

Margin loans back from the brink

Margin lending has had a bad run, with the global financial crisis (GFC) and high-profile cases of failed gearing strategies. Simon Hoyle and Krystine Lumanta examine the impact of new rules on this sector.

It's been a tough period for margin loan borrowers and lenders alike. The global financial crisis (GFC) and the high-profile failure of certain gearing strategies led to a significant drop-off in the number of clients willing to borrow to invest, and consequently in the volume of margin loans written.

In response to the losses sustained by a relatively small group of investors, the Government moved to tighten up the requirements for providing and advising on margin loans. The Corporations Legislation Amendment (Financial Services Modernisation) Bill makes margin loans "regulated products", and imposes "responsible lending requirements" on lenders, to ensure that steps are taken to ensure that a margin loan is "not unsuitable" for a borrower, and to make it absolutely clear who is responsible for communicating a margin call to a borrower, should one arise.

The changes required the holders of Australian Financial Services Licences (AFSLs) to vary their licences to allow them to advise on margin loans. It required the AFSL holder to authorise its representatives to advise on margin loans. And it required those representatives to be adequately trained to do so. The deadline for achieving the appropriate training is June 30, this year.

It was perhaps fortunate that the legislative distraction occurred when there was a lull in interest in margin loans anyway; it has given AFSL holders and their representatives time to get organised in the event that clients' interest in gearing strategies should be rekindled.

David Simon, an executive financial planner with Westpac, says clients are "certainly coming back to a certain degree". But they're coming back wiser, and somewhat more cautiously.

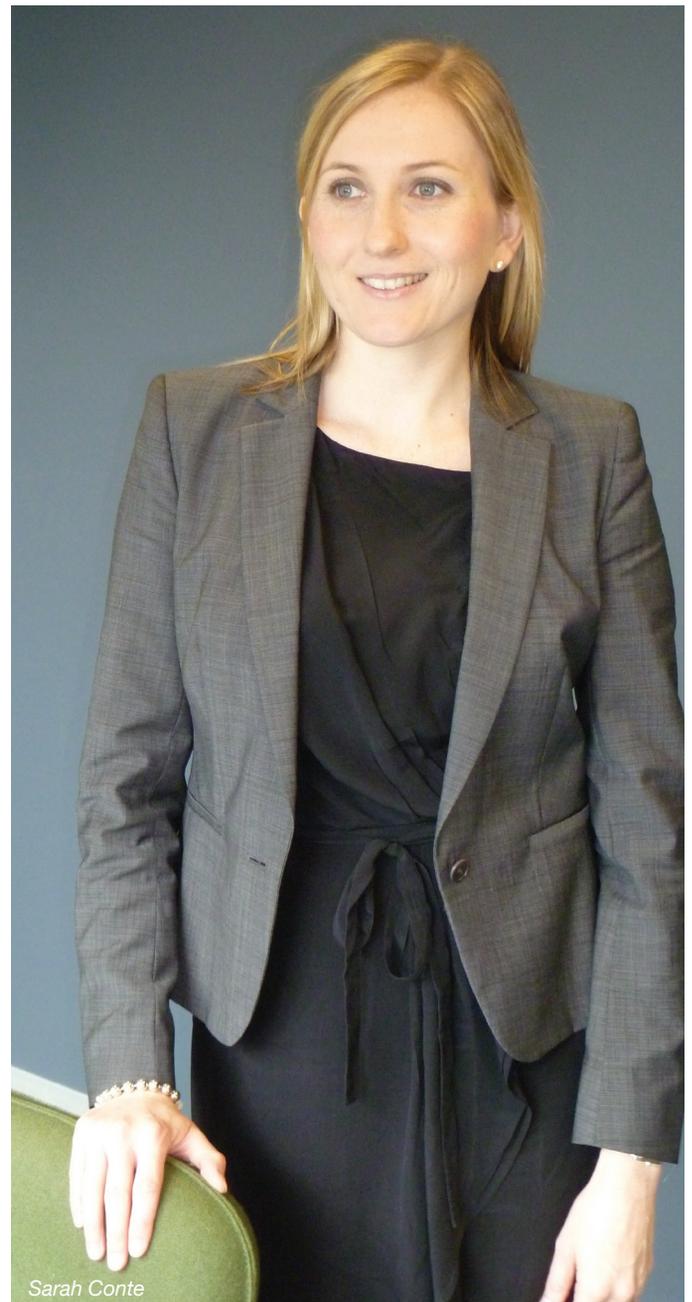
"Clients are really keen to ensure adequate stress-testing or simulation of their portfolios," he says.

