SUBMISSION

Submission by Kenneth Allan, Financial Adviser and Authorised Representative of WB Financial Management Pty Ltd AFSL 236839**.**

Part One – Case History
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Background of writer – Ken Allan

Having been a financial planner since 1986, I was made a Certified Financial Planner (CFP) in April 1990. I served as a trustee of the Westpac Staff Superannuation Fund for a number of years.

PART ONE - Case History - Summary

A recently bereaved widow whose husband usually dealt with all the finances, appoints an experienced financial planner for advice. She has a $60,000 mortgage on her $600,000 unit, a Centrelink benefit of $10,920 p.a. and no other assets. The adviser arranges borrowings of $715,000 through a bank that owns his dealer group, resulting in not only a large fee for him, but margin calls and losses for the widow soon afterwards. Within 18 months, the widow loses her home and is penniless with a debt.

Case History Outline

On 15th October 2008, I was asked to assist a lady who was in dire financial circumstances. (I will refer to her as Mrs C)

- Mrs C was widowed in late August 2006.

- Following the finalisation of her husband's estate, Mrs C was left with the family home worth $600,000 and a mortgage to Westpac Bank of $60,000. She had no other assets.

- Her sole income was a Widows Allowance of $10,920 p.a.

- Close friends of Mrs C referred her to an experienced financial planner for professional advice. She was reassured by the fact that the adviser had been licensed since 1984.

- The adviser was an authorised representative of the Securitor Financial Group AFSL 240687. Securitor at that time was a subsidiary of the St George Bank.

- Mrs C had reasonable expectations of receiving qualified, well resourced, professional advice.

- Up until that time, Mrs C had never invested in equity based products.

Advice Given

Mrs C was given a Statement of Advice (SOA) dated 10th January 2007. This was only 136 days after the death of her husband.

At the time the advice was given, loan interest rates were rising. The advice was to borrow $300,000 from St George Bank and a margin loan of $400,000 from Colonial Margin Lending. A line of credit facility of $70,000 was also arranged.

The borrowings were used to:

1. Payout the Westpac loan of $60,000
2. Provide some funds in a St George Bank working account
3. Invest $650,000 (less $19,987 upfront entry fees) into an Asgard portfolio of managed funds. Asgard was owned by St George Bank.

Although vulnerable in the weeks following the death of her husband (who usually dealt with all their finances), Mrs C was reassured by the qualification and experience of the adviser, and accepted the advice as being in her best interests.

Even though the advice was given four years into a bull market, the adviser clearly stated on page 25 of the SOA that '***the strategy relies upon market performance of at least 10.5% p.a***'. For this strategy to succeed, my calculations show that a return of 17.25% p.a. was required.

In April 2007, Mrs C had a starting debt of $715,000. The returns from the $630,000 net investment in Asgard were required to pay the interest on the loans and provide Mrs C's living expenses.

Outcome

1. As arranged by the adviser, the Asgard portfolio commenced making monthly distributions of $3,500 to Mrs C's bank account.

2. Mrs C received a margin call of $25,000. The adviser instructed it be paid on 12th March 2008 with money drawn from her line of credit account. As

at 31st March 2008, Mrs C's debt had increased to a total of $778,273. The Asgard portfolio had fallen to $508,909.52.

3. Mrs C received a second margin call of $150,000 on 18th July 2008. Colonial Margin Lending redeemed funds from her Asgard investments reducing them even further.

4. Mrs C met with her adviser in mid August 2008 for a review with concerns about the strategy. Mrs C states that he advised her to sell her home in order to pay out the St George Bank debt. She was also informed that the planned monthly distributions would be reduced from $3,500 to $800.

5. Mrs C received a third margin call of $52,000 a few days later. In desperation, she borrowed the funds from a family friend.

6. Mrs C wrote to her adviser on 25th August 2008 expressing various concerns.

7. Mrs C's adviser issued a Statement of Additional Advice (SOAA) dated 3rd September 2008 which did not address any of the concerns of her letter dated 25th August.

8. Mrs C lodged a letter of complaint direct to Securitor on 9th September 2008. Securitor responded on 17th October 2008. (Refer point 11)

9. Under duress, Mrs C sold her family home for $460,000 on 19th September 2008. Proceeds were used to clear all debts owing to St George Bank. She still had a margin loan to Colonial which was secured by her greatly depleted Asgard portfolio.

