Inquiry into Financial Products and Services in Australia

Introduction

Since the start of this century, businesses, banks and individuals have lost more than $20 billion. The following analysis will explore the causes of these losses and how they can be minimised. It would be misleading if the role of capital markets participants, accountants, and credit rating agencies were not also examined to determine their part in the collapses that led to investor losses.

The capital market

The capital market, for the purpose of this submission, is the market where companies and governments raise funds either in the form of short and long term debt or equity. ASIC, APRA and the Australian Stock Exchange (ASX) are responsible for its oversight to ensure that investors, borrowers and businesses seeking equity finance are protected against fraud and irregularities.

Banks, which primarily make money by taking deposits in one window and handing out loans in another window, play a vital part in the capital market. Their decision to approve loans to creditworthy business borrowers is essential to their business customers' survival and growth. This judgment is based on an assessment that the risks and rewards justify the transaction and hence the establishment of the relationship. The importance of a satisfactory banking relationship can not be overstated. Without bank loans, soundly managed companies will not reach their potential. On the other hand, the failure of poorly managed companies will wreak more havoc as they grow larger. WorldCom and Enron were allowed to expand to such an extent that their failures created one of the largest and most infamous corporate collapses. Had the banks competently analysed the risks in these relationships, America would have been spared the disastrous after effects.

Likewise, had Australian banks properly evaluated Storm Financial, Opes Prime, Tricom, ABC Learning, Timbercorp and Great Southern, a few of the business failures, they along with investors would have been spared much of the pain, humiliation and hammering that they are currently receiving. For the first 6 months of the 2008/09 financial year, the big 4 banks recorded total loan impairment charges of $6.3 billion. Their provisions for future loan losses totaled $16.6 billion. These are significant numbers which indicate that banks are facing serious problems in their loan portfolios and their lending procedures. Loan losses are the result of weak risk management and poor credit processes, especially in the area of risk analysis.

The role of financial advisers

Financial advisers are those who influence the decisions of investors and capital market participants with their expert knowledge, skills and experience. This group consists of accountants, lawyers, valuers, bankers, financial planners, share brokers and underwriters. Like banks, they are expected to understand and explain the risks in the investments and financial products they recommend to their clients. The worst thing they can do is to recommend a deal that turns out badly; a deal which ends up in a losing investment or a loan which can't be serviced, resulting in the liquidation of a borrower's security, sometimes their house.

What some investors and borrowers forget is that integrity is just as important as competence and expertise. What is also lost sight of is the reality that banks and advisers are looking after number one - themselves. To stay in business, they have to encourage their clients into deals that earn them income in the form of fees, commissions and interest. Some advisers put their interests ahead of their clients and this can lead to harmful consequences for investors and borrowers.

Banks too have played a part in investor losses as the Storm Financial, Opes Prime, Great Southern and Timbercorp fiascos show. They often encourage highly geared businesses to seek additional equity such as a stock exchange listing or other funding. An increase in equity lowers the business's leverage ratio. Banks take comfort because their exposure lessens, the business's creditworthiness appears to improve and the stock exchange, share brokers, lawyers and accountants gain additional income from the listing. But a stock listing or an increase in equity does not always translate into sustainable success as the failures of Babcock & Brown, Allco, ABC Learning and Storm Financial demonstrate. Banks failed to assess the capacity of these companies, as well as other business failures, to service their obligations from operating cash flow in good times as well as in bad times.

Lenders concentrate on hard quantifiable data and overlook the importance of qualitative information such as strategy, organisation structure, director experience and skills. The latter considerations are also important factors that determine how well a business performs. Then too, executive remuneration is frequently overlooked, possibly because the information is not readily at hand. Nevertheless, it is becoming an important issue as executive remuneration continues to escalate, frequently disproportionate to shareholder returns. Financial incentives can motivate executives to take bigger risks in the search for bigger profits and this may lead to the failure of the venture bringing the business or the investment scheme down.

Accountants and auditors played a major role in the downfall of some of these businesses. They failed to ensure that the financial statements that they had a hand in preparing were accurate, transparent and complete. This led some investors, creditors and other stakeholders into making bad decisions. Cosima Maririner in the 30 – 31 2009 May Sydney Morning Herald points to one example when in mid 2008 Storm Financial reported a $37.5 million profit. Six months later it failed.

