26 August 2009

Committee Secretary
Parliamentary Joint Committee on Corporations and Financial Services
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By email: corporations.joint@aph.gov.au

Dear Sir/Madam

Inquiry into Financial Products and Services in Australia

The Australian Financial Markets Association (AFMA) wishes to make a submission to the Committee's inquiry into the provision of financial products and services in Australia. AFMA represents participants in the wholesale banking and financial markets in Australia. A number of our members offer margin loan products to retail and wholesale clients and they substantially account for the standard margin loan business written in Australia.

Our submission provides information on the general characteristics of margin loans and includes an assessment of recent regulatory change in this area. Our comments are provided solely from an industry perspective and address structural regulatory issues. We cannot comment on the individual situation of particular lenders, advisers or their clients.

1. Summary Comments

Margin loans can benefit investors if they are used in a properly informed and appropriate manner and, thus, they remain a popular investment medium. While mainstream margin lenders have typically conducted their business in a responsible manner, it is apparent that some margin loan investors have suffered substantial hardship during recent market turbulence. This could have been avoided, or markedly reduced, under tighter regulation and more consistent industry practice. Therefore, as stakeholders with a vested interest in the stability of the industry and good ongoing client relationships, our members support the Government's policy to appropriately regulate the provision of margin lending services and associated financial advice, so that the quality of regulatory protection available to retail clients is improved.

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The regulatory system cannot prevent investors from losing money as financial markets fluctuate up and down - even if they avail themselves of soundly based financial advice. However, the cases of hardship under consideration by the Committee are not explained by market volatility alone but rather they raise significant concern about the way in which some business was conducted. While it is evident that the business models adopted by Storm Financial and Opes Prime had serious shortcomings, AFMA is not in a position to comment on the allocation of responsibility between the various parties involved. However, we can contribute to the Inquiry by commenting on the changes to the regulation of margin lending that are before Parliament.

The Margin Lending Bill before Parliament Closes a Regulatory Gap and is Supported by the Industry

In particular, we believe the regulation of margin lending in the form proposed by the Government through Schedule 1 of the 'Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009' (the 'Margin Lending Bill') is the appropriate policy response to the problems encountered. In conjunction with operational enhancements by margin loan providers, it will provide a better platform to protect margin loan investors, so they can continue to confidently use margin loans to meet their investment objectives.

A 'Whole of Government' Approach to Policy is Necessary to Support Investors

The Margin Lending Bill before Parliament is one component of the regulatory infrastructure provided by the Government to protect retail investors and help them to meet their financial goals in a secure, confident and efficient manner. While this component is important, the Government should endeavour to ensure that all of its policies interact cohesively to deliver this outcome.

In this regard, we believe that a more consistent 'whole of government' approach to the regulation and taxation of capital protected products is necessary to achieve the Government's policy objectives. This will require a refinement to the Margin Lending Bill and an adjustment of the May 2008 Budget announcement by the Treasurer in respect of capital protected products, as outlined below.

The Committee can contribute to the future development of public policy on the financial sector by commenting on the need for effective coordination of government policy, so its various taxation and regulatory measures reinforce each other to the greatest extent possible.

2. Background on Margin Loans

Margin loans are most commonly provided by bank groups prudentially regulated by APRA. Members advise that the majority of margin loans are sourced through intermediaries, such as stockbrokers and financial advisers. In March 2009 there were 189,000 margin loan accounts, compared with 200,000 at the beginning of 2008.[1] The value of margin loans outstanding at March 2009 was $18.7 billion, just half the amount outstanding at the

[1] Margin loan figures are derived from Reserve Bank published data.

beginning of 2008. Average gearing on margin loans was 46% in March 2009, compared to 45% on average in 2008.

Used appropriately, margin loans can assist investors seeking to grow their wealth and manage their financial affairs responsibly. Access to leverage enables investors to optimise the composition and size of their investment portfolio. Increasing the available pool of investment funds enables investors to build a larger and more diversified investment portfolio. Therefore, it is important to provide a regulatory framework for this business that allows investors to access margin loans with confidence and enables lenders to manage their risk and service their clients in a cost effective manner.

Like most financial products, margin loans carry inherent risks. By their nature, markets rise and fall, and investors that are exposed to the market via margin loans (or other forms of leverage) will be exposed to these fluctuations in the market on a leveraged basis. Leverage magnifies the effect of both positive and negative market fluctuations, meaning that in falling markets (where the likelihood of diminishing asset prices is increased), leverage magnifies the potential market loss to investors.

