

Chapter 3

The collapse of Storm Financial

Acknowledgement of effect on investors

3.1 The committee acknowledges the catastrophic effect that the collapse of Storm Financial has had on many investors, particularly those double-g geared clients who were not afforded an opportunity to respond to margin calls; fell into negative equity; and were sold out of their portfolios in late 2008, at or near the bottom of the market. These investors now face great challenges in meeting living expenses, repaying debts and, in some cases, keeping their homes.

3.2 Some media reporting and some submissions to the inquiry have suggested that Storm investors were generally caught up by the promise of high returns and were motivated by greed to enter into risky investment arrangements. However, the committee has received evidence from many clients that their key aim in investing through Storm was simply to generate an independent income during retirement. Indeed, it was one of Storm's marketing strategies to appeal to this aim:

Our aims were not to be rich but to be mostly independent in our older years and enjoy the company of our family.¹

... the plan was that we would do all this investment and be independent, never have to claim a pension off the government and be able to look after ourselves.²

Like the majority of victims caught in this financial disaster, we were made vulnerable by our desire to be independent in our retirement. Sadly, at our initial consultation in 1997, we had set a time line for our investment portfolio of seven to 10 years. If we had not been persuaded otherwise we would not be here today. However, once in the Cassimatis system it was very hard to get out again ...³

3.3 The committee has received in excess of 200 submissions (some on a confidential basis) from Storm investors. They are a variable group: some were nearing retirement; some are already retired and relatively elderly; some have young families to support well into the future. Many came from the same community or workplace, and many were referred to Storm by friends or family:

Storm asked people considering them to talk to others who were current clients. People like to share prosperity and they talked positively, even in glowing terms, about how they felt when they were securing their future. Now, after the fact, there are whole families who are caught up together.

1 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 48.

2 Ms Margaret McClean, *Official Committee Hansard*, Cairns, 1 September 2009, p. 89.

3 Mrs Jill Dixon, *Official Committee Hansard*, Townsville, 2 September, p. 54.

They have very few financial reserves that are not caught up in this to use to keep roofs over their heads. People feel morally devastated to have brought their beloved family and friends into such a terrible situation. This cross of financial loss is a big enough one to bear without additional concerns about having recommended it to others.⁴

3.4 Others were longstanding clients of financial advisers who joined Storm or whose previous firms were bought by Storm, particularly during recent years in the period when Storm was looking to launch an initial public offering (which ultimately did not go ahead). In these cases, clients migrated to Storm with their adviser, rather than actively seeking Storm out.

3.5 For many investors, the consequences of their involvement with Storm have been financially and emotionally devastating. Their losses have typically been magnified by the degree of leverage in which they were encouraged to engage. Some are now faced with trying to return to work at a time in their lives when it will not be easy for them to find work, or when doing so will be inconsistent with their current state of health.

3.6 The committee sincerely thanks those submitters and witnesses who have contributed to its deliberations and knowledge in relation to the collapse of Storm Financial.

Limitations of the committee's inquiry

3.7 The committee's understanding of Storm Financial's business model, the company's collapse and the subsequent impact on clients has been informed by a range of sources, including:

- submissions from affected clients, including from the Storm Investors Consumer Action Group (SICAG);
- submissions from financiers including the Commonwealth Bank of Australia (CBA), Macquarie Bank, Bank of Queensland, ANZ Bank and MLC/NAB;
- submissions from former staff of Storm and CBA;
- a submission by the regulator, the Australian Securities and Investments Commission;
- submissions by industry bodies and professionals;
- evidence taken at public hearings;
- media reporting; and

4 Mrs Kate Maccoll, *Official Committee Hansard*, Cairns, 1 September 2009, p. 86.

- other information in the public domain, including on relevant web sites.

3.8 The causes of the collapse of Storm Financial are complex and contested. The committee's sources disagree in many details, including the true nature of the relationship between Storm and the banks (particularly but not solely the Commonwealth Bank); the processes for filling out loan documentation; the obligation (if any) of the banks to contact customers directly regarding margin calls; key meetings and events between September 2008 and January 2009; and the sophistication and understanding of risk by clients who entered into double-gear investment strategies under Storm's advice.

3.9 In the following sections, the committee summarises the range of information that has been put before it and comes to a view on the key lessons to be learned out of this collapse.

3.10 At the outset, it is important to emphasise that the committee is not a judicial body and has no power to make judgements in relation to individual claims that have been brought to its attention. It has also not been possible for the committee to resolve all the contradictions in the evidence put before it.

3.11 The committee's overall role, having regard to what it has learnt through the examination of this corporate collapse and others, is to make any necessary recommendations for legislative change or regulatory improvement to help guard against, or mitigate the effects of, similar collapses in the future. The committee's deliberations on the need for regulatory or legislative change in Australia's financial products and services sector are discussed in further detail in Chapters 5 and 6 of this report. In Chapter 6, the committee sets out eleven recommendations for change.

The Storm Financial business model

3.12 Storm Financial had a total of around 14,000 clients, of whom approximately 3000 were leveraged investment clients. Typically these investors, who included retirees or people intending to retire in the near future, were encouraged to take out loans against the equity in their own homes in order to generate a lump sum to invest in the share market, via index funds (primarily Storm-badged Colonial First State managed funds and Storm-badged Challenger managed funds). Clients were generally then advised to take out margin loans to increase the size of their investment portfolio.⁵

3.13 Mr David McCulloch, long-time group accountant for Storm Financial, summarised the business model as follows:

... using debt, mortgaging the home, using margin lending and using only share market investments.⁶

5 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 25 February 2009, p. 183.

6 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 10.

3.14 All Storm advisers operated under direction from Storm's headquarters in Townsville. As Mr Gus Dalle Cort, director of Storm Financial (Nine) in Cairns, explained to the committee:

Everything was directed back to the one system at Storm, from the way we developed our statements of advice to the process of quoting to banks. Everything was sent back to Storm central and farmed out from there. Our planning was done back-office, but our input from talking to a client and certainly a lot of our file notes were all sent to the one point.⁷

3.15 This description was corroborated by Mr McCulloch:

No advisers were permitted to undertake their own financial planning modelling. Rather, their role was to explain the Storm financial planning model to clients who were interested and to ensure that clients who were not comfortable with this did not become a client. All modelling of plans were undertaken by Storm's compliance or cash flow modelling cell, headed up by Julie Cassimatis.⁸

3.16 Clients were charged an up-front fee of around seven per cent for the advice they were given by Storm. Before they became clients, they were required to participate in a number of 'education' sessions. The committee was told by Mr Gus Dalle Cort that it took on average 180 days to be accepted as a client:

We had a dozen staff in Cairns, including me. We met existing clients and new clients, and we had a process. We tracked everything at Storm, and the process for a client to do business with Storm Financial took, on average, 180 days.

...

... That process entitled the client to a number of sessions... This involved finding out not only their personal position but also their financial position and right through to having a number of banks quote on the business, whether it was margin lending or equity lending...

We as a business did not go out and invent any products. We went to the marketplace. We invested in a vehicle called 'index funds' ... We then asked, 'How does one make more money to expand on one's capital base?'⁹

3.17 Mr Dalle Cort explained the education sessions to the committee as follows:

We would show the clients the difference between shares, cash and property. We would show them volatility and educate them on how different markets react and give them a broad based information session—only an information session. No advice was given on these evenings, just pure information. Should clients decide to come back and have a chat to us,

7 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 4.

8 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 4.

9 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 2.

they did that on an individual basis and we would explore their individual circumstances after that.¹⁰

3.18 For those attendees who ultimately signed up to become Storm investment clients, margin loans were organised with a loan to value ratio (LVR) of around 80 per cent, with a buffer of 10 per cent. There were some variations in these figures, depending on the finance provider and individual contract, but as a generalisation Storm clients were put into margin loan facilities with more generous LVR and buffer provisions than was the industry standard.

3.19 Storm tendered out the client's requirements to a number of banks with which it did business and claims to have made a selection on the basis of service and conditions offered. Home lending was organised through a range of banks; margin loans were largely (although not exclusively) through either Colonial Geared Investments, which is wholly owned by the CBA, or through Macquarie Investment Lending.