"They are actually looking at, and have seen the benefits of, quality financial advice, rather than setting up margin loans themselves and getting into all sorts of trouble where they previously didn't think of the benefits of diversification and the like.

"Clients are a lot more keen to explore testing situations where interest rates [might] rise.

"Clients are still coming to us, they're just a lot more aware of those things that I just mentioned, as well as making sure their portfolio is really adequately and comprehensively diversified to various asset classes, sectors, industries, countries.

"But ultimately, clients are really committed to having a well-prepared



Sarah Conte

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contingency plan - at what point would they go into a margin call? And if they did go into a margin call, what would be the most suitable strategy to get through that? And if a further margin call were to occur after that, what is the strategy again? So certainly clients are a lot more keen to understand the benefits of quality advice and they are seeking knowledge and expertise to really understand what a margin loan is and indeed its characteristics."

Andrew Stewart, head of adviser distribution for Core Equity Services, says even though "planners aren't writing as much margin lending this year as they have in the corresponding previous periods in years gone past", gearing remains a relevant strategy for many clients.

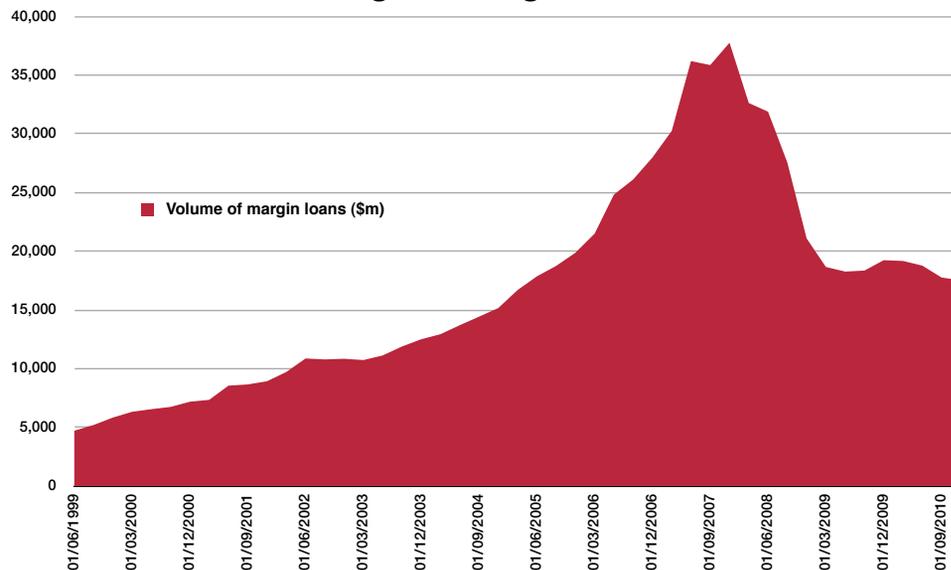
"Certainly the legislative change has meant that for many planners, who didn't have margin lending as a big part of their strategy previously, given what's happening with their clients, and perhaps the sentiment of clients full-stop, they're not writing a lot of new business, potentially. And on the back of that, margin lending volumes are down anyway.

"So I think that in combination, we're seeing that margin lending volumes are lower than they have been for some time.

"Every time I see information coming through from the platforms - and I use that as a barometer for how the industry is going in terms of new funds flow - there's a lot of funds flow that seems to be moving towards TDs and cash, so I think the margin lending flow is probably in-line with expectation, on the back of that kind of sentiment in the industry.

"And I think that, again, now is possibly the right time to be thinking about margin lending. We're doing some work on some strategies that we can help planners provide to their clients [focused on] funding the superannuation gap, the tax-effective side of gearing and whether that's appropriate for some clients. So we're working harder than we have previously."

Margin lending 1999 - 2010



Source: Reserve Bank of Australia

Sarah Conte, manager of technical research at BT financial Group, says AFSLs and planners still have a few months to get sorted out to advise on margin loans, if they haven't done so already.

Conte says the new margin lending legislation commenced on January 1, 2010, but there was a 12-month transition period for licences to be varied.

"On the training obligation, there's an 18-month period on that, so 30 June, 2011, the RG146 component needs to be completed," Conte says.

"We've got an interesting situation from 1 January until 30 June, in that provided you're authorised under a licence, you can continue to give margin lending advice up until 30 June. Outside of 30 June, if you haven't completed the RG 146 requirements, you will not be able to continue to give advice.

"It's quite important to make the distinction between being authorised under a licence, versus having that accreditation, which is the RG146

component. They are two separate things. You have to have the authorisation to continue to give advice currently."

