# STEER CLEAR OF STORMY MARGINS

A new era is dawning in margin lending, but the high risks to investors remain

Tony Kaye

THE collapse of the Storm Financial group in January this year has left a trail of devastation that is still painfully visible.

In submission after submission lodged with the Parliamentary Joint Committee on Corporations and Financial Services examining the Storm debacle, customers recall in vivid detail how they were enticed by Storm advisers to leverage themselves into the sharemarket.

Using their home, other investment assets and the underlying value of the shares they were purchasing as collateral, the customers were able to borrow big via Storm's margin lenders, including the Commonwealth Bank and the Bank of Queensland.

But when the market came crashing down during 2008, halving the value of their borrowed shares, the lenders quickly came knocking on the investors' doors, seeking additional loan security. Many Storm customers, including retirees, have since been forced to sell everything they own, just to meet their repayment obligations. Some will never recover financially.

It was largely in response to Storm that the federal government announced sweeping changes in May aimed at providing better protection to investors in margin loan products. New legislation is set to come into force that will finally regulate the lenders, providers and advisers involved in this multi-billion-dollar industry.

The banking and financial services industry has unanimously backed the legislation that will regulate margin lending under the Corporations Act, with lenders to be responsible for assessing the suitability of individuals applying for margin loans.

Margin lenders will only be allowed to provide a margin loan if they are reasonably sure the borrower can afford the loan without suffering substantial hardship. Under the changes, margin lenders and advisers also will need to obtain a licence and be subject to supervision and enforcement by the Australian Securities and Investments Commission. More detailed product disclosure documentation will be required, and compliance will be strictly monitored.

"The global financial crisis has identified some obvious weaknesses in the margin lending arena and we're quite supportive of the licensing, disclosure and advice requirements which are being taken," says John O'Shaughnessy, deputy chief executive officer of the Investment and Financial Services Association. "The key area that we're focusing on is improved education, particularly the risks pertaining to margin lending. Part of it is to make sure that where there are substantial risks, that the consumers are aware of those risks, and those providing financial advice are aware of their responsibilities [to customers]."

Deen Sanders, deputy chief executive of the Financial Planners Association, considers it fair to say that the legislative agenda has been substantially escalated as a consequence of the Storm collapse.

"It's a pretty big shift in thinking in recognition of the fact that there are multiple parties in the margin lending relationship with a client. There is the role of the lender themselves and then there's the role of the adviser."

Sanders describes Storm as an "aberration", but admits that before margin loans became regulated, the lenders had no specific obligations to meet. "The single best change about the legislative agenda is the inclusion of what's colloquially known as responsible lending provisions. We're quite optimistic about the fact that the lender plays a specific and clearly defined role now."

Getting a margin loan has not been very difficult in the past, with the main banks the biggest players.

Susan Oddie, head of margin lending for ANZ Bank, which has about 7 per cent of the margin lending market, says the legislative changes on margin lending are positive, adding that consumer education is vital in the process.

"We see that margin lending and gearing, if it's offered responsibly, can be a good solution to help people reach their financial goals sooner," Oddie says. "We take the responsibility side very seriously and it needs to be done in a way that people understand what the risks are, and what they're personally taking on, and we see the regulation as promoting that."

Oddie says consumers wanting to take on a margin loan need to realise before doing so that gearing is a riskier strategy than if using your own money.

"The benefits are that the underlying investment will increase by more than the cost of funds. The downsides are that the investments will drop sharply," she says.

One way to cover the potential downside of gearing is to use a product where the lender will provide capital protection, so that if the underlying value of the shares drops below the purchase price the borrower will not be out of pocket at the end of the loan contract. There is a higher cost for having this capital insurance, however, and borrowers will need to achieve bigger market returns to break even.

Brian Phelps, head of investment lending for CommSec, which has about 20 per cent of the margin lending market, says consumers must know what they are getting into with gearing.

"I don't see a huge change there for our clients in that for the last 10 years — and I think ASIC is basing some of their guidelines on what we've been doing anyway — we have had a client suitability test," Phelps says.

"Every client has to pass the suitability test to get involved in margin lending in the first place. This test incorporates questions and answers around their understanding of the market, gearing, the concept of a margin call and how to address a problem if it occurs."

CommSec is owned by the Commonwealth Bank but was not involved in lending to Storm clients.

CommSec and ANZ have 5 per cent margin call buffers and have introduced SMS text messaging to advise their customers if they have entered what is known as the buffer zone, when an account holder is close to receiving a margin call if the value of their portfolio has dropped sharply.

"We would tell them that their gearing level is high and suggest they go online, check their account and maybe take some action to avoid a margin call," Phelps says. "That's been incredibly successful for us in terms of reducing the number of clients who would eventually go into margin call because they can step in and take action before it actually happens."

