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JOINT COMMITTEE ON CORPORATIONS AND FINANCIAL SERVICES

Reference: Financial products and services in Australia

WEDNESDAY, 16 SEPTEMBER 2009

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JOINT STATUTORY COMMITTEE

ON CORPORATIONS AND FINANCIAL SERVICES

Wednesday, 16 September 2009

Members: Mr Ripoll *(Chair)*, Senator Mason *(Deputy Chair)*, Senators Boyce, Farrell, Marshall and Williams and Ms Grierson, Ms Owens, Mr Pearce and Mr Robert

Members in attendance: Senator Farrell, Senator Mason, Senator McLucas, Senator Williams, Ms Grierson, Mr Pearce, Mr Ripoll and Mr Robert

Terms of reference for the inquiry:

To inquire into and report on:

Issues associated with recent financial product and services provider collapses, such as Storm Financial, Opes Prime and other similar collapses, with particular reference to:

1. the role of financial advisers;
2. the general regulatory environment for these products and services;
3. the role played by commission arrangements relating to product sales and advice, including the potential for conflicts of interest, the need for appropriate disclosure, and remuneration models for financial advisers;
4. the role played by marketing and advertising campaigns;
5. the adequacy of licensing arrangements for those who sold the products and services;
6. the appropriateness of information and advice provided to consumers considering investing in those products and services, and how the interests of consumers can best be served;
7. consumer education and understanding of these financial products and services;
8. the adequacy of professional indemnity insurance arrangements for those who sold the products and services, and the impact on consumers; and
9. the need for any legislative or regulatory change.

WITNESSES

Committee met at 6.33 pm

CHAIRMAN (Mr Ripoll)—I declare open this public hearing of the Joint Standing Committee on Corporations and Financial Services. It is part of a series of public hearings the committee will hold to inform its inquiry into financial products and services. The committee is inquiring into issues associated with recent financial product and services provider collapses such as Storm Financial, Opes Prime and other similar collapses. In conducting its inquiry, the committee has made a decision to focus specifically on non-superannuation products and services.

Witnesses giving evidence to the committee are protected by parliamentary privilege. Any act which may disadvantage a witness on account of their evidence is a breach of privilege and may be treated by the parliament as a contempt. It is also a contempt to give false or misleading evidence to the committee. The committee prefers to hear evidence in public, but we may agree to take evidence confidentially. The committee may still publish confidential evidence at a later date, but we would consult the witnesses concerned before doing this.

[6.34 pm]

BIRD, Ms Joanna, Senior Executive Specialist, Strategic Policy, Australian Securities and Investments Commission

D'ALOISIO, Mr Tony, Chairman, Australian Securities and Investments Commission

HANRAHAN, Dr Pamela, Senior Executive Leader, Investment Managers, Australian Securities and Investments Commission

KOROMILAS, Ms Deborah, Senior Executive Leader, Financial Advisers, Australian Securities and Investments Commission

MEDCRAFT, Mr Greg, Commissioner, Australian Securities and Investments Commission

RICKARD, Ms Delia, Senior Executive Leader, Financial Literacy and Consumers and Retail Investors, Australian Securities and Investments Commission

CHAIRMAN—I welcome witnesses from the Australian Securities and Investments Commission. Mr D'Aloisio, if you like to make some opening remarks, that would be welcome.

Mr D'Aloisio—We are appearing as a group that has appeared before you once before and has been responsible for the submission that we put to this committee. I would just make one brief comment and then update you on Storm Financial. The preliminary comment is that what we would like to do is to amplify and be clearer on the suggested changes in table 2 of the executive summary of our submission that we lodged with you on 14 August. What we have done and will now hand up is to provide more detail on each of the suggested reforms and changes in table 2 simply to assist the committee. We felt on reflection, looking back, that we were quite short in describing some of the changes we had suggested. We felt it may assist the committee to see how those changes would work in the context of the Corporations Act. That has been handed up so hopefully you will find it useful.

If I can then move to update the committee on our investigations on Storm Financial, the committee will recall that on 17 June I said to the committee that our investigations in relation to the collapse of Storm were continuing and that those investigations extended to the possible actions under section 50 of the Australian Securities and Investments Commission Act against all involved, including financiers, and that we had set an internal objective to be able to make decisions on those matters by the end of August—but we emphasise that that was very much an internal objective.

We say, first of all, that our investigation on the collapse of Storm and the conduct of all involved, including the financiers, is one of the largest investigations that ASIC has undertaken. Naturally we have a full-time team on it. We have supplemented that team with external resources as well. The investigation is being coordinated by a small group of senior executive leaders with a commissioner and I as part of the strategic team. We are satisfied that we have put in place the resources that are required for this sort of matter. The work on it is progressing

quickly given the number of potential parties involved and the number of investors, and at the commission level we are pleased with the quality of the work and the hard work and commitment of our team.

On 4 September at the commission level we assessed the progress of the investigation and were satisfied that considerable progress was being made, including in relation to the scoping and the nature of potential causes of actions and possible legal proceedings. But we felt that additional investigative work and legal analysis was needed before the commission would be in a position to make decisions. So we set the next six weeks for that additional work to be completed and will again review the matter to determine if the matter has advanced sufficiently at that time for commission decision. That is likely to take us to around the end of October. We are not in a position today to outline the potential causes of action or other legal proceedings that we are assessing and our reasons for that are, first of all, that it could affect the effectiveness of our investigations and we do not see it as being in the interests of the investors if we were to outline our thinking at this point. Secondly, the public hearings of this committee are not complete and the liquidator examinations will commence on 24 September. Additional relevant material or evidence may emerge which we may want to evaluate.

While we would have liked to have been able to say more this evening, for the reasons that I outlined we are not in a position to. Let me reassure the committee, and in particular let me reassure investors, that we have their interests as our primary concern. As we have said before, for those investors who may wish to participate in the CBA settlement scheme that is a matter for them. They will still benefit from any ASIC actions that we may bring as there is a carve-out to that effect in documentation that the CBA is using. That is all I wanted to say in my opening remarks. I am happy to answer questions on that, and on any things you may wish to raise.

CHAIRMAN—I would like to begin by again thanking you for the work that ASIC has done and the submissions that you have provided. I just want to explore a couple of issues with you in terms of licensing. You make some comments in your submission about essentially raising the bar for the entry-level of licensing or giving ASIC more power to prevent someone getting a licence. Could you just go into a bit more detail to explain the licensing procedure? I have a few other questions around that but I am interested in your view in terms of how you make that a higher standard and set a higher bar.

Ms Bird—In our submission we suggest something which we would do—which would be to review the financial resource requirements that are imposed on licensees. So that is a project that we have now and we are looking at ways that we can do that. We are very conscious that there are limits to what we can do in terms of financial resource requirements because we are not a prudential regulator and we cannot set the sort of capital and liquidity requirements that a prudential regulator would. In terms of regulatory reform we actually only suggest fairly minor reform around the licensing regime. So, as we have said before, we are required to grant a licence if the conditions in the legislation are met. The two substantive conditions are that the key people are of good fame and character and the other one is that we have no reason to believe that they will not comply with their licence conditions. The test of having a state of mind that somebody will not comply before they have even started business is extremely difficult, and so we have asked that we have a slightly lower threshold in terms of 'may not comply' or we think that there is a possibility that they may not comply so that we do not have to reach that very high

level of conviction before we can refuse a licence. The reforms that we have asked for are mirrored in the existing credit reform legislation.

CHAIRMAN—You also make mention of wanting increased powers in terms of making it easier for ASIC to be able to remove someone's licence.

Ms Bird—Yes, there we have asked for the same thing—that we can remove a licence if we think that somebody may breach their obligations in the future. Because it is exactly the same problem: we have difficulty acting before a breach with the current test. Where we have asked for more powers that extend beyond that sort of thing is on the banning of individuals. We have asked for additional powers there.

CHAIRMAN—How realistic is that view though in practical terms? What is it that you would like you be able to do in the future that you could not do in the past? I would make particular reference to Storm, for example, given that ASIC did an audit and a compliance check. My understanding is that they passed shortly before they collapsed. So what is the importance of that in terms of had you had had those powers given that they passed the audit and compliance test? What difference would it make?

Ms Bird—I do not think I can talk about Storm so I will talk about it more in a general sense.

CHAIRMAN—I am just using that as a reference point. I am not asking you for details. I am just using it as a case study.

Ms Bird—It will not be easy to take away a licence, and it probably should not be easy to take away a licence. Taking away a licence brings to an end a business which may have many employees. We have in the past tried to take away licences and made decisions to take away a licence and been overturned by the Administrative Appeals Tribunal. So I guess we would think that with this change in the test we might have been more successful in those cases. So I guess we think it would have a practical impact, but I am not suggesting to you that suddenly we would be taking away hundreds of licences every year. When you look at the numbers of licences that are taken away, you see that it is a small number. This would enhance our ability to act before a breach. I think the changes in banning would be more significant.

Mr D'Aloisio—I think also that in our submission we have not put these changes to the licence conditions as the things that we think are right at the centre of improving quality of advice and so on in this industry. What we have said is that the key things are the clarifying of the actual duty itself on financial planners and advisers and the remuneration structure. They are things that we are saying that, if the changes are made, could make a real difference. The licensing conditions, as Jo indicated, are there. We think we can improve them. But we have not used the licensing regime as the thing to really try to get to the nub of this. We think it is to do with quality, remuneration structure and training. They are the things that we feel are going to see a lift in the standard.

Short-term that may well mean that a lot of people will go out of this industry, and we think there is a short-term issue there; but longer term we believe that if that basic framework of quality, training and the remuneration structure—and not creating the wrong sort of incentives—is at the centre of the reforms. And then there are a number of other changes that we think are

important such as the licensing changes that we are talking about and education. We see all of that adding to it. We are not putting those up as 'the thing' that is going to fix the problems that are in the back of your mind and that are clearly in the back of my mind and which have occurred over more recent times.

CHAIRMAN—Still on the licensing issue, there are certainly some concerns about the number of licences that exist. The vast majority of those are at a corporate level. They are, let us say, high-end users or holders of an AFSL. And it is exactly the same licence as would be held by somebody who is a single operator—an owner-operator of some sort of firm. So there does not seem to be any way of distinguishing, through the licence itself, the capacity or the ability of the service provider. It just seems to be a catch-all licence, where the same conditions are applied.

And if you were to double the requirements—just for argument's sake—I do not suspect that the large corporations in Australia would have any problems in complying. They would complain but in the end they would just comply, meet whatever requirements were set and get on with business. But the lifting of the standard could have a dramatic impact on single operators or small operators. I am just wondering how you distinguish between the levels within this giant grab bag of all those who hold a licence.

Ms Bird—The obligations are quite flexible so the way they apply—what is expected of you, your financial resource et cetera—will vary depending on the nature of the business you are conducting. As a general point, compliance costs are more expensive for smaller entities.

Mr D'Aloisio—It is a matter, also, of what condition you are talking about. Clearly, in your example of the big players and the small players, if you apply a financial resource condition that you have to have certain capital adequacy in the millions, then that licence condition can only be complied with by the big end of town. But if you put a quality condition in there—to do with the standards and quality—then that could be used to lift the lower end up. And the big end could probably comply with that as well. So in order to deal with the concerns you have—and we are happy to—we would probably have to talk a little bit about the types of condition you have in mind.

CHAIRMAN—The reason I raise that is to do with the link between the AFSL holder and the responsibilities they have, particularly for their authorised representatives, and the work that they carry out. In a larger organisation there are obviously many more people and if something goes wrong we can assume, from past experience, that it is not going to be the holder of the AFSL—the actual licensee—that is dealt with directly. It is more of an operational corporate issue which is dealt with down the line and past practice indicates that it is really an individual low-end employee or authorised representative who ends up carrying the responsibility for whatever took place in the organisation, whether it was policy or not. I am concerned. I just want your view on how that operates in practice and ASIC's experience in terms of who is held directly responsible for issues that arise out of conditions from the licence.

Ms Bird—The licensee is responsible for the conduct of its authorised representatives and other representatives. So the licensee will be held liable. There is quite a complicated liability regime.

CHAIRMAN—Okay.

Ms Bird—That is the way the system works. The licensee is ultimately responsible for the breaches and the acts of its representatives.

Mr D'Aloisio—But the question you are getting to is: if you have 3,000 authorised reps and one or two of them do the wrong thing, do you take the licence of the main entity away? That is a tough call for ASIC.

CHAIRMAN—I am not suggesting anything at all, Mr D'Aloisio. I am asking the questions rather than making suggestions.

Mr D'Aloisio—No, I am saying that that is where the existing regime take you, and that is why we have wanted more direct power to be able to intervene at the authorised rep level, rather than just dealing with the licensee.

CHAIRMAN—I was just looking at the responsibility taken. There seems to be a disconnect between the responsibility of the person who holds the licence and the people physically giving the advice and the responsibility they take on, either personally or through their organisation. There just seems to be a long way that separates them.

Mr D'Aloisio—That is a fair observation.

CHAIRMAN—I think you have made the point for me: how much control can an organisation with 3,000 authorised reps really have in the end? How much responsibility does the individual carry in terms of the processes, procedures and all the myriad vagaries that might exist within that organisation, particularly given that of late a range of them have admitted to a whole range of mistakes?

Mr D'Aloisio—It is a matter for you and the committee. There are other possibilities. You can license individuals, you can license everybody—they have to apply for a licence—or you can go with the current structure. We have not expressed a view on whether you would register or license everybody and apply standards against those. But they are clearly matters for the committee.

Mr PEARCE—Thank you very much for being here and for your submission. I want to ask a number of questions about some comments that you have made in your submission, but before I get to those I want to talk more broadly. It seems to me that in your submission you are making a call for quite a lot of additional powers, for want of a better term. You provided us with this update this morning, but I think it is on page 13 and 14 of your submission that you essentially summarise what it is that you are after. You say down the bottom of page 13:

In ASIC's view, the following two reforms are likely to have the most significant impact …

You talk about imposing a statutory fiduciary duty and preventing rem structures. Then you go on to more far reaching changes. You talk there about prudential regulation of a greater range of financial products and product design prohibitions or limitations. You are also talking about getting extra powers to influence the content and the material in advertising campaigns et cetera.

My very simple question is this: if ASIC were given more powers to approve products and to control advertising—what is in the advertising and what is not in the advertising—what would be the situation if and when something goes wrong in the future? Who is going to have the liability? Let's just say you sign off on a product, you say, 'That looks okay,' you sign off on an ad, the company goes ahead and advertises and it gets a stream of customers coming in the door to buy this newfangled product that ASIC has approved and the product falls over. Who has the liability?

Mr D'Aloisio—Let me put that in context. We are actually not advocating the more far reaching changes that are listed in paragraphs 29 and 30. What we are saying is that, to assist the committee, these are things that are being debated and being used internationally. Then there is the later chapter that elaborates on that. We have not gone that far, and we have not gone that far for the reason that is behind your question.

It is a very simple answer to say that somebody says this product is okay, that they give it a rating of A or AAA and that investors are safe. Not only could that be wrong—and we have seen enough of credit rating agencies to know that that could be wrong—but it could have a perverse effect on competition or on buying power. People will think that the product is safe and then when it turns out not to be safe there is no option for government to step in as a guarantor of last resort. So we are very concerned about those issues. In the public statements we have made—indeed, in the opinion piece that was published under my name more recently—we draw attention to these issues. We are saying that these things are happening internationally, but we need to be careful in the way we regulate.