Another is conflict of interest. It is understood that about half the sales of the investments in Great Southern and Timbercorp were sourced by accountants who had an advisory relationship with these MIS companies.

In June 2009, Timbercorp's administrator released figures that showed the company's olive and almond managed investment schemes (MIS) had not made money since 2001. Rural based agribusiness MIS are tax advantage investment schemes that in the late 1990s were encouraged by the federal government. Other factors in the losses besides drought and high operating expenses, especially in the start up years, are the fees and bonuses paid to promoters, advisers, managers and lenders.

Auditors PriceWaterHouseCoopers signed off on Fincorp's, 30 June 2006 annual financial statements on 9 October 2006. On 23 March 2007, the company went into receivership owing $200 million to retail investors and $95 million to banks and other financiers. Remarkably, even though Fincorp lost money and was eventually insolvent, the auditor had not qualified the accounts during the 2002 – 06 period.

Accountants, who audit a business' financial statements, limit their obligation to the business that pays for their service. They overlook the major reason they are hired is to authenticate the report on the business' financial performance and condition. Owners, financial and trade creditors are stakeholders in the business and have an interest in knowing how well a business is operating. Without their knowledgeable support the business's future success will be more difficult.

The regulatory environment
Australia's foremost regulators are the Australian Prudential Regulation Authority (APRA) the prudential regulator of the Australian financial services industry, Australian Securities and Investment Commission (ASIC) and the Australian Stock Exchange (ASX) which oversees the stock exchange and listed companies' activities.

APRA's mission is 'to establish and enforce prudential standards and practices designed to ensure that, under all reasonable circumstances, financial promises made by institutions [that APRA] supervises are met within a stable, efficient and competitive financial system.'

The 18 May 2007 Statement of Intent prepared by APRA's Chairman John Laker addressed to former Treasurer Peter outlined the regulator's goals shown below in italics. Comments are in capital letters.

- *APRA's supervisory approach is forward looking, primarily risk-*based, *consultative, consistent and in line with best international practice.* IF THIS WERE SO, THEN APRA HAS FAILED MISERABLY AS THE BANKS' LOAN LOSSES HAVE SHOWN.

- *APRA's role is to promote prudent behaviour by financial institutions through a robust prudential framework of legislation, prudential standards and prudential guidance which aims to ensure that risk-taking is conducted within reasonable bounds and that the risks are clearly identified and well managed.* THERE ARE MANY EXAMPLES OF BANKS' IMPRUDENT LENDING. ONE IS ANZ'S FAILED $650 MILLION OPES PRIME LOAN, A SHARE BROKER ENGAGED IN MARGIN LOAN LENDING. HOW COULD APRA REACH THE CONCLUSION THAT ANZ'S LARGE EXPOSURE TO A RELATIVELY NEW COMER IN THE LENDING BUSINESS, SECURED BY SHARES IS PRUDENT?

- *Risk based approach involves regularly analysing the financial condition of institutions and reviewing their risk management to assess their relative risk of failure and whether they meet prudential requirements.* IF APRA HAD REVIEWED RISK MANAGEMENT PROCEDURES, WHY DID THE BANKS MAKE LARGE LOAN LOSSES? FURTHERMORE WHY DID IT TAKE APRA UNTIL SEPTEMBER 2007, TO DISCOVER THAT THE NBA, COMMONWEALTH AND THE ANZ HAD PARKED BILLIONS OF DOLLARS OF LOANS AND $20 BILLION OF LIABILITIES IN OFF BALANCE SHEET SPECIAL INVESTMENT VEHICLES OR CONDUITS?