3.20 From time to time, clients were encouraged to 'take the next step' and further increase the size of their portfolio, by applying for additional margin loans or increasing their existing margin loans. On occasions, additional borrowing was carried out on the basis of increased value in an underlying property. In the wake of Storm's collapse, use of the CBA's VAS system to revalue Storm client's houses has been a particularly contentious matter. This is discussed further below, starting at paragraph 3.66.

3.21 The completion of loan forms for Storm clients has emerged as a troublesome area. The committee has been told by many investors that they signed blank loan applications; that they discovered after the collapse that they had additional loans that they were not aware of taking out; and that copies of forms provided by the banks post-collapse show overstated income figures or asset values that led to grossly inaccurate portrayals of their capacity to repay the loans. This matter is also discussed further below, starting at paragraph 3.57.

3.22 In a rising market, leveraged investment strategies magnify financial gains. However, the converse is also true: in the case of a sudden market fall, losses will be magnified too. Unfortunately, as the market collapse of late 2008 unfolded, Storm's strategy ultimately proved catastrophic for many.

Events surrounding the collapse of Storm Financial

3.23 As the world's financial markets collapsed across 2008, the value of Storm clients' investment portfolios decreased. It is this decline in value and investor equity, compared with the static value of the loans held, that took the clients' accounts into margin call territory. In evidence to the committee, Mr McCulloch reflected that:

10 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 14.

In retrospect, the telling period for Storm clients appears to be around early October 2008...What appeared to be the strength in the Storm modelling now became its Achilles heel, that is, the margin call at 90 per cent ...Under normal margin lending arrangements, as existed with most or all other planners around the country, that is, 75 per cent to 80 per cent margin call ratios, at this time clients would have been margin called and at the very worst would have had about 20 per cent equity left in their portfolios—enough in most cases to clear home loan debts—but of course leaving Storm alone to account for lost values and client dissatisfaction.¹¹

3.24 There is substantial dispute about what in fact happened to Storm and to the accounts of Storm clients during the closing months of 2008. The following claims, some of which are inconsistent with each other, have all been made in the voluminous evidence put to the committee:

- Many Storm investors should have received a margin call or calls but were not notified of any such call, either by their adviser or by the relevant bank.
- Some Storm clients do recall being contacted by their bank(s) but instructed the banks to deal through their adviser.
- Many clients would have been able to rectify their position if given a chance to act on margin calls at an appropriate time. Instead, many found out in December that they had moved into negative equity and that their portfolios had been sold down at some time during October and November, without their knowledge and at or near the bottom of the market, thereby crystallising and maximising their losses. Clients remain unclear as to who sold their portfolios and at whose direction.
- Storm staff claim that the information they were receiving from banks during these critical weeks and months was inaccurate and out of date and that there was no way for them to check whether client accounts were in margin call.
- Bank staff (from more than one bank) claim that their efforts to work with Storm to resolve accounts in margin call were not successful and that requests were not being dealt with in a timely fashion. They also note that they used the same approach to margin call management with all the advisory groups they deal with, yet Storm Financial clients are the only group who *en masse* failed to be appropriately notified by their advisers of the true status of their accounts.
- The banks claim that their responsibility in the event of a margin call is to inform the intermediary, the financial adviser, whose responsibility it is to then work with the client to determine how to resolve the margin call within the required time frame.

11 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 7.

- Storm staff contest this by claiming that, based on the management of margin calls that occurred in 2002, it was their understanding that the banks were responsible for informing clients directly.
- Many clients question why, if the banks were not getting satisfactory responses from Storm in relation to margin calls, they did not make more substantial and effective efforts to contact clients directly.

3.25 There are also differing accounts of some key events occurring at the executive and regulatory levels during this period, particularly:

- a meeting between Mr Emmanuel Cassimatis and senior Commonwealth Bank staff in early December, at which Mr Cassimatis attempted to make an arrangement to consolidate client debts into a large corporate debt facility; and
- a December attempt by ASIC to get Storm to agree to an Enforceable Undertaking (EU). Although all parties now agree that this EU was never signed, at critical periods during December and January clients were refused advice when they tried to find out the current status of their portfolios and were led to understand this to be due to an ASIC gag order.

3.26 According to Mr McCulloch, at the meeting with CBA staff Mr Cassimatis offered to transfer the client debt and take it on as a corporate debt, to be repaid over a three to four year period:

The choice for the bank was to seek money from the clients. The debt was already out there. Instead of the debt being owed to 400 people, Storm undertook to have the debt owed to itself. It would be Storm that would take on the commercial risk of that \$40 million or whatever the magic figure was. But Colonial was more worried about the margin lending negative equity than anything else. They were not worried about the home loans that were associated with it. They just wanted their money back for the negative equity.¹²

3.27 The CBA characterised the meeting in the following terms:

As best we understand it, the intention was that money would be borrowed by Storm from the Commonwealth Bank to meet the margin calls of its clients.¹³

The arrangement that was being proposed, as we understand, was that the bank lend further money to Storm and Storm in some fashion—frankly, this proposal did not go far, for fairly obvious reasons—would fund customers to meet their margin calls. I know some importance has been attached to this by various witnesses, but it was actually against the interests of the Commonwealth Bank and it was against the interests of our shareholders. In

12 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 25.

13 Mr Ian Narev, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 92.

fact, the liquidator of Storm has reported that Storm was insolvent in early December; [meaning] a further loan to Storm in those circumstances had all sorts of legal and insolvency implications.¹⁴

3.28 In discussing the proposed EU, Mr Dalle Cort clarified for the committee that the instruction not to talk with clients in the closing days of 2008 came not from ASIC but from Storm's directors:

...by the directors Julie and Emmanuel Cassimatis. We were instructed by them not to talk to our clients.¹⁵

3.29 Furthermore, Mr Dalle Cort acknowledged that the EU that ASIC presented to Storm was not agreed to: 'It was never signed'.¹⁶

3.30 Of note, Mr Emmanuel Cassimatis, founder and former CEO of Storm, believes the collapse of the company was due to the actions of the CBA:

... despite the large amount of conjecture around the issue, the reason Storm collapsed, when you boil it down, was that the Commonwealth Bank—the major supplier of credit to Storm and its customers—withdrawed the credit suddenly, without notice and, most importantly, without justification or indeed without the power to do so under the margin lending contracts.

Despite the fact that the CBA caused a great deal of damage, it exercised its power simply because it could and chose to wreck rather than support Storm and our mutual clients as it had done in the past. The decision by Mr Norris and his colleagues at the Commonwealth Bank of Australia to withdraw credit was made with full knowledge of the devastating consequences such an action would cause. Without this action, the margin lender customers would undoubtedly have suffered some losses, but they would have retained at least some of their assets and would not be in the devastated financial condition that most are in today.¹⁷

3.31 There were several more events of note leading up to the collapse, including:

- A \$2 million dividend paid to founders Emmanuel and Julie Cassimatis in December 2008 was successfully frozen in February 2009, following ASIC-initiated court action. This freeze was later extended by further court action by Storm's liquidators.¹⁸

14 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 93.

15 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 12.

16 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 12.

17 Mr Emmanuel Cassimatis, *Official Committee Hansard*, Brisbane, 3 September 2009, p. 3.

18 See <http://www.theaustralian.news.com.au/business/story/0,,25307584-17044,00.html>; accessed on 30 October 2009.

- Attempted court action by Storm against the CBA was interrupted when Storm went into administration on 9 January 2009.¹⁹

3.32 Liquidators were appointed to Storm in March 2009.

Issues of concern

One-size-fits-all advice

3.33 The overwhelming characterisation of Storm's operations is that the majority of Storm clients were given the same, or substantially similar, financial advice:

The big issue would appear to be that Storm was giving the same advice, irrespective of the client circumstances. It was often margin loans which possibly exceeded their capacity to pay or even their need for the underlying investment. It would appear Storm were doing a one-size-fits-all approach to advice. Everyone was doing the same, getting the same advice and clearly, whilst they might have been doing the right thing around disclosure and so on, that is not in line with section 945A of the Corporations Act where there has to be a sound basis for the advice.²⁰

3.34 The committee's impression that Storm's investment clients were all given the same or substantially similar advice was confirmed in an exchange between the committee chairman and the former CEO of Storm Financial:

CHAIRMAN—It appears that everybody got the same advice and, in the end, everyone was put into a particular fund, used a particular type of leverage and used a particular number of lending institutions. They all seemed to be using the same model. As you describe it, it all seemed to be very much like a factory but everyone had the same outcome in the end.