10. On 15th October 2008, at the urging of concerned friends, Mrs C called at my office requesting assistance and an explanation of her financial state. After reviewing her situation, I took immediate action to stop the continuing losses. I explained that although she had paid approx $20,000 for professional advice, that advice had resulted in her losing the $540,000 equity in her home. Furthermore, I pointed out that even though she had lost everything, she still had a debt owing to Colonial of $17,000. Mrs C was totally devastated. She has little financial know-how and had no idea that she was now destitute.

11. Securitor wrote to Mrs C on 17th October 2008 offering $6,131.79 in full settlement of her complaint with no recourse. Mrs C rejected this offer.

12. On 18th November 2008 I lodged a formal complaint with ASIC and to date have received no response.

13. On instruction from Mrs C, I wrote to Securitor on 18th November 2008 detailing the numerous deficiencies in the Statement of Advice dated 10th January 2007. To date, Securitor have not addressed Mrs C's complaint, shown any interest in her welfare, or offered any resolution to the matter.

Conclusion

Mrs C's situation is similar to that of clients of Storm Financial. She was encouraged to double gear into the sharemarket without a detailed explanation of the risks involved. Many dealer groups and advisers use a simple tool to computer model (stress-testing) the outcomes of any gearing plan. Had this been done in Mrs C's case, then it would have been ascertained that a minimum return of 17.25% p.a. was required for the plan to be viable. A return of 17.25% p.a. on a long-term basis is clearly unattainable. The advice given to Mrs C was wrong from the outset.

Industry consultant and writer Paul Resnik states:

Gearing client portfolios without testing them is dangerous enough; double-gearing without testing should attract criminal penalties.

See Appendix - *Stress-testing: There ought to be a law (Complete article r*eproduced by kind permission of author)

PART TWO - Issues for the Committee to Consider

1. The Committee should investigate how widespread the practice of double gearing Centrelink recipients is. This case shows that it obviously is not limited to Storm Financial clients.

> ***Comment:*** *The adequate supervision of authorised representatives by large dealer groups must be brought into question. ASIC is clearly under-resourced and legally impotent.*

2. The Committee should question how a person on a Centrelink benefit of $10,920 p.a. is advised to obtain, and subsequently be granted, loan facilities of $780,000

> ***Comment:*** *Bank lending practices need to be tightened. I support tougher regulation on the use of margin lending*

3. All dealers and advisers need to be members of a complaint resolution mechanism.

> ***Comment****: Mrs C's complaint exceeds $150,000 which is outside the jurisdiction of the Financial Ombudsman Service (FOS). She initially complained on 25th August 2008 to Securitor, yet to date has never received any satisfaction. In fact, Securitor have only responded after I complained vehemently about Mrs C's treatment. I fully support the introduction of a Professional Standards Board to deal with matters outside of the scope of FOS.*
>
> *Mrs C and clients like her are extremely vulnerable and need protection. Most have little understanding of financial matters, which is why they sought professional advice in the first place. The financial hardship they are forced to endure puts them under extreme stress. Due to poor advice, many do not even have money left to live off, let alone take corporations to court. Financial institutions and their solicitors exploit this vulnerability and prolong a resolution. Dealer groups should be compelled to settle complaints within a specific timeframe.*

4. Financial Services Reform Act 2003 has failed the investing public.

> ***Comment:*** *In the Corporations Act, reference is made to 'misleading or deceptive conduct', 'false or misleading statements', 'unconscionable conduct', 'appropriateness of advice'. These are all well intentioned guidelines; however, they have no impact at the investor level when the person involved is not in a strong position to go to court.*
>
> *I support the formation of a Professional Standards Board which can refer certain cases to ASIC who then have the power (and funding) to*

seek legal redress in the courts. This assumes that arbitration has failed. There is a clear precedent with ASIC taking some advisers to court over the use of Westpoint investments.

5. The Financial Planning Association (FPA) has only belatedly stated that a financial planner must place the client's interests first. The new FPA's professional standards apply to all members regardless of membership category.

***Comment**: Unfortunately any new guidelines appear to be a rehash of those stated in the comments on FSR. At the end of the day, the only way advisers will exercise adequate professional care is if they know they will be held accountable for the advice given. The regulator needs to be given legislative teeth for this to occur.*

6. To become a financial planner, a person must meet the minimum education requirements outlined by ASIC – regulatory guideline 146.

