

## FINANCIAL REGULATORY REFORM: A SCORECARD



As the dust settled shortly after the worst of the global financial crisis in late 2008, enraged citizens and governments around the world clamored for one thing in unison: financial regulatory reform. The events and practices that led to the near meltdown of the entire global banking system should never be allowed to occur again, they argued. Over a year and a half later, the wheels that were set in motion in those dark and horrifying days have finally produced some of the framework the new financial world order will have to abide by. With a labyrinthine financial reform bill likely to hit President Obama's desk for approval within the next week, the rest of the world is watching the United States—the place where many argue the crisis began—lead the way in setting the worst of the wrongs right again and therefore hopefully averting another similar crisis at some point in the future.

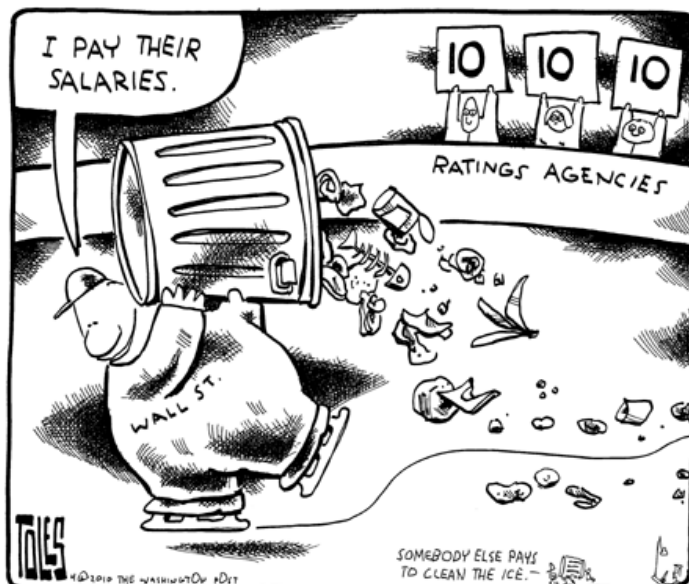
Across the sea, Europe has moved significantly slower to curb the excess risks of the outsized financial conglomerates which crisscross its borders. However, with the Americans poised to transform their proposals into law, this could change the dynamic and other countries will most likely feel compelled to catch up. The paradox in Europe is while the anti-bank rhetoric has been even fiercer than that in the United States, the action taken to reform the financial system has been more muted. This is due to banks having much more political sway in Europe—where they account for a larger share of the economy and where some are owned at least in part by the state. Specifically the lobbying power of European banks is much stronger. Not so much in the sense that lobbying activities finance political careers as they do in the United States, but rather that in many countries banking and politics are intertwined. Additionally the European legislative process is much more bureaucratic and slow, and has little centralized authority to impose laws and regulations easily across national borders.

Financial regulatory reform will affect everyone from the financial institutions themselves to investors, traders, asset management houses, hedge funds and even the consumer on

Main Street. Let's take a look at some of the largest areas that the proposed legislation looks to address and then ask how each of those will impact the financial system going forward. Although these are strictly speaking only laws that apply in the United States for the moment, this first huge step is most likely to shape the direction other countries around the world will take in the coming months and years. The Americans are aware that the financial industry today is a global animal. By simply denying the financial institutions at home certain types of risky actions, if regulatory reform is not followed up elsewhere, those practices could easily be just shifted overseas to avoid the regulations. The Treasury Secretary was communicating this to the world when shortly following the announcement of the final draft legislation he said, "The U.S. is ready to lead by example."