- *If necessary, taking enforcement action to protect the interest of beneficiaries or to make it clear that illegal or materially imprudent behaviour will not be tolerated.* APRA WAS UNCONCERNED ABOUT THE RISKY EXPOSURES OF BANKS TO STORM, GREAT SOUTHERN AND TIMBERCORP WHO ENDED UP COSTING INVESTORS DEARLY. THE BANKS STEERED THEIR CUSTOMERS INTO INVESTMENTS WITH THESE COMPANIES. APRA SHOULD HAVE POINTED OUT TO LENDING BANKS, THE RISKS TO UNASSUMING RETAIL INVESTORS WERE UNACCEPTABLE. THE BANKS SHOULD HAVE ADVISED THEIR CUSTOMERS ACCORDINGLY. THEN THERE WOULD HAVE BEEN FEWER DISAPPOINTMENTS.
- *APRA's risk based approach is underpinned by supervisory tools that developed within APRA to ensure that the risks are assessed rigorously and consistently, that critical warning signs are identified early and that our supervisory response is prompt and measured. APRA seeks to act pre-emptively, so that emerging threats to financial institutions are addressed before the interests of beneficiaries are damaged; where pre-emptive action is not possible, APRA's objective is to set in train appropriate wind-up or other exit strategies that minimise losses to beneficiaries.* IT TOOK THE FAILURE OF OPES PRIME TO DISCLOSE THE SHORT COMINGS IN ANZ'S CUSTODIAL SERVICES. WHATEVER TOOLS APRA HAS USED, IT HAS FAILED TO DETECT THE HIGH RISKS IN COMPANIES THAT WENT ON TO COLLAPSE RESULTING IN MILLIONS OF DOLLARS OF BANK LOSSES.

ASIC is Australia's corporate, markets and financial services regulator. Its responsibility is to ensure financial markets are fair and transparent and that investors and consumers are 'confident and informed'. This requires it to monitor the ASX's regulatory role. Comments are in capital letters below to the Australian Securities and Investments Commission Act 2001 which obliges it to

- *maintain, facilitate and improve the performance of the financial system and entities in it.* ASIC FAILED IN THIS REGARD AS SHOWN BY NAB AND CBA BANKS' LOAN LOSSES, ESTIMATED AT $3 BILLION AND $1.6 BILLION RESPECTIVELY. NAB'S LOSSES INCLUDE $1.15 BILLION IN CDOS (COLLATERALISED DEBT OBLIGATIONS). THESE LOANS AND CDOs HAD BEEN BOOKED FOR SOME TIME, TIME THAT SHOULD HAVE ALLOWED THE REGULATORS TO BRING THIS MATTER TO THE BANKS' ATTENTION AND CORRECTIVE ACTION.
- *promote confident and informed participation by investors and consumers in the financial system* IT WOULD BE DIFFICULT FOR ASIC TO CLAIM THAT IT *PROMOTED 'CONFIDENT AND INFORMED PARTICIPATION BY INVESTORS AND CONSUMERS IN THE FINANCIAL SYSTEM'* SINCE $8.4 BILLION HAS REPORTEDLY BEEN LOST IN MANAGED INVESTMENT SCHEMES. IN JUNE 2009, TONY D'ALOISIO ADMITTED THAT AGRIBUSINESS MANAGEMENT INVESTMENT SCHEMES 'INVOLVED A HIGH LEVEL OF SELF- REGULATION'. IN OTHER WORDS, ASIC HAD IGNORED OVERSIGHT OF AN INDUSTRY WITH $350 BILLION OF INVESTORS' FUNDS.

- *administer the law effectively and with minimal procedural requirements enforce and give effect to the law*. SOME OBSERVERS CLAIM THAT WHATEVER SUCCESS ASIC ACHIEVED WAS MOSTLY AT THE SMALL END OF TOWN AND NOT AT THE BIG END. ASIC REALISED THAT THEY FACED A BIGGER RISK FIGHTING BIG BUSINESS THAN SMALL BUSINESS. THEREFORE IT WAS RELUCTANT TO ACT AGAINST THE BIG PLAYERS WHO HAD LARGE RESOURCES TO DRAW ON TO FIGHT ASIC.
- *receive, process and store, efficiently and quickly, information that it is given, make information about companies and other bodies available to the public as soon as practicable*. PRACTICABLE FOR WHOM? CERTAINLY NOT INVESTORS IN FINCORP AND STREETWISE, A PROPERTY DEVELOPMENT AND INVESTMENT BUSINESS. ASIC INTERVENED IN FINCORP SIX TIMES ALLOWING IT TO RIP $200 MILLION OFF 7,800 MANY OF WHOM WERE ELDERLY INVESTORS. THE LAST INTERVENTION WAS INFLUENCED BY A CLEAN BILL OF HEALTH FROM THE AUDITOR. IN ACR'S CASE ASIC INTERCEDED SEVERAL TIMES OVER A PERIOD OF SEVEN YEARS.