But what we are also saying is that when you look at the Wallis inquiry underpinning of the current regime, we are also querying whether it has gone far enough in protecting retail investors, given the important role, which was not foreseen by the Wallis inquiry, that retail investors would play in the market. They had not foreseen and could not have foreseen the impact that the superannuation levy has had on investment in our markets. In that situation, you have a much broader range of retail investors and retirees. You have groups of people who lose money at the wrong time in their life and it is no answer to them to say: 'Well, it was a risk, you know. There was disclosure. You should have read the disclosure statement.' The fact is that they cannot easily come back into the workforce.

So the changes we are pushing are to say: 'Look, this is a real issue. We've got to re-examine this underpinning and there is probably a case for some more-targeted and better regulation to protect retail investors, without losing sight of the efficiency of the markets and not moving to moral hazard or guarantor of last resort.'

The changes that we were advocating in the previous paragraphs, which you have just referred to, fit in with what I have just said. When we look at the advice industry and the way that it has unfolded—and with the benefit of hindsight at the movement of retail investors—we think we need to focus a bit more on the quality of that advice, the training of those that give the advice and the commission structures. We think that that would protect these people—the retail investors—that I am talking about. So that is where ASIC is, as an organisation, in terms of providing assistance to this committee. We do not want to be the guarantor of last resort. Indeed, I have spoken about that publicly on a number of occasions. For ASIC to be a guarantor of last resort—if the government wanted it to do that, that is okay; it is a matter for the government—

you would need resources that would be exponentially different from those that ASIC has today. And we would need all the skills of the investment bankers and so on. Indeed, the investment bankers had all those skills and they did not avoid problems.

Mr PEARCE—Let's take, as an example, your suggestion about the role of marketing and advertising campaigns. You say that there should be mandatory content in advertising. You are making a recommendation that the act be amended to give particular power to require issuers to include specific content et cetera. Just talk me through, very briefly, how that would work practically. Let's say that when I leave the parliament, which I intend to do at the next election—

Senator MASON—A great loss!

Mr PEARCE—and I decide to hang up my shingle, if I am clever enough to qualify, and I want to advertise something, how is it going to work? I preface this, Mr D'Aloisio, by saying that I know you already do some of this. Talk me through how, if you got some extra powers in this, a practitioner would go about this.

Ms Rickard—I think the first thing to clarify here is that ASIC is not talking about pre-vetting or approving ads. There is no suggestion that we would pre-approve ads or give them our tick of approval. What we are saying is that in certain situations there may be additional information which we believe investors who are viewing or listening to an ad should have in order to be in a position to work out how to respond to that ad. So it might be something about who that sort of product is suitable for. If it is a complex product the ad might say, 'This product is only suitable for experienced investors.' That is just an example off the top of my head. Or it might be that we require all advertisers of unlisted and unrated debentures, for instance, to disclose the ratings or to say, if they do not have a rating, why they do not have a rating.

Mr PEARCE—But you are asking for a consideration that you be given power to require the product issuers to do this. My question is: how are you going to implement that power?

Mr D'Aloisio—Well, if you take the example of the unrated and unlisted, where we trialled this on a voluntary basis, there is no point putting out an ad saying to mums and dads, 'Go into this debenture; you'll get nine per cent or 10 per cent. You can sleep well at night because you know you're going to get nine or 10 per cent,' if you do not have in that ad that the repayment of the principal is at risk. The fact that it is not rated by a credit rating agency will tell you that it is probably not capable of being rated. So in the unrated and unlisted area, we pushed the industry to say, when they did the ads, what the risk was for the repayment of the principal. We did that without legislative power. We did that through our powers.

What we are saying is that we ought to have that power more formally in order to be able to do that in other cases. It does not mean that we would do it for every advertisement, but we would consider it for those areas where you have particularly vulnerable groups. The unlisted and unrated area, the mortgage trusts and the unlisted property trusts have relied typically on having large numbers of retirees who would come in and take those products because they are yield products. They are products where people feel, 'Well, I've got my money effectively invested in real estate. I have X per cent coming in; I can live off that and our principal is safe.' We are tackling that through the advertisement and we are tackling it through education—asset diversification and understanding of risk reward premium. We do that through the work Delia

and the group does on the FIDO web site. There are a number of ways that we are tackling it, but we also think that—coming back to your question—we should have the power in relation to some of the ads.

Mr PEARCE—In relation to remuneration structures, it says here that the act should be amended to prevent the use of particular structures. You said that would mean that some forms of remuneration would not be permitted, such as upfront commissions, trail commissions, soft dollar incentives, bonuses and everything else that we know goes on in the industry. I set my next question in the context that a lot of the industry, as you know, is already moving to a fee-for-service basis. We acknowledge that. If that power was written into the act, if the act was amended to do that, how would you envisage implementing such a thing?

Mr D'Aloisio—We are saying it ought to be prohibited by legislation. So it should be a self-executing power in the sense that that is the law.

Mr PEARCE—But would you imagine that, if it got passed in the parliament at eight o'clock tonight, it would start at five past eight tonight and just happen automatically? That is my point. As the regulator, you would be given the responsibility to implement—

Mr D'Aloisio—That is quite right.

Mr PEARCE—I want you to talk us through how you think that would happen, because it would be quite a significant shift.

Mr D'Aloisio—It would be, but really at the end of the day the industry has had plenty of time. We have known this issue has been there. A number of firms and entities have moved away from the wrong incentive that is created by selling commissions as distinct from giving advice. The FPA has done a lot of good work in the area, as you say. IFSA has been doing work in the area. So certainly there is a much greater level of consciousness of it and they are moving in what we think is the right direction. But, again, given what we have seen and how things have unfolded with the more recent collapses, our feeling is that these things should be banned either directly or through the standard of advice that you give.

Coming to your question of how ASIC would implement it, once the law is clear ASIC's role in surveillance, compliance and enforcement would be no different to other things that you may have banned. Certain types of share offers are prohibited—what does ASIC do? They might have been allowed before. ASIC through surveillance and enforcement will ensure that the law is complied with. I do not think we are looking for a power for ASIC to be able to say which commissions in which companies are banned and which are not, because that takes us into competition and an unlevel playing field. We are simply looking at it as being a legislative change, and we will just use our powers in the normal way.

Senator MASON—Can I just ask a typical legal question. We have heard different answers from different witnesses we have taken evidence from over the last few weeks. If the committee was minded to recommend the imposition of a fiduciary duty, would that necessarily be inconsistent with the receipt of commissions by financial advisers? Is it necessarily inconsistent?

Mr D'Aloisio—I will preface my answer by saying that it is a legal question. Even though I have a legal background—

Senator MASON—What is your best advice?

Mr D'Aloisio—The position we have taken and clearly will continue to take as the regulator is that the law at the moment is uncertain as to whether the fiduciary duty exists or not. We take the view that it may well exist, but it is unclear. What we are asking the committee to look at is making it clear, and making it clear by saying, 'The duty applies but you have to ask advisers to act in the best interests of clients, and it could be fiduciary.'

What difference does it make? The difference it makes is that, once you are in a fiduciary relationship, if you are going to take commissions or some other benefit, that benefit belongs to your client. It is not yours; it is your client's, unless your client through disclosure but more importantly through informed consent allows you to keep it. The standard and the way you discharge that duty is that, if you are running a large organisation, for practical purposes you would be hard pressed to say, 'Yes, you can still have commissions,' because in each individual case you run a risk. So the change we would see to industry practice would be that a lot of the front-end, trail and ongoing commissions would probably not sit well with a clarification of that duty.

It does not of itself bring about that the commission has been banned. That is why we have asked you to consider the second limb of our recommendations which is to actually put it beyond doubt. But even if you did not do the second limb and only did the first limb, we would still feel that a significant number of the existing commission arrangements would go, and that would be in line with where the industry itself is moving and indeed, to be fair, where quite a number of companies have already moved.

Senator MASON—That was excellent evidence, thank you.

Mr PEARCE—I would like to clarify one thing about your submission. On page 5, point 10 you say that:

> Recent events in the Australian and global financial system have lead to the Inquiry and with that the possible reassessment of the policy settings of the FSR regime and the economic philosophy that supports it.

I have not seen, in our terms of reference, any suggestion that the FSR regime or the economic philosophy that supports that regime is being reviewed. It is rather that we are looking at what has caused some of the problems in relation to some of the collapses and what can be done from a legislative point of view. I contrast that with the following paragraph where you then say that Australia has fared better in the global financial crisis than any other country, and part of that was the regulatory framework. So on the one hand you are questioning the regime and the economic philosophy and then on the other hand you are saying that it is part of the reason why we have fared better—which I would certainly concur with. I do not think there is any evidence to say that the committee is necessarily looking at the economic philosophy that underpins it. We are looking more at the practical implementation of the regime. Can you share with us—

Mr D'Aloisio—I am happy to clarify paragraphs 10 and 11 to make it clear that it is, I think, quite consistent with what we have said before. We do believe, and clearly, that Australia has fared better, and one of the reasons we have fared better is that we have had a better system and that in the RBA and APRA we have had excellent regulators. And it has been underpinned by a lot of other factors of macroeconomic policy of successive governments and by the resources boom. We have been lucky, it is great and we have got good systems. There is no doubt about that, at least in my mind for what that is worth.

At the same time, though, we are saying that the recent collapses are not divorced from the economic crisis in terms of the financial crisis that occurred and the impact it had upon the markets. In turn, it had an impact on leverage models and so on. There were investor losses in Australia. What we are saying is that that is sufficient for us to say, 'Okay, can we improve the system and build on its success?' And what we are saying is that when you look at the underlying philosophy of the FSR regime under Wallis, which had left it to the market but regulated conduct and relied on disclosure, we are just saying that probably those things, as I said earlier in the evening, need to be re-examined and looked at again.

Further, we think that that is also likely to happen internationally because you have got a situation where a number of changes are now coming in in various regulatory regimes, and there is a retesting and a rethinking about whether the market efficiency theory that a lot of this is based on needs to be tweaked. No one is suggesting that it has not worked; it just needs to be improved.

Mr PEARCE—That does not change the underlying philosophy, does it.

Mr D'Aloisio—No, it probably does not in that sense. I think you can re-examine that philosophy but I agree with you, it is not likely that you will see a change to it in the broad sense. Sorry, I was probably not as clear as you wanted me to be.

Mr PEARCE—That's all right. You are a lawyer; I understand!

Mr D'Aloisio—Before, I wasn't!

Mr PEARCE—You referred just now to what is happening internationally. How much time has ASIC been spending in looking at what has been happening internationally? What is your view of what is being proposed in the US and in the UK, and what is your view of how our regime will compare internationally?

Mr D'Aloisio—Clearly, as you would well know, initially the international work was very much around the toxic assets. That then moved very quickly into the prudential requirements for the financial institutions—the banks and so on—and more recently it has moved into our space, into the securities and investment space. In the securities and investment space three or four key issues have emerged internationally. One is short selling, which we have discussed with this committee, as well as where IOSCO has got to and the change that has been brought about in Australia as part of that. Another issue is hedge funds and the principles that are now emerging around greater control over and knowledge of what hedge funds are doing as part of the international work that is going on there. There is work on securitisation and credit default swaps, and Greg Medcraft is one of the people who have been heading that and looking at how

we bring confidence back into the securitisation market, for example. On the accounting side, there are a number of changes going on around impairment, fair value—those principles.

What impact they will have in Australia and whether they will be taken up is a matter for government, as you would know. At the moment the government has responded on short selling. It has responded on credit rating agencies with ASIC, and in terms of how and whether the government responds to the other issues will be a matter for it.

You also raised a question about how we are faring against the US and Europe. There is no question that our system—the system they want to move to—already has a lot of those underpinnings. I think that is a fair comment. I think the twin peaks approach that Canada and Australia have is looked at very favourably. The work that APRA and the RBA do has been looked at very favourably. When you look at where the US is trying to move to, my limited experience tells me they are probably moving closer to where we are rather than us having to move further. But, again, these are matters for government, for Treasury.

Our role is really to work through IOSCO, to use the positions that we have, including co-chairing the task force on securitisation, to get those issues to a stage where each individual jurisdiction and each individual government can make an assessment as to which bits they will go with and which they will not. On that, we are in the hands of government. In terms of the issues we are concerned with here this evening, there is not as yet any international move at the IOSCO level on financial advisers, disclosure and so on. I think that is probably down the track. I think it is coming—we are seeing signs—but it is probably down the track.

Senator McLUCAS—Thank you for your submission. I want to go to questions of consumer protection or what I prefer to call consumer empowerment. In the relationship between a person who is probably in their early 60s and a financial planner there is an absolute imbalance of knowledge. I note that you recommend that we change the school curriculum, which really troubles me. I suggest to you that a person who is 17 will not remember when they are 65 what a margin loan is. I don't think that is where we need to do our education, to be frank—but let's put that to one side. What can we do? What tools can we provide to a consumer? You say in your submission that you recognise there is a fairly low level of literacy in our country. I don't think we are any different to anyone else, but what tools can we provide a consumer who for the first time in their life has an amount of money—probably their superannuation—and is about to make some fairly major decisions?

Ms Rickard—I think there are a number of things that we can do there. We are in the process of producing a range of materials which we have been out testing which are designed to teach people investing basics. We do not want to teach people to understand all the intricacies of what a CFD is, but we want to teach them the importance of things like diversification, the relationship between risk and return and the importance of asset allocation.

We are refining those core messages and then we have to look at delivering them in a way that actually gets them into the hands of people who need them, which means using multiple channels. Whilst FIDO is our core communications network we are very conscious that not everybody has access to the net or uses the net, so we need to look at other ways. One of the things we have trialled is delivering seminars through Centrelink's financial information service to try to reach those preretirees—the people you are talking about—and help them with those

messages. You also use the media and messages and radio and all of those forums that reach people and you look at ways of distributing paper based publications through phone, through libraries and through working with adult education units. There are a raft of channels we can use to get those core messages out.

One of the things we know too is that, once you can give people some basic questions and some basic understandings, should they go and deal with an adviser, the more they are empowered to know the questions to ask, the better the advice is that they are likely to get. There are a range of things we can also do online in terms of tools that will help people to test advice and to understand risks of things that they are getting involved with. It is one of ASIC's two key priorities in terms of our financial literacy work because we realise that this is a place where, if you suffer a loss, it is really very difficult to recover.

Senator McLUCAS—I will go back to my term 'consumer protection'. Some of the evidence that particularly troubled me during our hearings was the repeated evidence from people who have lost their total life savings. They had informed the financial adviser that they were people who wanted very low risk, yet they ended up with what we now know was an extremely high-risk product. I am trying to think of a way you can insert something between advice that in my mind was not accurate and protection of an individual who, for very good reasons, has taken that advice and believed it. Can you insert in there a requirement, before you sign on the dotted line, that the planner has to provide almost an external tool to the consumer so that they can basically confirm the advice that has been given?

