

**Commonwealth Bank of Australia**



**Submission to the Parliamentary Joint  
Committee on Corporations and Financial  
Services**

***Inquiry into Financial Products and  
Services in Australia***

**July 2009**

# Commonwealth Bank

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31 July 2009

The Hon Mr B Ripoll  
The Chairman  
Parliamentary Joint Committee on  
Corporations and Financial Services  
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Australia

We are pleased to enclose our submission to the Parliamentary Joint Committee on its inquiry into financial products and services in Australia.

We are one of Australia's leading financial services institutions with around 10 million customers and more than 40,000 employees.

As you would be aware, we are also one of Australia's largest financial planning groups and, in this capacity, willingly accept our responsibility to take a leadership role in contributing to what is an important and still, in some respects, emerging profession.

We believe the fundamental challenge is to build a sound and professional financial advisory sector capable of delivering a consistently high standard of quality advice and making it more accessible to more Australians.

We have attempted to respond concisely to the Committee's Terms of Reference which focuses on several issues central to delivering quality advice.

The recent collapse of Storm, a licensed financial planner group, has attracted an understandable amount of scrutiny. It appears Storm took a legitimate and widely used wealth creation strategy - using debt to provide its clients with greater exposure to investment opportunities - and in some cases aggressively applied it with little regard for its clients' individual needs, circumstances or attitudes towards risk. We believe the resulting hardship endured by some Storm clients during the global financial crisis was largely caused by inappropriate advice provided by Storm.

Many major financial services organisations in Australia, including us, however, provided products to Storm's clients in order for them to implement Storm's advice. As I have stated publicly, we accept responsibility for any deficiencies in our provision of loans to Storm's clients. Our submission provides an overview of our association with Storm, what we have learned and what we are doing to assist our customers where, with hindsight, we are less than proud of our conduct.

We continue to work proactively with our customers, employees and regulators to ensure there is minimal risk of Australians being exposed to another Storm.

Yours sincerely

A handwritten signature in black ink, appearing to be 'J. Gind', followed by a long horizontal line extending to the right.



## Executive summary

The Commonwealth Bank of Australia Group has structured its submission so as to give Members a clear overview of:

- Our views on, and approach to, the importance of quality financial advice including a number of issues affecting the way the industry operates
- Our association with Storm
- What our review into that association has identified
- What we are doing to help Storm clients.

We have already publicly acknowledged there were shortcomings in the way we went about business with some Storm clients and, as the Committee will note from our submission, we are moving ahead with the resolution process.

How the impact suffered by some Storm clients came about may be summarised as follows:

- The advice offered by Storm, a licensed financial planning group, to its clients appears to have been inappropriate and seemingly without regard for the need to ensure that debt levels and client cash flow would be able to withstand market fluctuations. In our view, this factor is by far the main cause of the financial hardship now being experienced by Storm's clients.

Additionally, it can be argued that two other stakeholders are also involved in the circumstances leading to this hardship. They are:

- ASIC. As the regulator which provided Storm with its licence to operate and is responsible for monitoring licensees
- Product providers such as ourselves. In our case we accept responsibility for any poor lending.

Our submission also addresses the current process we are undertaking to assist people facing significant hardship.

### **The importance of quality financial advice**

It is our view that, distressing as the impacts were on some individuals, they do not represent a systemic failure of the financial planning industry. Therefore, we do not believe that the existing financial advice framework requires wholesale legislative change. Indeed, we believe that, where there is reasonable application of the current advice framework, poor client outcomes will be rare. We believe the current arrangements, effectively enforced by ASIC, are capable of delivering quality advice.

Our submission suggests 11 areas where additional information provided to ASIC would enable the development of a risk-weighted, strategic view of an advice business to assist ASIC to identify either a failing business or one which has potential to fail.

Further, we support proposed legislative changes in respect of margin lending and advice and the disclosure work being done by the Financial Services Working Group. In our submission, we recommend some changes to ensure that ongoing licensee supervision and monitoring becomes more effective.



## **Our association with Storm**

In the Townsville community, Storm was high profile and very active. Indeed, as a significant source of business in that region, several local staff were assigned to work exclusively with Storm clients. Moreover, some front-line staff were persuaded to join Storm, giving Storm inside knowledge of our systems, policies and processes. Although the intent was genuinely to assist customers, the local relationship with Storm was sometimes too close, and on occasion we lost objectivity.

Storm had around 13,000 customers, approximately 30% of them had a relationship with us. But, although in margin lending Storm represented a significant proportion of our third party business, home lending represented approximately 0.2% of our overall business. In short, visibility of line management to the different dealings between us and Storm varied.

## **What we've learned from Storm**

We have discovered that, when it came to providing loans, mostly secured by property, we failed at times to follow our own policies and lending practices. Additionally, a property valuation assessment system known as VAS was misused on occasion by some staff with the effect that loans against some properties were larger than they would otherwise have been.