Mr Cassimatis—Yes, it was a unique offering—like a motor car. There was one particular model of vehicle ... Those who wanted that could buy it ...²¹

3.35 Mr Graham Anderson told the committee that he had become aware that many of the Statements of Advice issued by Storm advisers contained clauses in common, regardless of whom the advice was being issued to:

My understanding of financial advice is that it is independent and it is suited to my needs. Since I have been involved with the committee of SICAG, I have found out that this is not the case and that two clauses appear on every statement of advice. They basically say:

19 See <http://www.abc.net.au/news/stories/2009/01/08/2461406.htm> ; accessed on 30 October 2009.

20 Mr Michael Davison, CPA Australia Ltd, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 62.

21 *Official Committee Hansard*, Brisbane, 3 September 2009, pp. 5 – 6.

We have identified that your current asset base is not large enough to fund the lifestyle that you desire now, or in the future. You have sought our advice on ways to expand your income streams so that you can become more financially independent from work and have lifestyle choices in the future. To improve the provision of capital growth and income for the future, the size of your asset base should be increased.

Attempting to purchase assets solely by using your surplus income would result in a relatively small change in the size of your assets base; hence there would be an excessive delay before your investment delivered a substantial change to your income or delivered significant growth.

We recommend that you mobilise your existing assets to produce an increase in the size of your asset base. This could be achieved effectively by purchasing liability and offering your existing assets as security for the loans. The liability would in turn be used to purchase high quality assets to provide capital growth. This capital growth will be converted to income streams over time. In doing so, you would be effectively purchasing the capital base that you require for real wealth creation.

Care must be taken that these liabilities are kept at levels that are safe and that the servicing of the liabilities is easily manageable, and both of these aspects have been of paramount importance in the construction of these recommendations.

To me, if that is on everybody's statement of advice, I have a problem with that.

...

... the fact that everybody got the same advice shows the cookie cutter mentality. That annoys me, and the fact that the financial adviser is basically being controlled by the directors of Storm. I find that a bit of a conflict as well.²²

Committee view

3.36 The committee cannot reconcile the practice of financial advisers giving all their clients the same advice, regardless of their life stage and circumstances, with the existing section 945A obligation to give advice that is appropriate to individual personal circumstances. In particular, the committee is not persuaded by Mr Cassimatis's explanation that Storm clients 'self-selected' after being told what the investment model was.

3.37 The committee is firmly of the opinion that, for at least a subset of Storm's investment clients—namely, clients on average incomes at or near the end of their working lives—the advice to engage in an aggressive leveraged investment strategy was clearly inappropriate.

Insufficient client understanding of product, risk and protection

3.38 Some of Storm's clients did not understand, or fully understand, that by borrowing against the equity they had in their family home they were, effectively, putting their ownership of that home at risk.

3.39 The committee has been told that Storm advisers strongly downplayed the risk of losing the family home:

22 Mr Graham Anderson, *Official Committee Hansard*, Brisbane 3 September 2009, p. 71.

We were told that the risk was minimal and that the world would have to fall in before that happened, which it obviously did. But, yes, we were told that there was a minimal risk.²³

... we were told that we could not lose our home—²⁴

Storm Financial advisers had always told us that our home and investments would be safe, and we felt secure in that from day one. That stemmed from the fact that our adviser had worked with us prior to him coming to Storm. So we had a system there with him already before he went to Storm. Storm Financial advisers always told us that our home and investments would be safe. It did not happen that way.²⁵

We were advised that, having paid off our house, we had a certain amount a month that we could use for investing. They called it getting equity out of our home, which at the time we did not realise meant that it was another mortgage.²⁶

3.40 Some investors have acknowledged that they signed authority for Storm to manage their accounts in the event of a margin call, on the understanding that the following would take place:

If we were to receive a margin call, we were told that some of our portfolio would be sold down to cover the margin call and that everything would be taken care of.²⁷

3.41 Some investors report being reassured by the fact that Storm held a professional indemnity insurance policy:

This was our first venture into investing in the stock market and it was all new to us but Mr. Dalle Cort advised us that we were in safe hands and that even if the market went "egg shaped", there was a Storm indemnity insurance policy that would ensure that our original investment would be covered.²⁸

... at the seminars ... Emmanuel Cassimatis would say, 'You are perfectly safe with us. If we were to give you the wrong advice you could sue us, because we have insurance to cover that.' Those were not his exact words, but it was something like that.²⁹

3.42 There has also been some acknowledgement by some that they did not truly understand the investment strategy they were buying into:

23 Mr Quentin Bates, *Official Committee Hansard*, Cairns, 1 September 2009, p37.

24 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 60.

25 Mr Jack Dale, *Official Committee Hansard*, Cairns, 1 September 2009, p. 63.

26 Mrs Jill Dixon, *Official Committee Hansard*, Townsville, 2 September 2009, p. 54.

27 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 51.

28 Jack and Frances Dale, *Submission 121*, p. 1.

29 Mrs Jill Dixon, *Official Committee Hansard*, Townsville, 2 September 2009, p. 55.

We trusted our adviser and we thought his advice was well founded ... We thought we understood. This was the problem. A lot of the clients thought they understood and signed off on that.³⁰

Unless you were a financial expert, I do not think anybody completely understood the model. I think it was ... too complicated and far too difficult. It all looked simple. When they tried to break it down or seemed to be breaking it down for people, you thought you understood. But when you look back at it, you did not understand at all.³¹

Committee view

3.43 The limited understanding that some Storm clients had of their financial arrangements is of concern to the committee. The committee acknowledges that some of these clients admit they did not have a strong understanding of the leverage and margin loan arrangements that they signed up to. Indeed, some explained that it was out of awareness of their limited knowledge that they sought the guidance of, and acted on the recommendations of, professional financial advisers.

3.44 Accordingly, there is a multifaceted problem to solve here:

- There is a need to improve the standard of advice offered to consumers, whether that be through enhanced legislative requirements about the standard of advice required or enhanced enforcement of existing standards, or both, so that consumers can be confident about the advice received.
- There is a need to better inform consumers about the products signed up for, so that consumers can take a higher degree of responsibility for financial decisions and only buy products that entail a comfortable level of risk.
- There is a need to ensure that advisers are better informed about the products being sold.

3.45 The committee addresses these matters in a broader context in Chapters 5 and 6 of this report.

The nature of the relationships between Storm and the lenders

3.46 The committee was told by several banks that Storm had firm ideas about how it wanted the relationship to proceed:

We found that the approach Storm wanted to adopt with the bank was that they effectively were the central manager of the client relationship. They requested the bank to respond to their requests for loan approvals or renewals and for the bank to take Storm's advice directly around 100 point checks and so on, which are part of our normal procedures, and that they

30 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 58.

31 Ms Margaret McClean, *Official Committee Hansard*, Cairns, 1 September 2009, p. 91.

would manage the customer interaction. The bank has a procedure where we will not do that. Our approach is that we have to contact our customers direct ... We ... have to have direct contact with the clients.