  BY NOT SEIZING KOVELAN BANGARAU'S PASSPORT, THE PRINCIPAL OF STREETWISE, ASIC ALLOWED HIM TO FLEE AUSTRALIA THREE YEARS AFTER IT HAD RECEIVED WARNINGS. IT TOOK A DETERMINED INVESTOR TO FIND HIM LEADING TO HIS CAPTURE. FINCORP, WESTPOINT, STORM BRIDGECORP AND ACR ARE OTHER EXAPMPLES OF ASIC's RELUCTANCE TO DO ITS JOB .

The supervision of banks must not only focus on the loan portfolio but also the risk asset process and the operations that produce and administer loans. Had APRA or ASIC been doing its job competently and timely it would have detected these exposures and highlighted weaknesses in credit and administration.

ANZ, Merrill Lynch and Dresdner Bank were hardly 'fair and transparent' in their seizure of $1.3 billion worth of shares from 1200 Opes Prime clients who had pledged this security for loans following Opes Prime's collapse. There was little in APRA's or ASIC's supervisory approach that was 'forward looking.' There was nothing preventing them from mandating that all shares purchase loans in a publically listed company require documentation covering the ownership and liquidation of shares when a borrower defaults. The conditions of default should also have been clearly stated. Borrowers would have known what they were getting into and where they stood. Much of the confusion and legal wrangling that followed the sale of the shares by ANZ and other lenders may have been avoided.

There are several explanations for regulatory failure. Either the laws, rules, procedures or guidelines concerning regulation are inadequate or their enforcement is deficient; or perhaps both. It may be that regulators are not properly resourced, managed and motivated. If they had been there may have been fewer investment losses. It should be recognised and accepted that both ASIC and APRA must change the way they operate to avoid a recurrence of recent events.

Regulators must leave the comfort of their offices and enter the real world where things go wrong. They must become more proactive and less reactive, more aggressive and less passive. ASIC and APRA must define their turf and patrol it frequently. In this way, the likelihood of surprises occurring will be minimised. In our globalised world, regulators should be knowledgeable of overseas events and be prepared for its impact in Australia. Similar procedures that good banks use in managing their business portfolios should be adopted. This will necessitate a change in culture and leadership. Training in risk analysis is essential towards better regulatory performance.

ASIC's 31 July 2008 ASX assessment was that the ASX had adequate arrangements for supervising its market and managing conflicts under its markets licence. While this may be the case, many market observers do not agree that it has used its clout to effectively discipline companies that have 'overstepped the mark.' As a result there have been calls for the ASIC to assume ASX's watchdog role.

Licensing of the sale of investment and financial products and services
ASIC's licensing and monitoring of investment advisers has not made investment any safer for investors who lost billions in so-called safe investments. This does not mean regulation will or should remove all risk. Investments are risky because they involve a future financial return and no one knows what will happen in the future. This is the essence of risk. ASIC can improve the licensing of investment advisers through better evaluation criteria of adviser performance. This should be done in context of an annual review that includes the losses of recommended investments.

Consumer information, advice and education
The media is a significant provider of information and advice that is often slanted towards marketing and sale of investment products and services. Many business and finance reporters omit commenting on risks because they are ill equipped to inform their readership otherwise. They lack experience and expertise. Further education and training is needed to improve financial literacy and risk analysis skills. This will result in better informed readers.

In 2007, Glenn Stevens the Governor of the Reserve Bank of Australia acknowledged that there was a lack of information concerning the sale of 'opaque' financial products and investments. The information memorandum does not provide prospective investors with sufficient and necessary information to assess investment risks. It should cover the basic issues of what the business or scheme does or will do to generate income, details of its ownership and operation, why investment is needed, the specifics of where the investment dollars are going and how the business will provide investors with the promised return. Information on the principals and their managers should specify age, education, training, experience as well as their track record in running similar businesses or schemes.

The involvement of credit rating agencies in the global financial crisis and specifically in rating CDO's and other toxic assets has destroyed their credibility. To ASIC's credit it has undertaken to implement measures to ensure that ratings are professionally and competently performed. Nevertheless, investors should adopt a cautious approach regarding ratings, simply because not enough is known about how ratings are produced.