In our submission, we detail for Members how some Storm clients became too highly leveraged as a result of Storm's advice and, where this happened with our involvement, how it could occur with little obvious visibility.

One broad conclusion is that, based on previous experience of Storm acting appropriately in relation to margin calls, we relied on Storm to continue "doing the right thing", in particular to take timely action with its clients in relation to margin calls.

## **What we're doing to help Storm's clients**

Finally, and positively, we set out for the Committee in the final section of our submission how we have addressed and are continuing to go about resolving the hardship suffered by some clients.

While we are not proud of our shortcomings, we take pride in the manner and focus with which we are seeking to relieve the pressure on all affected Storm clients who had either a margin or home loan with us where our conduct did not follow our policies and lending practices.

Rather than attempt to focus exhaustively on all issues relevant to Storm, our submission focuses on what is most important to us; our customers.

We commend the Submission for the Committee's consideration and welcome the opportunity to participate in the Committee's hearing sessions.



## A – The importance of quality financial advice

A number of recent corporate collapses (e.g. Westpoint, Fincorp) were the result of the failure of financial services product providers, and ultimately the failure of the products they offered. Financial advisers were involved to the extent that they recommended these products to their clients. In other cases, the products recommended by advisers were not central to the downfall of these businesses. Instead, it was the way those products were used to implement financial advice on behalf of clients which contributed to the failure of the business.

Those cases are not representative of the mainstream financial advice industry in Australia, which generally offers quality financial and other outcomes for clients. Nor do they reflect the failure of the legislation which governs the provision of advice. Therefore, in our view, these recent events do not represent a systemic failure of the financial planning industry.

For the reasons discussed below, it is difficult to see how compliant advice, properly executed, could have delivered the client outcomes which resulted, despite the extreme market conditions which have prevailed. While consumers might benefit from some changes to the general regulatory environment within which financial advisers operate, we believe wholesale legislative change to the existing advice framework is not required.

### The role of financial advisers

Quality financial advice is important in assisting individuals to build wealth for retirement and to achieve financial security. Financial advisers who recommend a strategy which meets a client's particular needs and goals, within their risk tolerance, therefore contribute to an individual's sense of wellbeing. Quality financial advice also results in a more efficient allocation of a client's capital and cash flow, and is essentially designed to achieve a level of self-reliance in retirement or to reach some other specific savings objective.

Additionally, when financial advisers assist clients to create wealth and develop self-reliance in retirement, they also play a broader role in national economic policy. By encouraging investment in domestic capital and infrastructure through superannuation and investment products, advisers indirectly enhance the productive capacity of the economy. This has national benefits. More directly, good financial advice is critical in assisting governments to implement retirement income policy, which is aimed at reducing the fiscal burden created by the ageing of the population.<sup>1</sup> This is evidenced by the Government's development of superannuation policies which are optimised at the consumer level through good advice. This contribution to national policy delivery is important in all markets – strong or volatile. As Assistant Treasurer and former Minister for Superannuation and Corporate Law, the Hon. Nick Sherry stated in an address to financial advisers recently "...the current period of financial turbulence has highlighted the need for your services — sound financial advice, with a view to the long term."<sup>2</sup>

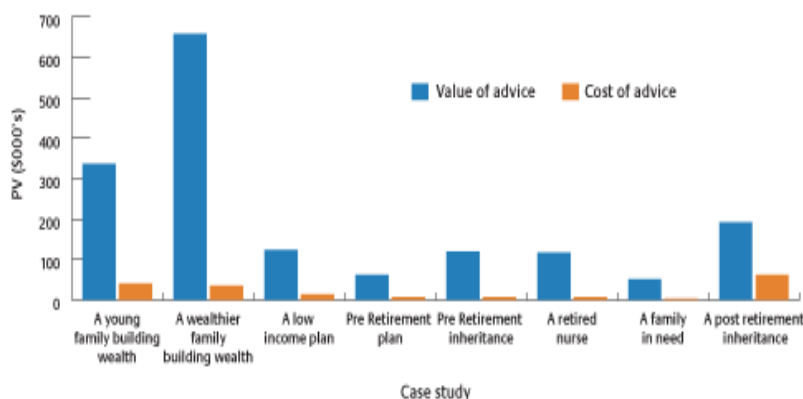
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<sup>1</sup> This fiscal pressures created by the ageing population and other factors was highlighted in Australia's second Intergenerational Report (IGR2) released in 2007. That report projected a fiscal gap of 3.5% of GDP in 2046-47 and the proportion of people aged 65 and over is projected to double to 25% of the population by 2047.

<sup>2</sup> Nick Sherry, Speech to Lonsdale Financial Group, 2008 Annual Conference, 17 October 2008



Good financial advisers can add significant value for clients and their dependents. The value of advice has been demonstrated most recently in a report prepared by RiceWarner Actuaries for the Financial Planning Association (FPA).<sup>3</sup> Based on a number of typical and diverse advice scenarios (including a wealthy family, a retired nurse and a family in need – see chart below) the report quantifies the value of the advice unlocked throughout the course of the advice process and across various life stages. In each case the financial benefits far outweighed the cost of advice. For the eight case studies the estimated total value was around \$1.7m.