... We were also not prepared to act on Storm's instructions around rollovers or account maintenance ... Having had a meeting with them, having gone through this, the bank declined to have a formal relationship with Storm and Storm said that they would not deal with ANZ.³²

3.47 Notwithstanding comments from the Commonwealth Bank about the routine nature of its arm's length business relationship with Storm Financial, this is not necessarily how the relationship was seen by—or portrayed to—Storm's investment clients.³³ According to SICAG:

Evidence before this committee shows patently that the Commonwealth Bank had what can only be described as an umbilical connection with Storm Financial, one that has endured for many years. A key factor in the decision by the majority of our members to engage in the Storm strategy was the strength of the Storm connection with the Commonwealth Bank and its funds management division, Colonial First State.³⁴

3.48 The CBA did not see the relationship in the same light. According to senior executives of the bank:

It was not a relationship that ran to the highest levels of CBA. It was an association whereby Storm did refer customers to the CBA ... The relationship was no more than a referral of business to us, and we in turn serviced the business.³⁵

3.49 Mr Ralph Norris, CEO of the CBA, put the relationship with Storm in the context of the bank's overall business:

My view is that this was not a tight relationship. From the organisation's perspective—from my perspective, from the board of the bank's perspective—we are talking about an organisation where the revenue from Storm itself was less than \$10 million per annum and, when we look at that in the context of around \$14 billion of revenue per annum, this was relatively, in relation to the overall bank operations, quite small.³⁶

3.50 The CBA does acknowledge, however, that there may have been a strong relationship at a local level:

32 Mr Graham Hodges, ANZ, *Official Committee Hansard*, Melbourne, 26 August 2009, pp. 43 – 44.

33 Mr Matthew Comyn, CBA, *Committee Hansard*, Sydney, 4 September 2009, p. 62.

34 SICAG, *Official Committee Hansard*, Brisbane, 3 September 2009, pp. 69 – 70.

35 Mr Matthew Comyn, CBA, *Committee Hansard*, Sydney, 4 September 2009, p. 62.

36 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 27.

Although the intent was genuinely to assist customers, the local relationship with Storm was sometimes too close, and on occasion we lost objectivity.³⁷

3.51 Other banks may also have had close relationships with Storm at a local level. For instance, the majority of Bank of Queensland home equity loans for Storm clients originated through the North Ward branch.³⁸ Furthermore, BOQ admits that in approving at least some of these loans, officers failed to check financial information directly with the client and instead relied on information provided through a third party, that being the Storm financial adviser. This approach was outside BOQ's lending policy.³⁹

Committee view

3.52 The committee is concerned that close relationships and integrated systems, at least at the branch level, and perhaps in combination with bank sales and lending targets discussed at paragraph 3.54, may have caused some bank staff to lose sight of who their true customer was and to fail in their obligations under the Code of Banking Practice to exercise prudence and diligence in their lending decisions.

3.53 The committee therefore welcomes the acknowledgement by several banks that compliance with lending policy needs to be improved. The committee also welcomes the expected imposition of responsible lending provisions on credit providers under National Consumer Credit Protection Bill 2009.

Increases in bank sales and lending targets

3.54 The committee received suggestions that increases in sales and lending targets affected bank behaviour. Mrs Carmela Richards, who worked for the CBA for 20 years until she left to work with Storm in January 2000, commented:

I started with the CBA when I was 15 years old and I never thought I would work anywhere else, but the bank changed dramatically in my last five years or so and there was an extreme sales culture that left little time for client service, which was a major deciding factor in my decision to resign.⁴⁰

3.55 Mrs Richards and Mrs Devney told the committee that increased targets caused many staff to leave the bank and that there had been a change from a service culture to a sales culture:

37 CBA, *Submission 357*, p. 1.

38 *Official Committee Hansard*, Canberra, 16 September 2009, pp. 32 – 33.

39 *Official Committee Hansard*, Canberra, 16 September 2009, pp. 33 – 34.

40 Mrs Carmela Richards, *Official Committee Hansard*, Townsville, 2 September 2009, p. 27.

...people left the bank because they were not happy with having to have those sales targets and those pressures put on. A lot of people believed that service would bring referrals, and I believe that is the case as well.⁴¹

3.56 When it was suggested to Mr Ralph Norris, CEO of the CBA, that increased sales targets in the Townsville region may have skewed the behaviour of CBA staff and caused a rapid growth in the relationship with Storm, he defended the CBA's sales and service program:

The selling process and the sales and service program that we have in the Commonwealth Bank is based around what is called a needs analysis process, which is identifying the needs of a customer and providing products that meet those needs.

...

... from my perspective, I think that our sales and service program has actually done a lot for our customers and certainly improved our relationships. I think it is also important to note that we run a balanced scorecard—it is not all about sales; it is about making sure that risk factors are looked at; and it is about making sure that our people surveys are of a high level from the point of view of engagement.⁴²

Inaccurate figures on loan applications, leading to inappropriate lending

3.57 The committee received considerable conflicted evidence about who filled out loan documents on behalf of clients. The committee received many written submissions from individuals stating that they signed blank forms, discovered post collapse that they had loans they did not even know about, or belatedly discovered that information on loan documents—particularly relating to income and assets—was inaccurate:

It was either Storm or the banks were putting their own figures on the forms. We obviously signed the loan applications to get the loans, but—

...

We signed the forms at Storm Financial.

...

They were blank.⁴³

3.58 Mr Dalle Cort of Storm (Nine) in Cairns told the committee that the documents were filled out by the banks:

Loan documents were done by the banks, not by Storm ... They were bank documents ... If they came from the bank, they were all filled out and they

41 Mrs Kristy Devney, *Official Committee Hansard*, Townsville, 2 September 2009, p. 35.

42 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 36.

43 Mr Quentin Bates, *Official Committee Hansard*, Cairns, 1 September 2009, pp. 38 – 39.

just needed a signature from the client. So they were all filled out by the banks.⁴⁴

3.59 Mrs Carmela Richards, speaking in her capacity as a former CBA employee, confirmed that bank staff completed these forms but denied that they lied about critical figures:

The staff did not lie about income or assets. Anything that was told to the bank was advised to us by the clients and with appropriate supporting data provided to back this up.⁴⁵

3.60 The forms were apparently *not* filled out by staff at Storm headquarters in Townsville:

We did not complete bank applications. We would send our own form of advice listing the client's position. As far as I remember, all of the banks—and we have had discussions with them on many occasions over the years—were adamant that their credit policy was that they had to confirm with the client, and that was perfectly acceptable. We understood they would either do a face-to-face interview depending on the bank or they would do it over the phone ... There was feedback to suggest that was occurring so I am a little bit surprised to hear that it maybe was not.⁴⁶

3.61 Many investors question why the banks did not take greater responsibility for ensuring a borrower's ability to repay their loans:

I do believe that the banks have some responsibility in our demise, as not once did Colonial meet with us or interview us regarding our loans or how we intended—at our age—to repay approximately \$1.6 million. If things went bad, as they did, we were as we are. Not once did they contact us regarding a margin call, and we were given no opportunity or say in the matter. The first contact we had with Colonial was on 8 December, and by that time everything had been sold down. That, consequently, left us with nothing.⁴⁷

3.62 Several banks have explained to the committee that, for margin loans, standard industry practice is to simply use the value of financial assets such as shares, cash or managed funds to secure the loan.⁴⁸

Committee view

3.63 The committee is concerned by the bulk of evidence received that suggests there may be a gap between bank policy and practice regarding the approval of loan

44 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 25.

45 Mrs Carmela Richards, *Official Committee Hansard*, Townsville, 2 September 2009, p. 27.

46 Mrs Carmela Richards, *Official Committee Hansard*, Townsville, 2 September 2009, p. 30.

47 Mr Quentin Bates, *Official Committee Hansard*, Cairns, 1 September 2009, p. 35.

48 See, for example, Macquarie Group Limited, *Submission 396*, pp. 13 – 14.

applications. The evidence that the committee received from Storm and bank staff about approval processes did not match up with the evidence the committee received from investors about inaccurate and misleading data on their loan forms. The committee has some doubt about the degree to which banks were acting ethically, appropriately, morally and prudently in their decisions to grant loans to some Storm customers.

3.64 The committee is also concerned by the number of people who indicated that they signed blank forms or documents that they had not read. The committee reminds consumers that their ability to protect themselves from poor decisions or poor advice will be increased by them exercising greater caution and diligence before agreeing to sign any documents.

3.65 The committee notes the expected passage through parliament of the National Consumer Credit Protection Bill 2009. This imposes responsible lending conduct provisions on lenders, who for the first time will have a legislative obligation to ensure that loans are not unsuitable for clients. This will provide a new layer of protection for clients entering into the full range of lending arrangements with banks and other credit providers.

