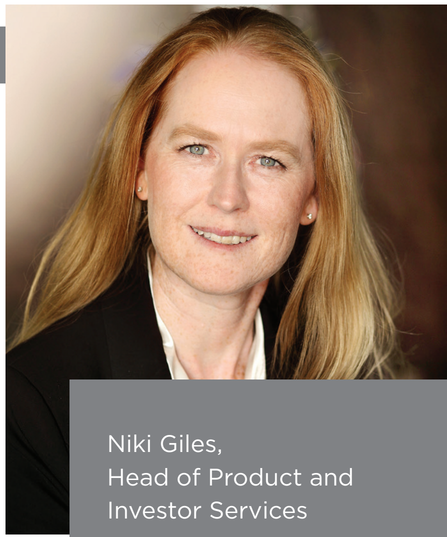
PRESCIENT

The unintended consequences of regulations in asset management

Niki Giles, Head of Product and Investor Services



Niki Giles,
Head of Product and
Investor Services

In early July, Lloyds, the London-based insurer, came under fire from asset managers when it allegedly told its members that Irish and Luxembourg Undertakings for the Collective Investment in Transferable Securities (UCITS) funds will "no longer be acceptable assets for Funds at Lloyds". The reason they gave was the onerous due diligence requirements following regulatory changes in the EU earlier in the year.

While no one will deny that regulations are necessary for a complex environment such as financial services, where the man-in-the-street hands over control of their life savings to a third party to invest, the sheer volume of regulation can result in unintended consequences.

UCITS funds in Luxembourg and Ireland are designed to provide maximum protection to retail investors. Yet, the general view is that anti-money laundering (AML) requirements are overly demanding and thus large organisations, such as Lloyds, are declaring these investment products a 'no-go'.

In South Africa, complying with financial services regulations has also become a burden for many companies in the industry. Over the past few years, a plethora of new conduct standards and regulations have been introduced as South Africa has transitioned to a so-called "Twin Peaks" environment. Financial services companies are already under pressure to lower fees and now also have to grapple with the increasing costs of meeting growing compliance requirements.

There's no doubt the regulator has good intentions, but the consequences or knock-on effects are often not evident until the regulation is imposed. Another difficulty is that regulation is usually created to deal with a particular issue identified in a subset of financial services, without thinking about the broader impact on the industry as a whole.

For financial institutions, this has meant withdrawing from or giving up a particular product or financial service license as the cost and constraints of doing business has become prohibitive. Others have found ways around regulation by moving to products that might be perceived as having less regulatory requirements.

An example of this in South Africa is the two popular pooled, unitised products: the Collective Investment Scheme in Securities (CIS) and the linked life policy. Both can be used to pool investor assets. However, the restrictions on what a CIS can hold are governed by the requirements of Board Notice 90 of the Collective Investment Schemes Control Act. In contrast, there are no restrictions imposed by the Long-Term Insurance Act or the Insurance Act on the assets held within a linked life policy. Yet both can be sold via a living annuity to a retail investor.

A further anomaly is where regulation starts and where it stops. In the accumulation phase of saving for retirement, if you wish to save in a tax-efficient manner, investors need to use retirement savings products, where the asset allocation is governed by Regulation 28 of the Pension Funds Act. However, in the decumulation phase, once the investor has retired, their savings can be invested in a living annuity product where there are no restrictions on how investments are invested.

The Conduct of Financial Institutions Bill attempts to address unintended consequences specifically. Section 9 (6) (a) states "*The Authority must regularly assess the impact of requirements that are imposed on financial institutions, …, and whether the requirements are resulting in unintended consequences or disproportionate impacts on financial institutions, prudentially financial regulated groups and conglomerates, or other persons to whom requirements apply*".

But only time will tell whether the regulators can get this right. What we can be sure of, is that regulation is here to stay and is highly unlikely to decrease. ■