Westpac's Simon says the new regulations are "really designed to prevent the irresponsible usage of margin lending".

"From a planner's point of view, certainly a planner that provides quality financial advice, there is actually no change," he says.

"One of the changes would be the notification of a margin call, that it's got to be provided in a 'reasonable manner', and that includes electronic means such as the phone, fax, SMS. But that's all really ... the responsibilities of the lender not the financial planner."

Simon says that for planners used to dealing with margin loans, "these incoming regulations are not much of a change".

"Ultimately, if a planner is providing quality financial advice, [irrespective of] the global financial crisis, they would've been doing adequate stress testing, cash flow simulations and having

...with margin lending, debt optimisation...

those contingency plans in place anyway," he says.

"The only change to a planner would probably be that the planner now has to supply the lender with relevant information on the client and they've got to do it within 90 days of the loan application. Apart from providing the information to the lender about the client, and [the fact] that actual loan-to-value ratios on stocks and managed funds are a little more prudent than what they used to be before the GFC, there really isn't an amazing change to planners.

"The new regulation just means that planners have to conduct further training and accreditation. That's really it, it's not major for someone who's already doing the right thing."

BTFG's Conte says responsible lending is "an interesting concept".

"There are certain obligations in that section of the Corporations Law that say they must not issue, and they must not increase, a margin loan contract unless they have ensured that the contract is not unsuitable for the client, that it's within 90 days of that assessment - so they are not issuing it outside of that timeframe - and they've made reasonable enquiries about the client's financial situation, and that they've also verified that information," she says.

"The type of information they'd be looking at are things like their assets, their income, their liabilities, their expenses, and verifying that - so they're wanting to look at things like payslips. And that's imposed on the margin lender.

"There's another section of the legislation that says the margin lender can omit that verification step if that information has been captured in the SoA by the financial planner. But the obligation of responsible lending is not imposed at the financial planner level, it's at the lender level."

Conte says the lender still needs to make proper inquiries, it's just the verification. And there are a number of criteria that need to be met before they can in fact use the SoA to omit that step.

Conte says the legislation is "trying to ensure that lenders are lending responsibly, so that a loan is being issued to someone where it's appropriate to be issued to them".

"The premise behind the legislation is to protect consumers and to protect them by making sure people are licensed in margin lending and they have all the checks and balances in place to ensure that Tier One product is treated as a Tier One product," she says.

"From where I sit, it does allow better protection of investors."

Investor protection is also enhanced by the clear responsibility placed on the margin lender to advise the borrower of a margin call.

"In legislation, the obligation to communicate the margin call, or to take reasonable steps to communicate the margin call, rests with the margin lender," Conte says.

"There is the ability for the margin lender, the financial planner and the client to enter into an agent agreement for the financial planner to communicate or take reasonable steps to communicate the margin call to the client."

Conte says this requirement is designed to eliminate any confusion over who is responsible for letting a borrower know there's a margin call.

"When you're dealing with margin calls, it's quite a timely situation," Conte says.

"You have to address it quite quickly so as to get clients out of that position."

Stewart says the responsible lending requirements of the new legislation have had, and will continue to have the greatest impact.

"I think the key is responsible lending, and the Government and the regulators looking to impose a requirement on financial planners - clearly that's the case, given that margin lending is now a regulated product under Chapter 7 - but I guess it's an attempt to impose some stricter criteria around responsible lending and ensuring that investors are not unsuitable for a margin loan," he says.

"That's the spirit of the legislation: ensuring that investors who shouldn't be in a margin loan aren't in a margin loan.

"As far as I'm aware - and again, this is a technical part - there's no actual definition of 'not unsuitable' in the legislation. And so, as a business, we've taken a view that the spirit of the legislation is making sure that those who aren't appropriate don't get a margin loan, and we're trying to enact that.

"What it means effectively is we have a credit assessment process in place for clients, and part of 'not unsuitable' talks about the ability to pay a margin call, and ensuring that if a client is [required] to pay a margin call they have to do that out of liquid assets and that in doing so, in meeting the demands of a margin call, they won't be put into financial hardship as a result. So in that sense we look at the liquidity of the client - their ability to pay a margin call - we ask for more detail around income, expenses, assets and liabilities, and we look at the overall gearing level of a client.

"In our application forms we request that information, and we're quite specific about the information that we request.

"An adviser is able to verify the financial position of a client for loans under \$250,000 - this is in our application form; this is a CGI [Colonial Geared Investments] process - and we've said that in order to verify that an adviser has to have written an SoA for their client and that information should be relevant for up to 90 days, from the time of settlement of the loan.