**RATINGS AGENCIES.** The sorry performance of the three major credit-rating agencies—S&P, Moody's, and Fitch—played a crucial role in the financial mess. Over and over they stamped AAA ratings on the sausage-like securities made up of poisonous minced-up mortgages. One of the largest problems appears to be a severe conflict of interest in the "issuer pays" system whereby companies that come out with financial products often can effectively shop around for the best ratings, since they are paying for it. As a result, many critics called for the removal of the agencies federal designation as "nationally recognized statistical rating organizations", which essentially gives them a government mandated oligopoly. This, in turn, deters competition and keeps the cost of ratings unfairly high and to some degree produces ratings of lesser quality than would be otherwise available in a truly liberal market. The new legislation fails to address any of these problems, and only makes the agencies slightly more accountable for the ratings they produce, with provisions for investors to sue them or regulators to fine them, if negligence is found. Investors therefore are encouraged going forward to increase the amount of due diligence on new investment opportunities and rely significantly less on ratings alone to guide them. Ratings are most useful when used in conjunction with other qualitative measures and should never be the sole variable in selection.

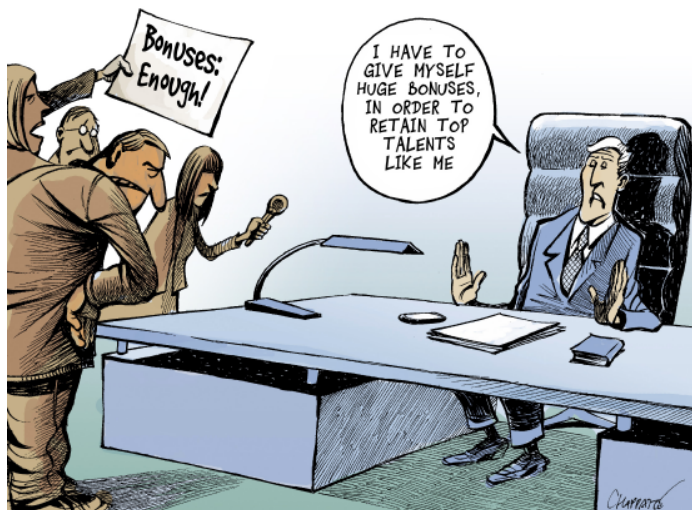
**DERIVATIVES.** These are the shadowy products that led to the



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downfall of Lehman Brothers and brought in the need for a government takeover of the insurer A.I.G. Warren Buffet even warned some years back that they were “financial weapons of mass destruction.” The new legislation for the first time extends comprehensive regulation to the over-the-counter derivatives market, including the actual trading of the products and the companies that deal in them. It requires that many types of derivatives be traded through centralized clearinghouses with the requirement of parties to post significant capital and margin requirements to ensure against losses in the contracts. Many types of more common derivatives would now be traded openly on exchanges, bringing transparency to what before was rather opaque pricing. This would reduce the profits of the major derivative dealers by providing purchasers of the contracts with much more pricing information and the ability and incentive to shop around for the best deal. Increased reporting standards would be required of dealers, clearly outlining to regulators where the interconnected exposures to institutions are. Banks will no longer be able to trade in derivatives for their own account except in special cases where they can prove they are only doing so to hedge existing risk. They can however transact in derivatives on behalf of their clients. Finally, banks will be forced to spin off their dealing in the most risky derivatives to separate businesses. This includes credit default swaps based on bundles of mortgage loans—a huge area that crippled many of the largest banks and dealers during the crisis. These separate units would be required to raise their own capital and could not utilize government subsidized funding that the main part of the banks’ operations and tier one capital rely on. Going forward, regulators and lawmakers will be forced to continually watch the markets for the unregulated “off-exchange” customized derivatives that have been excluded for the time being, in order to ensure this market does not continue to grow.

**PROPRIETARY TRADING.** The Volcker Rule, as it is known in the new regulation, prohibits banks from trading any of their own capital to make bets on anything other than treasury securities. This means that risky bets on mortgages, stocks, commodities and derivatives are out. Additionally, the capital used in allowed transactions would have to be in some cases raised separately from the financial institutions normal funding sources. This rule strives to bring banks back to what is seen as their core business: taking deposits from customers and lending those deposits out to make loans. Banks are still allowed



however to invest no more than 3% of their tier one capital into



their own hedge funds and private equity funds. This last provision has led many to criticize that the reform is largely watered down and will not be as effective, as banks have rarely exceeded this level before. Nevertheless, a huge swath of speculative trading has been curtailed, and banks would be required to set up separate unrelated entities if they wanted to continue to make these huge bets. Europe, by contrast, is not keen at all on a blanket ban on proprietary trading and any such law has much less chance of being replicated there. However, the Europeans seem ahead of the Americans in wanting to impose stricter leverage limits on hedge funds and private equity vehicles.

