choice is best served by clearly delineating highly regulated from less regulated financial institutions and products. In many countries, deposit insurance arrangements (in addition to prudential regulation) serve to demarcate the outer limit of the financial safety net. Australia and New Zealand, which at present have no explicit deposit insurance schemes in place, have been considering their own variants on such arrangements. In our December 2006 statement, the ANZSFRC advocated finalisation and introduction of such schemes as soon as possible, and we now repeat that call.

Enlarging the prudentially regulated sector at the expense of the less regulated sector compromises efficiency and choice. It may not even reduce risk if the perception arises that there will be intervention by government to bail out investors and this

exacerbates moral hazard. The proposals to bring finance companies in New Zealand under the purview of the Reserve Bank, and subject to its possible intervention in times of financial crisis, should be questioned in this regard (unlike the Australian proposals which leave such entities subject to regulation by ASIC but not to prudential regulation by the Australian Prudential Regulation Authority (APRA)).

While the proposed regulatory responses to the recent failures are constructive, the ANZSFRC believes that there is a range of alternative proposals that warrant consideration. Government and regulatory action can potentially occur on four fronts: information provision and disclosure requirements; prevention of unlawful or unethical behavior by those raising funds or advising investors; measures to prevent retail investors participating in certain markets or investing in certain high-risk products; and compensation schemes for, or bail-outs of, retail investors who suffer loss. We do not regard either of the latter two approaches as appropriate (to preserve consumer sovereignty and avoid moral hazard) nor should prudential regulation be extended beyond its current ambit. In the remainder of this Statement, we put forward a range of issues relating to the former two approaches for consideration in formulating appropriate regulatory responses.

Financial literacy

In both Australia and New Zealand there are ongoing and developing government and private sector initiatives to enhance consumer financial literacy. A key benefit of financial literacy is that it enables investors to evaluate risk-return tradeoffs sensibly. We endorse such initiatives, although we recognize that implementing effective strategies is no simple matter. But understanding how consumers interpret financial information is a useful first step.

Consumer testing of disclosure proposals

Governments often propose additional disclosure requirements as a solution to perceived regulatory failures. However, typically we do not see proposals for such new disclosure requirements being road-tested by consumer focus groups, questionnaires, etc., to see how well they are understood. This is particularly important when the issue relates to investments which are complex and sold to relatively unsophisticated investors. Hence, we recommend that such testing should be considered as part of the regulatory impact assessment processes required for proposed regulatory changes.

Financial adviser incentives

Financial advisers are an increasingly important part of the financial decision making processes of retail investors. A matter of concern is that financial advisers can be conflicted and have unsuitable incentives because of commission payments from issuers of securities. In these circumstances the actual risk taken on by retail investors may be significantly greater than what they believe to be the case, and this is the problem which warrants addressing. Better ways are needed of linking remuneration of advisers to the quality of advice and ultimate outcomes for their clients, to promote improved incentives.

Potential value of secondary markets

Debenture or "deposit-like" investments which have caused such grief recently have the characteristic that they are not traded in a secondary market. This means that investors have limited ability to exit their investments if they perceive a decline in credit quality or increased risk, and that there is no mechanism (other than press publicity) for information about changing quality and investment value to be conveyed to investors. Indeed, for a range of investments there is existing regulation aimed at protecting consumers because they do not have the option of a secondary market which allows them to exit their investment. Furthermore, continuous disclosure which has been suggested in both countries is most useful for existing investors if they can act upon that information by exiting their investments via a secondary market. Promoting further development of markets for the secondary trading of such products thus has significant merit.

Limitations of credit ratings

One common recommendation in both countries is that institutions raising funds from retail depositors through debentures or "deposit-like" securities be required to obtain a credit rating from an established international ratings agency such as Standard and Poor's, Moody's or Fitch. However, the recent round of global financial volatility has been marked by the failure of ratings to provide any reasonable prediction of company failure. Most of the time the models work well but they tend to break down just when they are most needed. As a result, credit ratings may provide a false sense of security. In addition, the assessment of risk is duplicated under the regulatory suggestions, since trustees already have the responsibility to monitor the financial performance of the company. Where there is duplication of functions, this is costly. Similar incorporation of relevant information about borrower status is provided by secondary markets in credit instruments.

What role for trustees?

Regulatory suggestions in both countries involve continuation or enhancement of trustee roles in overseeing these borrowers. It is interesting that in Australia, following a joint report of the Australian Law Reform Commission and the Companies and Securities Advisory Committee in 1993, the requirement for trustees for managed investment schemes was abolished. Is it time to revisit the arguments as to the circumstances under which trustees are required for the protection of unsophisticated investors in debenture issues? If there are to be credit ratings, the value added by trustees for debenture issues needs to be considered, and on past experience there may be some interesting answers to this question. Are there alternative, more efficient and less costly arrangements possible for protecting retail investors? For example, would a structure which requires the borrowing institutions to have a minimum number of independent directors — who have incentives to protect debenture holders because of the risks they face due to directors' liabilities — be superior?

The "If not, why not" approach to disclosure

The Australian suggestions have taken the concept of "if not why not" disclosure which has been valuable in the corporate governance field and suggest applying it to financial "benchmarks" for these borrowers. Examples include minimum capital and liquidity requirements. New Zealand has taken an alternative approach of suggesting exemptions for small entities, although it might be argued that this is where risk to retail investors could be most severe. However, before suggesting that New Zealand should consider the "if not why not" approach, it is necessary to determine whether this approach effectively leads to binding requirements because of risk aversion on the part of financial advisers, investors and reputational risk for issuers. If so, there needs to be more discussion about the relevance and appropriate values of proposed benchmark financial ratios.