The use of a margin call mechanism (outlined below) means borrowers may be asked to reduce their gearing if the market falls, such as by selling pledged securities or pledging additional collateral or cash. The number of margin calls made per day in 2008 (at 5 per 1,000 clients) was almost 3 times the historical average, reflecting the impact of turbulent markets consequent to the global financial crisis. If margin calls are not complied with, securities held as collateral may be sold by the lender. As margin loans are full recourse loans, if there is a shortfall in the event that all securities have been sold, the lender may pursue the borrower's other assets for any residual loan principal.

Against this backdrop, it is essential that a margin loan investor understands the risks associated with the loan, as well as its potential benefits. Effective disclosure by loan providers and intermediaries (such as financial advisers) to the client is very important in this regard. The industry has worked constructively with the Department of Treasury's Margin Lending Disclosure Industry Consultation Group to develop a short form Product Disclosure Statement (PDS) as one aspect of the Government's new margin lending regulatory regime.

It is important to note the significant role of an investor's financial adviser in assessing the appropriateness of a margin loan (and the overall degree of leverage) for the investor and in explaining the inherent risks of such leverage. Under current 'know your client' obligations, a client's financial adviser plays an integral role in determining the risk appetite and financial objectives of each client, and formulating their advice on that basis. Generally, the adviser will be the best placed person to determine and explain the most appropriate use of particular financial products, services or investments by the investor as part of an overall strategy. Sound and appropriate ongoing financial advice that takes into account the individual circumstances and objectives of the client is important, especially when the client requires assistance in respect of leveraged structures such as margin loans.

It is likewise important that lenders only provide margin loans to borrowers such that the borrower can meet the obligations of the loan without enduring substantial hardship. Depending on the circumstances, this could mean consideration of the ability of the borrower to meet interest payments and/or margin calls, or offering a loan credit limit below that supported by the collateral pledged as security. At present, the collateral pledged as loan security forms the primary risk mitigant for the margin lender, compared to interest or margin call serviceability. The responsible lending condition in the new regulatory regime for margin lending will provide this additional protection.

Apart from regulatory protections, the major margin lending providers also make available trading tools within the loan facility that enable investors to manage market risks. For example, a popular tool is the purchase of put options over investments in loan portfolios. By guaranteeing a sale price for their investments, investors will receive a higher LVR and are protected from margin calls in the event of falling asset prices.

3. Key Features of Standard Margin Loans

Margin lenders have traditionally explained the features and risks of a margin loan in product guides, marketing materials and loan terms and conditions. While most major margin lending providers have generally provided an appropriate degree of disclosure in this manner, this information will need to be formally provided to clients in the form of a Product Disclosure Statement (PDS) under the new regulatory regime. It may be useful for the Committee's purposes to provide a short summary of key loan features.

A standard margin loan is a line of credit secured by collateral pledged by the borrower that is generally used to purchase a variety of investment assets (most commonly shares and managed funds). The loan is granted on an "interest only" revolving credit basis, with interest charged on a regular basis. The borrower may be required to pay margin calls and is subject to other lender risk controls, like approved security lists. A margin loan is not an investment in its own right, but a lending service available for borrowers to use as a tool to leverage their investment portfolios, and is generally intended to be used as part of an overall financial strategy.

Loan Security

Standard margin loans are secured by one or more specific parcels of shares or managed funds. Cash is also an acceptable security. Importantly, the loan recipient retains legal ownership of the pledged and purchased securities. The lender has a mortgage over the pledged securities.

Securities (shares or managed funds) that are pledged may be securities already held or securities being purchased with the loan funds or a combination of both. The securities that are pledged, as well as subsequent investment securities purchased using loan funds, are either registered in the security holder's name or in the name of a nominee, depending on the lender's internal process. Regardless of the maximum credit limit awarded to

the borrower, the borrower is only ever able to drawdown a loan amount that is sufficiently covered by the value of the collateral they have pledged.

Loan-to-Value Ratio

The loan-to-value ratio (LVR) is the maximum amount of funds a loan will be made against a portfolio of pledged securities. The maximum loan granted is based on the market value of the securities pledged and their quality and the volatility of their price. For example, a higher LVR will typically be allowed for blue chip stocks, relative to other stocks. Maximum LVRs range from 30 to 80% but clients do not have to borrow up to the maximum amount. RBA statistics show that actual LVRs are typically well under 50% (46% as at March 2009).[2]

Margin Calls

Once a margin loan has been granted, the value of the pledged securities is continually monitored. The LVR of the margin loan portfolio will move in line with the changing market value of the pledged securities. A fall in the value of the portfolio will cause the gearing level to rise and an upward adjustment to the LVR. The opposite will occur if the value of the portfolio rises.

A margin call may be triggered where there is a fall in the market value of the investment assets, resulting in a corresponding fall in the security value of the portfolio. A margin call will only be made where the fall in value results in the maximum gearing ratio being exceeded.

