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Finance firm debacle shows light touch failed

Watchdog is looking for the regulation sweet spot, writes FMA's Sean Hughes

A lot of newsprint has been devoted to the investigation of failed finance companies. During the past eight months, the Financial Markets Authority announced its intention to file civil proceedings in relation to the Hanover group, laid charges against three people associated with Belgrave Finance, secured some guilty pleas in the Bridgecorp, National Finance and Huljich Wealth Management cases and negotiated a settlement with Kiwi Finance that saw investors paid in full.

It has been a busy time — and frustratingly retrospective in its focus.

Looking ahead to this year, the FMA seeks to work closely with the market on its core task of identifying future trends and facilitating healthy, buoyant capital markets that fund local business and feed economic growth.

The work is integral to the sort of economic conditions consumers and businesses are seeking, and far more closely entwined with the everyday lives of New Zealanders than one might think.

But while we're keen to move on with those forward facing goals, the intensive and resource hungry work on finance company investigations needed, and still needs to be done.

It's important work. Between 2006 and 2011, 46 finance companies collapsed, affecting an estimated $6 billion of investments and 200,000 investors. The consequences for those investors have been devastating, with a lifetime of hard work and savings decimated.

The investigations, trials and convictions need to happen not just to facilitate justice, but also to allow public scrutiny and to understand what happened. From that understanding comes appropriate regulatory reform and a lot of learning — not just for governments and legislators, but also market participants, investors and commentators.

We've said that the finance company failures were largely a failure of corporate governance. That is, that many of the directors of these companies (and others who were closely involved in their operations) weren't doing their jobs adequately.

Sentences such as the prison terms given to some of the former Nathans Finance directors do send a message to our corporate community that they have clear responsibilities and a duty to act with diligence and care.

But the failures also raise the bigger question of the role of regulation and the pros and cons of "light touch" regulation versus more invasive supervision. Key to the debate are assumptions around whether markets are inherently stable or unstable, and whether they can be relied on to resolve their own problems through some natural law. In other words failure is sometimes necessary.

It would be fair to say that there is little faith remaining in the notion of "light touch" regulation and inherently stable markets in the UK.

This sentiment is reflected in the words of Lord Turner, chairman of the UK regulator the FSA. He contends that the assumption that markets are inherently stable and the consequences of "political pressures for a light touch regulatory regime", are problematic and unsustainable.

The New Zealand market has had a long history of scepticism about the value of regulation — with the common perception it's all about red-tape form-filling demanded by faceless bureaucrats in Wellington.

But we have tested the efficient markets hypothesis, or light touch regulation.

In the finance company debacle, it has been shown to have failed a generation of investors.

Mature regulators don't see their

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job as simply enforcing a set of laws which Parliament has passed.

The FMA has a responsibility to assist investors to understand for themselves the risks of any given product offering or advice they receive — and make a decision on an informed basis.

We cannot predict the future or guarantee success, but we want to ensure they are helped to help themselves.

The role of regulation is a big debate and not one we can do justice to here. But we can put a stake in the ground and say that the role of legislation, regulatory supervision and litigation is not to remove risk, nor is it to stifle innovation.

It does need to redress the asymmetry of information so that investors understand risk and make informed decisions. And it does need to bring clarity of expectations and raise the bar on the behaviour of market participants so that investors can rely on the transparency and integrity of the information they are given.

We can also say that the principles-based approach we have here and in Australia offers a more flexible regime. It ensures organisations don't spend their time either ticking boxes or innovating to try to get around the rules.

They need to adhere to the principles behind the law. To that end, innovation — the staple of any good market — becomes smart innovation with willing and informed participants.

Close to the heart of this discussion is the issue of financial literacy and its offspring, investor education. The FMA's role in improving investor education is critical to our mission, and we plan to work closely with other agencies to deliver on that.

The Commission for Financial Literacy and Retirement Savings is already very active in this area and will be an important partner.

Another factor that will be critical in helping New Zealanders to make sound investment decisions is access to high quality financial advice.

Since July, anyone offering financial advice has been required to comply with the Financial Advisers Act.

Under the new rules all advisers must provide advice with the appropriate care, diligence and skill and ensure clients are matched to products that meet their needs. They must provide disclosure so that clients can make informed decisions about using the adviser and whether to follow the advice. And they have a duty of care for their clients' interests.

The FMA's role is to monitor and assess advisers' compliance with these requirements and we are working hard to ensure advisers understand their obligations and are able to fulfil them.

Lord Turner also makes the point that effective and efficient financial markets depend on integrity.

He talks about the "precise intersection between law and ethics".

That precise intersection is the sweet spot for the regulator. It's where enforcement takes a back seat to actively informed market participants, on both sides of the equation.

Where risk is understood, innovation flourishes and integrity prevails.

The end result? Investor confidence, a rebalance of asset classes and ultimately capital made available for local businesses, resulting in a robust economy. A sweet spot indeed.

Sean Hughes is the chief executive of the Financial Markets Authority.

Sean Hughes says the FMA's role in investor education is critical and the authority will work with other agencies to achieve it.

Picture / Mark Mitchell

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