Institute of Actuaries of Australia

Equity and Transparency in the Financial System

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Equity and Transparency in the Financial System

It would appear that the world has been ‘saved’ from the GFC. Do we know exactly what that means? The only way that I can get close to justifying such a view is to observe that the flawed financial infrastructures have been preserved while the ratings agencies, risk management and regulation industries have benefitted.

At the same time, politicians and others tell us about how everything is being improved to avoid the same problems in future. The demonization of securitization, derivatives and the ratings agencies obviously helps to deflect blame. Given that much of the GFC resulted from a heavy reliance on low interest rates and cheap credit (and marginal assets), it seems odd that huge government debt and short-sighted government investments could provide the long term answer.

I understand that it would be courageous politically to back alternative approaches so any attempt at renovating the financial system probably needs to begin with some external initiative and will then require some grassroots support. Thankfully, there is currently a huge opening for anyone who can offer some genuine credibility, transparency and alternative ways to achieve more robust and equitable outcomes. However, that does not mean that this void will be filled.

Equity is the opiate of the masses - or more accurately the perception of broadly equal opportunities in a forgiving and greedy world provides a working platform for society. As governments become more economically constrained and transparency slowly improves, there will be greater social problems unless we return to buoyant economic times coupled with some prosperity for the majority.

Actuaries are clearly involved in the process of improving current control systems, regulation and risk management. I am sure that they are adding depth to the analyses and output but I wonder if they could do more as a group to improve the robustness of our financial structures in the long term. The reasons that such a small group can be influential is their ability to project future financial outcomes with some sense of the variance, their credibility and their long history of dealing with issues of equity.

Clearly it is easy to find fault and impossible to find perfect alternatives to the current structures that often cause the destruction of value or simply impose unnecessary barriers or costs. The paper *Equity Driven Productivity* set out some thoughts on establishing greater equity and greater productivity by establishing a more transparent and sustainable philosophy for allocating returns between shareholders and employees. It seems appropriate for this conference to look at alternatives for generating ‘better outcomes for savers, investors and retirees’.

The Investment Industry

Studies tend to show that over time investment outperformance is difficult and reason tells us that should consistent outperformance exist it would be guarded (and/or competed away) rather than sold. Despite this, much effort and cost goes into developing and selling the perception of outperformance. Clearly this can improve one competitor's position at the expense of another's and also assists in the process of justifying charges.

The investment industry usually charges for some combination of performance, structuring, analysis, selling/recommending and managing investments. In addition, associated costs of investment management would often be levied on the funds managed.

With huge sums involved, some concern about excessive remuneration, alignment of interests, transparency, structural integrity, quality of analysis, improper selling and recommendations naturally exist.

> Remuneration: Much has been said about remuneration (especially commissions) but it is not clear to me that investors have benefitted greatly from the discussion. Industries and many individuals (and therefore industry lobby groups) find it difficult to change.
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> Alignment of interests: Does a backend performance fee align interests if the investment manager and the sellers have already been rewarded for their services?
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> Transparency: Disclosure of commissions, and remuneration generally, has always been difficult for anyone trying to sell the perception of adding value. A poor understanding of benchmarking and high long term returns have helped to lessen the pressure for greater transparency. The focus on remuneration has also lessened the focus on full disclosure of conflicts of interest, structure, etc.
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> Structural integrity: Nothing is more important than ensuring that appropriate assets, regardless of their performance, are secured for the investors. Cases of fraud and misuse of funds seem to be difficult to eliminate.
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> Analysis: The quality and purpose of analyses seems to vary greatly.
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> Improper selling: At least this has become topical and there are moves to reduce these risks.

Better Outcomes for Savers

So if the industry is not ready for change and the government has other issues to address, how can it be improved? The answer may lie in finding agents who could benefit from the improvements and then relying on competition to cause entrench improved practices.

I see actuaries and some investment analysts as potential change agents - gaining interesting and diversified work (and eventually making life difficult for the cowboys). They may already perform similar analysis work for large clients but the volume and scope would change. There is also some possibility that an IAA supported vehicle might become very profitable and assist in other institute and community activities.

I think that there are also likely to be some promoters of investment opportunities who are willing to provide more complete disclosure and to be subjected to more analysis in order to be seen on a fairer and more credible information platform. This is similar to how green or environmentally sustainable investment funds created their niche.

As a saver (and an actuary), I just want to see facts. A 50% chance of default would be fine if the upside was sufficient (though not for 100% of my investments). I do not want to get hand-picked statistics or misleading statements that lawyers have judged to be broadly correct (without creating too much legal risk). Clearly there are often complexities and small legal risks that cannot be fully indemnified but, in principle, accuracy and transparency should be an easy request.

An approach that I would like to explore would be;

1. Establish a standard presentation;
2. Create a platform to make presentations available (probably an internet site);
3. Filter out non-complying, suspicious or inadmissible presentations;
4. Create a peer review or actuarial review process;
5. Categorise, date and post all other presentations;
6. Offer some sample portfolio approaches (possibly – need to understand consequences);
7. Update presentations but maintain a historical record;
8. Perform some A/E analysis (particularly by source) as the experience develops;
9. Maintain a database of names and relationships to unexpected changes and results;
10. Provide access to sophisticated investors initially with the target of open access.

Standard Presentation of an investment opportunity

The Institute of Actuaries provides guidance on the writing of various reports. Some of these are statutory reports so at least some of the content is mandatory but prescription of format may be dangerous. This suggestion relates to a voluntary document that requires a prescription of content and format so as to make it easy to compare with other similar reports. It should also be easy to have the numerical detail in one format so that the data could be reviewed and analysed quickly.

A standard presentation of an investment opportunity would simply go through a series of topics using a standard format. Incomplete or blank areas would be presented as such. Topics might be;

Description and basic details;

Names: Any associated parties should be listed including the promoters of the investment;

Structure: This section would highlight the risk of fraud or misuse of funds;

Risks: It might be useful to highlight and describe, say, the three most significant risks and list the other risks. Otherwise there is a danger of burying important disclosures;

Remuneration: This section would disclose all 3rd party remuneration and costs and depict graphically their relationship to various levels of total return at various time points. Some standardised measure could be constructed;

Cash Flow projections and sensitivities: This section would produce an expected net cash flow to the investor and some confidence limits to show the uncertainty. A suitably qualified expert would be required to perform these projections. The skills required are not uniquely actuarial but are most commonly performed by actuaries as far as I am aware. There should be some assessment of the competence of individuals, including actuaries, to do this work for each investment opportunity.

Distribution

A target format for investor presentations creates few risks and might be enough to encourage some analysts to add useful data to their reports. However, to produce a significant change in practice in a reasonable time frame would probably require further action.

The list above describes one approach to this challenge in order to facilitate discussion. That discussion should not be isolated from the issues raised earlier but is not intended to confuse them either. Naturally, distribution follows creation of a product and the creative process requires some discussion. Hopefully, this would be the first step in an evolutionary process leading to a more transparent and equitable investment landscape.