Misuse of valuation assessment system (VAS)

3.66 The committee has heard some suggestions that local CBA staff sought additional business by proactively and inappropriately using their desktop computer home valuation assessment system (VAS) to revalue Storm client's houses, thereby making them eligible to borrow more against the new, higher value.

3.67 CBA executives contested this suggestion:

Effectively, Storm was selecting customers who were Commonwealth Bank loan customers. They would approach the bank under the pretext of their customer wanting to take out additional borrowing against their home. They were not solicited or sourced by the bank ... we were told the customers were supplying their owners' equity—the value that they put on their own home—and VAS was used to decide whether a valuation was required to verify that valuation. The only spreadsheets that I have seen are spreadsheets that came in from Storm, where we used the VAS system to identify whether an external valuation was required. The results of those were then sent back to Storm.⁴⁹

3.68 The CBA has, however, admitted that its staff did not always use VAS appropriately:

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

49 Mr Matthew Comyn, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 29.

VAS was misused on occasion by some staff with the effect that loans against some properties were larger than they would otherwise have been.⁵⁰

3.69 This was disputed by Mr Andrew Jackson, a former CBA employee:

I would argue that the staff working in the team did not use VAS in any way that is not standard practice by almost every lender in Australia ...there is no override button. If there was a problem with how they were using VAS then this would have been an issue for every lender in Australia.⁵¹

Poor management of margin calls by multiple parties

3.70 That breakdowns in handling and resolving margin calls during September – December 2008 had a catastrophic effect for many of Storm's investment clients is not in dispute. What is in dispute is who is responsible for this failure.

3.71 Many investors have expressed understandable frustration to the committee that delays in Storm receiving or acting on margin calls led to them being in a much worse position than would otherwise have been the case:

If we had been sold down early enough then there would have been enough cash in that accelerator cash account to cover the margin loan and there would have been enough money for us to live on—to pay our bills and petrol; the lot—while the market was doing its thing.⁵²

3.72 Mr David McCulloch told the committee:

Advisers were specifically told not to contact the margin lenders, leave it to Storm Central, as Colonial Margin Lending and Storm Central preferred one point of contact as resources were thinly stretched.

We now know the share market had temporarily recovered by around 15 per cent in late October to early November, and if ever the margin lenders were going to act now was the time. The fact they did not—and with assurances from the principals they were working closely with the lenders—gave assurances in the advisers' day-to-day client dealings. The rest, sadly for all concerned, is history. I have met many ex-clients who are now emotionally and financially destroyed. My personal situation is no different from many clients.⁵³

3.73 According to evidence from Storm staff, Storm directors Emmanuel and Julie Cassimatis strongly believed that Storm's investment model should have been able to ride out the crisis, if margin calls and buffers had been triggered appropriately. Mr David McCulloch explained to the committee that:

50 CBA, *Submission 357*, p. 2.

51 Mr Andrew Jackson, *Official Committee Hansard*, Townsville, 2 September 2009, p. 30

52 Mr Jack Dale, *Official Committee Hansard*, Cairns, 1 September 2009, p. 75.

53 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 8.

... the advisory team at Storm received many assurances from the senior executive that, whilst these were worrying times, the Storm model had stood up in previous testing times, the banks knew this, and clients who remained steadfast came through the process in a stronger position ...

We were constantly assured during the falls of early to mid-2008 that the business's cash buffers and reserves in place would be tested and used up to support clients approaching danger levels or needing living allowance support from Storm. Whilst downward share market pressure existed from December 2007, this was explained to advisers as normal share market volatility. In any event, should downwards share market pressure persist, we were informed, and advised clients accordingly during 2008, that there were a number of levels of comfort available to Storm clients. These were pretty generous buffers to margin call, 90 per cent as agreed with Colonial Margin Lending, and 85 per cent with Macquarie Bank. If someone was sitting at 60 per cent in early 2008—and I believe most were; and that is after the market had already fallen 15 per cent—they still had protection against a further market fall of around 35 per cent before a margin call would occur. At this time no-one was predicting a fall of this magnitude. Even if they did, along the way, client cash reserves could be used to support the portfolio. Failing this, we were advised that some of the portfolio could be converted to cash temporarily, with an undertaking by Storm to support clients re-entering the market by providing its own funds as supplementary margin loan security once a recovery appeared underway. After all, this is exactly what happened for some clients in the 2002-03 downturn and it worked well.⁵⁴

3.74 Mr Dalle Cort is of the clear view that the difficulties experienced by Storm clients resulted from a failure of the banks to advise Storm of margin calls in an appropriate and timely fashion:

Storm Financial would still be in business today had our clients actually got a margin call.⁵⁵

3.75 When asked what he was doing to monitor the falling market and whether he was asking the banks appropriate questions about customer accounts during the period in question, Mr Dalle Cort told the committee that the banks were not able to provide accurate information about account status during this critical period:

... when one gets a margin call one should be informed. But it was impossible for one to be informed when at that point in time—in this case for over a month—the data being received directly from the banks, being Macquarie and Colonial Geared Investments, simply did not show that.

...

... the data coming through from the banks was bizarre. It certainly was not showing what was real.⁵⁶

54 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, pp. 6 – 7.

55 Mr Gus Dalle Cort, *Submission 153*, p. 14.

3.76 Mrs Carmela Richards, compliance manager for Storm, explained to the committee how Storm generally managed margin calls:

We did not have a written process for what we would do, but the process was that, if we were advised that a client was in margin call, we would have a look at it in the compliance area from the information that we had on the file already to see what we could do to fix it quickly and easily. As well as that, we would let the adviser know and ask the adviser to talk to the clients about it and see if they had any resources or anything they could do to fix it as well. That was the general process. However, somewhere in the middle of October we had 600 clients theoretically go into margin call. If you looked at the Colonial Geared Investments website for any period after that for a number of weeks there were 600 clients in margin call, but that information was not correct. Colonial themselves, as far as I recall, did not give me any information on clients that were in margin call for that period for a good three weeks. Were we issued with margin calls? Yes, generally we were advised. Was it reliable to look at their website and understand who was in margin call and who was not in that period? No, it was not. Was Colonial actively following up on the margin calls during that period? No, they were not ... The normal process is easy. You let us know, we will deal with it, we will let the client know, we will have the adviser talk to them and we will give some advice about how to fix it and we will put it in writing once that advice is formalised ... But it was not normal in October.⁵⁷

3.77 Mr Cassimatis claims there was a deliberate strategy by the CBA not to issue margin calls to Storm:

Despite the multiplier effects of [the global financial] crisis, the directors of Storm firmly believe that its risk management strategies would have ensured that the company and clients would still have been standing, albeit somewhat battered and bruised, had the CBA issued its borrowers the margin calls as it had always done in the past. For some reason unknown to us, this protocol had been switched off. We know that each day the CBA system produces letters to be sent to customers. These letters were the bank's notices of margin calls. We know that someone decided not to send these letters.

... CBA's data feeds to Storm, and hence its website on which the customers and Storm were supposed to be able to check their positions, were deeply and hopelessly flawed.⁵⁸

3.78 There seems to have been an unacceptable degree of confusion and abdication of responsibility in relation to communicating margin calls to clients. Mr McCulloch put this responsibility firmly with the banks:

56 Mr Gus Dalle Cort, *Official Committee Hansard*, Cairns, 1 September 2009, p. 5.

57 Mrs Carmela Richards, *Official Committee Hansard*, Cairns, 1 September 2009, p. 43.

58 Mr Emmanuel Cassimatis, *Official Committee Hansard*, Brisbane, 3 September 2009, p. 3.

From my experience, the margin lenders always made margin calls to clients ...⁵⁹

3.79 Mrs Carmela Richards echoed this understanding of the situation:

Colonial Margin Lending has stated that it was Storm's responsibility, not theirs, to action margin calls. The last time Storm had to deal with margin calls was in 2003 and then only a relatively small number. The bank's procedure at that time was to issue a margin call in writing to the clients and to advise Storm as well. If the procedure had changed so much, someone should have let us know what our perceived obligations were and provided training on how to deal with them to ensure that both of us were on the same page. I find it incredible that when the risk was so much with the bank, when they were the ones that stood to lose if not managed correctly, they would release so much control and responsibility without being sure that each party clearly understood/agreed their role and had the systems and training in place to deal with it.⁶⁰

3.80 In their joint submission to the committee, Storm staff members Mrs Richards and Mrs Devney state:

The Commonwealth Bank has stated that Storm was adamant that as the customer's financial adviser it was its responsibility, not theirs, to action margin calls. This is not true.