In order for consumers to benefit, financial advice needs to be delivered according to the relevant legislative provisions contained in the Corporations Act. This is best achieved through a robust and efficient internal advice infrastructure driven by a best practice compliance culture.

Whether financial advisers hold an Australian Financial Services license in their own right or, more commonly, by acting as an authorised representative or employee of a licensee, the Corporations Act sets out a specific framework for their role. One of the most important obligations under the Act is for financial advisers to have a reasonable basis for the personal advice and recommendations they offer. A key component of this is that advice must be appropriate for clients' needs. These obligations require advisers to assess the client's individual risk tolerance and to tailor a recommendation to their particular needs. Licensees also have a number of general obligations, including the responsibility to act efficiently, honestly and fairly, to maintain competence and to have adequate arrangements in place to manage conflicts of interest.

The infrastructure and services necessary to deliver appropriate advice under these legislative provisions are generally provided by the adviser's dealer group - or financial advisory network. In many cases this sophisticated support framework includes: compliance resources and monitoring, training and professional development functions, product quality controls in the form of an approved product list, technical support and access to technological efficiencies. The dealer group is also required to be a member of an external dispute resolution scheme and will generally be a member of the relevant industry association and subject to its membership standards.

<sup>3</sup> "The Value of Advice" prepared by RiceWarner Actuaries for the Financial Planning Association, February 2008



## **Our approach to delivering quality advice**

We believe the framework described above, complemented by appropriate monitoring by ASIC, is sufficiently capable of delivering quality advice. Across our dealer groups, which comprise more than 1,100 financial advisers, we operate a centralised model which maintains a high commitment to advice oversight. This has a number of elements including ongoing training, monitoring and supervision.

Policies and procedures in relation to the provision of quality advice, including the abovementioned licensee standards and business rules, are developed by the Operations and the Advice Quality Teams within the dealer group and in conjunction with our Group's Risk and Compliance function. This depth of self-regulation imposes a very high standard for advice quality. Consequences for the adviser who fails to meet compliance requirements can range from being required to undergo additional training and coaching, through to revised remuneration, termination of employment, or revoked authorisation and being reported to ASIC.

Our commitment to advice quality is also demonstrated by:

- A rigorous product selection process, which combines the involvement of external research and an internal product review committee to evaluate potential products
- A strong focus on understanding the needs, goals, and risk profiles of our customers
- A strong governance structure which ensures our four dealer group Boards benefit from oversight by our Executive and Board structure as well as certain Group functions
- The ongoing rigour of a 'continuous improvement compliance program' which is aimed at achieving improved advice outcomes
- Our approach to conflict management and continual development of remuneration policies to ensure advice quality is reinforced.

Consistently high customer satisfaction surveys are, we submit, a tangible indicator that we are delivering on our objective of quality advice and strong customer service.

## **Failures occur when advice is delivered outside the advice framework**

If advisers and licensees comply with their legal and professional obligations it is difficult to see how advice which fails to take into account a client's particular goals and risk tolerance, can be delivered consistently across many clients within a firm. It is extremely difficult to reconcile systemically poor client outcomes within a firm with a reasonable application of the current advice framework. This suggests recent corporate collapses demonstrate a failure on behalf of the licensees to manage advice processes appropriately.

We consider that recent business collapses occurred because of a general failure to meet the expectations set by the existing advice regime. This is evidenced by the use of inappropriate strategies for clients, such as higher risk strategies for older and potentially less sophisticated investors, an unusually high concentration of an individual's portfolio in a single product and a 'one size fits all' investment strategy being consistently recommended to many clients without proper regard to its appropriateness.



## **Adequacy of licensing arrangements**

In its testimony before the Parliamentary Joint Committee on Corporations and Financial Services Inquiry, ASIC made reference to the role of the existing licensing regime, explaining that licensing is a gate keeping mechanism, which seeks to ensure that people who provide specific financial services have the competence, integrity and resources to do so. While we have found the initial licensing process to be reasonably rigorous, we believe it may be appropriate for ASIC to consider enhancing this process. This may include:

- An assessment of the suitability of a licensee's business model including how they intend to implement appropriate advice under the 'know your client' rule in section 945A Corporations Act and the diversity of products and strategies offered
- Gradually strengthening the requirements in relation to the education and training for authorised representatives as well as making sure there is a rigorous assessment of management's relevant experience
- An investigation of the advantages and disadvantages of introducing a requirement for licensees to hold an adequate amount of physical capital to assist in offsetting claims made against them
- Assessing a licensee's intended approach to compliance and advice oversight.