Mr D'Aloisio—I understand. I think the problem you have is the unknown, and the unknown is that in every investment there is a risk. There is the risk/reward that you need to assess and, as Delia says, the asset diversification: do not put all your eggs in one basket and understand the risk. There will always be a risk in investment. The only way you can ultimately remove it is if the government takes that risk so that it is the guarantor of last resort. Given that is not going to happen, and should not in my view, you are looking at protection. So the tools that we would use are clearly to improve the education, the way that people ask these questions and understand it themselves. We are looking at improving the financial advice industry so they provide better advice and do not get distorted by commissions. I would disagree with you: I think taking it right back to the schools and bringing it right through as part of someone's education and whole development in life in understanding financial risks and so on will last and stay with them long beyond school. You cannot remove it altogether. Really, for someone to come in and vet it—let's say it is an ASIC or an organisation that sits between the financial adviser—and the customer says, 'Yes, you can go into that,' all it is doing is transferring the risk to someone else.

We could look at it but it is going to be very difficult given that the heart of our system will always be, 'If you are going to go into investments, there will be a risk. In your stage of life, you have to assess whether you are better off with a term deposit in a bank even though inflation is going to eat into the principal overtime. That is kind of at the lower end of the spectrum. How far up the spectrum do you not want to go in taking risks?' You will have situations where retirees will lose. We can minimise it. Some of the experiences we have had more recently have troubled us. We are making suggestions, but I think we are talking about minimisation and not eradication of that risk.

Senator McLUCAS—Sure. I am trying to find a tool you can give a consumer so that the power imbalance is somewhat levelled out. It will never be equal, but—

Ms Rickard—There are things we are looking at. We are looking at the moment, for instance, at whether or not you could have a risk indicator tool in relation to superannuation and examining closely what a front end of that would look like so that it was simple enough for people to use and what the back end would look like so that the information underlying it was accurate and reliable. That work is still in progress and at a relatively early stage, but from that work it is possible to say, 'If we can get that right there, can we apply it in other areas?' When I talk about the basic messages we are trying to get out there on investing, there will be basic messages about borrowing to invest that become core messages. Yes, I think there is more that can be done, and there are things we are actively looking at.

Mr D'Aloisio—Let us take the term deposit as the simplest of products to illustrate this point. You say to an investor, 'If you put your money in the bank you will get three, four or five per cent.' If you then go further and say, 'You have to factor in inflation over the life of that,' do you then rate that investment for the investor as low risk, medium risk or high risk? The label you give it will be telegraphing something to that investor. Where would you put that product when you try to factor in movement in interest rates over a long period of time? Would you put it in low risk, middle risk or high risk? There are two factors here. We are talking about movement in interest rates and inflation. It is money, so it is clear. We are not talking about complexity. So, even when you strip this down to the simplest of products, it is difficult to help the investor or the consumer. It is difficult for organisations to come in and say that they can remove the risk from the investment. All we can actually do is help, assist, educate and make as clear as possible what the risk is. But, in the end, each investor has to take the risk and has to wear the consequences of the risk.

Ms GRIERSON—I think Senator McLucas has raised a very good point, and I do not find the answers very satisfactory. She has alluded to vulnerable groups. Those are groups who get a lump sum for their superannuation. I am sure people who get a lot of cash in hand at a redundancy are also a vulnerable group. I would think that ASIC should be thinking of tools. For example, when I look up something on Google, a pop-up comes up from another advertiser who I have not looked up. Surely when people look up their superannuation a pop-up could come up that is mandated and says, 'This is your ASIC protector here. We are warning you.' I think there are ways that you can do that. Senator McLucas has identified vulnerable groups in the community, and you are not telling them whether it is a risky product or not a risky product; you are just informing them at a moment when they have that need that there is something else they should be considering. I think that is a really good point and I think there are ways you could be doing it better. What we have seen in our inquiry is that there are vulnerable groups. There is a point of vulnerability when they start thinking about investing their money.

Mr D'Aloisio—Let us be clear. We know we have to do more to ensure people know about the risks in investments they make. If you can come up with simple tools and find out how to warn people, that is fine—

Ms GRIERSON—Be creative.

Mr D'Aloisio—but it is not the panacea that is going to fix this because in the end—

Ms GRIERSON—But it will let you sleep more soundly in your bed, I am sure.

Mr D'Aloisio—you have got to take the risk.

Ms Rickard—I suggest that you know that we do use it.

Mr PEARCE—This point has come up.

Mr D'Aloisio—ASIC is here.

Ms GRIERSON—I like it.

CHAIR—You can go to sleep now, because ASIC is here.

Ms Rickard—I was just going to let you know that we do use Google pop-ups—

Ms GRIERSON—Good.

Ms Rickard—and we do have things that go in so that, if people type in 'get rich quick' or any of a whole lot of other keywords, then one of the things that will come up is a link to FIDO—

Ms GRIERSON—That is excellent.

Ms Rickard—So it is something we are doing and we are working with Google about how we can refine it and do it better.

Ms GRIERSON—Wonderful.

Senator McLUCAS—I understand your comments about whether or not we should be having trail commissions et cetera. Putting that to one side, it has been put in front of the committee that what might assist is one page in the statement of advice which, in clear, understandable and very plain language explained all of the fees that a consumer is paying, in all the various ways, around all the various products. It has also been put to me that you have been trying to do this for some time and that it is very hard. Why can't we do it?

Ms Koromilas—The legislation does require you to disclose all of the information—

Senator McLUCAS—We know that. We also know that most of the people we have spoken to had no idea that that disclosure was in there.

Ms Koromilas—I think that comes from the complexity of the remuneration structures that actually exist within the industry. So, when you have multiple types of remuneration that are predominantly paid by the product manufacturer to the adviser and to the licensee for the sale of that product, on top of volume bonuses and potential conferences that you can go to, that complexity leads to the consumer's lack of understanding of how much it is costing them at the end of the day. So you do come across people who believe to a large degree that, because they

have not written a cheque, they have not had to pay for the advice that they have received. A lot of that has to do with the structure of the remuneration itself. I think also on top of that—although remuneration is disclosed in the statement of advice—when a document is rather lengthy, it often can be lost on the consumer by the time they have actually got to that page. So I think that, when you add together the complexity of the remuneration structure and the complexity of the document in its entirety, it gets lost on people, and something that is relatively obvious to people who work in the industry—the way they get paid—is not something that the consumer pays attention to, because they are not asked to actually write a cheque.

Senator McLUCAS—It is more than that. For those planners who do not feel encouraged to disclose, the way the SOA is constructed at the moment almost facilitates that.

Mr D'Aloisio—Your point of trying to get it to one simple page and distil the essence—clearly we are with you on that, and we are working to do it. But there is a second issue embedded in it. The investor not only has to understand the fee structure; they also have to turn their mind to whether or not that fee structure could have distorted the advice they have been given.

Senator McLUCAS—You have got to have the first before the second.

Mr D'Aloisio—That is quite a different analysis. In a sense, yes, you can have a short-form disclosure and it has a—Deborah, in running this area, they have been working to achieve the one- or two-page disclosure documents that we all would want to see. But you then have to go to the next step, which is when someone reads that, and this is where disclosure has a limit. Yes, I have disclosed it, but is it an informed consent? Or is it really that, as the investor, when I have seen these fees, I have turned my mind to the fact and said, 'Could this guy have distorted his advice because of these fees?' And that is extremely difficult for an investor to do unless they are really experienced, because the person you are with is a trusted adviser. But you have gone to the person in the first place.

Senator McLUCAS—That is right. Thank you.

Mr ROBERT—Mr D'Aloisio, in your recommendations 3, 4 and 5, you are looking for a power to literally take away the livelihood of organisations and the people in them because you believe the person 'may not comply' or is 'likely to contravene' or where you believe a person 'is involved'. There are a fair few qualifications there and a fair few verbs like 'may not' and 'likely to believe'. How do you reconcile that with the concept of natural justice?

Ms Bird—The decision still has to be made by ASIC in accordance with natural justice. It is reviewable by the Administrative Appeals Tribunal. The changes we are asking for there are the changes that are before the parliament now in the credit bill. So you are right. Taking away a licence is a significant step and it is not a step that ASIC takes lightly. When you look at the figures, we have taken away 20 or so each year for the last few years. ASIC will take a whole lot of other regulatory actions before it would do that. So it might get an enforceable undertaking or take an individual banning or bring some other action. I agree with you that it is a significant step; we are just saying that at the moment it is an extremely difficult threshold to get over and it means we cannot act before a breach. We have to find the breach before we can take it away. We cannot act in a preventative way. If we had this change, which will probably come through in the

credit legislation, we could possibly, in the appropriate case, where the other regulatory tools are inadequate, act in a preventative way.

Mr ROBERT—Why didn't you propose this earlier? For example, we had a bull market running like mad, we were approaching 7,000 and ASIC knew that people were being pushed into high areas. You knew from your shadow work that when you went out there advisers were pushing people into areas where they had high fees. You knew that following a bull market comes a bear market. There are always corrections. This could on the surface look like a knee-jerk.

Ms Bird—Are you talking about the whole package or the particular—

Mr ROBERT—No, I am talking about those specific recommendations.

Ms Bird—I suppose the licensing regime has been in full force since 2002. It is an experience thing. We have had appeals to the AAT where we have lost. It is a matter of experience. The reforms in the credit legislation are based on ASIC's experience in administering the financial services legislation and so we have already communicated our concerns. We are pleased to see that they have been taken account of in the new regime.

Mr ROBERT—You have to admit the timing of this looks like a knee-jerk considering this has not been flagged previously.

Mr D'Aloisio—How these things are characterised is a matter for you. I do not think any of this submission is knee-jerk. We have considered this very carefully. As you would know, we are the regulator. We apply the law to the fullest. Our job is to do that and to be able to demonstrate to government when we think a change is needed because the law is deficient. We do not ordinarily jump in and ask for changes. We will only ask for those changes where we feel we really need them. Here we are not actually asking for the changes. We are suggesting that these are the changes that the committee might want to put to government.

Mr ROBERT—If I could move to recommendation 6 on the fiduciary standard, cognisant that you are referring obviously to a legal relationship of confidence and trust for advisers investing money in an orderly and wise way. It would appear that you are looking to define that fiduciary arrangement regarding good faith where it says: 'Amend the Corporations Act (s945A) to expressly require that a person who provides personal financial product advice must act in good faith.' Are you intending to define 'good faith' as a term or are you intending to rely on what the Federal Court is defining as good faith?

Mr D'Aloisio—I think the concept of good faith has been subject to a lot of judicial and other case law, so we would not be seeking to redefine it. We would leave that to the courts.

Mr ROBERT—Cognisant that good faith is being defined in different ways across the courts?

Mr D'Aloisio—Yes, I think so. I think there is a basic concept of honesty and integrity around good faith. Even though you might get slightly different definitions there is a central concept to it.

Mr ROBERT—With respect to training and minimum qualifications, you have made no reference to the minimum qualifications required of people nor with respect to what is required for someone to be called a financial advisor or a financial planner or a product adviser or all of these terms. I am cognisant we have taken advice that people are doing courses for as little as a week to nine days and are out popping product advice, advising people to put millions of dollars into different products, which in my humble opinion is sheer nonsense. Do you have any advice for the committee with respect to minimum training requirements or minimum accreditation?

Mr D'Aloisio—We think that minimum standards need to be lifted. We ourselves set the training regime and we have think we need to reassess that. Clearly, we are not at this point in a position to say to you that we are at point A on the graph and we have to go to point C. What we are saying is that the way forward is that we have to consult. If the committee's approach is consistent with that and the government takes that on, what we would see happening is that we would consult quite widely with industry again on training and we would float and discuss key ideas about whether it will be a course that will run for a week or six months, whether it will be a diploma course, whether it will be equivalent to a degree course and so on. There are a lot of issues. Then there is of course the important issue of transition. What you do with the groups that are already out there giving advice, and how do you transition to this higher standard? Again, we do not apologise for the fact that we have not given you all the detail. We saw this very much as giving you direction in terms of where we think we need to go.

Mr ROBERT—I would have thought that one of the most significant outcomes we have seen in the last 18 months is that there is no accreditation process. If you were a chartered accountant, you would have sat the chartered accountant exam. But there seems to be nothing that accredits someone as a financial planner, financial adviser or product advisor.

Ms Bird—The document we handed up related to the table 2 reforms that we suggested. In our submission, we also put forward a forward program that ASIC felt that it should take on in light of its experience. We said that one of the key things in that forward program would be a review of the training standards, taking into account the sorts of issues that you have raised.

Mr D'Aloisio—They are good points. You may have a situation where, as there is to call yourself a solicitor, there is a training requirement and accreditation to call yourself a financial planner, authorised representative, financial adviser, product distributor or product salesmen. There are a whole lot of categories in this industry already and we really have to look at those categories and the training around them because we accept and the industry accepts that the training standards need to be lifted. In the process that Jo has outlined, we will consult widely and see what changes we need to make to one of our regulatory guides.

Mr ROBERT—What is your time line for that?

Mr D'Aloisio—It is in the forward program. This is certainly ongoing now.

Ms Koromilas—We have set standards. There are some minimum standards that are set, and those standards do apply depending on the type of advice that you are providing and the different products. That is one thing. Certain products that are deemed to be more of a risk or more complex require a higher level of training, which is to a diploma level. Those that are left, such as bank deposits and general insurance that are at a lower level, such as tier one, would probably

be to a certificate III level. There are standards. I think the question you are raising is whether or not they should be higher. In that regard, we have a project in my team looking at the way in which training can potentially affect the quality of the advice. Fundamentally, what you want is advice that is provided to retail investors that is of a good standard. Where that standard sits is obviously really a question for what the legislation then puts forward. Because there are already close to 19,000 people in this country out there providing personal advice to retail clients, a lot of the work in that project needs to be considering and consulting. That project is underway and is considering potential changes that could be made to the training standards and all of the things we have discussed today. It will look to get out there and start consulting with the industry once we can set some ideas around where those training standards should actually—

Mr ROBERT—I think we can all violently agree that they are, at present, far too low. I will move on to recommendation 8, which is looking at remuneration models. I am cognisant from paragraph 177 and surrounding paragraphs in your submission that the market is moving towards shaking itself out on how it is going to remunerate itself. You have quite rightly pointed that out. You are looking for a recommendation here to legislate and to regulate exactly how commissions are paid. How would you reconcile that with the overarching belief in efficient market theory?

Mr D'Aloisio—These are the balances that need to be made. I think efficient markets work well if there is information symmetry and if indeed the disclosure regime on remuneration is not distorting investor behaviour or the behaviour of the financial planner or adviser. Our feeling is that we are not achieving the necessary level of disclosure and informed consent and, as such, sometimes you have to intervene and regulate. My understanding of market efficiency theory is not that there is no regulation; it is that there is limited regulation.

Mr ROBERT—Minimal regulation.

Mr D'Aloisio—In certain areas you do need to regulate. Every market is regulated.

Mr ROBERT—Granted, but I would not call this minimum regulation: knocking out upfront commissions, trail commissions and soft dollar incentives—some of these should go, you are quite right—volume bonuses, rewards and fees based on percentage. That is significant regulation.

Mr D'Aloisio—If we go back to the last 10 or 15 years, the existing model has been in operation and there are strong arguments that it has not worked. So you have left it to market efficiency to regulate these trail commissions and so on, and there is dissatisfaction with some of the outcomes. So I think as a regulator we need to point those things out to the committee. In the end it is a policy matter for government whether it seeks to intervene and ban these commissions or not. We are simply saying that, when we look at it and the way it has unfolded, this is an area that has to be or should be re-examined. We are not putting it any higher than that.