...

Whilst Storm has always been happy to assist clients in Colonial with the margin call process, we understood the bank had their own processes for advising clients of margin calls.⁶¹

3.81 But the evidence of these Storm staff is contradicted by the statement of another staff member, Mr John Fuller, who clearly states his understanding that the margin calls would come to Storm, not to the clients:

I was educated from the outset within Storm Financial that no client would ever receive a margin call direct from their margin lender. If maximum LVR's were breached or threatened, the margin lender would direct the call through Storm Financial and the problem would be dealt with by both bank and advisory body according to client position.⁶²

3.82 In response to these contradictory claims, the Commonwealth Bank acknowledges a change in process since 2002-03 regarding the management of margin calls:

59 Mr David McCulloch, *Official Committee Hansard*, Townsville, 2 September 2009, p. 11.

60 Mrs Carmela Richards, *Official Committee Hansard*, Townsville, 2 September 2009, p. 28.

61 Mrs Carmela Richards and Ms Kristy Devney, *Submission 386*, p.6.

62 Mr John Fuller, *Submission 281*, p. 2.

In 2002 and 2003, the process for margin calls was that the dealer—the adviser—would actually notify the client and that would be followed up by letter from Colonial Geared Investments, which would typically arrive four or five days later.⁶³

3.83 In contrast, the situation in 2008 was described as follows:

Our practise undoubtedly in the business at the time, with 7,000 dealers, was to make margin calls through the dealers. I can say that, in the October 2008 to December 2008 period, 15,000 margin calls were made to customers outside Storm from the Colonial Geared Investments business. To the best of my knowledge, having made inquiries of my team, every one of those was made through a dealer. So our understanding was certainly that the margin calls for Storm customers would be made through Storm, as the financial adviser, and three files a day of information were provided to Storm to this end.⁶⁴

3.84 The CBA contends that this is standard industry practice:

... the industry practice in this type of business was for the conduct of margin calls to be made firstly to the dealer group and then the dealer group of the financial adviser would in turn contact the customer. That was a process that was industry wide. It was a process that operated throughout the 7,000 dealers that CGI had a business with.⁶⁵

3.85 Somewhat to the dissatisfaction of the committee, the CBA was not able to confirm at what point between 2002-03 and 2008 CGI ceased sending written notification of margin calls to clients:

I know this will not be a satisfying answer, but we cannot point to the exact time the policy was changed. What we can say is that to our knowledge it was significantly in advance of the events of 2008 and certainly not at all related to the events of 2008.⁶⁶

3.86 The CBA's evidence conflicts with Mr Cassimatis's claim that no margin calls were being received:

During October we received over \$600 million worth, effectively, of action in response to margin calls from Storm. It was very, very clear that Storm was acting on margin calls. Storm was passing on margin calls to customers because that was the way the industry was operating and that was the way Storm had operated with us.⁶⁷

63 Mr Ian Narev, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 65.

64 Mr Ian Narev, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 65.

65 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 75.

66 Mr Ian Narev, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 33.

67 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 75.

3.87 Later in their evidence, the CBA directly countered Mr Cassimatis's position that he thought, as in 2003, the bank would contact the customer directly in relation to margin calls:

... we simply cannot agree with that characterisation. We have documents from Storm that make it very clear that Storm was acting on margin calls by passing on the margin calls that CGI was making to Storm ...

Storm was highly active in responding to margin calls ...

... It was very clear to us that Storm was active processing calls. There was no silence from Storm; there was action on Storm's part. However, what concerned us was that the speed of response and the action taken in response to margin calls declined significantly through November. It was at that point that we decided that we had to take direct action.⁶⁸

3.88 The CBA insisted that Storm was well aware of its current policy in relation to the handling of margin calls:

I accept that there is contradictory evidence. What I can say is that, based on my own review of discussions internally et cetera, I would be very surprised if, going into 2008, Storm could have been under the impression that Colonial Geared Investments' practice was to contact clients directly. Also, it would have been the only one of 7,000 dealers that we had that policy with. I think that, as you have heard from Macquarie, they had the same policy. I would find it very difficult to understand ... that there was any misapprehension about that at the time we are talking about.⁶⁹

3.89 As further clarified by Mr Cohen:

There were occasions—not many, admittedly—prior to 2008 when Storm did respond to margin calls using this model, so I do not think there could have been any doubt on Storm's part given that they had responded in this fashion previously.⁷⁰

3.90 Macquarie Bank, another major provider of margin loans to Storm investment clients, similarly told the committee:

... our approach to margin calls was to notify the intermediary ... We did this across our entire loan book. In addition, we provided both clients and the intermediaries, including Storm, with access to a secure Macquarie website which was updated daily with all relevant loan information including the current LVR and whether the loan was in margin call. So every client had the opportunity to access their own website with up-to-date daily information on their investments and their margin loans.

During October 2008, we became aware that there was a breakdown in margin call loan notifications within Storm. Storm was apparently not

68 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 76.

69 Mr Ian Narev, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 33.

70 Mr David Cohen, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 34.

passing them on to their clients. We responded by immediately investigating the situation and by late October we had commenced direct notification of margin calls to clients. We continued to be in daily contact with Storm to notify them of client margin calls during this period, and daily updates on the website were maintained. The intermediated margin call process continued to operate satisfactorily during this period with other dealer groups that we were dealing with.⁷¹

3.91 Macquarie Bank also emphasised to the committee that a margin call is a risk that Storm clients should have been well aware of:

... there has been public discussion suggesting that margin calls operated or were designed to operate as a stop loss for the benefit of the borrower. Our product brochures ... disclose margin calls as a risk for the client; they are not a stop loss. This risk was identified in our documents that, if an investor did not act in response to a margin call, the lender might sell the investment ...⁷²

Committee view

3.92 The committee finds it somewhat surprising and highly concerning that there was such lack of clarity around this critical facet of the Storm model. The leveraged investment strategy was sold to clients on the basis that there were sufficient buffers and triggers in place, as well as cash reserve funds, to ensure that any margin call situation could be appropriately managed. It seems remarkably careless, from Storm's point of view, to leave any room for doubt around this process.

3.93 Equally, the lenders carry the risk of default on the loans and have a clear interest in ensuring that all parties to the transaction are fully aware of their obligations and the agreed processes to be followed in the event of margin calls.

3.94 While the committee acknowledges the banks' contention that their legal obligation was to inform the intermediary financial adviser, who in turn was obliged to consult with the client about how to resolve a margin call, the committee nevertheless believes the banks had a moral obligation to attempt to make direct contact with the loan account holders once it became clear that, for whatever reason, Storm was not functioning successfully as an intermediary to clear the margin calls.

3.95 The committee heard in evidence that the CBA first made margin calls on Storm clients on 18 September yet did not make direct contact with clients until December—an elapsed time of approximately 11 weeks.⁷³ Even noting the CBA's evidence that it received some 'action' from Storm during October, the committee

71 Mr Richard Sheppard, Macquarie Group Ltd, *Official Committee Hansard*, Canberra, 28 October 2009, p. 3.

72 Mr Richard Sheppard, Macquarie Group Ltd, *Official Committee Hansard*, Canberra, 28 October 2009, p. 3.

73 *Official Committee Hansard*, Canberra, 28 October 2009, p. 30.

views the length of the delay on the CBA's part as inexcusable, and it contrasts poorly with evidence from Macquarie Bank that it moved to make direct contact with clients within two weeks of realising that Storm was not notifying their clients.⁷⁴

3.96 The committee therefore welcomes the commitment made by the CBA that, following an internal policy revision, it will now notify all clients of margin calls directly, rather than through an intermediary financial adviser.⁷⁵ This is discussed further below, starting at paragraph 3.104.