We would encourage the Committee to investigate how failed licensees have adhered to their obligation to profile each client's risk tolerance. It would also benefit from investigating how risk was addressed in the relevant disclosure documents and whether alternative strategies were considered.

The Committee may also wish to consider the merits of a regular licence refresh or check-up (although our suggestions in relation to ongoing ASIC monitoring may be sufficient) as well as the basis on which failed dealer groups had received positive external compliance reports prior to their demise.

## **Commissions and recent corporate collapses**

Commissions have played a role in some corporate collapses but not others. Where Storm is concerned, it is apparent that its advisers did not rely heavily on product based entry fee type payments.

While it has been reported that Storm advisers generally received a high (6 - 8%) upfront fee, that fee is not considered to be a commission payment because it was not paid by the product provider, but instead was paid directly by the client. For example, the average upfront fee payment paid within the Storm product managed by Colonial First State between 2000-2008 was 0.38%, even though a maximum upfront fee of 6.6% was possible. This is lower than average and we do not believe commissions were a key driver of the Storm failure.

## **Commission arrangements and conflicts of interest**

As demonstrated above, appropriate financial advice has significant value for consumers but the cost of providing such advice is high. Research commissioned by Colonial First State suggests that it costs advisers an average of \$3,570 to produce a full service financial plan. However, few investors, in fact around just 3% of superannuation members who had recently switched super funds, were prepared to pay this amount<sup>4</sup>.

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<sup>4</sup> Superannuation switching research undertaken by Colonial First State.



This reality results in subsidies being employed to ensure that consumers have sufficient access to advice. These subsidies take many forms and may include commissions and other payments by product manufacturers to either independent or aligned advisers; salaries paid to advisers employed by product manufacturers, including superannuation fund providers, or associates of product manufacturers and ownership of dealer groups by product manufacturers, superannuation funds or associates. These subsidies are present in most types of product/adviser relationships, including the retail investment and superannuation markets and the industry and public sector superannuation fund markets.

The presence of subsidies provides net benefits to consumers by enabling the provision of cost effective advice. To the extent that subsidies and associations have the potential to influence advisers to make recommendations that may not be in the best interest of the consumer, proper conflict resolution and disclosure mechanisms are required to be in place. In a number of the product collapses which are the subject of this Inquiry, commission payments were high (sometimes up to 10% of the initial investment). This may have influenced advisers to recommend these products, increasing sales of the products and masking potential problems associated with their business models.

We would argue that in these instances, which do not represent the norm for commission based products, proper conflict resolution and disclosures were lacking. In any case, as the Committee would well be aware, the industry has begun the move towards more transparent adviser remuneration structures.

### **Recent industry developments in adviser remuneration**

We refer the Committee to the proposals in the Draft IFSA Superannuation Charter and the FPA's Financial Planner Remuneration Consultation Paper. It is also worth noting that a general shift away from commission based charging has been underway in recent years. As a proportion of total adviser revenue, upfront commission decreased by 13% from 2007 to 2008, while asset based fee for service increased by 21%. Many product providers already facilitate a fee for advice remuneration model by offering advisers the ability to charge their advice fee separate from the product fee. Asset based fee for service is where a percentage fee is negotiated between the client and financial planner and deducted from the client's account<sup>5</sup>. Within Colonial First State's retail personal investment and superannuation group of products, FirstChoice Wholesale, which is an asset based fee for service product represented around 60% of Colonial First State's gross fund flows in 2008-09.

A complete transition from commissions to other remuneration structures could not be undertaken lightly. However, IFSA and the FPA's approach is preferred to any potential move by government to regulate adviser remuneration, such as by a legislative ban on commissions or by a legislative cap on fees. To place an outright ban on commissions, for example, will only encourage these subsidies to emerge in another form. Industry self-regulation should be supported.

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<sup>5</sup> Investment Trends 2008 Planner Business Model Report.



## **The general regulatory environment for these products and services / need for regulatory change**

In light of recent extreme market conditions, the relative health of the Australian financial services system compared to its international peers proves the regulatory regime is effective. As discussed earlier, advisers/licensees who adhere fully to their legal and professional obligations will not deliver inappropriate advice.

We support the proposed legislative changes regarding margin lending and advice, and the disclosure work being done by the Financial Services Working Group. Imposing further and complex regulation on the industry, however, as a result of several fringe operators would be inappropriate and risks placing further regulatory burdens and costs on otherwise compliant licensees.

We recommend the following changes to ensure that ongoing licensee supervision and monitoring is more effective.

In its role as corporate regulator, ASIC has substantial supervisory and compliance monitoring powers. We believe it is in the interests of licensees and consumers alike to ensure the regulator's approach to monitoring and surveillance is appropriately risk-weighted. This will assist ASIC to identify early failing advice businesses, or those which have the greatest potential for failure because of their inherent risks. For a risk-weighted surveillance approach to succeed we believe ASIC requires additional, regular and standardised information. Therefore, we recommend licensees be required to report a standard set of information periodically, say annually, about their respective business models.

