

## **ACST834 Financial Institutions Management and Regulation Outline 2006**

Financial Institutions are managed by very smart, well-educated people (like you!). But each year some of the financial institutions fall into financial difficulties, and may even become insolvent, causing major losses for their customers.

In this course we will look at a number of case studies of financial institutions such as banks and other savings institutions, life insurers, general insurers, pension funds, investment funds, and health funds. We will be looking at examples from several countries (Australia, the UK, the USA, Canada, Japan, and some Asian countries). We will look at cases from the distant past (more than 200 years ago) and from the recent past – unfortunately the same problem keep recurring. We will look at both small companies and large companies.

This course is recommended for anyone who is likely to be in a senior management position in a financial institution; for professionals such as auditors and actuaries; and for regulators who might be responsible for supervision of financial institutions.

In each session, the lecturers will present one or more case studies. Students will also be asked to research and prepare case studies which can be presented to the class. As an example, the first assignment is attached.

Assessment will be based on

- essays (case studies) and class presentations      60%
- final exam      40%

The students have some flexibility in choosing their assessment tasks.

The course counts for credit in

- the Master of Commerce in Business, or
- the Master of Commerce in Actuarial Studies.

There are no other pre-requisites.

### **Topic 1: Introduction**

Based on empirical studies, what are the main causes of failure for financial institutions? We shall see that there are many recurring patterns – companies keep making the same mistakes. We will look at “red flags” – factors which should give regulators early warning of potential problems.

We will also consider methodology for research: what are the advantages and disadvantages of case studies relative to other approaches?

### **Topic 2: Overview : causes of failure suggested by empirical studies.**

Most insolvencies result from a combination of many factors, including economic instability, competition in the market, regulatory change, investment booms and

busts, improper corporate objectives, poor risk underwriting / credit control, inadequate pricing, rapid growth (particularly in new markets), capital shortages, weaknesses in accounting standards, untrustworthy information systems, optimistic valuation, poor corporate governance, reinsurance failure, delays in regulatory response, etc. etc etc. We will look at three case studies to illustrate the interaction of these factors.

### **Topic 3: Simple frauds**

In some cases the financial institution is deliberately set up to defraud the customers and/or with a reckless disregard for prudential management. Learn how to steal money by setting up our own bank, pension fund, insurance company, or small South American country. Learn how to fool the regulators and get away with millions of dollars of other people's money.

### **Topic 4 : Product design and marketing issues**

Learn how to create "time bomb" products – products which may initially be successful, but will "blow up" your company when the economic conditions create a trigger. These products often contain hidden options and guarantees, and/or are mismarketed.

### **Topic 5 : Corporate Objectives and The Winner's Curse(dangers of rapid growth)**

Quite often, companies which appear to be very successful (in the short term) end up failing disastrously a few years later. This is known as "the winner's curse". Suppose that management sets objectives based on rapid growth and increasing market share. Growth may be attained by inappropriate means (underpricing, poor credit risk assessment, poor underwriting, excessive commission and initial expenses, excessive credit rates or bonuses, etc). Problems are particularly likely to arise when expending in to new products / new markets (e.g. geographical). Growth also uses up capital reserves, so the company is in a weak position when trouble comes.

### **Topic 6 : Successful Companies**

Growth does not always lead to disaster: in this topic we look at some companies which have able to grow successfully been successful. What is the secret of success ?

### **Topic 7 : The Problem of Competition**

Many industries move through competitive cycles. A new company enters the market, undercuts the competition, and grabs market share. There is a "race to the bottom" which erodes the profitability of all market participants – until one of more companies become insolvent. This often leads to a correction i.e. price increases and less competition. How can management deal with the threats of competition ?

### **Topic 8 : Defined Benefit Pension Funds**

Defined Benefit Superannuation funds are subject to special risks. In recent years there have been many problems in the UK, USA, Canada, and Australia as superannuation funds have become insolvent – for example when Ansett Airlines went broke in 2001, the staff pension fund has a deficit of \$150 million. How can employees be protected from such losses ? What are the loopholes in the regulation ?

**Topic 9: Takeovers and Acquisitions / Fronting**

A strong financial institution can be weakened by taking over business from a weaker company. What are the hidden pitfalls in mergers and acquisitions ?