Ms GRIERSON—I would like to say firstly that the fact that you have recommended across such a wide range of areas is terrific and I think it reflects the work of this committee, in that it is obvious that it takes every measure to make an impact. So I think that is wonderful. In terms of your recommendation about a statutory compensation scheme, I think the industry would want to

know a little bit more about what impositions that would require of them and whether that would then flow on to clients through fees or whatever.

Ms Bird—We have not recommended a statutory compensation scheme—I should say that to start with. What we have suggested is—

Ms GRIERSON—You have drawn attention to the problems with professional indemnity insurance.

Ms Bird—We have drawn attention to the existing compensation regime and we have pointed out that it is not a perfect form of compensation. But we agree it is an incredibly difficult question how you get that backstop and what the imposition on industry would be. We have just pointed the committee in the direction of a scheme that operates in another jurisdiction and pointed out the sorts of issues that need to be considered in the design of such a scheme.

Ms GRIERSON—It certainly should be considered. This is not really your area of responsibility, but besides the vulnerable people who were taking lump sum super or had redundancies or some sort of cash in their hands we also saw people who have access to reverse mortgages or to lines of credit that allowed them to put their homes at risk et cetera. Have you made recommendations to the lenders or to APRA regarding the tightening of that sort of leniency in terms of their loans regime?

Mr D'Aloisio—APRA regulates mortgages and so on, and it does that very well in terms of what it requires. We have worked through Delia Rickard's area to improve disclosure around products like reverse mortgages and the unlisted, unrated debenture area—those areas that we think relate to the vulnerable groups that you are thinking about. Certainly the work that we did on reverse mortgages has been picked up in the credit reforms that are coming through. So they are there.

But, again, reverse mortgages are another example of these products we were talking about earlier that are attractive in the sense that they release some equity at a particular point of life, but they have the unpredictability of asset prices and interest rates—two components that can go in different directions. That puts a higher risk around that product, because it is a product aimed at a vulnerable group in the sense that at 60, 70 or 80 you do not have the ability to go back into the workforce. So that is an area that we have been concerned about. I think government has picked it up and we will continue with our efforts to make sure that the investors are really careful and understand what the outcomes of these sorts of products are.

Ms GRIERSON—If there is a tighter regulatory regime, and if people breach that regime, what do you envisage would be the action, enforcement measure or penalty that might flow from that?

Ms Rickard—In terms of reverse mortgages—

Ms GRIERSON—I just mean generally in terms of the recommendations before us. I am talking about if they do not meet the provisions for mandatory advertising, if they do not have a disclaimer on their advice or if they do not meet the disclosure provisions.

Ms Bird—The details I will have to take on notice. The new credit bill which is before the parliament involves licensing and special obligations such as responsible lending. It is a licensing regime so it would give ASIC all the administrative powers that come with a licensing regime as well as other enforcement remedies. I am not familiar enough with the bill to be able to tell you what all the remedies are for the various forms of breaches of the legislation.

Ms GRIERSON—The stick is not often the way we do things, but I think that down the track it probably needs some more consideration. Finally, and do humour me, but when I look up my superannuation in regard to making retirement decisions in the future I do hope that there is a pop up box that says, 'You could lose the lot. Read this,' or whatever with ASIC's badge on it.

Mr D'Aloisio—That is a fair point.

Senator WILLIAMS—I thank the witnesses from ASIC for being here. Following on from Ms Grierson's point about the risks of investing, you have, as I see it, stringent regulations for debenture-issuing companies where they have to say, 'If you invest with us, you may lose some or all of your principal.' I think the situation is that they cannot use the words 'invest', 'deposit' or those sorts of terms. Is that correct?

Mr D'Aloisio—They cannot use the words 'term deposit' or like a bank deposit et cetera.

Senator WILLIAMS—I guess what I am saying is that you have really strict regulations on debenture-issuing companies and obviously banks can go broke as well—we have seen that around the world, unfortunately; and hopefully that is not the case in Australia. The point I am getting at is that we see these products out there in the market. We have referred to ones that are heavily geared such as the Storm products—where people had their houses mortgaged to the hilt, were leveraged very high and had high LVR. Yet what we have heard through the submissions and in evidence given at public hearings—and we have travel extensively—is that they asked, 'Is my house at risk,' and they were told, 'No, your house is safe as can be.' So they never had those stringent warnings that you have on debenture-issuing companies, which may or may not go broke—I know some that are very sound. Should we have the same message and regulations on some of these investment products that you have on the debenture-issuing companies?

Mr D'Aloisio—I think, in the way that we are approaching some of these recommendations, you will see that we are moving in that direction. We talked earlier about advertising and what needs to be disclosed and not disclosed. So that is moving in that direction. The other thing to bear in mind is that, even though you might have out there some Storm models and we have had those issues, there has been a lot of financial advice and planners who have advised not to put the house at risk and have advised not to take margin loans beyond 30 or 40 per cent debt as opposed to 70 or 80 per cent debt. So there is evidence that people out there are acting responsibility in the way they are advising, and we have also had the 'excesses' or alleged excesses.

I think what this period is doing to us is causing us to really try and assess it—to sort out the chaff from the wheat, so to speak—and to focus these changes on those areas where people are most vulnerable and get 'sucked in' by some of these investments. So I guess to put it simply we are trying to target these changes that we are talking about to those areas that are going to need them, concentrating on the more vulnerable and the more risky products but still allowing the

market to operate and allowing the operators who have been working well in this industry to continue to work well. While we can get it out of context, there was something in the order of $1 trillion under management in Australia before the recent issues arose. There is still a significant amount under management now. Yes, there was the impact from the stock market. But it is coming back now. It is a well-run, efficient and global industry.

Senator WILLIAMS—At some stage did ASIC give advice to the effect of 'when investing, retail investors should swim between the flags' or something like that? Did someone say that?

Mr D'Aloisio—Delia will talk about that. She is a good swimmer.

Ms Rickard—We have been looking at ways to engage people with basic investing messages. A lot of people think it is too hard, too complicated or too boring. So we have been looking for frameworks in which we can grab their interest and get them within their comfort zone. One of the ones we have been trialling is investing between the flags to look at what are safe investing behaviours.

Senator WILLIAMS—Who decides where the flags are put? That is what I am getting at.

Mr PEARCE—And where the sharks are.

Mr D'Aloisio—The fact that it is eliciting these comments is good because it is getting people to think about investment and to think about risk.

Senator WILLIAMS—The point I am making is that that is good of advice but, as I said, who decides where the flags are put, because obviously with many investments—such as Opes Prime and Storm—the flags were put very wide apart or maybe people swam outside the flags.

Ms Rickard—The way in which we have been using the metaphor has been around behaviours rather than trying to place products inside or out. We have a lot of separate information that we provide on FIDO and elsewhere about types of products, what the risks are and what the benefits are. We really take people through the pros and cons in detail, and we do that work outside of the use of the metaphor.

Mr D'Aloisio—To come back and speak generally for a moment, when you analyse it you say, 'Well, what are the things that you would like to change to prevent some of the issues that have occurred?' If investors thought in terms of understanding the risk-reward premium and understanding asset diversification then I think that would have gone a long way with some of the examples we heard earlier about people taking the whole of their super fund and putting it into a debenture or not understanding that a nine or 10 per cent return could actually mean that your principle could be at risk. So I think that, when you try to distil what happened in the market and bring it back to commercial concepts and investment concepts. a lot of our effort is going to go into getting people to understand those two basic issues: how does risk-reward work with investments and what does asset diversification mean. In the Storm model asset diversification included the house, for example. Is that a sensible asset diversification that you want given the way that Australians protect their home?

Senator WILLIAMS—The last thing I would like say is that we have heard about, and you would have been following this case of course, some outrageous actions carried out during the Storm product application. For example, figures were filled in on applications for loans where Storm clients did not know who filled them in. They never spoke to the bank. There were all these sorts of things going on. They were not speaking personally with the loans officers; they simply trusted their financial adviser. Do you have any comment to make on those sorts of activities, which have obviously been brought to the attention of this committee?

Mr D'Aloisio—You will know from my previous answers that I will not be drawn into the issue of Storm right now.

Senator WILLIAMS—Yes, but what about just as a general issue.

Mr D'Aloisio—As a general concept, the first line of defence in a loan application is the bank—the bank and its systems and its compliance systems have to be such that these things are carried out in accordance with the law and, more importantly, in accordance with the proper business practices that they operate under. There is no reason to think that banks in Australia do not do that. So that is the first line defence that you would see. If indeed that line is crossed then it is fraud; and we will get involved and we will investigate and we will take action.

Senator MASON—I would like to raise an issue that does not relate to your statutory responsibility, but given your expertise in the area and your experience I would welcome your comments. We have had a bank assert that it was standard industry practice to leave the transmission of margin calls to agents such as Storm Financial rather than contact their contractual clients directly. That is the evidence that we have heard. In the case of the Commonwealth Bank in Sydney we heard evidence that they first made margin calls directly to Storm in late September and then only started contacting clients directly in early December. That is about nine weeks later. Do you think that is prudent, principled and responsible banking?

Mr D'Aloisio—I think if I can say this, as I said in answer to Senator Williams, I will not get drawn into the specifics.

Senator MASON—But what about the principle?

Mr D'Aloisio—If the loan document provides that the lender will notify the margin borrower three days before they exercise their right to sell the shares, for example—as some margin loan agreements provide—I expect that they would comply with that. If they do not, they will breach their contract. If they have breached the contract, it does not require ASIC to take action.

Senator MASON—This is not about ASIC.

Mr D'Aloisio—If indeed the agreement, on the other hand, provided that the lender could exercise the right to sell the stock at any time for any reason at whatever time of day on whatever view it formed, the lender would say, 'I have a term in a contract that enables me to do that.' In that situation, under existing law, unless you can show unconscionable conduct or some other type of misleading conduct, the lender would have been entitled to do what they did.

Senator MASON—That was not my question. My question was whether it was principled, responsible and prudent.

Mr D'Aloisio—Again, the first line of defence on those sorts of issues is the chief executive and management of a lending institution and their customer relationships. I would expect that they turn their minds to those things every day and look at customer relationships and making sure they look after their customers. As a customer of a bank, if I was treated in that way, I would exercise whatever rights I had, and probably the best one I would have would be to move.

Senator MASON—Ms Bird, you mentioned in response to Mr Roberts' question the amendments to the Corporations Act. Of course, margin lending has been brought within the Corporations Act.

Ms Bird—Yes.

Mr D'Aloisio—Yes, it has.

Senator MASON—Do you endorse what has happened in relation to the margin lending regulations? Do you think it is a good idea? Is that an improvement?

Ms Bird—Yes. ASIC made submissions to the Productivity Commission when it was looking at consumer law pointing out that margin lending was unregulated and suggesting it be brought into the Corporations Act.

Senator MASON—In relation to making that submission, were the events surrounding Storm at the top of your mind?

Ms Bird—No. I think it was prior to the events surrounding Storm that we made the submission.

Mr D'Aloisio—I think it was 2002—

Ms Bird—No. It was 2007.

Mr D'Aloisio—It was not even with the benefit of hindsight.

Senator MASON—Does that vindicate your submission?

Ms Bird—We think the regulation of margin lending will make a difference. There will be a responsible lending obligation, which should make a significant difference. The regulations suggest that one of the things that the lender will have to look at is making inquiries about whether someone's home is at risk and whether the borrower has borrowed the capital to get the security for the margin loan. So, yes, we do think it will make a difference.

Mr D'Aloisio—What we did not anticipate—or the market did not—was the growth in margin lending that occurred in a very short space of time.

Mr PEARCE—While the market was going up.

Mr D'Aloisio—The market was going up at the same time. As you saw in many other things, the risk/reward got lost sight of.

CHAIR—Mr D'Aloisio, in your submission on page 35 you say there is a perception amongst some consumers that being an AFSL holder means that the licensee has been approved by ASIC or that it signifies the high quality of the financial services provided by the licensee. I am wondering whether you have any evidence of that. If you could take that on notice, that would be good. What I am interested in is: could that perception—particularly in relation to Storm—have come out the fact that people have said to us, 'ASIC came in and did an audit and a compliance test and it came out clean, which is probably a good indication that there is nothing wrong with the business or the model or anything else. There was nothing of concern to ASIC.' It just puzzles me. Either there is a deficiency in law in what was happening at Storm or there was a deficiency in the audit process or compliance checking. Without going into the investigations that you are carrying out, no-one today could possibly look at Storm and say everything was okay and that they met all their obligations. No-one could possibly imagine that was the case. What did ASIC miss?

Mr D'Aloisio—We have gone through in some detail, in the confidential parts of our submission, just what we did and did not do. I am happy to go into a private session and go through that. I have said publicly that we do not believe we missed the issues, and we have answered those questions in the public part of the submission as well. So I do not accept the premise that we are behind what has been missed here.

CHAIRMAN—I am challenging what you have put in your submission. You are saying there is a perception amongst consumers that, because they have a licence, they have suddenly gained credibility. Of course they have—they have been granted a licence. This was part of the point of asking you very early on about the licensing. If by the very fact of granting the licence you give them credibility, then that credibility does exist, but then that is divorced from the process of going in, auditing and checking a company and giving it a tick of approval, which is what happens. It is no longer a perception; it is reality.

Mr D'Aloisio—You are licensed to drive a vehicle and the RTA gives you that licence. If you are involved in an accident, is it the licence that is at fault? Is it the licence condition? Is it the fact that the RTA did not check you?

CHAIRMAN—But if I am checked or audited, re-checked and tested?

Mr D'Aloisio—All that licensing does is to set the minimum requirements which must be met. At the end of the day, under our system the boards and management have to run these things and make money for their investors.

CHAIRMAN—So there is a big gap in law. If you go in and audit a company and you cannot find anything wrong, you tick it off. There is a big problem in law.

Mr D'Aloisio—I do not accept that we ticked it off. That is where we disagree. If you would like to go into a private session, we can go through all that.

Mr ROBERT—I have one very quick question which I am sure you will be able to give a yes or no answer to.

Mr D'Aloisio—I will try!

Mr ROBERT—To flesh out how you would view a fiduciary arrangement based on good faith, let me give you a quick scenario that ASIC should be able to answer. If there were an organisation that was leveraging people to 90 per cent LVR, that was then leveraging unrealised gains to 90 per cent LVR, that had the same price and the same plan for everyone, that did not diversify at all but just shoved everyone into the same high leverage and that kept clients from speaking with their banks, do you believe that in that scenario there might be a threat that perhaps that organisation may not be fulfilling its fiduciary duty of good faith?

Mr D'Aloisio—I would have thought yes.

Senator McLUCAS—I have a quick question that goes to page 53 of your submission, paragraph 186. I know you are talking about a fiduciary style duty of advisers and a range of things that would not be permitted, including 'rewards for achieving sales targets'. You are making that comment about financial planners and advisers, I imagine. Do you see, though, that the reward for achieving sales targets in the banking sector is also skewing the behaviour of players?

Ms Bird—You are right—the recommendations that we have made have been limited to providers of personal financial product advice, and obviously in other situations those sorts of targets could have the same distorting effect. But we are not making any suggestion in relation to that; we just suggest that the committee might want to look at whether there are other distorting effects of remuneration arrangements in other circumstances.