Eric Blewitt, general manager of Leveraged Equities, says that with interest rates still low (a fixed margin loan can be obtained at less than 7 per cent) and the market recovering, it is a reasonably attractive time to be gearing up.

"Absolutely. Despite revisions in guidance on corporate earnings and a reduction in dividends, dividend yields are still very attractive and there are many scenarios around whereby moderate levels of gearing against blue chip stocks at the moment can actually be self-funding.

"An investor needs to decide how well gearing fits into their strategy by way of cash flow to make it work, and also the longer the time in the market clearly the less probable the chances of experiencing negative returns over set time horizons. Where we've got depressed asset prices at the moment, personally I feel there is an extremely solid role for moderate levels of gearing to play a role in a wealth accumulation strategy," Blewitt says.

ANZ's Oddie says that, as with any wealth accumulation strategy, diversification is key for investors using margin loans to gain greater leverage into the market.

"In relation to where the market is now versus 12 months ago, in many ways what we're looking at from a customer perspective is a greater understanding of what markets can do around volatility," she says.

"Some people have continued to invest and gear into the market, but they've done two things to overcome the recent volatility that we've experienced. One is to ensure a conservative gearing level and the second, which I think has really been highlighted by the past 12 months, is the principal of diversification.

"A lot of the people who received significant margin calls had invested in a single stock. One of the things that we do and have as a key feature of the loan is the principal of diversification. This is for that very reason that we are seeking to encourage responsible investing and enable people to be able to ride out the ups and downs of the recent volatility, but not necessarily risk having to realise a portfolio ahead of when they were planning to," Oddie says.

She says that changes in taxation laws and superannuation mean that people are now starting to look for alternative ways to accelerate their wealth, especially those in the mid accumulation phase.

"There is an awareness that they can't rely as much as they otherwise would on superannuation because the valuation has dropped."

Financial adviser Renate Tonks, of the Adelaide-based Payne Group, agrees gearing is always an option to access assets that you wouldn't normally be able to access.

"At the moment, especially while the market is low, if you can borrow now to get into the sharemarket then you're taking advantage of the potential growth," Tonks says.

"Margin lending is certainly a good option for gearing for the high-income earners because they will receive greater tax benefits. One of the advantages of gearing is that you can pre-pay the interest upfront to get the maximum tax benefit in any one year."

However, financial strategist Theo Marinis, principal of Marinis Financial Services, believes gearing is for the very wealthy "or greedy" and he rarely recommends it.

"Based on my training as an economist with accounting and financial planning qualifications, I see gearing as a roll of the dice, and I don't think anyone should gamble with their retirement savings," Marinis says.

"You might get lucky, but the risks of telescoping your losses are enormous, as we have seen quite catastrophically at times over the last few years, so in most cases I have not and do not recommend it to clients.

"The only time I would entertain the idea was if a client specifically requested a gearing strategy and then I could only act in good faith if they were financially sophisticated, on a high income, young or at the very least five years away from retirement and in a stable financial position."

Marinis says that given the marginal tax rate for those on incomes under $80,000 is only 31.5 per cent (including the Medicare levy), the tax benefits do not stack up for most people.

"I think this re-enforces that the average working Australian should steer clear of gearing," he says.

**Margin for error:** Commsec's Brian Phelps says buffer zones have been successful in reducing margin calls

## HOLD THE PHONE

When margin calls are triggered

| Initial gearing level | Fall in the stock market | | | | | | |
|---|---|---|---|---|---|---|---|
| | 10% | 205 | 30% | 40% | 50% | 60% | 70% |
| 30% | 33% | 38% | 43% | 50% | 60% | 75% | MC |
| 35% | 39% | 44% | 50% | 58% | 70% | MC | MC |
| 40% | 44% | 50% | 57% | 67% | MC | MC | MC |
| 45% | 50% | 56% | 64% | 75% | MC | MC | MC |
| 50% | 56% | 63% | 71% | MC | MC | MC | MC |
| 55% | 61% | 69% | MC | MC | MC | MC | MC |
| 60% | 67% | 75% | MC | MC | MC | MC | MC |
| 65% | 72% | MC | MC | MC | MC | MC | MC |
| 70% | MC | MC | MC | MC | MC | MC | MC |
| 75% | MC | MC | MC | MC | MC | MC | MC |

Portfolio with a maximum LVR of 75%

**Example:** with a gearing level of 30% you wouldn't get a margin call (MC) until experiencing a fall in the market of greater than 70%. If you geared at 50% it would need to fall more than 40%. Note these figure do not include a buffer, standard on many loans.

Source: ANZ

### REDUCING THE LIKELIHOOD OF A MARGIN CALL

- **Gear conservatively.** A lower gearing level in a portfolio provides an additional buffer so that the market will need to fall further before a margin call occurs.
- **Include cash.** A cash account can be linked to some margin loans to reduce gearing.
- **Diversification.** Diversifying a portfolio across a broad range of shares or managed funds can help minimise volatility.

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