In order to develop a risk-weighted, strategic view of advice businesses the type of information required to be reported to ASIC could include:

- Number of advisers/authorised representatives
- Number of CFPs
- Number of SoAs produced
- Quantum of funds under advice
- Details of management qualifications/experience
- List of approved products
- Products most frequently recommended
- Advice strategies recommended
- Number of clients and breakdown of risk profiles within client population
- Certain information on fees charged
- Number of complaints.

This would allow the regulator to assess whether a licensee's business strategy is robust and sufficiently sustainable, allowing it to cope with market, operational and other risks. Importantly, this would make it simpler for ASIC to identify and investigate advice businesses considered to be risk 'outliers' amongst their peers.



## **The adequacy of professional indemnity insurance arrangements**

In recent times, ASIC has sought to raise the standard of available professional indemnity (PI) insurance for licensees. In March 2008, ASIC introduced *Regulatory Guide 126* (RG 126) which requires licensees to have a higher standard of PI cover from 1 January 2010 (now extended until 2012). During the extended implementation period, ASIC considers it to be adequate for licensees to have a standard PI insurance that is based on what is available in the market, but that still achieves important improvements in the standard of compensation arrangements generally available to retail clients.

We support the work carried out by ASIC to ensure licensees have adequate PI insurance. The benefit is that retail clients will generally be covered in the event of loss incurred as a result of the licensee's conduct. We also appreciate the fact that the market for PI insurance has tightened in recent times, giving rise to an increase in premiums. This means certain licensees may find it difficult to afford initial cover or renew existing policies in order to meet the requirements set out in RG 126. ASIC has the discretion to approve alternative arrangements where licensees may not be able to source adequate cover. As suggested above in relation to licensing arrangements, an appropriate requirement for these licensees may be to hold an amount of physical capital.

## **Preventing poor quality advice**

In general, institutionally-owned dealer groups are likely to have the resources to implement sufficiently robust operational, training and compliance systems which enable them to provide quality financial advice. One example of these systems in practice relates to Westpoint. For many licensees, including us, Westpoint products did not pass their in-house product approval process.

## **Compensating for the effects of poor quality advice**

Institutionally owned licensees generally have sufficient capital to ensure restitution where inappropriate advice results in client losses. This has previously occurred. Consumers significantly benefit from receiving advice from a dealer group which is well capitalised or which has a well capitalised parent company as these businesses are better placed to make good any claims made against the group in the case of wrongdoing or loss. In effect, consumers who access the financial advice through an institutionally owned dealer group are insuring against corporate collapses.

## **Appropriateness of information and advice for consumers**

While an appropriate level of disclosure is vitally important in any financial services regime, excessive disclosure is generally ineffective. Simpler and more effective advice and product disclosure has a role to play in any improvements to the system and we are supportive of both Government and industry initiatives to reduce the length of disclosure. Colonial First State, through its membership with IFSA, is actively engaged in the Financial Services Working Group's project to shorten Product Disclosure Statements. We also support efforts to achieve greater consistency in relation to the presentation and labelling of risks involved with investing, including developing consistent labels and parameters for commonly used investment options.

## **Consumer education**

We believe it is important that financial advice is better understood by consumers. At present, consumers do not have a benchmark against which to test the quality of advice they receive.



We support ASIC's current project to develop standards/criteria for quality of advice.

Through our licensees we are involved in this process by providing advice documentation. The success of this project will of course depend on the level of input the regulator obtains from the industry itself. We acknowledge that the quality of advice is a very difficult measure to define.

A key issue is consumers' lack of understanding of risk. We support initiatives to assist consumers in this area, for example by developing consistent measures of risk for investment product disclosure and developing consistent classifications for product investment profiles.

Although Storm clients were entitled to believe that the advice they paid for was appropriately high quality, we believe more needs to be done to increase financial literacy in the Australian community. Improved knowledge in this area would include understanding the risks of high levels of debt and the inevitable reality that markets go down as well as up.

We fully appreciate that improved financial literacy delivers significant potential long-term benefits, not only for individuals but also for the Australian economy and thus the wider community. This appreciation is reflected in our Group's existing heavy commitment to building and supporting financial literacy in Australia.

In 2003, we established the Commonwealth Bank Foundation, building on our community activities and contributions towards education and financial literacy over the previous 70 years. The Commonwealth Bank Foundation encourages developments in education, in particular the financial literacy skills of young and indigenous Australians. It aims to create awareness, skill and understanding of the benefits of a more financially literate community.

The Foundation has developed a range of programs to support the teaching of financial literacy. These include an Australian Financial Literacy Assessment (AFLA), a national financial literacy curriculum resource for teachers, a Financial Literacy Grants program and the StartSmart Workshop program.

Since its inception in 2007, StartSmart has reached more than 115,000 students and their teachers across Australia. In 2008 the Commonwealth Bank Foundation expanded its focus specifically to include financial literacy for indigenous Australians. The Foundation has worked closely with the education sector and advocated for the inclusion of financial literacy education into the national curriculum for young Australians.