Limited oversight and regulatory gaps

3.97 Investors feel substantially let down by bodies that they believed would help to protect them from events of this nature:

Before joining Storm, we checked to see whether they were members of the Financial Planning Association, as we believed this gave them credibility. After sending the FPA a copy of a letter of complaint, the response we received from them was extremely disappointing. We also believed that the government watchdog, ASIC, was there to protect investors, yet we now feel that this is not the case.⁷⁶

3.98 The Financial Planning Association (FPA) told the committee:

... as an association we certainly accept responsibility for the fact that Storm Financial was a member of the FPA and we certainly wish that we could have acted early and we wish that we could have prevented some of the losses that have occurred. We acted very swiftly when we became aware of the issues in October last year through a complaint that we made against Storm as a result of a letter that they had sent to their clients ... In summary, Storm promoted a very aggressive investment strategy which carried significant risk.

There are a number of reasons why we believe that Storm failed and there are a number of actions that are under way, including margin lending and credit regulation, which will address some of those issues. We as an association have made some changes and are moving to make some more changes to improve the nature of our audit process and to introduce a whistleblower policy so that staff, clients and financial planners in the community feel that they can blow the whistle in a safer environment ... We believe that we all have a lot to learn as a result of Storm.⁷⁷

3.99 There has been significant criticism by investors of ASIC for not identifying the risks posed by Storm's one-size-fits-all financial advice model before the collapse

74 *Official Committee Hansard*, Canberra, 28 October 2009.

75 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 25.

76 Mr Francis Grainer, *Official Committee Hansard*, Cairns, 1 September 2009, p. 49.

77 Ms Jo-Anne Bloch, Financial Planning Association, *Official Committee Hansard*, Canberra, 28 August 2009, p. 27.

occurred. ASIC does not have a role in assessing business models for risk per se, but it does have a role in ensuring compliance with current *Corporations Act 2001* (Corporations Act) requirements in relation to standards of advice, including the section 945A requirement that advice takes account of the personal circumstances of each client and is appropriate for that client. More effective risk-based auditing processes might have assisted ASIC in recognising Storm's practices as being problematic at an earlier point in time. This matter is the subject of further discussion, in a broader context, in Chapter 6 of this report.

3.100 Critically for Storm investors, at the time of the collapse of Storm Financial, margin lending facilities did not fall within the definition of a financial product within Chapter 7 of the Corporations Act. Consequently, these products did not lie within ASIC's regulatory responsibilities and were not regulated at the national level. Because they were generally purchased for investment strategies, they also fell outside state-based consumer credit laws.

3.101 This regulatory gap has now been closed, following the October 2009 passage through parliament of the Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009. This bill explicitly defines margin loans as financial products for the purposes of the Corporations Act and sets out a range of requirements on financial product providers and advisers when selling these products to clients. The measures in this bill are intended to substantially enhance protection for investors and to provide ASIC with powers to take action where these facilities are not offered or managed in accordance with the law.

3.102 This legislation will provide a new layer of protection for future investors in margin loans and margin loan-like products. Treasury explained to the committee:

The main change that we have made in the legislation is that, regardless of what advice you get from your financial planner, at the end the responsible lending requirement rests on the bank or the lender. The lender has to make an independent assessment of whether this loan is not unsuitable for a particular client regardless of what the financial planner has said. So there is a second line of defence.⁷⁸

Committee view

3.103 The committee welcomes the passage of this legislation and, through such mechanisms as its regular oversight hearings with ASIC, will monitor its implementation and impact in the marketplace, particularly its ability to further protect investors from inappropriate advice or inappropriate product sales.

3.104 The committee remains concerned about the process for notifying clients of margin calls. During late 2008 when the market was falling rapidly, there were unacceptable delays in clients being made aware of their true position, such that by the

⁷⁸ Mr Michael Lim, Treasury, *Official Committee Hansard*, Canberra, 28 August 2009, p. 15.

time many became aware of their circumstances they either no longer had the capacity to take their accounts out of margin call or had had their portfolios sold down without their knowledge. The banks have indicated to the committee that they followed standard industry practice of notifying the intermediary financial adviser of margin calls and assuming that they would take responsibility for notifying the client and actioning a response to the call.

3.105 The new legislation requires that, unless a client specifically elects to have the bank deal only with their adviser, the lender is required to notify both the adviser and the ultimate customer when their account falls into margin. This is an improvement on the current (unregulated) situation but the CBA, among others, has suggested that it would prefer to see a situation where banks *must* contact the client in all circumstances. The committee agrees that this may need to be the subject of future legislative amendment, to further strengthen client protection. This matter is considered further in Chapter 6 of this report.

Lender responses to the Storm collapse

3.106 On 17 June 2009 the Commonwealth Bank issued a press release acknowledging that it carried some responsibility for the situation in which Storm clients who were also customers of the bank found themselves.⁷⁹ Notably, Chief Executive Officer Ralph Norris made the following apology to Storm investors:

“In some cases we have identified shortcomings in how we lent money to our customers involved with Storm Financial,” Commonwealth Bank CEO Ralph Norris said.

“We are not proud of our involvement in some of these issues and we are working toward a fair and equitable outcome for our affected customers.”

“Our customers can be assured that where we have done wrong, we will put it right. I am committed to the identification and resolution of all issues relating to the Bank’s involvement with Storm Financial,” he said.

Mr Norris said the Bank would meet its obligations to those customers identified as being in financial difficulty as a result of any shortcomings identified in the Bank’s lending practices.

“However, the Bank is not responsible for the financial advice provided independently by Storm Financial to the Bank’s customers. That was clearly the responsibility of Storm Financial, a licensed financial advisory company,” he said.

3.107 These sentiments were repeated in the bank's first public appearance before the inquiry:

... I echo Mr Norris's statement that we are not proud of the bank's involvement in some of the issues faced by those customers ... customers

79 See <http://www.commbank.com.au/about-us/news/media-releases/2009/170609-news-storm-financial.aspx>; accessed on 30 October 2009.

can be assured that, where we have done wrong, we will put it right ... Both before and since that announcement we have been taking action to put wrongs right. First, our customer assistance program established with customers on the ground in Townsville and, second, our innovative resolution scheme.⁸⁰

3.108 Bank executives identified steps taken in the wake of the Storm collapse:

... the bank has learned from mistakes that we have made in relation to some of our lending to Storm customers. Amongst the steps we have taken to remedy the situation, we have improved our valuation decisioning tool, known as VAS, ... we have tightened our loan approval processes, and we have augmented our compliance and audit checking processes.⁸¹

3.109 In acknowledging mistakes made, however, the CBA noted the involvement of other parties:

... it needs to be recognised that there are other parties significantly involved in the hardship suffered by Storm clients. CBA is not responsible for either those parties or their contribution to the hardship being experienced.⁸²

3.110 At the committee's final public hearing for the inquiry, Mr Norris and senior CBA executives provided an update on the resolution scheme the bank has established to assist CBA customers who were also Storm customers:

At this point, around 2,300 people have registered to participate in the scheme, which is a little over 80 per cent of all the people who had relationships with the Commonwealth Bank. Approximately 100 offers of settlement are currently being considered by our clients, we have reached a resolution for 53 customers, and the independent panel is currently reviewing documents and will be providing evaluations and determinations soon. Another clear and important priority for the foreseeable future is to expedite as many offers and settlements as we can. We want to help as many customers as quickly as possible.⁸³

3.111 At the same public hearing, Macquarie Bank told the committee:

Macquarie has an established dispute resolution process and we have been using that process to respond to complaints made by Storm-advised clients who had margin loan facilities with us. We have made some payments for certain account errors where delays in our processing of redemptions or

80 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p.57.

81 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p. 58.