***Comment:** If an adviser has a high level of training, then I believe this will reduce the chances of a client receiving inappropriate advice. According to a training website, any person can be qualified to provide Personal Advice by attending three 5 day workshops at a total cost of $6,000.*

ASIC have said they are reviewing regulation 146. I strongly recommend that the committee look to legislate tougher entry conditions for advisers rather than leaving it to the regulator ASIC. I believe that the level of double gearing inappropriate investor clients would have been reduced if PS146 guidelines had been much tougher.

7. A large part of the debate into financial advice has centred around the taking of commissions. Submissions to the committee have asked for the banning of these commissions.

***Comment:** Investors were placed into products such as Great Southern by advisers who received brokerage of up to 11%. A large number of the promoters of Great Southern were in fact accountants; however, it is clear that Storm Financial **did not** receive the bulk of its income from brokerage or commissions. They levied upfront fees at a very high level. Banning commissions in favour of fees will not stop investors from getting bad advice – Storm proved that.*

Submitted by Ken Allan, 24th August, 2009

APPENDIX

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Stress-testing: There ought to be a law

By Paul Resnik
June 19, 2009

PORTFOLIO POINT: Gearing client portfolios without testing them is dangerous enough; double-gearing without testing should attract criminal penalties.

There are no laws prohibiting the individual sale of petrol, matches, glass bottles and cotton rags. Separately they offer little menace, but combined and dispatched by a political terrorist they are lethal. Similarly, gearing in the hands of financial terrorists (read financial planners) has also reaped great damage. This is particularly so when the initial deposit for the margin loan was sourced from a home equity release loan.

It is of scant comfort to victims – in the fallout of the Storm Financial/CBA affair, for example – that the defence of ignorance is claimed by the planner.

We hear it every day: “No one could have expected it!” We believe that a sense of history and the merest dash of common sense tell us all that we need to know about the risks in double gearing.

In short, I believe that if all advice carried the obligation for receipt of the client’s “properly informed commitment” before proceeding to implementation most clients would refuse to take on the risk of losing their home.

A short history lesson

Students of investment market history know that extreme market behaviour happens about once every 10 years. Since 1970 there have been four falls in the Australian equity market that exceeded 30%.

Start of fall	Depth of fall
February 1973	–51.90%
October 1987	–43.50%
November 2007	–43.20%
December 1980	–33.40%

The global financial crisis rates third in terms of depth of fall. I suspect that many advisers do not consider such occurrences in putting together geared client portfolios. Communication of downside risk, if explored at all, focuses on nothing more than two standard deviation variations of historical returns.

The 1987 fall was very sharp, with an initial fall of 25% on one day, October 20. At the other extreme, the fall of 2007-08 was like a slow-moving train wreck, the biggest fall being 26% over the three months from September to November 2008.

In 1987, everyone understood that the rules had changed, and where the rubbish was held (Bond, Skase, etc). This was a quick landing. In 2007-08, when the claimed Black Swan hove into view, people also knew what the issue was. It was subprime mortgages that had been packaged up into CDO securities. However, nobody could ascertain the size of the problem or, more importantly, which institutions held these securities on their balance sheets. Hence the slow-moving crash.

When a market suffers trauma, it is almost certain that the following three events will take place:

- Clients panic.
- Institutional operational systems fail.
- Stop-loss systems fail.

Client panic

I remember the day of the 1987 crash clearly. Wall Street had a huge fall the previous night and our market opened down about 20%. Clients panicked, fearing they would lose much of their recent gains (the market had risen by almost 50% since January 1 alone). Clients rang their brokers, instructing them to sell. Telephone systems clogged and fax machines melted.

You could feel panic set in as clients invaded the lobbies of their stockbrokers, fund managers and financial planners. Yet few of these professionals knew what to say because they had never experienced this kind of fall. The vast majority of investors were relatively new to the market, often because they had their money in managed funds that had arrived in the market only after 1980. Lots of them were taking advantage of Paul Keating's superannuation rollover legislation introduced in 1983.

All that many investors could think to do was sell, which put more downward pressure on the market. Fund managers were forced sellers of their better, more liquid shares, as they had to meet client redemption requests.