Senator McLUCAS—You may have seen the evidence given in Townsville around the changing lending targets that were applied to the Commonwealth Bank in that particular agency.

Ms Koromilas—The submission in relation to the reforms suggests that potentially you may want to consider where there is an execution only service or where there is general advice provided as well. So it is not limited to personal advice but relates to the situations you are describing, which would typically be either a general advice situation or potentially just execution only, where someone comes in and says, 'This is what I want,' and there is merely the execution.' Those things are put into the submission for further consideration.

Ms GRIERSON—I am looking at an article in the *Sydney Morning Herald* today: 'ASIC plans call for "super-regulator"'. It is apparently an exclusive. It does say that you seek these extra powers so that you would be able to address business models that are seen as risky. Are you confident that the set of recommendations that you are putting forward for a new regime would always support the clear identification of risky business models?

Mr D'Aloisio—First off, the journalist has taken licence with the submission that you have been given. ASIC has not called for a super-regulator and ASIC has not called for a Wallis-style inquiry. What I think the journalist picked up is what is in the submission before you, and the earlier discussion we were having about a re-examination of the balance between market

efficiency and regulation. On the second part of your question, I would say that, clearly, we have given a lot of thought to these risks and how to deal with them as part of what this committee's work is doing, concentrating heavily on the retail investors, financial consumers, the mums and dads and the retirees. With the benefit of the experience we have had with the market, we think the reforms that we are talking about are things you should consider and governments should consider. Beyond that, we are doing a lot of other work and there are other areas we are concentrating on, but we are not purporting to have a panacea to deal with all the issues that are out there at the moment.

Mr PEARCE—Mr D'Aloisio, Can I just quickly ask you one question about paragraph 15 of your submission. Before I ask you a question about that, I do note what you say in paragraph 16, the following paragraph. But, you say in paragraph 15:

The primary causes of these collapses—

that is, the ones listed above this paragraph: Storm, Opes, Great Southern, Timbercorp, ABC Learning, Allco, and Babcock and Brown—

and corporate failures were the market downturn and flawed business models …

Can you confirm to the committee that it was not a result of the law?

Mr D'Aloisio—No. Let me explain. There is no question at all that, with the market downturns and everything else, the business models that relied heavily on rising asset prices and leverage were flawed and proved to be flawed. The prime responsibility for those flawed business models is what I talked about earlier—the first and second line of defence, boards and executives. We have gone on to say: that does not mean that as part of those collapses—

Mr PEARCE—I know that.

Mr D'Aloisio—there has not been wrongdoing.

Mr PEARCE—I know that. But you are saying to the committee that the primary reason is that it was not the law's fault, that it wasn't a bad law?

Mr D'Aloisio—No; we are saying that within the existing law there could have been wrongdoing and we are investigating and taking action. Then we are going further and saying that, with the benefit of knowing what has occurred, and in trying to look at how to avert similar issues in the future, we think the committee should look at some basic changes to the law in the areas we have talked about. So we are saying: yes, the flawed business models and the economic times we are in—

Mr PEARCE—The primary—

Mr D'Aloisio—broad issues. There were failures. There was possible wrongdoing, which we are investigating. Industries responded and want us to make some changes. We are saying, 'We think you have to go further or should think about going further.'

Mr PEARCE—Okay. Thank you.

CHAIR—Thank you very much for appearing before the committee tonight.

[8.10 pm]

Mr David Liddy, Managing Director and Chief Executive Officer, Bank of Queensland

Mr Ram Kangatharan, Chief Financial Officer, Bank of Queensland

CHAIRMAN—Thanks very much, Bank of Queensland. If you would like to make some opening remarks, that would be appreciated.

Mr Liddy—Firstly, I would like to thank the committee for this opportunity to provide information about Bank of Queensland's dealings with Storm Financial. I am here this evening to answer your questions and I look forward to clearing up what I think are some inaccuracies that have been publicly reported. I appreciate the committee giving the bank the opportunity to make a late submission to this inquiry. As you are aware, the bank is currently being investigated by ASIC. Our own internal review has not yet been completed; however, we are now sufficiently progressed to be able to provide, I believe, useful information, and that is what I hope to do tonight.

I would like to clear up any possible misunderstanding about the bank's supposed reluctance to make a public comment about Storm related matters. The bank have been subject to court proceedings since 21 August; we have been under specific ASIC investigation, as I mentioned, since mid-June; and we have been busy with our own internal review. In light of those ongoing matters, the bank took the decision—correctly I believe—not to provide a running commentary to the press or any other forum.

Now that our internal review is well advanced, I am looking forward to answering the committee's questions. As the committee would be aware, 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. As outlined in our submission, 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. I am very happy to discuss in more detail what we are doing to assist our customers if that is of interest.

The bank's relationship with Storm Financial was one of referral only. There was no corporate banking relationship. There were no commissions paid by the bank to Storm or by Storm to the bank. There were no incentives or performance expectations with respect to writing Storm business.

The Bank of Queensland are not a big bank; we are a small bank. We do not provide advice on or manage complex leveraged or geared equities. We did not and do not provide margin loans. In the context of Storm investors, the bank provided plain vanilla home equity loans to Storm customers. The bank's relationship with Storm's customers was atypical of our usual customer relationship in the sense that the borrowers were brought to us by Storm in what was effectively

an auction process. As part of that process, Storm, as the licensed financial advisor to the borrowers, acted as agent on their behalf in sourcing loans and providing information about the borrowers. The bank assessed customers' income and the ability to service the home equity loans on what we regarded at the time to be a conservative basis. We did include expected income from the Storm related investments, but we discounted Storm's estimates of that income significantly. While our experience with these loans for over half a decade reinforced the conservatism of those income assumptions, the experience since then and hindsight now show what a fragile investment model it was.

Let me reiterate: as a bank, our role is not to provide financial or investment advice. In fact, current laws prevent us from giving an opinion or providing advice in this regard unless we are specifically licensed to do so. Our role is to provide loans based on our assessment of the risk we will bear in those loans. Our role is to provide finance, and our commercial success depends on our ability to give all Australians fair access to finance. Importantly, BOQ provides an alternative to the big banks, and we are working as hard as we can to be a real alternative and provide all Australians with choice. We do that by trying to build long-term, mutually beneficial relationships, by having our branches owned and run by people who live in the local communities they serve, by supporting local community activities and by supporting the customer through the hard times as well as the good. I guess that is what it comes down to.

We do not believe we have acted illegally or dishonestly in our dealings with customers referred through Storm Financial. I am also dismayed by the impact on our customers of the collapse of Storm and want to see it righted, but I reiterate that the losses were not our doing. It was not our role as a bank to advise on investments—nor are we qualified or licensed to do so. We nevertheless feel for our customers who are suffering financially and in many cases, as I mentioned, emotionally. We are working with our customers to help them through what is a very difficult time.

Before I close I should note that we have included some comments on responsible lending in our submission. The proposed national consumer credit protection law will formally introduce the concept of responsible lending for the first time. Let me be clear: I am not against the concept. It is difficult to see how anyone could be. My caution is that the devil is often in the detail. Until we have seen the regulations and seen how the courts interpret the breadth of the concept of responsibility, it is difficult to assess exactly how far the new law will transfer responsibility for decision making from borrowers to lenders. My main point is that nothing in this world is costless and the further this responsibility is transferred the more likely it is to increase the cost and reduce the availability of finance to consumers. These are the issues that need robust public debate. Thank you very much.

CHAIRMAN—Thank you. You have repeatedly made it clear in your submission and in media statements that you had no formal relationship with Storm and that it was just an auction process where you bid, like anybody else, for business. I understand it did not involve that many customers—160, unless that number has changed.

Mr Liddy—About 319 customers.

CHAIRMAN—Okay. That is not a very large number, given the overall numbers that we have seen. And you are yet to finalise an internal investigation. It seems odd to me that, since

Storm collapsed in late 2008, and you have had a fairly long period of time with a very small number of customers, to whom you say you have provided no margin lending, it is taking the bank so long to work out what happened. Why is that?

Mr Liddy—We started to review and go through individual files around late January-February this year. That was following a credit risk review, where we looked at the asset quality issues associated with the collapse of Storm. That indicated to us that there were other issues that we needed to look at, so we commenced a review by review file. We completed that by June—hence the statement we made in June, which you are aware of. We have subsequently picked up and are doing a much more forensic review of each of those files. That review is still incomplete. Bear in mind that data is available and sourced from many, many sources. Some data is in the branch. Bear in mind also that ASIC took control of all of our files so we had no access to them for a period, because they are investigating us. So we have information in branches, in data systems, in credit files et cetera. Believe me: it is a forensic review and we will do it correctly and properly.

Mr Kangatharan—Chairman, I will just add something to ensure the record is correct. On 25 June we made a market announcement that we had 319 customers. In the submission you will find mentioned that we have 261 current customers. A number of customers have actually paid out their loans during that time. In addition, ASIC has informed us of a list that they have derived through access to the Storm database. We are in the process right now of truing up the difference between their list and ours. Their list actually has more names, which may come into that pool at a later date.

CHAIRMAN—That is fine; thanks. You say you are currently reviewing your policy with respect to customers who have agents acting on their behalf. What was wrong with your policy such that you are reviewing it?

Mr Liddy—Our preferred option is for all of our customers to be interviewed by bank staff. That is our policy.

CHAIRMAN—Sorry—'preferred policy' or 'policy'?

Mr Liddy—That is our policy. But, where we were instructed by our clients to deal solely with an authorised licensed financial planner, our policy was silent.

CHAIRMAN—So who controls the bank—the customers in terms of saying, 'You'll do this and you'll do that,' and, 'You'll talk to this person but I won't talk to you directly.' How does that work?

Mr Liddy—I believe the customer does control the bank.

CHAIRMAN—That might be what you say here, but that is obviously not the experience of people in banking. The bank controls how much money you get, the bank controls whether you get the money or not, the bank controls how much you pay. The bank controls all of those processes. The customers do not control the process. They have no control over the process. You cannot have it both ways. I cannot just decide with my bank that I give authority to somebody else to deal on my—

Mr Kangatharan—Chair, I think it is appropriate to say that the client can choose who represents them, and where the bank has to form an opinion—

CHAIRMAN—So you are saying that people actually chose somebody to completely represent them and the bank agreed to do that, so there is a formal document that exists to demonstrate it with a signature?

Mr Kangatharan—We had a situation where a licensed authorised financial planner had, in most instances, an authority to deal with the bank on behalf of the client—

CHAIRMAN—So what have you got from the broker or the adviser? You have got a signed bit of paper that says what?

Mr Kangatharan—If you look at a typical loan file for a customer of Storm who is also our customer, usually you would find a Storm request for quote, which usually included a signed authority from the customer. It included—

CHAIRMAN—A signed authority to do what?

Mr Kangatharan—For the bank to deal with Storm with respect to the loan application. It also contained a financial plan that Storm Financial had put together for the customer. It included details of the customer's income as well as the planned investments for the customer.

CHAIRMAN—That is fine. Where you received an authority you would automatically grant that authority but you would not meet, talk to, have a face-to-face meeting with the person you were loaning money to. You would just take it on good faith—

Mr Kangatharan—No, in a number of instances we actually did—

CHAIRMAN—You cannot have it both ways.

Mr Liddy—Chair, policies and processes are put in place for good reason. If I could just indulge for a moment, when the bank lends money our shareholders are the ones that carry that risk. Our assessment needs to be that the borrower can repay the facility. So we put processes and procedures in place to adopt that. Some of these processes and procedures are not always followed. That is standard across the world, across banking, everywhere. In my 41 years in retail banking I certainly can see plenty of examples where that is the case. Some of those are errors and in some cases it is a case of deliberate manipulation. In the case of errors, that is dealt with through training and education and so forth, and reprimanding. In the case of deliberate falsification, if you like, that is much more severe. Fortunately, there are not many instances of that but there are instances of that. In the case of Storm our policy was for all lending managers to interview their customers. In this instance our lending managers were given an authorisation by their customer or the Storm client to deal directly with Storm. They took that as their judgment and did not seek a policy exception for that. In my words that was a reasonable assumption for them and I wouldn't cane them over it.

CHAIRMAN—Did all of those applications come through the North Ward branch?

Mr Liddy—Not all, but the majority certainly did. There were about 28 applications that came through six other branches.

CHAIRMAN—Where were the other six, roughly speaking?

Mr Liddy—Some in Brisbane.

CHAIRMAN—So they might have been more related to other Storm entities that existed, but the vast majority—

Mr Liddy—Yes.

CHAIRMAN—In terms of the number of applications that went through one branch, and they all might have had similarities to them in terms of the authority, did it not ever occur to the bank to look specifically at the pattern that was happening there?

Mr Kangatharan—In terms of that authority, let me expand on that. On a number of occasions the branches did try to contact the customer for verification of certain information provided by Storm. In most cases they were directed back to the Storm adviser. That is one thing. The second thing is, with respect to our overall risk management—

CHAIRMAN—On that point, I am not comfortable with this. The bank rings up a customer and the customer says, 'Look I don't know, just ring up my adviser.'

Mr Kangatharan—No, the customer says, 'My authorised licensed financial adviser—

CHAIRMAN—'I am not going to talk to you. You are my bank, I am borrowing money from you,' and the bank just accepts that?

Mr Kangatharan—No. If the customer says, 'I am aware of this loan, I am aware of this process and I have authorised my financial—

CHAIRMAN—Seems like a very compliant bank that just does whatever. You ring a client because you have a concern—you are only going to ring them if you have got a concern—and the client that borrows the money from you and your shareholders says to you: 'I'm not going to talk to you. Talk to my authorised represent.' It just does not seem to me to be normal.

Mr Kangatharan—But in the context of an authorised and licensed financial planner who the customer recognises having a relationship with, and the customer directs us to deal with them, why would we have any reason to suspect—

CHAIRMAN—Because you are lending your shareholders' money to them.

Mr Kangatharan—But why would we have reason to suspect something is amiss—

CHAIRMAN—Because you rang to find out some information that you were concerned about.

Mr Kangatharan—And they have informed us they have provided the information to their financial planner and, 'Please get that from the financial planner.'

CHAIRMAN—In hindsight, is that good policy?

Mr Kangatharan—We are reconsidering this exactly because there has been a failure here, where an authorised financial planner could potentially not provide the right information. With the benefit of what has happened in the Storm case, that has caused us to rethink it. But I do not think we have reached a landing to say that that means we cannot accept any agent dealing on behalf of a client applying for a loan with us.

Mr Liddy—It is quite common to rely on third party information. Banks and other businesses deal with accountants and solicitors who, on occasions, are instructed to provide information to the bank rather than the customer themselves. That is quite common practice.

Senator MASON—Mr Liddy, you say in your submission:

… we believe that there was no dishonest or illegal practice or conduct by the Bank of Queensland in connection with Storm clients.

I am sure that is right. Our concern is not so much with that. It is more with, even though banks may have behaved in accordance with standard industry practice or common industry practice—I think you used those words—that in fact was prudent, principled and responsible. That is really our point. You yourself have said in your submission that you are reviewing your policies. So clearly there is concern within the banking industry. Do you think in retrospect that you were sufficiently diligent and responsible and prudent?

Mr Liddy—I think proof is in the pudding. The performance of the loans—

Senator MASON—The proof is in the pudding, and I am not sure it necessarily bounces your way.

