Rule of law more important than securities laws in growing wealth management centre, says academic

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A jurisdiction's securities law and regulation does not matter as much as its broader rule of law for purposes of growing its wealth management sector, said an economist in Hong Kong. He stressed that it was primarily the nexus of civil and criminal laws and law abiding cultures, followed by sound contract, banking and insurance law that made jurisdictions like Hong Kong, Singapore, London and New York trusted international financial centres. To that end, compliance officers and in-house counsel at banking and financial institutions need to be aware that the rule of law drives asset allocation far more than investment returns.

"For the last 15 years, macro-economists have said that [the strength of a country's] institutions were the main determiners of wealth. But when we look at the literature, that does not really explain much," said Dr Bryane Michael, a research fellow at the University of Hong Kong's (HKU) Asian Institute of International Financial Law. "It is not so much the quality of a country's securities and banking law that determines the quality of its wealth management, but rather, the quality of its rule of law in general. The general quality of law in a place drives asset allocation and wealth growth more than anything else."

Michael's comments came at a presentation last week entitled "What Effect Does Financial Law Have on the Wealth Management Industry (and Wealth) in Emerging Markets?", delivered at HKU.

Michael said it was unclear precisely why the rule of law created more millionaires. "The standard production function has not fully explained why wealth has changed as much in some jurisdictions compared to others," he said.

Michael added that the wealth management sector made the wealthy "less wealthy" in emerging markets than in developed markets. "The law affects wealth more than any other factor."

Citing World Bank research, Michael stressed that the overall quality of laws — across the civil and criminal spectrum — was more important in explaining the emergence of a jurisdiction's wealth management industry than any detailed analyses of its banking and securities laws.

"Better civil and criminal law provisions lead to better wealth management regulations, which leads to a better legal system and greater prosperity in general," he said.

Additionally, he said the Financial Stability Board's recent proposals for the post-global financial crisis system placed less...
emphasis on financial law and regulation. "If you look at the FSB's proposals, they are not suggesting large-scale reforms of securities or banking law, but they are trying to reduce the fragility of investments. For example, if you invested in over-the-counter derivatives, how sure are you that you will be able to get your money out in a year's time?" Michael said.

He said that when looking at the effects of securities regulation in the wealthy, developed Organisation of Economic Cooperation and Development (OECD) nations, there too, the focus was on the effects of laws on the fragility of wealth. The particulars of financial rules, therefore, were of secondary importance.

"It is all about the quality of law in a place and membership in the OECD has a greater impact on that [than most other factors]. According to regression analysis, if your country has strong rule of law, your country is going to be wealthier than anything your wealth manager can do for you," said Michael. "We know that correlation holds good for different classes of wealthy people, irrespective of whether you are looking at the top one percent, the top 10 percent or the top 20 percent."

The 'Labuan paradox'

Just off the coast of the eastern Malaysian state of Sabah lies the federal territory of Labuan. The Malaysian government's objective was to create an offshore financial centre in Labuan, with the aim of attracting primarily mainland China's newfound wealth. To date, the endeavour has been unsuccessful.

"The hope was to encourage capital flows and all the benefits that go along with that, but it did not raise as much capital as hoped," Michael said. "Nor did it create many millionaires in either Malaysia or China," he said. It was something that Michael dubbed the "Labuan paradox".

In Labuan's case, the aim was to have minimal regulation or supervision of the banking and wealth management sectors — coupled with no capital gains taxes. Yet, the plans did not work as intended and the island has not attracted anywhere near as much as financial hubs such as Singapore, Hong Kong or Bermuda.

"So, how come Labuan is not like Hong Kong?" Michael asked the audience. "Because, basically, they do not have Hong Kong's laws. In our case, it is not just Hong Kong's banking, securities and insurance law that works, but our other laws such as our civil and criminal laws that, generally, help protect the wealth of the wealthy," he argued.

It was the nexus and quality of such laws that Michael said was imperative to understanding the success of the wealth management sector in some jurisdictions. "It is the nexus of contract law, tort law, civil law, criminal law and the overall degree of investor protections and that helps people feel secure. That explains why money returns to the wealth management industry in some places rather than that place's banking or securities law," he said. "It's the quality of the law rather than the specifics of financial rules and regulations on the books."

Legal engineering is futile

In the modern age, many emerging markets have opted to borrow — and in many instances, slavishly copy — financial
regulations from the U.S, UK and EU, with mixed results. It is an approach that Michael eschews. "You could ask: 'Why does a place like Labuan not just transfer the 'best in class' laws from the UK or Switzerland to turn itself into an international financial centre?' It just does not work like that," he said.

For example, in recent times, Middle Eastern jurisdictions such as Egypt, Turkey and the United Arab Emirates have copied their financial rules wholesale from the West. Yet, their attractiveness as in luring investment funds and their perceived investor protections was disappointing and differed widely across regionally.

"You have got to ask, 'how good are the banking and securities laws at providing investor protection?' Turkey's good, Yemen's not so good and places like Casablanca and Dubai have essentially 'Xeroxed' their banking and financial regulation to become offshore financial centres," Michael said.

Yet, mimicking the West is insufficient in drawing the types of investment capital that New York, London, Hong Kong and Singapore attract. "In theory such efforts [developed market legislation] should generate the highest returns. But Casablanca and Dubai do not generate the kind of returns we see in London and Hong Kong," Michael said. "The top financial centres do not feel a need to engineer their financial laws."

While acknowledging the high rates of return to be had in developing markets, Michael reiterated that the broader legal framework and proclivity to be a law-abiding society was more important than yields or taxes.

"Turkey has one of the highest rates of return for foreign investors, but they still do not draw as much capital as developed financial centres. There has to be something else and I would argue that investors prefer 'safer jurisdictions' over those that are perceived as less safe; rates of return do not determine the amount of money that goes into a market," Michael said.

He alluded to the preference for many Middle Easterners to use private banking services in established hubs such as London and Zurich. "If you go to a Saudi billionaire and ask him: 'are you putting your money into the Indonesian and Malaysian stock markets because of their high returns to capital and familiarity with Islamic finance principles?,' he will probably say no. He has probably got [much of] his money in London and Switzerland," Michael said.

"They are probably not getting the highest rates of return in Switzerland. Yet, Swiss banking and securities law gives them an ability to recoup the funds they have placed with asset managers and they know they will not be assaulted to and from the airport, and can still access their money 10 years from now," he said.

Michael also described the futility of countries trying to compete on the basis of tax rates.

"A large number of tax havens compete for capital by trying to reduce capital gains [rates] and reducing banking supervision. It just does not work and Labuan's example shows," he said. "What works is having a wealth manager that not only invests your money into shares or bonds, but also helps you grow your business; the wealth managers that focus on the marginal productivity of capital. That is something you do not have in Indonesia, Algeria or Venezuela,"
Michael said.

He added that private bankers in New York or London differed, culturally from Labuan. "In Labuan they will tell you about what to invest your money in and how to minimise your taxes," he said. But since rule of law matters more than asset allocation, more funds still flowed into wealth management in developed financial hubs, he said.

Ultimately, Michael argued that empirical evidence and experience were more relevant to discussing the broader impact of law on financial systems than conventional wisdom from textbooks. "Legal engineering is not the answer to developing a world-class banking and securities industry," he said.

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