Institutional operational systems fail

When subject to a large market movement you have to expect operational failures. Some will say that this shouldn't [be allowed to] happen; this view is of course naïve. An analogy is the recent Black Saturday bushfires that killed 173 people in Victoria. Many will argue that we should have had more fire crews, but there can never be enough fire personnel for the intensity of such a fire storm.

An example of failure in operational systems in late 2008 was with margin calls. Consider this scenario:

1. Market falls 20%.
2. Margin loan lender makes margin call to wrap account.
3. Wrap account calls dealer and financial planner.
4. Financial planner calls client.
5. Client decides to inject more cash, or more likely, sell down the portfolio.

This scenario can (and generally does) play out efficiently in normal times, but what happens when the sheer volume of margin calls overwhelm the participants? What happens when the financial planner is away at a compliance workshop? What happens when the client is on holidays? What happens when the client doesn't understand what a margin call is?

Margin lenders are often reluctant to immediately sell down client portfolios, without the client themselves having at least 24 hours to consider their position. Combine this with systems overload at the margin lenders office and margin calls can take weeks to be executed. By then, the portfolio may have fallen another 10–20%, and the client is in even greater financial difficulties.

Stop-loss systems fail

Many clients and some advisers believe (did believe?) that a "stop-loss" system can be put in place to limit downside losses in a client's portfolio during a market fall.

An example of such a process might be: "Sell all of my portfolio should the market fall by 10%." This sounds quite reasonable, as the client and his planner might feel that the maximum losses to the client will be 10%. This is an amount that the clients feels comfortable with, taking into account her tolerance for risk and risk capacity.

However, stop-loss systems can fail due to a combination of market pricing gapping, and lack of liquidity.

Markets can "gap" such as on October 20, 1987, when the market opened 20% below its previous day's close. Clearly, executing a stop-loss plan to limit losses to 10% would have failed then.

Furthermore, when there is a significant fall in the markets, liquidity evaporates on the buying side. This means that there is nobody ready to buy the stocks you wish to sell in order to satisfactorily execute your stop-loss strategy.

When markets fail investors will have to hang on tight and keep riding the portfolio downwards. History shows us we have no viable alternatives.

For example, there is a reasonable chance that if you are 45, you will experience three or more significant market corrections in your lifetime. Can you survive these crashes? Have you stress-tested your portfolio?

Stress testing

There is a simple way to stress-test portfolios:

First, set out your current assets and liabilities including your home, investment properties and mortgages.

Existing portfolio				
Assets			**Liabilities**	
House		**$1,000,000**	Mortgage	$400,000
Superannuation				
Shares	$300,000			
Property	$ 50,000			
Fixed Interest	$100,000			
Cash	$ 50,000			
		$ 500,000		
		$1,500,000		**$400,000**
Less Liabilities		-$ 400,000		
Net Worth		**$1,100,000**		

This could be a fairly standard balance sheet for a couple aged 45–50 earning perhaps $200,000 a year.

How do we stress-test this portfolio? We believe that the simplest practical approach is best. Therefore, based on past experience, assume the following falls in the various asset classes:

Shares	30%
Property Securities	20%
Fixed Interest	10%
Cash	0%
Residential Property	10%

Black swan, scenario one					
	Original Value	**Black Swan Fall**	**Black Swan Value**		
Assets				**Liabilities**	
House	**$1,000,000**	-10%	$ 900,000	Mortgage	$400,000
Superannuation					
Shares	$ 300,000	-30%	$ 210,000		
Property	$ 50,000	-20%	$ 40,000		
Fixed Interest	$ 100,000	-10%	$ 90,000		
Cash	$ 50,000	0%	$ 50,000		
	$ 500,000		**$ 390,000**		
	$1,500,000		**$ 1,290,000**		**$400,000**
Less Liabilities	-$ 400,000		-$ 400,000		
Net Worth	**$1,100,000**		**$ 890,000**		

The net worth has dropped about 20%. This should normally be OK for the investor, provided they were aware in advance that Black Swan events occur with surprising regularity.