We participate in ASIC's "Community of Practice" working group that focuses on financial literacy and also provides support to the Australian Financial Counsellors and Credit Reform Association (AFCCRA), the peak body for the financial counselling sector.

### **The role played by marketing and advertising campaigns**

Direct advertising played a significant role in the promotion (mainly to retirees) of high-yield fixed interest and property schemes run by providers which collapsed in recent years (Fincorp, Australian Capital Reserve, Westpoint Group). In these circumstances the advertising in question was generally criticised for promoting high levels of return which purported to be guaranteed by the promoters.



Greater scrutiny by ASIC of the direct promotion of financial products/strategies to clients will assist the potential for any repeat. This scrutiny should have a specific focus on disclosure of the level of potential returns, how these have been calculated and the level of risk involved. The approach to sales/marketing could be assessed by ASIC as a key indicator in identifying the risk level of a licensee's business model.

### **The need for industry and regulatory change**

We support the Government's initiative to regulate margin lending as a financial product under the Corporations Act. Measures which strengthen licensee monitoring and the licence approval process may also be appropriate and we are committed to achieving shorter, more meaningful disclosure as part of the Government's initiatives through the Financial Services Working Group.



## **B Our association with Storm**

Storm was the creation of its founder, Mr Emmanuel Cassimatis. The business was based in Townsville and grew over the past decade.

As one of approximately 4,800 entities holding an Australian Financial Services Licence, Storm was responsible for the personal financial advice its 35 financial advisers (approximately) provided to some 13,000 Australian consumers.

In order to implement its advice, Storm recommended to its clients a range of financial products and services provided by many of the large financial institutions in Australia, including us. We understand that about 30% of Storm's clients have some type of a relationship with us.

We provided a range of services and products to Storm or its clients including:

- Corporate banking facilities
- Margin lending
- Home lending
- Indexed managed funds
- A small number of loans to its financial advisers.

At no time did we provide any personal financial advice to Storm's clients. The advice provided and the associated duties and obligations were unquestionably the responsibility of Storm.

As clients advised by Storm prospered for many years, no breaches of loan conditions by these clients came to our attention. Storm dealt with separate business units in relation to our specific offerings. The visibility of line management varied depending on the products or services in question. For example, with margin lending, Storm represented a significant proportion of our business through third party, licensed financial planner groups. By contrast, Storm clients represented approximately 0.2% of our home lending business.

The fees and commissions that were payable by us to Storm through the margin lending and index managed funds were comparable with those paid to other independent third party dealer groups. There are isolated instances where we provided sponsorship to Storm on certain initiatives but these were not material and are consistent, rightly or wrongly, with industry practice.

We did not pay any commissions or rebates to Storm in relation to home lending.

Given the size of Storm's business in the Townsville region, our office there assigned several staff to work exclusively with Storm clients and to assist those clients with home lending enquiries. This arrangement, now no longer in force, developed within this regional office and is not replicated elsewhere within our retail operations. These customer-facing staff dealt directly with Storm and their clients. Subsequently, some of those staff, with knowledge of our internal processes, were persuaded to join Storm and, we have learned, exerted pressure on their former colleagues.



Under the terms and conditions of margin loans, we were entitled to contact Storm or the customer in relation to margin calls. Storm insisted we contact it, not the customer. This arrangement and Storm's strong reluctance for us to have direct contact with their clients is consistent with industry practice. While we advised Storm of margin calls, Storm did not action these with its clients on a timely basis. Once we became aware of this, we made direct contact with these customers and learned of their considerable hardship.

While some Storm clients are disappointed that Colonial First State terminated several managed indexed funds whose investors comprised Storm clients, this difficult decision was made after the value of the underlying equity funds diminished to such an extent that the small amount of remaining equity made the termination of the funds in the best interests of investors.

We are satisfied that this was conducted in accordance with the funds' deeds, industry standards and regulatory requirements.



## C What we've learned from Storm

We undertook a comprehensive review into the nature and extent of our association with the failed financial planner group.

As we have already publicly acknowledged, our review showed there were some shortcomings in our conduct when we lent money to some of Storm's clients. We have committed to putting right any wrongs on our part. We are not proud of our involvement in issues associated with Storm and are dedicated to identifying and resolving issues with our customers.

We believe the facts are clear and that the actions or inaction of three stakeholders gave rise to the hardship now confronting some Storm clients.

- **Storm.** Storm was a licensed financial adviser group and, as such, it had a responsibility to ensure there was a reasonable basis for the personal financial advice it offered to clients. That required appropriate advice to be given which involved an assessment of an individual's debt and cash flow to determine a capacity to withstand market fluctuations.

It is quite clear from our enquiries that it was Storm's advice that contributed principally to the significant financial hardship now faced by Storm's clients.