82 Mr David Cohen, CBA, *Official Committee Hansard*, Sydney, 4 September 2009, p.58.

83 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 24.

account closures may have contributed to financial detriment, but overall we have not identified any recurring or systematic errors.⁸⁴

3.112 At an earlier hearing in Canberra, the committee heard from Mr David Liddy, CEO of the Bank of Queensland, that:

... a number of BOQ customers were impacted by the collapse of Storm and are suffering financial hardship as well as real emotional hardship. We have every sympathy for those customers and have been actively contacting them about our hardship assistance package ... we are working closely with a number of those impacted to provide assistance and have also made a commitment to work with those customers to keep them in their homes. Every customer and every case is different. As such, we are working with any customer suffering genuine hardship on a one-on-one basis to find the best solution for them.⁸⁵

3.113 Mr Liddy stressed, however, that he is not aware of any fault on the part of BOQ:

We do not believe we have acted illegally or dishonestly in our dealings with customers referred through Storm Financial.⁸⁶

3.114 Through MLC representatives, NAB informed the committee at its Melbourne hearing:

... we do share the committee's concern for Storm's customers ... NAB has established an internal working group to fully assess its level of involvement with the Storm Financial group and any customer relationships that might exist between the two organisations. The working group is conducting a comprehensive review of all related processes and policies and this work is ongoing ... NAB is cooperating fully with the regulator and is devoting all necessary resources to accommodate ASIC's requests.⁸⁷

3.115 Also at its Melbourne hearing, the committee was informed of ANZ Bank's measures to assist Storm customers:

ANZ did not have a formal relationship with Storm Financial, nor did we provide margin loans to our customers to invest through Storm. We noted in our submission around 160 customers who may have borrowed from ANZ, mostly via mortgages, to invest through Storm. We are continuing

84 Mr Richard Sheppard, Macquarie Bank Ltd, *Official Committee Hansard*, Canberra, 28 October 2009, p. 3.

85 Mr David Liddy, Bank of Queensland, *Official Committee Hansard*, Canberra, 16 September 2009, p. 29.

86 Mr David Liddy, Bank of Queensland, *Official Committee Hansard*, Canberra, 16 September 2009, p. 30.

87 Mr Steve Tucker, MLC Limited, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 2.

our review ... and expect we will find additional customers who may have some connection with Storm ...

... so far we have identified a small number where lending decisions did not comply with ANZ's policies. We are contacting those customers and will treat them fairly. Our approach will include assessing hardship on a case-by-case basis and rectifying detriment that resulted directly from action on ANZ's part.⁸⁸

Committee view

3.116 The committee acknowledges that each of these lenders has made a public statement of their position in relation to assisting Storm Financial clients. The committee encourages any other lenders with exposure to Storm's clients to make similar clarifying statements.

3.117 The committee also acknowledges Mr Ralph Norris's statement that:

... we [the CBA] are the only organisation to stand up and comprehensively acknowledge its responsibilities.⁸⁹

3.118 The committee certainly welcomes the CBA's readiness to admit its mistakes in the way it transacted business with Storm and Storm's clients who are also clients of the bank. The committee appreciates the bank making the effort to establish an innovative and fast-tracked resolution scheme for affected clients.

3.119 The committee encourages other lenders, who in some cases are still reviewing their internal policies, to be similarly candid about errors that may have been made and similarly constructive in the manner in which they engage with clients to redress those errors.

ASIC's response to the collapse

3.120 On 16 September 2009, ASIC updated the committee on its continuing investigations into Storm Financial.⁹⁰ As one of the largest investigations ever undertaken by ASIC, considerable progress is being made in scoping potential causes of actions and possible legal proceedings. However, ASIC intends to evaluate material from all of the committee's public hearings and the liquidator examinations that commenced on 24 September 2009 before making any public announcements about its next steps.⁹¹

88 Mr Graham Hodges, ANZ, *Official Committee Hansard*, Melbourne, 26 August 2009, p. 35.

89 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 25.

90 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, pp. 2-3.

91 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, pp. 2-3.

3.121 Importantly, ASIC confirmed that investors who participate in the CBA settlement scheme will still be able to benefit from any actions that ASIC may bring.⁹²

Committee view

3.122 The committee appreciates that the regulator needs to ensure that its investigations and potential recommendations for actions are not compromised by premature public statements. However, the committee emphasises the extraordinary public interest in these matters and the continuing hardship being suffered by Storm investors, and urges ASIC to advance the investigation as a top priority. The committee also urges ASIC to make timely and appropriate public announcements regarding the progress of its investigations.

Committee conclusions

3.123 All share market investors were exposed to the dramatic market fall of late 2008, and many realised losses on their portfolios. However, few now find themselves in such dire circumstances as Storm Financial's former investment clients.

3.124 As the events of 2008 demonstrated, Storm's model was not capable of withstanding a severe market downturn. Its success was predicated on the market continuing to rise indefinitely. The buffer and LVR settings proved to be such that, when the market fell rapidly, there was insufficient time and capacity to put accounts back into order before they fell into negative equity. The responsibility for this failure to resolve margin calls may well be shared between several parties, but that does not change the fact that the strategy failed.

3.125 The committee is of a clear view that Storm's aggressive leveraged strategy, in combination with the failure of multiple parties to appropriately monitor and manage margin calls at the height of the market volatility, were of disastrous effect for Storm's investment clients. The effects are greatest on those for whom this strategy simply cannot be considered appropriate advice—that is, those who were at or near the end of their working lives, with limited capacity to rebuild from scratch in the event that all their assets were lost and they found themselves in negative equity. This is not to detract from the losses of other investors; they have also suffered markedly from the combination of circumstances that occurred.

3.126 It is not the role of the committee to make findings of blame. It notes, however, a recent statement by Mr Ralph Norris, CEO of the CBA:

In truth, a degree of responsibility rests on the shoulders of banks, individuals and the regulator to a greater or lesser degree, and primarily on Storm Financial, who provided the financial advice as a licensed adviser.⁹³

92 Mr Tony D'Aloisio, ASIC, *Official Committee Hansard*, Canberra, 16 September 2009, pp. 2 -3.

93 Mr Ralph Norris, CBA, *Official Committee Hansard*, Canberra, 28 October 2009, p. 25.

3.127 The committee also records its serious concerns with regard to the following matters:

- the apparent provision of one-size-fits-all advice to Storm's investment clients, without the appropriate regard for their personal circumstances (including their life stage and asset base) that section 945A obligations require of advisers;
- the unacceptable confusion or disagreement between Storm and its lenders about how margin calls would be managed and who was responsible for which parts of this process; and
- the inappropriate and ultimately devastating delay or failure, particularly by the CBA, to make direct contact with margin loan clients when it became apparent that Storm was not successfully acting as an intermediary to clear margin calls.

3.128 Claims that the banks were unable to provide accurate information about the status of margin loan accounts during the period of extreme market volatility are also deeply troubling. However, the committee notes evidence from the banks that they used the same approach to margin call management with all the advisory groups they dealt with (numbering in the thousands), yet Storm Financial clients were the only group who *en masse* failed to be appropriately notified by their advisers of the true status of their margin loan accounts. This points the committee towards the inescapable conclusion that there was something about Storm—be it their staffing and resourcing levels, their computing systems, the degree of leverage in their model, their understanding of their responsibility in relation to margin calls, or a combination of these and other factors—which led to an inability to receive, handle and resolve margin calls during the critical period before their customers went into negative equity and were sold out of the market. The committee does recognise that the rate at which market conditions were changing, taken together with the number of client accounts that would have been going into margin call at the same time, would create a formidable administrative burden. However, Storm is alone among the advisory groups in having ended up in a situation characterised by such catastrophic losses for its clients.

3.129 Finally, the committee acknowledges that it is not necessarily appropriate to recommend reform in response to a particular collapse or event. Isolated corporate failures, no matter how painful their impact for those caught up in them, are not necessarily indicative of, or caused by, regulatory failure. The mass of evidence the committee has received in relation to the collapse of Storm Financial has, however, contributed to the committee's broader understanding of the current operation of Australia's financial products and services sector and of the provision of financial advice. In Chapter 5 of this report the committee considers problematic issues in the sector in a broader context, and in Chapter 6 the committee makes a series of recommendations for reform, which are in part informed by the committee's extensive deliberations on the collapse of Storm.