Margin loan providers typically allow a 'buffer' of 5 – 10% after the gearing ratio has been exceeded before a margin call is made. When a margin call has been made, the loan recipient will be required to restore the portfolio LVR to below the maximum allowable gearing ratio. This can be done by selling securities in the portfolio and using the proceeds to reduce the loan balance, or by injecting additional cash collateral or pledging additional securities to be used as collateral. If these requirements are not met, providers have the right to sell sufficient securities to restore the required ratio.

4. Hybrid Margin Loan Products

The features of standard margin loans should be distinguished from that of riskier hybrid arrangements that combine aspects of margin loans with stock lending that were offered by some fringe providers (eg Opes Prime). These hybrid, or non-standard, arrangements represented a very small part of the margin lending market last year, though they have attracted much attention.

Under hybrid arrangements the investor borrows funds to purchase shares through a margin loan but the loan provider takes legal ownership of the shares acquired as security for the loan. This is unlike a standard margin loan because the borrower in a hybrid arrangement is exposed to the credit risk of its lender and the arrangement is more complex for investors to understand.

[2] Calculation based on the sum of protected and non-protected borrowings divided by the value of the underlying security.

Some providers of hybrid arrangements operated a more risky margin lending business for consumers than did providers of standard margin loans. This was reflected in the wider range of stocks (especially small listed companies) that they covered under margin loan arrangements, higher LVRs, lower interest rates and timeliness of margin calls. The underlying risk of this business model heightened the exposure of investors who transferred legal ownership of their shares under securities lending agreements (ie they took on the credit risk of the margin loan provider).

In contrast to the major providers of standard margin loans, the providers of hybrid margin loans did not form part of an authorised bank group and were not prudentially regulated by APRA. In addition, the margin loan and securities lending involved were not defined as a financial product under the Corporations Act. It appears that the consequent slippage in the regulatory brakes on their business contributed to the severity of the problems encountered by their clients, especially when their business failed.

5. The Government's New Policy Approach to Margin Lending

Margin lending regulation should protect retail investors by:

1. Ensuring that personal financial advice given to retail clients in relation to margin loans is competent and calibrated to the circumstances and needs of the client;
2. Achieving consistent, good quality disclosure to retail investors;
3. Promoting prudent margin lending and risk management practices;
4. Ensuring margin lending businesses are adequately capitalised.

AFMA supports the Government's policy objectives in introducing legislation to regulate margin lending, through the Margin Lending Bill, which we believe should satisfy these regulatory benchmarks.

AFMA's members involved in the margin loan market believe the proposed regulation will provide better protection to retail investors and assist their business by establishing minimum industry standards (including responsible lending) and promoting investor confidence in the product. They aim to operate to a high standard and service their clients in an efficient and responsible manner. This necessarily includes procedures that support effective disclosure, proper margin call notification procedures and good lending practices, which are required under the provisions of the Bill.

In effect, the Bill introduces minimum operating standards that must be applied by all margin lenders, whether they are mainstream providers or otherwise, and requiring related financial advice to be soundly based and provided in a competent manner.

The Bill also provides a framework for ASIC to ensure that margin lenders have adequate risk management systems, sufficient financial resources, properly trained staff and other operating capabilities to provide margin loans in a secure, efficient and fair manner.[3] This will improve the coverage of the

[3] ASIC is currently consulting, through Consultation Paper 109 *Margin lending: financial requirements*, on its proposed financial resource requirements for licensees that provide financial services in relation to margin lending facilities.

regulatory system by countering the risk that investors might be again exposed to providers who do not have adequate risk management systems for their business or sufficient capital to back their business if they do encounter problems.

In addition, the Bill will ensure that the regulatory system provides consistent regulatory protection across the financial advice, intermediation and loan provision phases of the margin lending process, including when advice is sought independently of the margin loan provider. For instance, the regulatory measures assist margin loan clients by requiring that financial advice is given in a professional and competent manner and puts measures in place to achieve this outcome. The Bill also provides the regulatory mechanism to mandate mechanisms for the effective communication of critical information, like margin call notices, to clients whether they are a direct client of the lender or the loan is intermediated through a financial planner.

ASIC's Consultation Paper 108 *Margin lending: training of financial advisers* outlines ASIC's proposals to apply training requirements to financial product advisers who advise on margin lending facilities. Margin lending facilities would be categorised as Tier 1 products which are more complex and attract more advanced training requirements. We believe this approach is appropriate. AFMA is a Registered Training Organisation with a number of courses that meet RG146 specifications listed on the ASIC training register. ASIC proposes a 12 month transition period from the date of the new legislation requiring margin lending advisers to complete their training requirements. We believe the proposed timetable for training providers to develop the necessary training materials is tight, but achievable.