Mr Liddy—Senator, if I could just explain. The performance of the loans in the Storm portfolio—until the collapse of Storm, there were no defaults, there were no overdues. Policies change. Innovations in business change every day and sometimes policy lags those innovations. It is our role to continue to change those. We are saying that, as a result of our findings and our review to date, policies and processes need to change.

Senator MASON—Correct me if I am wrong. I just want to go to the ethics before I ask a more general question. You do concede you are reviewing your policy because obviously there is some concern there. You think, in any case, clearly you have acted legally and you are reviewing the fact that perhaps in future you may wish to have direct contact with the customer. Is that is right?

Mr Kangatharan—In terms of our strategic direction, the Bank of Queensland is actually fairly unique among the banks for not strategically wanting to deal with the broker community, so as a matter of policy we have sought to avoid that in most instances. However, it is not just

brokers who can act as agents for their clients. You have accountants, solicitors and financial planners, who all hold themselves either—

Senator MASON—But the contractual relationship is between you and the client, isn't it?

Mr Kangatharan—Yes.

Senator MASON—As the chairman said, the risk ultimately is with you and your shareholders. The contract is between you and the client. I have been down this track with some other banks. I don't mean to be rude. I have got the code of banking practice in front of me. It says this:

Before we offer or give you a credit facility (or increase an existing credit facility), we will exercise the care and skill of a diligent and prudent banker in selecting and applying our credit assessment methods and in forming our opinion about your ability to repay it.

Do you think you did that?

Mr Liddy—As I mentioned before, in terms of the performance of the loan portfolio, that would suggest yes, because we had no defaults and we had no overdues. Let me run you through the process for approving a loan. In the instance of a consumer loan data is put into a statistical database—and we can outline more of that for you; it runs under a five C process—and an answer comes out: yes, no or maybe. That is based on information that is provided into that system. In the case of our customers with Storm, we relied on the income figures and the security figures, which were subject to an independent valuation of property by the bank's panel of valuations. That data was input and some of those loans were declined and some of them were approved. In the case of a commercial loan it is a much more forensic investigation, if you like, because of the complexity of both the borrower and the securities. So it is not just a simple thing that fits all cases. I would say definitely, in terms of our processes and the way that we assessed those loans, that that was correct.

Senator MASON—I am aware that you are reviewing your policy. Every time we ask someone about this they say, 'What we have here is standard industry practice but we are reviewing policy.' Let me go to another example. I am aware that you did not offer margin loans, and I accept that. Mr Liddy, you are an experienced banker and I would like your opinion, if that is all right, in relation to margin lending. We have had a bank assert that it was common industry practice, just like in relation to customers having agents acting on their behalf, to leave the transmission of margin calls to agents such as Storm rather than contact their contractual clients directly. That was described as standard or common industry practice. In the case of the Commonwealth Bank they first contacted Storm in late September—that is in the evidence from the Sydney hearing—and then about nine weeks later commenced contacting their clients directly. Do you think that is prudent, principled and responsible banking? It may be common industry practice, granted; but is it responsible, principled and prudent?

Mr Liddy—First of all, we do not provide margin loans and I have no intimate knowledge of the workings of a margin loan facility.

Senator MASON—You can comment on this, Sir. You are quite entitled to. You have parliamentary privilege. The committee would be very interested to hear what you have to say.

Mr Kangatharan—If I may comment—

Senator MASON—No, I would like to hear what Mr Liddy has to say.

Mr Liddy—I think the arrangements that are made with the borrower at the time should be adhered to.

Senator MASON—That is all very well but that is not answering my question.

Mr Liddy—I think it is.

Senator MASON—The contractual obligations may be adhered to but that does not mean something is ethical, responsible or principled. Can you answer that question? Let me ask you this question: do you support then the new amendments to the Corporations Act regarding margin lending?

Mr Liddy—To be honest, I am not familiar with them.

Senator MASON—Mr Liddy, you are the CEO of the Bank of Queensland.

Mr Liddy—And, as I said, we have deliberately steered clear of margin loans as a product.

Senator MASON—I hate to think what your salary is but I would have thought that it would be fairly legitimate for someone of your seniority to be on top of amendments to the Corporations Act regarding margin lending whether you operate them or not.

Mr Kangatharan—Again without having intimate knowledge of the specific contracts that were in place, let me just say that when you look at a margin-lending product by design it is actually designed to protect your equity through the LVR mechanism. Depending on the investment, whether it be a delisted investment or a share investment, those values move on a minute-to-minute basis.

Senator MASON—I accept that.

Mr Kangatharan—If the LVR is the key mechanism by which that equity is protected then you would imagine that the mechanism by which you protect that equity is actually disposal on a timely basis should those LVR limits be breached. Again without knowing the specifics of the arrangements that a particular bank may have had with its customers, you would think that nine weeks is an extremely long time in which to inform a customer of a market movement and then seek to protect their equity by disposing of those shares or the investment.

Senator MASON—I might agree with you, and indeed the committee may well agree with you; but you see that was also common industry practice, so the Commonwealth Bank tells us. And common industry practice does not seem to be that responsible, does it, Mr Liddy?

Mr Liddy—Senator, I cannot comment.

Senator MASON—You mean that you will not comment.

Mr Liddy—I cannot comment on that.

Senator MASON—Mr D'Aloisio was happy to comment. You are under parliamentary privilege. You are quite entitled to comment.

Mr Liddy—I am not saying that at all. I am saying that I cannot comment on the Commonwealth Bank's activities.

Senator MASON—Forget the Commonwealth Bank. This is a matter of principle, all right? If we have a situation where it is common industry practice to leave the transmission of margin calls to agents such as Storm—it does not have to be Storm—rather than contacting contractual clients directly and it takes up to nine weeks, is that responsible?

Mr Liddy—I think nine weeks is probably too long.

Senator McLUCAS—Thank you for your submission and for being here today. Mr Liddy, I understand that the North Ward branch of your bank has received the title of being lender of the year on a number of occasions. Is that right?

Mr Liddy—Branch of the year.

Senator McLUCAS—Branch of the year. And how do you become branch of the year? What do you do?

Mr Liddy—It is a combination of meeting various objectives. Partly those are lending objectives, partly they are deposit objectives and partly they are the sales—credit card sales et cetera.

Senator McLUCAS—So it is around activity?

Mr Liddy—Yes, and living the values of the bank, which are passion, achievement, courage, integrity and teamwork. They are measured against those.

Senator McLUCAS—Integrity?

Mr Liddy—Integrity.

Senator McLUCAS—How does the bank assess that?

Mr Liddy—Doing the right thing.

Senator McLUCAS—Doing the right thing. Do you use loan targets as a way of encouraging activity in your bank?

Mr Liddy—No, not specifically. Let me just outline this. An owner-managed branch is different to what you would probably understand as a corporate branch. So an owner-managed branch, firstly, if it is a greenfield site—

CHAIRMAN—Is that what the North Ward branch was—a franchise?

Mr Liddy—Yes, a new branch. The two individuals who co-managed that branch put in a certain sum of money. It would have been somewhere between, I guess, $300,000 and $350,000. That establishes the furniture and fittings, the signage and so forth. So all the fixed costs are borne by the operator. Then they get customers, and the earnings that the bank makes from those customers are shared with those owner-managers. So a branch, for instance, on a typical basis is paid to generate over-the-counter transactions—cashing cheques, ATM transactions, lending of all forms and deposit taking of all forms. That is the remuneration structure that is put in place.

Senator McLUCAS—So it is between the parent company and the franchised operation?

Mr Liddy—Yes, that is right.

Senator McLUCAS—But within the operation do your franchised banks use lending targets at all?

Mr Liddy—No. They establish their own targets. We have a minimum standard that we would expect them to make. They do not have a cap, but they would be brought under our notice if they were significantly lower than where we expected them to be in terms of all their targets.

Senator McLUCAS—And when they are brought under notice, what happens then?

Mr Liddy—We find out why they are behind target and, if they need training, we help them with training. If they need extra resources, we help them with extra resources.

Senator McLUCAS—Is there any penalty if they continue to be under target, so to speak?

Mr Liddy—The penalty to an owner-manager is that, if they do not reach their level of business generation, their remuneration is impacted, because as they grow their business obviously their business remuneration, if you like, increases.

Senator McLUCAS—So the incentive is for the owners of the franchise rather than the franchise owner transferring that incentive to their employees?

Mr Liddy—In some cases, I believe they share with their staff. The staff are part of the owner-managed team. They are not actually employed by the bank.

Senator McLUCAS—So they might get a bonus?

Mr Liddy—Yes, they would get a bonus or whatever it might be.

Senator McLUCAS—So the target is probably not set as a number but the incentive is still there, inherent in the model.

Mr Liddy—Most branches would have individual sales targets that they try and achieve each week, and they would have a team meeting, typically on a Friday or a Monday, to discuss how they are going against those targets. But we leave that pretty much to the individual operator.

Senator McLUCAS—I understand that. Coming back to getting the title banker of the year, can you tell me how many times the North Ward branch achieved that?

Mr Liddy—I believe twice.

Senator McLUCAS—And what years were they?

Mr Liddy—I cannot tell you exactly—probably three years ago, four years ago.

Senator McLUCAS—That would be 2005?

Mr Liddy—We think it was 2004 and 2006.

Senator McLUCAS—And that is when most of the loans were being processed?

Mr Liddy—The loans were processed, I believe, between 2004 and 2008. That branch is a very, very successful branch ex-Storm. I estimate that in terms of their business they were gaining about 10 per cent of Storm's business. That is pretty much in line with the Bank of Queensland's market share in Queensland. So that is not out of the ordinary. Both owners of that branch were former corporate branch managers, one based in Townsville itself and the other based initially in Brisbane. They were very successful corporate managers. It did not surprise me that they were successful there. In terms of day-to-day activity, the bank obviously supports the brand through advertising. These guys would have spent probably 10 times any other branch in terms of advertising in the local Townsville area, and that goes down to their success. They differentiated themselves clearly on their ability to provide a different level of service to customers. At the end of the day, that is the only way BOQ survives, because at the end of the day most bank products are the same and most prices are the same. It sounds like rhetoric, but service is really the differentiator and that is what we try to do.

Senator McLUCAS—I find it interesting that you talk about a different level of service. The difference that I have identified is that your people at the North Ward branch did not talk to the people they lent the money to.

Mr Liddy—I think in some instances they certainly attempted to but, as we mentioned earlier, they had authorities to deal directly with a licensed financial planner, and they did that.

Senator McLUCAS—I understand that. I just think that when that group of people came to your bank via Storm all with that box ticked on the application form that said, 'I authorise you to talk to Storm—don't bother talking to me,' it should have set some alarm bells ringing.

Mr Liddy—The bank would take that into account, but customers were dealing with someone that they trusted, that they were prepared to provide their personal information to—both their financial information and other information—and asked the bank to rely on that information. I do not think that is out of the ordinary.

Senator McLUCAS—In a technical sense, I agree with you. But the volume and the fact that all of them had ticked that box should have made someone say, 'I hope the risk is being assessed properly here.'

Mr Kangatharan—Senator, I think it is also pertinent to add that it was not just an authority. There were multiple pieces of information that were being channelled through the financial adviser back to the bank. Let's say there is income verification or a signed application form or, indeed, once a loan is approved, the actual signed contract—all of those have to be signed by the customer. When that information flow is fluid and in order and appropriately provided by the financial planner, we would not have reason to think that something was not right.

Senator McLUCAS—I might disagree with you; but I understand what you are saying.

Mr PEARCE—Thank you for being here tonight to chat with us. We have heard a lot about and seen in your submission this model that you were using—that is, an agent, for want of a better term, that does the work and sends it in to you. I presume Storm were not the only people that you dealt with like this. How many people would you deal with under this sort of arrangement where the third party does the work and they get the authority? It would be a few, wouldn't it?

Mr Liddy—Firstly, Storm were not agents of the bank.

Mr PEARCE—No, a third party—

Mr Liddy—They were agents for our customers. That is a very important point. It is not unusual to use third parties. As I said, accountants, typically, and lawyers, particularly, act in those capacities. As my colleagues mentioned, we do not deal specifically with third-party mortgage brokers. We certainly deal with brokers in equipment finance and in debtor finance. That is quite a common model. It is similar to seeking out an insurance policy. It is quite common practice to deal with third parties, and we still do.

Mr PEARCE—I am interested to know, Mr Liddy, whether there was anything in the arrangement that you had with Storm that was any different to any other relationship you have?

Mr Liddy—There were no commissions paid between—

Mr PEARCE—Is that different?

Mr Liddy—Not in all instances, no. In some commercial transactions—for instance, in equipment finance—there are commissions paid. But there were no formal arrangements here. It was simply a referral network that was established by this particular branch.

Mr PEARCE—But there was nothing different about it from what you might do with another mob down the road?

Mr Liddy—In some instances we pay commissions. In this instance there were no commission payments.

Mr PEARCE—I think you said that the majority of loans that came through to you were home equity loan—

Mr Liddy—Correct.

Mr PEARCE—people drawing on the equity of their home. Were you aware of the intended purpose of the loan?

Mr Liddy—I am sure we were to some extent but, as I said, our obligation is not to question—

Mr PEARCE—I understand that.

Mr Liddy—the purpose of that loan. I talked earlier about responsible lending that may be impacted next year. That is going to have a significant change.

CHAIRMAN—Are you really serious about that? You do not question the purpose of the loan?

Mr Liddy—I did not say that.

CHAIRMAN—You just did. You said. 'Our purpose is not to question the intent of the loan.'

Mr Liddy—Our role is not to question. I said I am sure that we do question.

CHAIRMAN—It is not to question, but you are sure that you do? Maybe I just did not hear it correctly. I thought I heard that you—

Mr PEARCE—Let me ask the question again. I am interested to know. If you get a loan form from Mr and Mrs Jones and you whack it into the system and it comes out that they can qualify, I understand that that is the way your process works and that is your process and that is your business, essentially, because you are taking the risk. It is your shareholders, as you rightly say. All I am simply saying is that, what have you ascertained with your review? Did you know whether or not Mr and Mrs Jones were borrowing an extra hundred grand to go on the holiday to Europe or to buy the kids their house or to whack it into some sort of investment or to buy a new car?

Mr Kangatharan—Just to be clear on this, when you are assessing a loan application, especially for investment purposes—let us take a completely different example. Let's say it is for the purchase of an investment property. To include the rental income that you would get from investing that money in the rental property is acceptable and required if you want to actually borrow.

CHAIRMAN—I think we accept all of that; we understand it. But I think the question Mr Pearce is asking is in relation to Storm—people were not buying rental properties; they were buying—

Mr Kangatharan—I am just coming to that. With respect to the financial plan that a Storm adviser would put together, if it includes the borrowing of funds from BOQ using the equity in your home to invest in the Storm products—which were usually provided by Challenger or Colonial et cetera—then you would have awareness that that is where the money is going and you would have awareness of the income potential from that investment.

Mr PEARCE—So you knew in a lot of cases what the purpose of the loan was?