Let's now go and borrow another $300,000 against the house, taking the loan-to-value ratio up to 70%. Then throw in the same Black Swan:

Black swan, scenario two

	Initial Value	Black Swan Fall	Black Swan Value		
Assets				**Liabilities**	
House	**$1,000,000**	-10%	$900,000	Mortgage	$700,000
Superannuation					
Shares	$300,000	-30%	$210,000		
Property	$50,000	-20%	$40,000		
Fixed Interest	$100,000	-10%	$90,000		
Cash	$50,000	0%	$50,000		
	$500,000		**$390,000**		
Non Super Share Portfolio	**$300,000**	-30%	$210,000		
	$1,800,000		**$1,500,000**		**$700,000**
Less Liabilities	-$700,000		-$700,000		
Net Worth	**$1,100,000**		**$800,000**		

At this stage, the investor has lost 27% of their net worth, and the loan-to-value ratio on the home is now 78%. Can they deal with the Black Swan? What if they lose their job? Can they ride out the storm?

Let's now see what happens when the $300,000 mortgage drawdown is used take out a margin loan facility of $600,000.

Black swan, scenario three

	Initial Value	Black Swan Fall	Black Swan Value		
Assets				**Liabilities**	
House	**$1,000,000**	-10%	$900,000	Mortgage	$700,000
Superannuation				Margin Loan	$600,000
Shares	$300,000	-30%	$210,000		
Property	$50,000	-20%	$40,000		
Fixed Interest	$100,000	-10%	$90,000		
Cash	$50,000	0%	$50,000		
	$500,000		**$390,000**		
Non Super Share Portfolio	**$900,000**	-30%	$630,000		
	$2,400,000		**$1,920,000**		**$1,300,000**
Less Liabilities	-$1,300,000		-$1,300,000		
Net Worth	**$1,100,000**		**$620,000**		

This “perfect storm” is looking really ugly. The investor has lost 44% of their net worth, or $480,000. The loan-to-value ratio on the margin loan is now 95%. Getting the figure on the margin loan back to 67% means having to sell $540,000 of shares “at the bottom” of the market.

The client’s position ends up as follows after the margin call:

End game

Assets		**Liabilities**	
Home	**$900,000**	Mortgage	$700,000
Superannuation		Margin Loan	$60,000
Shares	$210,000		
Property Securities	$40,000		
Fixed Interest	$90,000		
Cash	$50,000		
	$390,000		
Non Super Share Portfolio	$30,000		
TOTAL ASSETS	**$1,380,000**	**Total Liabilities**	**$760,000**
Less Liabilities	-$760,000		
NET ASSETS	**$620,000**		

At least this investor hasn't lost his home! Yet! However, he has a mortgage of $700,000 on a $900,000 home. What about a loss of share value of another 20–30% and a further drop in property values?

If the investor's total portfolio had been stress-tested using historical numbers and the consequences explained. It's hard to imagine many would have agreed to proceed.

I believe it should be mandatory for a client's total balance sheet to be stress-tested as part of any financial plan, particularly if it involves borrowing. How can a financial plan be complete if it does not include stress-testing? How can we allow plans implemented without explaining the risks and asking for the client's properly informed commitment?

Our previous article (see ***Odds stacked against margin lending***) argued that margin lending with Australian shares as an investment strategy is gambling. Double gearing we argue is immoral and probably fails to meet the adviser's duty of care obligations.

We believe it's a pity that financial planners who recommended double gearing are not subject to criminal penalties. Nevertheless we believe that a strong case exists under existing legislation for civil penalties. As a community we successfully stopped the use of petrol bombs; perhaps we can do something similar about double gearing.

– with additional reporting by Peter Worcester

Paul Resnik and Peter Worcester are industry consultants with more than 70 years of combined practical industry experience.

Expect black swans

A black swan is something we thought could not exist. A black swan event is something we think cannot happen! There is much discussion at the moment as to whether the global financial crisis was a black swan event. The author Nassim Nicholas Taleb describes a black swan event as something we should be surprised about, that has enormous consequences and that we can rationalise later with the benefit of hindsight. Our view is that similar circumstances can result in one individual describing their experience in the GFC as a black swan event, while another will more or less take it in their stride. This we argue is because the latter is better prepared; they understand what is possible and the range of consequences compared to the former. “Before the discovery of Australia, people in the Old World were convinced that all swans were white, an unassailable belief as it seemed completely confirmed by empirical evidence.” **– Nassim Nicholas Taleb, *The Black Swan*.**