In summary, we believe the approach taken in the Bill will close the regulatory gaps exposed by financial market turbulence in 2008 and it will improve investor protection, thus, help investors to make sound investment decisions and take responsibility for them on an assured basis.

6. Remaining Issues - A 'Whole of Government' Policy Response

A 'whole of government approach', that manages government market intervention in a coordinated and consistent manner, is required to provide the most effective regulatory system for retail clients. This is important because government policy reflects an expectation that individuals should meet their ongoing financial needs and provide for their welfare in retirement.

Much as it is important that government regulation ensures that retail investors receive protection by being properly informed and well advised, it is also important that there are no biases in the tax or regulatory system to encourage them to accept more or less financial risk than is consistent with their investment objectives. The absence of policy coordination at this level can press investors to accept more (or less) investment risk than they should in their particular situation, which can only have adverse consequences.

Two current problems require action by the Government in this regard because they encourage investors to take more risk than a neutral tax or regulatory treatment would otherwise do. Before outlining these examples,

we emphasise that we do not think these factors played a role in the specific cases of investor losses being considered by the Inquiry. However, they are relevant to the Committee's deliberations on the future design of the regulatory system.

In short, AFMA believes the Committee can contribute to the future development of government financial sector policy by recommending that the matters below are addressed by the Government in a manner that is consistent with its broader objective to provide an infrastructure for investors to make investment decisions in a safe and efficient manner that accords with their individual risk preference.

6.1 Taxation of Capital Protected Products

Capital protected products, like protected equity loans and instalment warrants, are specifically designed to limit the financial and market risk an investor is exposed to. These products are generally attractive to investors who wish to adopt a conservative investment approach, for example, because they have near term financial commitments or they want to reduce their downside market exposure in response to a change in their risk preference.

Consequent to a measure immediately effective from its May 2008 Budget announcement, the tax system creates a significant bias against the use of capital protected investments. The measure dramatically reduced the tax deductibility of interest paid on borrowing to finance capital protected product investments by changing the benchmark interest rate for allowable interest deductions from the variable rate for personal unsecured loans (currently 13.50%) to the Reserve Bank's indicator variable rate for standard housing loans (currently 5.80%). The restriction does not apply to other forms of finance, like personal loans and margin loans, which do not have a capital protection feature.

The new benchmark interest rate is too low to meet the cost to lenders of financing the underlying loans, given the credit risks involved. Consequently, the tax deductibility of interest on capital protected borrowing is restricted to an uneconomic level and investors are being penalised for seeking capital protection. This tax bias against capital protection on geared investments is especially of concern at a time when markets are unusually volatile.

The 2008 Budget announcement has not been legislated, as the Government has foreshadowed consultation on the appropriate change to the benchmark rate. Hence, there is still an opportunity to ensure that the tax system does not inadvertently cut across the Government's policy to provide a secure investment environment for retail clients by presenting a tax hurdle to their reduction of risk.

6.2 Regulation of Capital Protected Products

A good regulatory system meets its policy objective in a precise manner that avoids interfering in business that lies outside of its scope. In this regard, we are concerned that the Margin Lending Bill covers capital protected products that are not margin loans and have very different risk attributes to margin loans.

We believe there is no policy basis to bring capital protected lending products, like instalment warrants, within the margin lending regime because the lender's recourse is limited to the assets financed by the loan. Thus, these loans present a much lower risk to investors than margin loans, as their potential losses are limited to their initial investment, there are no margin calls and the loan amount is effectively capital protected.

Moreover, there is a practical complication in respect of listed products, as it is impossible for a product issuer to conduct an unsuitability assessment when trading occurs on the secondary market, as the issuer would be unaware of the details of potential buyers.

A problem arises in practice because the provisions in the Bill would capture some of these products. This issue affects many common instalment warrant products that are both capital protected and listed, as well as unlisted capital protected products. Typically, these products are derivatives and are already adequately regulated under Chapter 7 of the Corporations Act (including Product Disclosure Statement requirements) and, in the case of listed products, are subject to the Australian Securities Exchange's rules.

We believe the focus of the regulatory regime should be tightened through a regulation to exclude these products from the regime and better direct regulatory resources to objectives of the Bill. In the absence of this, the regulatory system will introduce a harmful bias against certain products offering capital protection by placing constraints and additional costs on investors.

7. Concluding Comments

We have focussed this submission primarily on the matters that specifically relate to margin lending. We are not well placed to comment on the broader issues in relation to the provision of financial advice, the payment of commissions and the management of related conflicts of interest. However, we are aware that these matters are dealt with by other industry submissions to the Inquiry.

Thank you for the opportunity to make a submission to the Inquiry and please contact me if there are any matters in relation to our submission that the Committee would like to discuss.

Yours sincerely

Duncan Fairweather
Executive Director