Notwithstanding that reality, there are two other stakeholders who are also involved in the circumstances leading to this hardship.

- **ASIC.** ASIC is the regulator and issued Storm with a licence to operate. ASIC has an obligation to monitor licensees to ensure they meet their licence obligations
- **Product providers, including ourselves.** While providers may have taken comfort that Storm was duly licensed by ASIC, we and other major financial services organisation, unwittingly provided the products and services that enabled Storm's potentially inappropriate advice to be implemented. In our case we accept responsibility for any poor lending.

As a result of our review, we arrived at four main findings.

### **Home Lending practices in relation to Storm's clients were sometimes deficient**

We have in place strict lending practices and policies across our home lending business. They are designed to ensure that we only approve loans where we can demonstrate that customers are able to repay while also meeting their other financial commitments. We believe our home lending policy to be broadly consistent with our peers.

Regrettably, these policies and practices were not always followed in our Townsville area office in lending to Storm customers.



Several staff in our Townsville area office were assigned to deal exclusively with Storm and its clients in relation to enquiries about, and applications for, home loans. While this approach was designed with the best of intentions to deliver quality customer service to a significant number of clients in a small office, it had the unintended consequence of staff, on occasion, losing sight of the ultimate customer. In 2006-2007, several of our staff with inside knowledge of our operating processes, policies and procedures were recruited by Storm. Moreover, these individuals used their pre-existing relationships with staff in our Townsville area office to encourage loan approvals. This small, on-the-ground team was under constant pressure from Storm in dealing with customer loans. As a result, in approving customer loans, staff in the Townsville area office at times relied too heavily on information provided to them by Storm advisers about customers and their loan requirements.

We acknowledge, with the benefit of hindsight, that we should have focused more on providing service directly to the customer and not to Storm. Our subsequent review concluded that this was aberrant behaviour in this particular regional office.

We also identified misuse by some staff of our property valuation assessment system known as VAS. There was clear evidence that Storm constantly pressured our staff. The message was that if they (our staff) did not process the loan applications in a manner and timeframe expected by Storm, the business would move to one of our competitors, of whom there were many. We allowed that pressure to result in lending behaviour which, at times, fell below our usual and expected standards.

As a result of our review we are ensuring that no such structures are allowed to develop through our retail network and that we have commensurate education programs, controls and consequences in place to prevent its recurrence. In relation to VAS, we have already amended certain functionalities to reduce significantly the instances where an external valuation is not required.

### **Our supervision in some areas should improve**

The fact that a relatively small financial planner group, in terms of adviser numbers, could have a disproportionately large, and, in some cases, devastating impact on some of our customers, is deeply regretted. That one of our relatively small offices could write a disproportionately large amount of home loan business without attracting further scrutiny is a disappointing operational concern.

We are currently reviewing and improving our supervisory mechanisms with a particular emphasis on where it involves a third party or reflects any continued outperformance.

### **Some Storm clients became highly leveraged**

As we have subsequently learned, one of the common practices of the Storm 'model' was to advise their clients to use the equity in their homes to gear heavily into indexed managed funds.

As Storm was not a mortgage broker and we paid them no associated commission, the 2,500 Storm clients (approximately) who had home loans with us were not readily identifiable in our overall home loan customer base of about 1,000,000. Further, while many Storm clients had relationships with many financial services organisations, when Storm advised its clients to enter into one of our margin loans, this involved staff from other divisions who had no knowledge of the source of investment funds (i.e. via home loans).



We believe, particularly in relation to our margin loans, that some Storm clients were allowed over time, to become too highly leveraged. In isolation this should not be a significant issue as we knew the clients were being advised by a licensed financial planner. However, it is now clear that Storm's advice was inappropriate to its clients as it depended too much on a continuing strong market.

While margin lending remains largely unregulated we are fully supportive of the government's reforms included in Corporations Amendment (Financial Services Modernisation) Bill 2009.

We have a comprehensive program currently underway within our business to prepare for the new reforms.

### **We relied on Storm to do the right thing**

During the years we dealt with Storm, not unlike other third party licensed financial planners with which we deal, Storm was adamant that as the customer's financial adviser, it was its responsibility, not ours, to action margin calls. Storm insisted that we were not to call its clients. This is not an uncommon demand by financial planning groups.

Over a number of years Storm had previously demonstrated a willingness to take any necessary action, particularly in relation to margin calls, as was agreed between us and as had become common practice. Based on this, we expected Storm would continue to fulfil its responsibilities and deal with its clients on a timely basis in relation to margin calls. We relied on Storm to do the right thing.

After some delay, when it became apparent this was not occurring, we intervened to advise Storm clients that they were in margin call and took appropriate action as detailed in our terms and conditions.

We are currently reviewing and improving the initial and ongoing due diligence arrangements we apply when agreeing for our products to be advised on or promoted by third party, licensed financial planners. This will include going beyond our regulatory obligations and copying our customers on important communications.