**TOO BIG TO FAIL.** In general, the newest regulatory reforms on the table fail on all accounts on this objective. The logic that financial institutions should not be allowed to get to a size which makes it impossible to allow them to collapse without risks to the broader financial market appears to have been lost in the final legislation. Capital requirements are only being tweaked a bit, to more narrowly define what constitutes tier one capital, and excluding certain securities not deemed liquid enough from calculations of such. Additionally, only banks with more than \$15 billion in assets would be required to follow such rules and would have 5 years to implement the changes. The G-20 meeting which took place at the end of June gave lip service to improving capital requirements but it became clear that it would be years before anything is agreed upon or takes effect. When the global powers take this task on, they will most likely have to do so via the Basel Committee which sets international standards that are then carried out by national regulators. When this will actually occur is anyone’s guess. For the time being the vast majority of banking transactions will continue to be carried out by a handful of supersized banking behemoths, the majority of which are still “too big to fail”.

**EXECUTIVE PAY.** Decisions by executives, traders and directors of financial firms whose eyes were trained on their outsized bonuses based on short term performance were crucial in precipitating the crisis. The new laws look to address this, without solving the problem completely. The real trouble is that investment bank traders are paid huge bonuses for making reckless bets that yield short-term returns. They aren’t penalized when their gambling ultimately costs their employers money, or drives the firms out of business. This leads to a casino culture lacking common sense caution. In the case where

financial statements have to be corrected after the fact due to tricky accounting to hide losses or inflate profits, executives will now have to pay back such bonuses. However traders whose short term bets turn sour long after they have received their lavish payouts will not be forced to repay such compensation, although the law encourages banks to adopt practices which compel them to do so. Many agree the solution would be for the lucrative bonuses to be paid into a long term escrow account until such time as the executives' and traders' actions had been proven to bring long term worth to the company. When and if this will happen remains to be seen. It's worth noting that simply passing stricter laws in one jurisdiction (such as the U.S.) will only drive these operations and traders to overseas units if those jurisdictions do not have similar restrictions on pay, so a coordinated global approach is essential.

**RESOLUTION AUTHORITY.** This is seen as one of the brightest spots in the legislation. For the first time, Washington would have what is known as resolution authority, that is, the power to take over and wind down a giant financial institution that runs into trouble. If policy makers had had that power during the tumultuous autumn of 2008, they might have averted the catastrophic failure of Lehman Brothers. They might have placed the teetering A.I.G. into conservatorship. And they might have taken over Bank of America and Citigroup, and possibly even Goldman Sachs and Morgan Stanley. Senior management would have been tossed out. The bill gives financial regulators the authority to liquidate failing financial companies by breaking them apart, selling assets and forcing creditors and shareholders to take losses so that taxpayers do

not pay the bill. The objective is to ensure an orderly bankruptcy and disposal of such troubled institutions rather than simply letting them implode and endangering the broader markets.

**MORTGAGE REFORM.** In response to a demand from the public and regulators to halt some of the worst mortgage abuse, the legislation addresses what is called retention requirements. This means that banks and mortgage brokers making the riskiest of loans are required to keep at least five percent of these loans on their own books. In this way, they would be partially liable for any losses if the loans went sour later. Previously there were no requirements for such and banks could churn out tons of loans and sell all of them on, leaving themselves immune to any problems that occurred down the road. One provision in the new law excludes the highest quality mortgages from this requirement—the logic being that these loans are the least likely to default as the borrowers have more “skin in the game”. However one glaring oversight in any regulation proposed thus far is that it fails to acknowledge the two huge white elephants in the room: Fannie Mae and Freddie Mac. These mortgage behemoths hold \$6.5 trillion worth of mortgages on their books and have been wards of the American government for nearly two years. The financial reform package failed to address their fate or even how they would be profitable without sustained government aid. Winding them down, while much discussed, was not put forward and lawmakers put off this huge task of dealing with the zombie entities for another day. Any meaningful mortgage reform in the future must tackle this issue.