Investors can be and should be educated through training programs to improve their analysis, understanding and management of investment products and services and risk. Financial literacy is a must. Investors should also be trained in the investment process to improve the quality of their investments.

Commission arrangements relating to product sales and advice
All sales of investment products, loans and advice must be clearly disclosed and understood by the investor and/ or the borrower who will acknowledge his or her understanding by signing a copy of the product statement for the investment or letter of offer for the loan. This will include short selling, margin loans and debentures.

The adviser must keep a record of all sales of investment products and services in a ledger of transactions. The ledger and records will be audited by a licensed auditor. A copy of the audited transaction ledger will be sent to ASIC annually as part of its annual review. Advisers that recommended failed investments that reach a specified limit and may have their licenses revoked.

The sale of all investments should be subject to a refund from the investment entity within a stipulated period which should be clearly stated in the information memorandum and the sales or offer document (for loans). The investor will be required to return all moneys to the investment vehicle.

Professional indemnity insurance arrangements
The writer does not have any experience or knowledge in this area to provide any worthwhile comments.

Legislative/ regulatory change
Binding vote of shareholders and unit holders should be required for executive pay, bonuses and changes to executive pay. Bonuses should be apportioned in accordance with business profits and distributed on an instalment basis over a 2-3 year period approved by shareholders at the AGM. A policy should also be adopted that executive termination payments should be apportioned over a 2-3 year period.

Any changes in strategy or direction or departure from the prospectus or information memorandum concerning investments must be approved by shareholders and/ or unit holders.

Real estate investments or schemes must clearly state what activities the investment entity will be engaging and investing in -

real estate development and specify the kind of development e.g. residential, commercial, retail or industrial etc,
income (currently) earning real estate assets,
non-income earning assets
lending money
shares

Loans to subsidiaries, parent company, affiliates, related parties, individuals or to directors should be strictly prohibited unless it has been specifically stated in the prospectus or information memorandum.

A corporate chart or family tree must be included in the prospectus or information memorandum. It will show all the parties, entities and how they are related to each other and to the investment vehicle. It will be signed off and dated by an accountant. Changes in the corporate chart will be formally communicated to investors.

Banks should link executive pay to budgeted risk management performance targets.

The Board of directors of companies must approve the conditions and terms of payment to consultants, accountants and auditors.

Financial advisers will be required to attend a risk analysis and financial products seminar at least once every 3 years. This should be a condition of their adviser's license.

APRA and ASIC will formalise their mission, regulations, policies and procedures in a manual which will be approved by the Auditor General, the appropriate Minister(s) and Parliament. The manual will also detail the entities, markets and industries that are in their 'market' subject to their investigative, monitoring and annual review activities. The manual will also list and comment on entities, markets and industries that will not be investigated, monitored and reviewed.

APRA and ASIC will be required to keep a register of all investigation requests, submissions of investment information of entities. A file will be kept and maintained for the entity that receives regulatory action and on information that has been received.

The Auditor General will annually audit ASIC's and APRA's compliance to regulations, policies and procedures etc in the manual.

All staff will be expected to know the manual and comply with it.

Appropriate staff will be expected to attend seminars etc on risk analysis and management to maintain or improve their skill base.

The Australian Stock Exchange's role in regulating publicly listed companies should be terminated and transferred to ASIC on the grounds that there is a conflict of interest or a possible conflict of interest between it and the companies it is supposed to regulate.

APRA will audit the adequacy and compliance of the bank's credit policies and procedures.

APRA will conduct audits of the bank's risk assets, its risk asset process and its operations.

The bank's head of credit will have a direct report to the CEO and matrixed to the Board of directors.

Banks and other credit providers must have credit officers who have specific skills and training related to approve or recommend investment loans to individual investors and businesses and promoters of investment schemes.

Laws should be passed or amended to allow or facilitate legal action by creditors and shareholders.

Related party transactions should be broadened to take into account the transfer, sale etc of assets. Transactions that adversely affect the business investment vehicle or scheme should be reversed and those involved should be subject to criminal action and appropriate penalties. Examples are Allco and Fincorp.

Directors of all companies should be solely responsible for the payment of external accounting and auditor work and not management. The money must be dispensed from an account that is available only to directors.

Joe Nagy
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