Mr Kangatharan—Yes, but I think what David has made clear and what is important is that we are not authorised to advise on—

Mr PEARCE—No, I understand that. I am not suggesting for one moment that you are. I understand that entirely. And good on you; it is not your job at all. I buy that absolutely—I agree. Mr Liddy, you mentioned in your opening remarks about the program that you put in place to help your customers. I commend you for doing that. Can you share with the committee how that program is constructed? Pretend I am a classic case. I have come knocking on your door. What is the process? Can you share with us very briefly what you intend to do with your clients?

Mr Liddy—The initial process was that we wrote to every client and pointed out that the bank had a hardship package and, if they needed to apply, please apply. We are looking now for extreme cases of hardship and we will deal one-on-one with each of those. There will be various solutions to each individual case. We are committed to doing that. You have got my undertaking that that is what we will do, and we have started doing that. The remedy can take a number of situations.

Mr PEARCE—What sorts of remedies are you looking at?

Mr Liddy—It could be interest-free loans, for instance. It could be an extension of a term. What we want to do is work with customers so they can keep hold of their homes.

Mr PEARCE—Sorry, would you say that again?

Mr Liddy—We want to work with customers so they can keep hold of their homes.

Mr PEARCE—That is great; thank you.

Ms GRIERSON—Mr Liddy, you said earlier that everything was okay until Storm collapsed. There were no problems evident until it collapsed. Do you think good times spread complacency in your organisation?

Mr Liddy—I think the good times have been around for a long time. I do not think 'complacency' would be the word. A bank runs under fairly strict policies and procedures, and certainly our bank does that. As I said, the market is dynamic and some processes and policies perhaps have not kept up with that—I would say very much so. I do not think for a moment that our bank became complacent; in fact, I think it was the other way around.

Ms GRIERSON—Talking about rigour, did your review uncover any written evidence or evaluation of the Storm business model or do a risk assessment of that? Does that exist in your organisation?

Mr Liddy—We did not do a formal assessment of the Storm business model, to the best of my knowledge.

Ms GRIERSON—No-one in your organisation did one?

Mr Kangatharan—Just to be clear, we were in no way involved with the Storm—

Ms GRIERSON—Even if it said it was great? It was not done?

Mr Kangatharan—Just so I understand your question, we were not corporate lenders to Storm, so we had no reason to—

Ms GRIERSON—But your customers were borrowing in their relationship with Storm, in relation to a Storm product. You will assess a house and see if it is falling down or a bad risk for a customer. You do assess the other products they are lending for, I would have thought.

Mr Liddy—They were dealing with a licensed and reputable financial planning business.

Ms GRIERSON—So you are telling me there is no documented risk assessment or evaluation of the product that customers were investing in, or borrowing from you to invest in?

Mr Kangatharan—For the sake of clarity, in terms of the—

Ms GRIERSON—I want a yes or no, really.

Mr Kangatharan—In terms of the security that was used, it was usually the home, for which we obtained an independent valuation from a panel of valuers. We did not in any way rely on—

Ms GRIERSON—Could you provide us with that independent evaluation?

Mr Liddy—No, a valuation of property.

Mr Kangatharan—Valuation of property.

Ms GRIERSON—I see what you mean, yes.

Mr Kangatharan—From a panel of independent valuers, we independently valued the property against which we were leading.

Ms GRIERSON—But you do not do the same with a product?

Mr Kangatharan—With respect to how the customer and then invests those funds, they were then being advised by Storm on which products to put their money into. I might also add that

they were not Storm manufactured products; they were usually from Challenger or Colonial, which were all very reputable—and remain reputable—funds management companies.

Ms GRIERSON—Do you think you should change your practice in light of these experiences?

Mr Liddy—I think the new legislation, if it is passed, will put a different onus on lenders in respect of responsible lending and the need, as I understand it at this stage—and it is only draft legislation—to ensure that the funds are going to be used in something that works. That is not the case today.

Ms GRIERSON—How many branches of the Bank of Queensland are there in Townsville?

Mr Liddy—In Townsville there are three: the Townsville branch, North Ward, which is the main branch, and—

Ms GRIERSON—Has your review uncovered any improper relationships between your staff and Storm or the people associated with storm?

Mr Liddy—Not at all, none.

Ms GRIERSON—Are all the staff still in place at North Ward branch?

Mr Liddy—Yes, I understand so.

Ms GRIERSON—Has anyone been transferred out, stood down or dismissed?

Mr Liddy—No. The North Ward branch is an owner-managed branch. The staff are the staff of the owner-managers.

Ms GRIERSON—So it is not your decision to make, you are saying?

Mr Liddy—If there was wrongdoing in the branch and we had identified wrongdoing, we would take action.

Ms GRIERSON—And you would take action how?

Mr Liddy—As I said, in the case of an owner-managed branch, if they do the wrong thing they run the risk that they lose their entire business, which is the equity they put into the business at the beginning and the equity that they are earning from the customer growth on that. So they run that risk, very clearly, and if there are instances of fraud or a customer has been impacted because of those situations we act.

Ms GRIERSON—If 251 of the 319 customers were at North Ward, how do you think that occurred?

Mr Liddy—Firstly, the North Ward branch is based in Townsville—

Ms GRIERSON—Yes, but you just told me there were three branches.

Mr Liddy—and Storm's head office is in Townsville. Storm were putting loans out to tender to a number of banks, including BOQ. BOQ bid, if you like, for those loans and, as I said earlier, I understand we gained around about one in 10 of those. They did that because of the service element they put in place where they would drop loan documents off at Storm's office, collect loan documents and so forth—nothing more sinister than that.

Ms GRIERSON—Did your other branches have any dealings with Storm?

Mr Liddy—Not that I am aware of. I think in the beginning one of the owner-managers at North Ward branch was initially in our corporate branch in Townsville and started to try and seek business through Storm at that stage. He then went to North Ward, and that is where the relationship extended.

Ms GRIERSON—Did any of your other branch managers decide not to deal with Storm?

Mr Liddy—They are all different markets. The corporate branch obviously is a completely different model and the other branch, no, to the best of my knowledge.

Ms GRIERSON—You said 58 of your customers have paid back their loans. Are they from North Ward branch?

Mr Liddy—I would say the majority would be.

Ms GRIERSON—When you say they paid back their loans, has that included any asset repossession or asset recovery?

Mr Liddy—No, not to our knowledge. Certainly I know some customers have actually sold their homes to repay their loans.

Ms GRIERSON—Do you think they were under duress or pressure from the bank to do so?

Mr Liddy—No.

Mr Kangatharan—No.

Ms GRIERSON—How do you know that? Is there documentation? Have they received any documentation from you that might put them under that duress?

Mr Liddy—We have individually identified all Storm customers, and my office is personally involved in what happens to those Storm customers.

Ms GRIERSON—What has been happening since January or February, when you started your review? That is a long period of hardship for many people.

Mr Liddy—As I said, we have written to every customer asking them, if they are suffering hardship, to let us know. We are going to extend that hardship package.

Ms GRIERSON—When did you take that action?

Mr Liddy—In July.

Ms GRIERSON—In July, six months after you started your review?

Mr Kangatharan—The hardship process has always been available.

Ms GRIERSON—You have a hardship unit in every branch?

Mr Liddy—Yes.

Mr Kangatharan—It is available across our network, and the hardship policies have been in place for a while. So if any customer is going through hardship they can approach us and go through that process. What we have done here is to actually take another step, which is to proactively contact these customers and invite them to apply for hardship if they are suffering hardship. So it is an additional step that we have taken.

Ms GRIERSON—You have done no asset recovery of your Storm clients, the customers who were involved with Storm?

Mr Liddy—Certainly not to my knowledge. Just to back up that other information, in January 2009 there were no Storm customers in hardship. In September there were 46 cases—

Ms GRIERSON—How do you know?

Mr Liddy—They were identified by contacting—

Ms GRIERSON—So how do you identify them? They were still making their payments—is that what you mean?

Mr Liddy—They were still making their payments, but if a customer suffers hardship across the whole bank network—and in fact across all branches of all banks—they usually talk to the bank. What I am saying is that, to the best of my knowledge, customers did not come and tell us.

Ms GRIERSON—No-one had talked to the bank? No-one had come to the bank before June?

Mr Liddy—I am not saying before June; I am saying that as at January we had none and in September we had 46. I cannot give you the number—I don't have that.

Ms GRIERSON—But you wrote to them in June offering hardship provisions.

Mr Liddy—Yes.

Mr Kangatharan—That is right—July.

Ms GRIERSON—Thank you.

Mr ROBERT—Mr Liddy and Mr Kangatharan, thank you for being here. I appreciate the lateness of the hour. I spoke before to the Chairman of ASIC and I put a hypothetical scenario to him, because they are making a recommendation that we amend section 945A to put a fiducial responsibility in good faith upon those that provide financial services product advice. I asked the chairman: if there were an organisation that was taking people's money and investing it with a 90 per cent LVR and then borrowing again on unrealised gains up to 90 per cent LVR, that had the same plan for everyone, that had little or no diversification across the portfolio—it was all highly leveraged—and whose policy was to keep clients away from banks, would that be likely to be seen as a fiducial breach of good faith, as per the chairman of ASIC's recommendation? His response was one word: yes. I don't think it surprised anyone to suggest that this is indicative of the model Storm was running, so the question is: when did you become aware that this was Storm's model, this high-risk, super leveraged model?

Mr Liddy—Personally, or as an organisation? Personally, it was as a result of our review. As I said, our initial review started in late January or February, and that was based on the collapse of Storm and, from our perspective, the implications from an asset quality point of view.

Mr ROBERT—Are you saying you only found out about the true nature of Storm's business model in February 2009, or 2008?

Mr Kangatharan—Just to ensure that we are on the same page, with respect to the Storm model, what you are talking about is the advice that Storm gave its clients with respect to products.

Mr ROBERT—That's the model. 'We will take money from clients, we will leverage the absolute guts out of it, then we'll leverage the unrealised gain out of it. We will give everyone the same advice.' That is their model—just use that term.

Mr Kangatharan—There is no way we could actually become aware of that, based on—

Mr ROBERT—I did not ask that; I just asked when you became aware of it.

Mr Kangatharan—I think with everyone else, in the papers.

Mr Liddy—I think when Storm collapsed.

Mr ROBERT—February '08. On behalf of your 300 clients who were borrowing from Bank of Queensland, predominantly, I suggest, on housing—so they were borrowing to go into a Storm indexed product through Challenger or something—what steps did you take to ascertain whether the money was going into a good fund, into a reputable organisation?

Mr Kangatharan—Again, that would be giving advice on those investment products, which is not within our capability and not within our licence.

Mr ROBERT—What do your Ts and Cs say about your relationship with your clients?

Mr Liddy—Ts and Cs to me are terms and conditions.

Mr ROBERT—That is right, sir, yes.

Mr Liddy—It is more P and P, which is policy and procedures.

Mr ROBERT—Right. As long as we are arguing the same line.

Mr Liddy—If we are arguing the same line we will stick with the P and P. Policies and procedures are put down as mitigants to manage risks. The preferred model across the bank, as I mentioned to the chairman earlier, is that lending managers meet face to face with their clients. In respect of Storm clients, we had a written authority to deal directly with their financial adviser.

Mr ROBERT—Did that make you uneasy, Mr Liddy?

Mr Liddy—We are reviewing our policy as a result of these findings and I am sure that we will want face to face.

Mr ROBERT—I am cognisant that you said that you were not aware of Storm's, let's call it, super leverage model until after the collapse. Were you aware that Storm was taking many clients—perhaps most, but let's say many—and borrowing $300,000 from Bank of Queensland on the base of their home as the asset, taking that $300,000 and then leveraging the guts out of a margin loan through another provider into a Storm indexed fund? When did you become aware that customers were doing that?

Mr Liddy—I am not sure that we would have become of aware of that. As I understand it—and I have read parts of the inquiry, obviously, where there have been step-ups—I think that is what you are referring to.

Mr ROBERT—Taking your 300K and borrowing $2 million.

Mr Liddy—Certainly the home equity loan was used as the foundation equity, if you like, in an investment strategy, which was advised by an independent adviser.

Mr ROBERT—When did you become aware that that was occurring? When did you become aware that Storm was taking your 300,000, the amount of money borrowed on the basis of property, and super leveraging it—stepping up, if we wish to use the same term—into an indexed product through a margin loan?

Mr Liddy—I am not sure that we were ever aware of that.

Mr ROBERT—On your Ts and Cs or whatever acronym you wish to use, sir—Ps and Ps, but mostly Ts and Cs—if I have got my house and I want to borrow some money from Bank of Queensland, when I sign the voluminous paperwork, having dealt with banks for a while, is there

a requirement within your paperwork that I have to tell you everything about what my current assets and liabilities are or, if they change, I must inform you?

Mr Liddy—Initially in a loan application process there would be a statement of assets and liabilities given and a statement of income and outgoings as part of the normal loan process.

Mr ROBERT—Does any of that documentation require me, using that same hypothetical situation, to keep you abreast if my assets and liabilities fundamentally change?

Mr Liddy—To be honest, Mr Robert, I am not sure. I will take that question on notice and come back to you.

Mr ROBERT—It is my understanding, and correct me if I am wrong, that most major lending institutions separate sales from credit. So sales are very different from the credit approval; is that a fair statement?

Mr Liddy—Yes.

Mr ROBERT—My analysis with Bank of Queensland's structure would indicate to me—correct me if I am wrong, sir—that your owner-managers actually may bring the sales and the credit together.

Mr Liddy—No, not accurate.

Mr ROBERT—Can you explain how that works?

Mr Liddy—What happens in a bank is that there are delegated lending authorities against certain policies and procedures. For instance, if a branch can automate a process, like the credit-scoring model I was talking about earlier, it puts the data into that model and then that is approved. That is what I call the delegated lending authority for that manager. The credit policies and the credit adherence et cetera are done by head office.

Mr ROBERT—So if the machine spits out a yes, great. That is systematising your process; I am happy with that. If it spits out a no, does that branch owner-manager have the authority to approve the credit without—

Mr Liddy—No. He has to submit that to head office and it is an independent assessment.

Mr ROBERT—Thank you.

Senator WILLIAMS—Mr Liddy, the North Ward branch is owned by Mr Buchanan and Mr Carnes, is it?

Mr Liddy—Yes. It is actually owned by a company name, but they are the directors of the company.

Senator WILLIAMS—Have you had discussions with them of late about their relationship with Storm? Have you asked them how close their relationship was, how confident they were in the Storm product, things like that?

Mr Liddy—Personally I have not, but we have certainly had a thorough investigation of their arrangement, if you like, or any involvement they have had with Storm, and I am confident that it was an arms-length relationship. There were certainly no payments made between either party.

Senator WILLIAMS—No. They would obviously have been very confident about the Storm plan though, wouldn't they?

Mr Liddy—To be honest, I have not asked that question, but they were dealing with a financial planning firm that had a good reputation, that was licensed and regulated. I do not think any of the individuals would have got heavily involved in what the actual investment policy was of that company.

Senator WILLIAMS—I put it to you that they would have been very confident in the Storm plan and they would have seen it as a way to lend a lot of money; that is the way I see it. Would you disagree with that?

Mr Liddy—No, I think they used the Storm model as a referral, the same as they use accountants and the same as they use solicitors.

Senator WILLIAMS—Would you agree with me that they were confident of the Storm model and they were keen to quote on Storm products—the loans were opportunities for them to lend money?

Mr Liddy—To be honest, I really cannot answer that because I just do not know the detail.