## SOUTHEAST ASIA: HEALTHY RECOVERY

Southeast Asia, which is comprised mainly of the 10 nations that make up ASEAN (Association of Southeast Asian Nations) and a handful of others, is an often overlooked area in portfolio geographic allocations. This is largely due to it being overshadowed by the much larger Asian giants China and India. However it is worth noting that the GDP of SE Asia as a whole is roughly equivalent to that of India and it is expected that within approximately 20 years the region shall have a larger and younger population than Europe. It is also a major exporting area of soft commodities such as palm oil, rice, and rubber.

The region has recovered relatively quickly from the global financial crisis for a number of reasons, but mainly due to the swift actions of governments there to implement large monetary and fiscal stimulus programs to support domestic demand. Many economies of SE Asia were easily able to do so as they had developed the necessary fiscal flexibility, liquidity tools and large foreign reserves in the aftermath of the 1997-98 Asian financial crisis. This allowed them to act decisively in 2008-9 without impacting their budgets in the drastic way that many Western economies were forced to do. As a result, Q1 2010 GDP results from the region, compared to the same quarter in 2009, confirmed a sharp “V-shaped” recovery. Despite fresh

uncertainties regarding the global economy and the continued strength of a recovery, notably the European sovereign debt crisis, the recovery in SE Asia is still firmly on track.

Essential to this region's recovery and growth has been the pull of China's booming economy, which takes a rising share of SE Asia's exports. Even though the nations of SE Asia are quickly developing their own domestic demand, China remains a key destination for the regions exports—many of which are re-exported to the West. This means that some caution could lay ahead if the breakneck pace of Chinese growth begins to fade. Chinese growth, while maybe slowing, is poised to remain strong. Many economists remain optimistic that a double-dip recession in SE Asia will be avoided. With a healthy fiscal position and sound macroeconomic management, helped by the regional reserve pooling facilities, known as the Chiang Mai Initiative, agreed to in 2000 after the Asian crisis, the region is in a much better position to weather a new crisis than Europe is.

Vietnam is one shining frontier market that stands out as one of the regions sexiest, albeit volatile markets. The country of 86 million people with a GDP of \$92 billion received nearly \$50 billion in foreign direct investment in 2009.



The big question is whether Vietnam's government is prepared to adopt more and more market oriented principles and economic models in the face of an economy yearning for development. One of Vietnam's strengths is her people—a hardworking and ambitious local population coupled with a large population living overseas, the "viet kieu", who are capable of contributing know-how and capital to grow the country at a faster pace. Valuations remain some of the cheapest in the world here with the local stock index sitting at roughly half its peak in 2007.

Procrastination is something that affects most of us, but the real effects sometime don't hit home until a long way off in the future. Most of us are guilty of this and I can count myself among the many! "Tomorrow never comes", "I'll deal with it later", sound familiar? We go on kidding ourselves day in day out that time will never run out and some way or another we can catch up, but the truth is what we are putting off usually catches up with us first. Retirement—some of us dread it because we don't want to admit to getting that old or how to fill the time we have. Some of us dream about it from the day we leave full time education, looking at careers as a necessary evil to fund the days sitting in the sun, travelling the world, filling the time as we choose.

However we perceive the 'Golden Years', the one common denominator for all of us is how to fund these years, to keep the status quo and carry on with the same lifestyle we had while working, or to live the dream we have carried for so many years looking forward to endless sunsets on distant shores. How this is funded is usually where the shortfall comes in and so often our eyes are taken off the ball.

Whatever approach to investing we take, short term for property purchases or Long term for retirement, an overall detailed plan needs to be put in place, which needs to be flexible. Most importantly, a target figure needs to be identified and achieved before you contemplate throwing the office desk and chair onto the scrap heap. Regular reviews need to take place to calculate if and how much shortfall is present, followed by adjusting contributions or underlying asset allocation within the fund to compensate for this. It can never be a case of pay your money and hope for the best.