We have commenced a series of initiatives exploring the extent to which our customers were impacted by the Storm collapse, to review our association with the failed group and to understand what could have been done better. In response, a Bank-wide project was established with the dedicated purpose of making good to customers where we had done wrong and, where appropriate, implementing internal process improvements. We are working proactively with our regulators and our initiatives will be subject to external review.



## D What we're doing to help Storm's clients

While we were one of many financial services organisations offering products and services to Storm's clients, we believe that, at this time, we are taking a leading position in offering assistance to those facing significant hardship. While we believe that hardship is principally the result of inappropriate advice provided by Storm, we have acknowledged that in some instances, we contributed to that hardship.

In the wake of Storm's collapse, we began hearing from Storm clients about the nature and extent of their financial difficulties. It became clear that many clients had become extensively indebted because they followed Storm's aggressive leveraging model. Given that a number of clients had also refinanced their homes to further invest in the market, there was also deep concern that, aside from having an unserviceable debt, they would have nowhere to live.

We sought to assist these clients by addressing issues of immediate hardship. No enforcement activity has occurred for debts owed by Storm clients. We have announced an interest suspension until 30 September 2009 and beyond for those customers who register to participate in our Resolution Scheme (see below). In late February 2009, we established a dedicated team from across the country and located them on-the-ground in the Townsville community where the hardship was being felt most acutely. We met face-to-face with hundreds of customers to learn more of their current circumstances and, wherever possible, to develop a longer-term plan to help them address their hardship.

Our offers of assistance have been tailored specifically to each customer's situation and include loan reductions and write-offs, loan restructures, reduced or zero interest rates for the life of a loan and permanent tenancy. To ensure that our customers' interests were protected, we paid for independent legal advice in each case and, if desired by our customer, for financial advice.

To address any deficiencies in our lending practices to Storm clients, we have initiated the establishment of a Resolution Scheme to provide swift and fair resolution for affected Storm clients. The critical attributes of the Scheme are that it will:

- Provide transparent and independent decision making
- Be efficient and timely in its processes
- Not be intimidating for Storm clients already in distress
- Provide paid legal representation for all Storm clients
- Only be binding on customers if they choose to take part and then agree to a settlement
- Allow for significant client input to the process and outcomes.

The Resolution Scheme is available to all affected Storm clients who have a margin and/or a home loan with us during the relevant period.



In the first phase of the Scheme (which occurs after the customer and their lawyer have registered to participate), we will supply all the customer's documents from our files, and certain general documents, to the customer's lawyer. The aim is to replicate a document discovery process and allow the customer and their lawyer a framework within which to assess our offer. We will consider the customer's situation (both in relation to the appropriateness of past lending and any current financial hardship being experienced by the customer) and we will make an initial Proposal which the customer may accept. Alternatively, the customer may make a counter-offer which we will take into account in developing a Revised Proposal. If customers are not made a Proposal or are unsatisfied with our Proposal or Revised Proposal, they are free to withdraw from the Scheme with all their pre-existing rights, at no cost.

Alternatively, they may choose to progress further through the Scheme and have their matter reviewed by the Independent Panel in a two stage process. At the first of these stages (Evaluation) an independent Evaluator from a panel (comprised of retired Federal Court judge, Mr Roger Gyles AO QC and senior counsel) will offer an opinion regarding the appropriateness of our offer and, if that offer is not considered appropriate, the Evaluator will be able to suggest an appropriate form of resolution. If customers disagree, they can refer the matter to the second stage of the Independent Panel process - determination of a claim by Mr Ian Callinan AC QC (retired Justice of the High Court). Mr Callinan's Determination is binding on the Bank. If customers are unhappy with the Determination, they have 14 days in which they can reject it, otherwise the Determination becomes binding on the customer.

We are meeting all of our customer's costs of the Scheme up to a predetermined amount, including all of the setup and support costs of the Scheme. The only circumstances in which a customer may be liable to pay their own costs, and reimburse a share of the Independent Panel's costs, is where they elect to have a matter referred to Evaluation or Determination and the result is less favourable for them than the offer they rejected. Such a costs arrangement is essential to keep the Independent Panel's workload manageable and to ensure that fair offers can be accepted without the need to unnecessarily refer them to the Panel.

Importantly, the customer can withdraw from the process at any time and seek other means of resolution. Further, all customers who take part in the resolution scheme and accept a settlement have their rights to any further ASIC-mandated remedy outlined in a dedicated clause in the deed of release.

The Resolution Scheme provides a fair, robust, transparent, efficient and cost-effective method of addressing customer concerns. There is an independence of decision making at both the Evaluation and Determination phases, overseen by eminent Australian jurists, and an invitation for customers to be involved in shaping the resolution, wherever possible and appropriate.

We have been working with ASIC since December 2008, when we proactively notified them regarding our concerns in relation to Storm. We are also working constructively with the Storm Investors Consumers Action Group (SICAG) to assist our customers.