Senator WILLIAMS—It is a pity Mr Buchanan and Mr Carnes are not here with us. I will go to some of the statements in the submissions here. There is a statement from Helen Rubin's submission: 'I got a second opinion from Matthew Buchanan, my Bank of Queensland manager, who told me the Storm approach was sound.'

Barry and Deanne Doyle, in their submission, said, 'We signed these documents in front of the Bank of Queensland manager and he told us how good Storm was and he praised Storm's system.' Mr and Mrs Doyle believed the manager was Declan Carnes. Mr Doyle said, 'The manager also said he was also thinking about investing in Storm himself.' I assume these people are telling the truth. Would I be right in assuming from that that Mr Buchanan and Mr Carnes were confident in the Storm plan and supported it?

Mr Liddy—Those allegations are denied and it is the subject of a legal matter at the moment, so we cannot comment any further.

Senator WILLIAMS—These are not allegations; these are comments from people who have borrowed off your bank and invested in the Storm product.

Mr Liddy—All I can tell you is that our staff are not authorised, nor are we qualified, to make investment decisions.

Senator WILLIAMS—I put it to you I think your staff up there were very confident of the Storm plan and they used it as a lending process to make money. That is the way I see it. You may disagree. When it came to the loan applications in North Ward, Kristy Devney and Carmela Richards worked for Storm and they said they would send a spreadsheet to the bank and then the bank would fill the details in. Is that is correct?

Mr Liddy—My understanding was that the process was that Storm initially would forward a request for a tender, if you like. Attached to that was a statement of income and of assets and liabilities, and permission to deal directly with the planner. We would do a first pass or our branch would do a first pass on those criteria to see whether it met our criteria standard. We would put back a quote saying, yes, we would like to tender for this business or no, we won't. There are other banks that also quoted for that business. As I understand it, Storm would then document all those quotes, give it to the customer and say, 'Make your choice.' If the customer chose BOQ then Storm would come back to us and we would go through the formal process of a loan application right through to documentation. We would call for an independent valuation et cetera.

Senator WILLIAMS—When you went through the formal process of a loan application, who would fill it in—the Bank of Queensland with your customer or with Storm or with who?

Senator WILLIAMS—When you went through the formal process of a loan application, who would fill it in, the Bank of Queensland with your customer or with Storm or with who?

Mr Liddy—No. In most instances, our North Ward branch was authorised by our customer to deal directly with their financial planner.

Mr Kangatharan—Usually, we would have a filled out application form with the customer's signature come back to us.

Senator WILLIAMS—The reason that I ask the question is that Helen Chambers—who is a 71-year-old pensioner—got her documents back after everything fell apart and went pear shaped and she was shocked to find that on the loan application her income was stated as $104,000 a month. Yet you said earlier on that you discounted Storm's estimations of income. Didn't your lending network ever question why a pensioner would have their income as $104,000 a month on a loan application?

Mr Liddy—That was a transposition error. It was shown on the loan application as $104,000 per month. But in the bank's system it was recorded as $104,000 per annum.

Senator WILLIAMS—That is still a lot of money for a pensioner.

Mr Kangatharan—That included the income that the Storm financial planner estimated on the assets that she was investing in. So again—

Senator WILLIAMS—Did you have a deeming rate on the Storm investment of five per cent or something?

Mr Kangatharan—The Storm financial planner estimated a return that was anywhere between 11 and 15 per cent on the total assets invested. We discounted back that down to roughly about a third of what they projected and included that.

CHAIRMAN—Was that 15 per cent after fees?

Mr Kangatharan—That 15 per cent figure was the expected return on the product that they stated as part of their financial plan. These were indexed products, so—

Senator WILLIAMS—So you are saying that on the application Storm said that they were expecting a 15 per cent return. Was that both dividends and capital growth on the ASX300?

Mr Kangatharan—That is correct. It was the total return; that is right.

Senator WILLIAMS—And you would take it back to about a third, so about—

Mr Kangatharan—About five.

Senator WILLIAMS—About four or five per cent.

Mr Kangatharan—Four or five, yes.

Senator WILLIAMS—On the lady's application that I have here, at the time she had total investments of $712,000 and net assets of $250,000, including her house. With a pension, $104,000 still seems a lot, because $200,000 of her portfolio was earning cash earnings of around five per cent. That meant that the balance of her portfolio, $500,000, would have to earn close to 18.4 per cent. This is on $104,000 a year, Mr Liddy, instead of $104,000 a month.

Mr Liddy—In that instance the borrower did sign a declaration that the information was correct.

Mr Kangatharan—I might also add that the vast majority of the lending that we made to that particular customer was actually a refinance. In fact, the increase in the loan was only $39,000.

CHAIRMAN—Can I clarify? You are saying that you discount back down to four or five per cent. Is that right?

Mr Kangatharan—Yes.

CHAIRMAN—If you discount down to four or five per cent, how does a pensioner even cover the cost of the funds? How is that possible? How does that work in numbers? That $104,000 per annum would have been their total earnings from the portfolio.

Mr Kangatharan—To clarify, in terms of that discounting back, there was a policy variation that was applied and approved. Before that approval, if any of the income from the Storm financial plan was to be included in an application it would go through an exception process. That is where the independent head office staff in risk assessment would give authorisation for the inclusion of that income. Where that was the case, it is possible that it is more than five per cent that was actually included. In this particular case, it is quite possible that on a $712,000 investment that the return component was calculated at eight or nine per cent.

Senator WILLIAMS—Just going back to this, you have obviously kept an eye on this inquiry as it has gone through. One of the things that we have been concerned about is the application forms and who filled them in. Often, the Storm clients signed them and never saw the forms again until everything went pear shaped when they got a copy back to see the figures on them. A Vietnam War veteran in Townsville, Steve Reynolds, was on a Vietnam War disability pension and not working. But the loan application form, filled in by someone other than him, listed his monthly income at $8,300 a month. His pension was $800 a fortnight. He had debts of over $400,000 and has not been able to pay interest on his home loan. We are not a court here; we are legislators. We cannot make decisions about who has done wrong or who has done right. We have to look at what we can do in the future as far as looking at regulations and legislation and whether anything needs changing and if so what. We need to hopefully ensure that future generations of Australians will not have to suffer the same fate as so many did through this whole Storm fiasco.

Mr Liddy—I agree. One good thing that is likely to come out of this inquiry is that where there has been wrongdoing by any party there will be some compensation scheme put in place.

Senator WILLIAMS—Mr Liddy, I would like to agree with you. We will probably end up with more ethical banking in the next five or 10 years. But then when the greed for money gets too much, we will be back here. I was involved in foreign currency loans with Swiss francs. When we looked back that was foolish lending. The banks should have learnt back in those days. But now we have the CBA and the CGI in the middle of this issue up to their ears. I agree with you: you will see ethical banking for the next five or next years. Then, as the banks strive for more profit and compete against each other, one will lower the bar of ethical banking, the rest will follow along anyway. I would not be surprised if we see the same issue in another 20 years time with people back here doing the same thing again.

Mr Liddy—I hope not. That is why competition in banking in Australia is so important. That is why there is a role for regional banks going forward.

Senator WILLIAMS—I agree with you. Competition is very important thing in free enterprise. Unfortunately, competition has been stuck away at the moment because of regulations that have come through this place here in relation to underwriting bank deposits. We have seen many companies such as banks, building societies et cetera that have deposits underwritten and many other institutions and financial organisations not having them underwritten.

Mr Liddy—Any help that you can give me on increasing competition I would greatly appreciate.

CHAIRMAN—North Ward branch was branch of the year twice. How many times were they the biggest lender or best lender of the year without any award being offered? Were they the best lender that you had?

Mr Liddy—If not the best, they were certainly in the top two or three.

CHAIRMAN—So consistently year after year—

Mr Liddy—And they still are. Last month, they lent $11 million. That is way above the norm. That is not in relation to Storm whatsoever. These guys literally work seven days a week, 24 hours a day.

Mr ROBERT—They need to get a life, Mr Liddy.

Mr Liddy—I agree with that.

CHAIRMAN—What have you learnt out of your best branches and your best lenders? What do you try to replicate in your other branches? You said before that they spend 10 times on marketing as other branches. Why don't you get other branches to spend 10 times more?

Mr Liddy—It is up to the individual—like in any business—in terms of how much they are prepared to put in. We learn good things in respect of marking or customer service. If there are any negative things, we learn from those as well.

CHAIRMAN—How much control do you have over your owner/manager branches?

Mr Liddy—A large degree of control. The things that are tight in our bank are credit—

CHAIRMAN—Except how much they spend on marketing, how many hours they work—

Mr Liddy—It is their business.

CHAIRMAN—except how they loan. I could run through a whole list of these. You cannot have it both ways; you either have a lot of control or you don't.

Mr Liddy—I think that that is a little unfair. The things that are tight are very much around credit policy in terms of our brand, the product and the pricing.

CHAIRMAN—You are a franchise system.

Mr Liddy—That is the franchise system.

CHAIRMAN—Within that—

Mr Liddy—In terms of them running their own little business, if they want to, for instance, support the Townsville Devils or whatever the basketball team is—

Senator McLUCAS—Taipans.

Mr Liddy—Taipans. Excuse me. They can do that.

CHAIRMAN—And that is from your best branch area, too. You should know that one.

Mr Liddy—And they sponsor local football teams, for instance, et cetera. We do not dictate that. We have our local area market concept that we support, but they can do what they like.

CHAIRMAN—They can do what they like.

Mr Liddy—In respect of marketing.

CHAIRMAN—Have they got the capacity in terms of doing what they like with marketing to offer incentives or to enter into special relationships?

Mr Liddy—Not to—

CHAIRMAN—Obviously, Storm did not have a relationship with the Bank of Queensland. But it certainly was with the Bank of Queensland's North Ward branch.

Mr Liddy—They have no authority to do that without our knowledge.

CHAIRMAN—No authority.

Mr Liddy—Any third party that we have a formal relationship with where there are payments has to be accredited. That is a central process done in Brisbane.

Mr Kangatharan—And if they were to ever do that, they would be in breach of their contract and we would have the right to take away their business from them.

CHAIRMAN—Back to my original question on how much control you have over your branches, what audit work do you do in your branches? How tough are you on your owner managers?

Mr Liddy—The way that we run operational risk and credit risk and so forth is that we have an audit procedure, which has a three-pronged approach. There is training and policies and procedures at a branch level, for instance. Then there is a regional management structure. Then there are health checks done by what we a call an assistant regional manager. That is done on at least a six-monthly basis. Branches are audited according to their results. For instance—

CHAIRMAN—What do you do in an audit? How deep do you dig in? Does the audit in the end up being the process of saying, 'You've lent the most, so you're the best branch'?

Mr Liddy—Not at all. There is credit risk. There are two procedures. I am talking about operational risk—things like closing the safe, counting the cash, making sure that the right forms are filled out, anti money laundering et cetera—

CHAIRMAN—Very much operational in terms of the—

Mr Liddy—The credit risk review looks at the processes involved in credit decisions. They are two separate reviews. In both instances, both of those are being strengthened as we talk.

CHAIRMAN—No alarm bells were going off? No red flags came up?

Mr Kangatharan—Adding to that, one of the key indicators that everything is travelling well is asset quality and arrears. The North Ward branch for most of this period—2004 to 2008—had exceptional results in terms of not having customers in arrears. They had a lower default rate and a lower arrears rate than the rest of our total network put together.

Senator McLUCAS—I have a very embarrassing correction of the record. The Taipans are the Cairns basketball team. The Crocodiles are the Townsville basketball team.

Mr Liddy—I did not want to correct you.

CHAIRMAN—What happens if one of your branches does not pass a health check? What do you do?

Mr Liddy—We reinspect. We sit down with the branch. To pass a health check, the branch has to get 80 per cent. It is a pretty high standard. Some fail that health check, for various reasons. Between 50 and 60 things are checked in a branch audit.

CHAIRMAN—Are you aware of any loans that were accepted through North Ward branch that were rejected by other banks?

Mr Liddy—We know of loans that were done through North Ward branch that were also approved through other banks. In a lot of instances, as we were explaining to Senator Williams before, there were refinances. But the way that the Bank of Queensland grows is because customers leave other banks—mainly the big banks. So that is nothing unusual.

Senator MASON—I thank you for your comments with respect to the National Consumer Credit Protection Bill in particular and about the word 'suitability'. You gave some examples and you said that they illustrate the difficulty in drawing the line between acting as a lender and as a lifestyle adviser. Thank you for your comments. Have you passed your concerns on to the government or has the banking industry more generally done that?

Mr Liddy—We have passed that on through the ABA. That is a view shared by the Australian Bankers Association.

Senator MASON—Very interesting.

Senator McLUCAS—Thank you for your earlier comments about how you deem is going to be banker of the year. You indicated that it was on the range of sales of different products and deposits and the five elements of the bank's principles. Could you take on notice for me and provide me in writing how that is applied. How much is around—

Mr Liddy—The weightings?

Senator McLUCAS—The weighting on deposits, the weighting on integrity and how you measure those five separate elements.

Mr Liddy—We will provide that information to you.

Senator McLUCAS—Thank you.

Mr Liddy—There are certain gate openers. If you fail your audit or you fail your credit risk review, you do not get considered, regardless of what your sales performance is.

Senator McLUCAS—I do not know that we have time to go through it now, so if you can provide it on notice that would be great.

Mr Liddy—Certainly.

Senator WILLIAMS—In your submission, you said that you have identified areas that are in need of attention and that you are attending to those. Obviously, you will look at those areas. Your franchise knew the people investing in Storm. My concern is that now that everything is over is for these people who are facing financial ruin. Many of them are 60, 65 or 70 years of age and are probably very concerned about being put out of their houses and that. Do you think that you will be able to come to some agreement with all of these people so that they all stay in their homes and perhaps have a bit of relaxation and a not so stressful time during the twilight period of their lives?

Mr Liddy—We are identifying extreme cases of hardship now. We will apply an extended hardship package to those customers to try to endeavour to keep them in their homes. That is our undertaking.

Senator WILLIAMS—'Try to endeavour.'

Mr Liddy—We will do everything that we can to maintain customers in their homes. Every case is different. What I am saying and what we are committing to is that we will extend our hardship package. What we are doing at the moment is identifying customers who are facing extreme hardship. We will certainly be working one on one with all of our customers in that respect.

Senator WILLIAMS—Good. Thank you.

Senator McLUCAS—What is 'extreme hardship'.

Senator WILLIAMS—I can explain that.

Mr Liddy—I cannot explain it directly, I guess. But if customers risk losing their home or risk not being able to live a reasonable life as a result of bad decisions made by someone else, we have a community role to play and we will try and play that.

Senator McLUCAS—What about those customers of yours who have acted on the requirement to sell their house in order to pay off their loan? Can you revisit those circumstances? I know of a couple who have done that. They are living with family members. They are now on the pension. Can we go back and revisit those sorts of circumstances?

Mr Liddy—Our priority is to look after customers. We have certainly not forced customers to sell their homes, as I mentioned to Ms Grierson before.

Senator McLUCAS—But people have done that in good faith.

Mr Liddy—If customers have issues and want to discuss individual situations with the bank, they are more than welcome to do so.

CHAIRMAN—Thank you very much for your submission and your appearance tonight. I thank Hansard, the committee secretariat and everyone involved.

Committee adjourned at 9.28 pm