Let's put this into perspective, the average real rate of return for UK pension funds since 1963 is 4.2% per annum, reasonable after taking inflation out of the equation. Equities averaged 5.2%, gilts 2.3% and cash 1.9% over the same period. For most people, investing over this time frame, these figures would be satisfactory, but alas we are all in different stages of our lifetime and the numbers don't always add up. If we look at the last decade, we may really start to contemplate how retirement will work out and when retirement will be possible. For the last ten years the average real return above inflation, is 1.1% per annum. A figure like that doesn't really add up for a retirement on the beaches of the world. Even if we look at how the separate asset classes performed over the same period, (equities – 1.2%, gilts

Indonesia is another powerhouse economy in the region with the world's largest Muslim population. Its capital Jakarta is poised to be the largest city in the world within two decades. Due to its extensive natural resources and large population, Indonesia has often been an attractive destination for investment, and this trend continues. The government is supporting this development while at the same time trying to deter any radical forms of Islam from becoming too entrenched in the country, lest there be considerable political and economic risks that would likely result.

2.6% and cash 1.8%) it's difficult to see how this return could be higher.

The figures above cover the UK, but they could quite easily be representative of most western developed economies. If we look at the Global Defined Benefits Pension status we can see that even after the market recovery in 2009 we are still a long way from the assets matching the liabilities. In 2008 we saw a rise in liabilities of 12%, yet a drop in assets of 15%. We have of course seen the gap close but not to the level where we see all liabilities covered. The global pension pot is still \$2 trillion short of the peak in 2007 and with the market volatility we are experiencing, it could be some time before that peak is reached again.

So what does this all mean to you and me? Hopefully not this: "In recent years more people of pensionable age are supplementing their pensions by staying in work. Since 2002 UK employment amongst pensioners has risen by over 500,000." That's half a million people who cannot afford to retire and the number is growing. At this time there are approximately 1.4 million pensioners in the UK alone who have no choice but to carry on working. The days of company and state pensions supporting us until the end is sadly not possible anymore, with defined benefit schemes not being able to cope. Maybe they never expected for us to live so long. It doesn't have to be like this for everyone. Again, start with a plan, make sure it's flexible and review this on a regular basis. Many who were caught out over the last decade didn't review their plans, and too many were caught in the last three to five years before retirement being heavily invested in equities, when they should have been looking to protect the capital and returns that had been generated earlier.

Get a realistic figure in your head of how much you need to retire on now, multiply this by average inflation for the number of years till you retire. This has to provide an income for life from the day you stop work. Don't include what cannot be guaranteed, i.e. state pensions. Do include physical assets but be realistic about future valuations and income yields and be conservative with all projections. Most of all start the plan now and review the plan on a regular basis, at least every six months. Make a point of sitting down with your adviser and going over the projections. Circumstances change and so will the projections over time. It's your retirement so be proactive. The truth is that tomorrow does arrive and usually faster than we imagine.