Alternatively a weak company might try to grow by buying a business – often seeking to stave off disaster by obtaining access to a new source of funds.

The same issues may arise in banking, where a poorly-managed small bank could bring down a much larger bank which syndicates its loans..

When there are strong links (or perceived strong links) between financial institutions, there may be a problem with “contagion”. The failure of one financial institution leads to the failure of others.

**Topic 10a : Accounting Standards, Accounting Irregularities, Financial Reinsurance**

**Topic 10b : Valuation Issues (for Actuaries) and Financial Reinsurance**

A company which under-reserves may be insolvent without knowing it. Inadequate information systems are often a feature of poor risk management.

However, an insolvent company will often try to hide its weaknesses by the use of creative accounting and/or simply adopting the most favourable interpretation of ambiguous accounting standards. What are the methods which may be used to defer losses, and/or bring forward profits?

Similarly, weaker companies will often take advantage of any loopholes or inconsistencies in the regulatory capital requirements. What are the most common loopholes? What is “financial reinsurance” and how does it work?

**Topic 11 : Corporate Governance Issues / Operational risks**

From time to time, a financial institution will collapse and cause significant losses to the community. In many cases, the problems have been concealed from the regulators (and the investors) by fraud. Often many people in the company are aware of and/or participate in the deceit (e.g. by falsifying accounts and statutory returns). In other cases the evidence suggests that those responsible for enforcing compliance to ethical standards are either oblivious to the problems, or are undermined when they attempt to address the problems.

How can a company manage the risks arising from unethical or dishonest behaviour by employees? What are the symptoms of a corporate culture which encourages or condones such behaviour ?

### **Topic 12: Booms and Busts**

Financial institutions are investors, and are vulnerable to the same booms and busts in the investment markets as other investors.

We will look at the history of speculation – from the South Sea Bubble in 1720, through the 1929 Stock Market crash, to the Dot.com boom of 2000.

### **Topic 13: Dealing with a company which is insolvent**

Once a company becomes insolvent, what can be done to minimise the effect on the depositors / consumers / fund members? At what stage should customers be informed of problems? What can be done to deal with the situation when customers are deserting in droves, or agents are churning customers? When there are insufficient assets, how can they be divided fairly? Is a run-off better than a liquidation? How can a company recover from insolvency?

### **Topic 14 The Regulator's perspective**

What are the difficulties which face regulators, in trying to fulfil their role of protecting consumers? In many of the insolvencies described above, there has been an inquiry into the regulatory response (or in some cases, the failure to respond in a timely manner). What were the outcomes? What are the limits on the regulator's powers? Are problems caused by lack of resources? Does the industry support effective regulation? What are the political issues which arise when trying to close down a company? How does the existence or guarantee scheme affect the decision-making process?

## ACST834 Assignment 1

Every now and then, some dishonest person uses his/her control of a financial institution to defraud the customers. Choose one of the following, write a 2-page report and prepare a 5-minute presentation for the class.

- West Middlesex (UK life insurers 1840s)
- The Royal Bank and Benjamin Boyd (Australian bank, 1800s)
- Bishopsgate (Australian General insurer, 1980s)
- Martin Frankel and Franklin National (among others) (USA life insurers 1990s)
- Anglo-American Insurance and Carlos Miros (USA insurers, 1980s)
- Robert Maxwell and the Mirror Group pension funds (UK pension funds, 1980s)
- McGregor, the Cazique of Poyais (mythical South American country, 1800s)
- The Nugan Hand Bank (Australia, Asia, and the Bahamas, 1980s)

In your report you might consider issues such as:

- How did this person gain control of the money? Were there any restrictions on owning this type of financial institution?
- How did this person manage to divert the money into his own hands?
- How long did it take for the fraud to be uncovered? If it took a long time, how did the perpetrator escape detection? Were there failures in the audit process / regulatory supervision?
- How was the fraud eventually uncovered?

In an attempt to prevent this type of fraud, prudential regulators now impose “FIT AND PROPER PERSON” requirements. Do you think that this will be effective ?

READING :

International Association of Insurance Supervisors – Fit and Proper Person Guidelines