"For amounts over \$250,000 we would do that ourselves.

"It doesn't change the cost to the client. The additional process, we think, is part of responsible lending; we've embraced those provisions, we think they're reasonable and in fact we're certainly complying with the requirements of the legislation and possibly taking it a step further to ensure that those who are not unsuitable are the

...and everything in between.

ones who are investing.”

Conte says it's instructive to look at the changes from the client's perspective.

“They'll still go through the same process that they go through with a financial adviser,” she says.

“They'll get a different FSG that lists this different thing, and you [the adviser] will then put together the strategy. You'll still go through the process of saying, ‘This margin loan, is this still an appropriate strategy for the client?’

“Advisers will be looking at what they normally look at. They'll be looking at their income, their assets, their liabilities, their expenses, what they're trying to achieve, and really working out is it appropriate for the client.

“The thing they'll also need to consider is paralleling what they're doing in the appropriateness of the strategy to what margin lenders will look at under the responsible lending tests.

“When the person issuing the margin loan looks at the responsible lending obligations, they'll look at, in the event of a margin call, could that client comply with a margin call, or could they only comply with the margin call under severe hardship?

“And advisers would have been doing this previously - looking at how will that client manage a margin call? What type of assets do they have to put up as additional security? Have they got cash to be able to meet that margin call?

From the client's perspective, I don't see a whole lot of change; it's more the change when they go through process of applying for the margin loan.

“There's a few other things that advisers will need to capture when they're putting together SoAs; they'll need to capture things like, where is the security coming from - is it debt itself? You need to understand that double-gearing position. Is there a guarantor to the loan? Is the guarantor clear about the risks and the obligations. And the adviser would want to know the other debt the client has, but that kind of information - par-

ticularly what type of debt they've got - is quite standard in their data collection currently.

“[Information] potentially gets used differently in the background. We talked before about when you go through the process of applying for the margin loan - from the margin lender's perspective, going through responsible lending - that third step: gathering the information and verifying the information. That verification step is potentially where the SoA could be used.”

One change some borrowers might experience is when or if they experience a margin call. It's now clearly the responsibility of the lender. Whether the adviser is kept in the loop will depend on the relationship between the adviser and the client, and the adviser and the lender.

“The obligation is on the lender,” Simon says.

“They've got to communicate and do it legally, in a reasonable manner. It's about the upfront education the adviser provides the client so the adviser will say that part of the contingency plan is that if we go into a margin call, you'll get a phone call from the lender, but we'll be in contact before it's called.

“So if we see a certain event that occurred that impacts the valuation of the portfolio, we'll be on the front foot before the margin call occurs to either avoid or minimise the obstruction of a margin call. It's about the preplanning upfront, not reacting at the end.

“It's a lot more scrutinised now because there's an accountability on the lender.

“We were doing contingency planning way before the GFC.”

Stewart says Core Equity has “put together a toolkit for advisers that goes through the detail around margin call processes”.

“We think it's clearly our responsibility to communicate that to the client, but where appropriate we will also make the adviser aware of that.

“What we've said is that from 1 January 2011, in the interests of transparency, CGI's poli-

cy will be to directly notify clients in each case of a margin call. Advisers will receive an e-mail that includes a consolidated list of all margin calls sent out to their clients on that particular day.

“So we're communicating to investors, and we're communicating to advisers. We think that's an appropriate way to proceed.

“Our first responsibility is to notify the client, and that is clearly what we're doing. There are a couple of ways we can notify advisers. They can access our website at all times and there's information on their client lists on the website; but we'll also attempt to notify them directly.”

Stewart says there is “a range of changes in the legislation” that alter the information that advisers have to pass on to their clients.

“Margin lending is a regulated product, they are required to write an SoA for their clients, and that's clearly required in our application for as well,” he says.

“Licensing requirements, training requirements, the legislative change, SoAs, new application forms, advisers need to provide a PDS, unsuitability tests - they're the key parts.”

Simon says the strategies that planners recommend have changed little as a result of the new rules.

“In fact, it just makes sure that advisers are going back to the basics,” he says.

“So making sure that they truly understand their client's individual circumstances, their current situation, investment time horizon, the cash flow, risk profile, needs and objectives - so really doing the foundation work better than what they did in the past.

“Other things like instalment gearing, so dollar-cost averaging, a lot of clients are more attracted to that rather than putting all their eggs in at once.

“There hasn't been any substantial changes to the way a financial adviser works since the margin lending legislation, and even since the global financial crisis.” ■

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