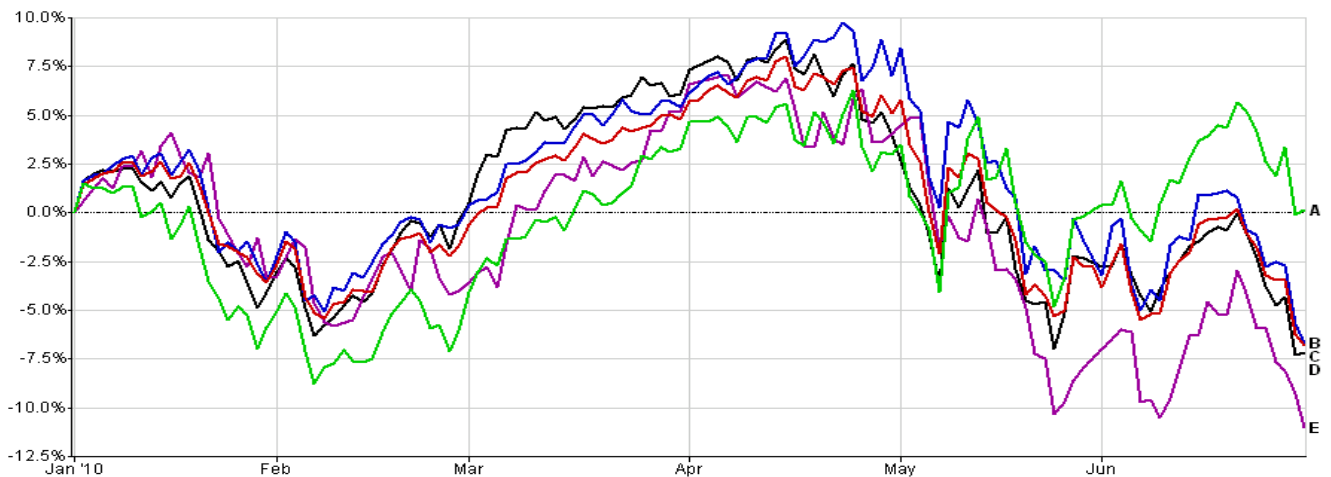
\*quotes and data from IFSL Research

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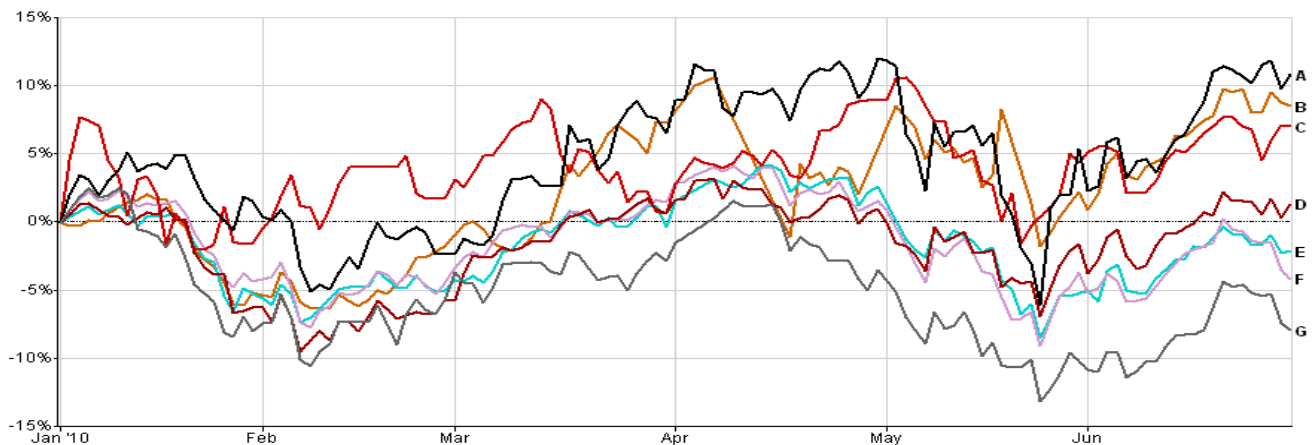
## PENSION CORNER



**2010 INTERIM YEAR-TO-DATE REPORT**  
GLOBAL STOCK INDEX PERFORMANCE



■ A - Xetra DAX GTR in EU [0.14%]  
■ B - S&P 500 GTR in US [-6.65%]  
■ C - MSCI THE WORLD INDEX GTR [-6.77%]  
■ D - FTSE 100 GTR in GB [-7.19%]  
■ E - Nikkei 225 GTR in JP [-11.04%]



■ A - MSCI INDONESIA GTR [10.88%]  
■ B - Thailand Bangkok SET GTR in TH [8.55%]  
■ C - MSCI VIETNAM GTR [7.05%]  
■ D - INDIA BSE (SENSEX) 30 SENSITIVE GTR in IN [1.27%]  
■ E - Straits Times GTR in SG [-2.14%]  
■ F - MSCI EM (EMERGING MARKETS) GTR [-4.17%]  
■ G - Hong Kong Hang Seng GTR in HK [-7.97%]

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