

“Unlocking the Equity in Your Home” – Just How Risky Is It?

By Shauna Ferris

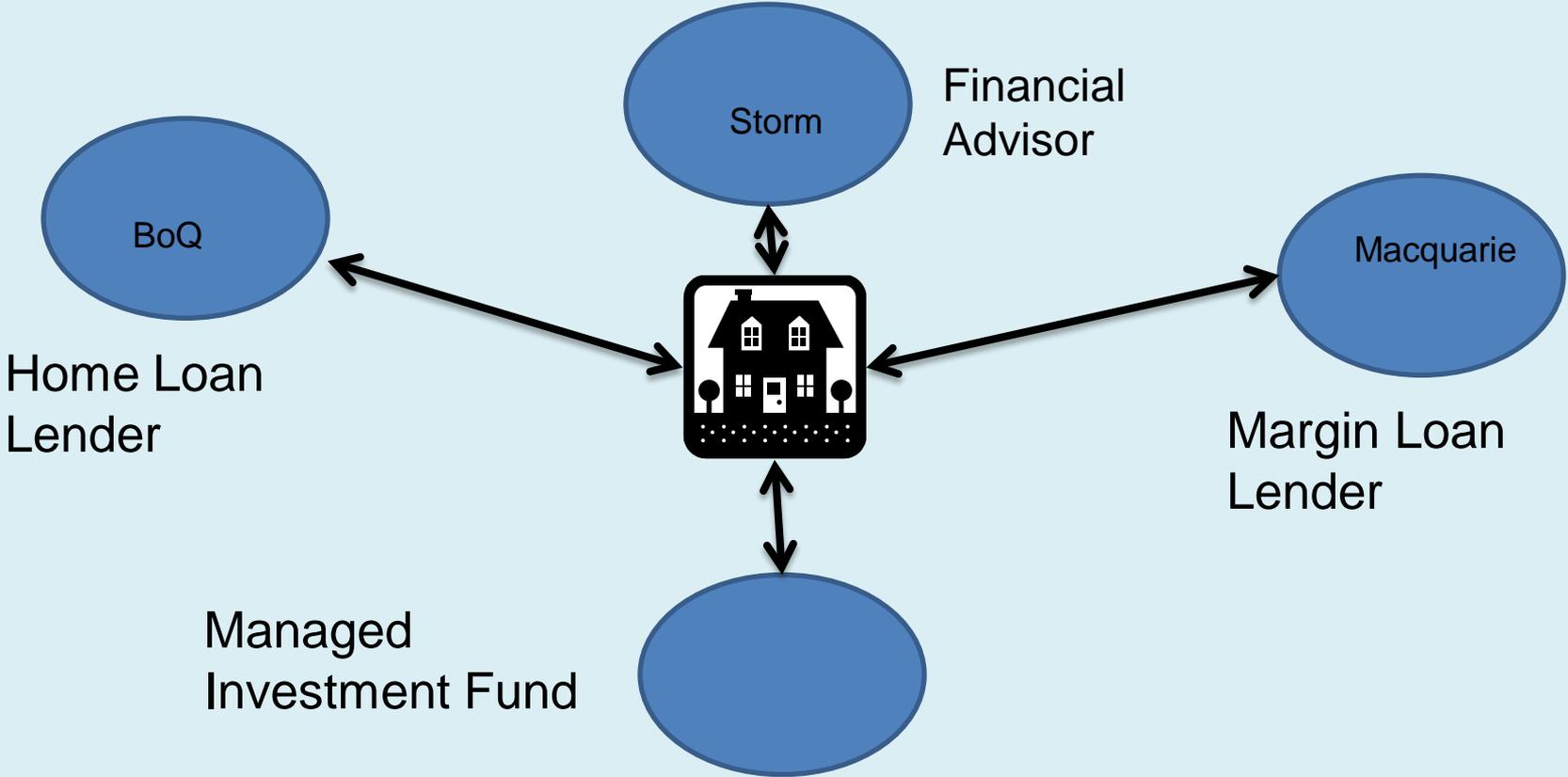
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“Your Home is a Pot of Gold”



- *Learn the secrets of wealth creation*
- *Your Home is not just bricks and mortar... It's dollars and cents!*
- *Saving won't make you rich, but your home can!*
- *Your home is the pot of gold you have been looking for...*
 - *...ask us how.*

Storm Financial Investment Package



Outcomes

- This is a risky deal for investors
 - *“catastrophic effect on many investors”*
 - *“now facings great challenges in meeting living expenses, repaying debts, and in some cases, keeping their homes”*. (ref 5, 3.1)

SICAG reports many investors are suicidal.

Risky for the advisors & lenders too

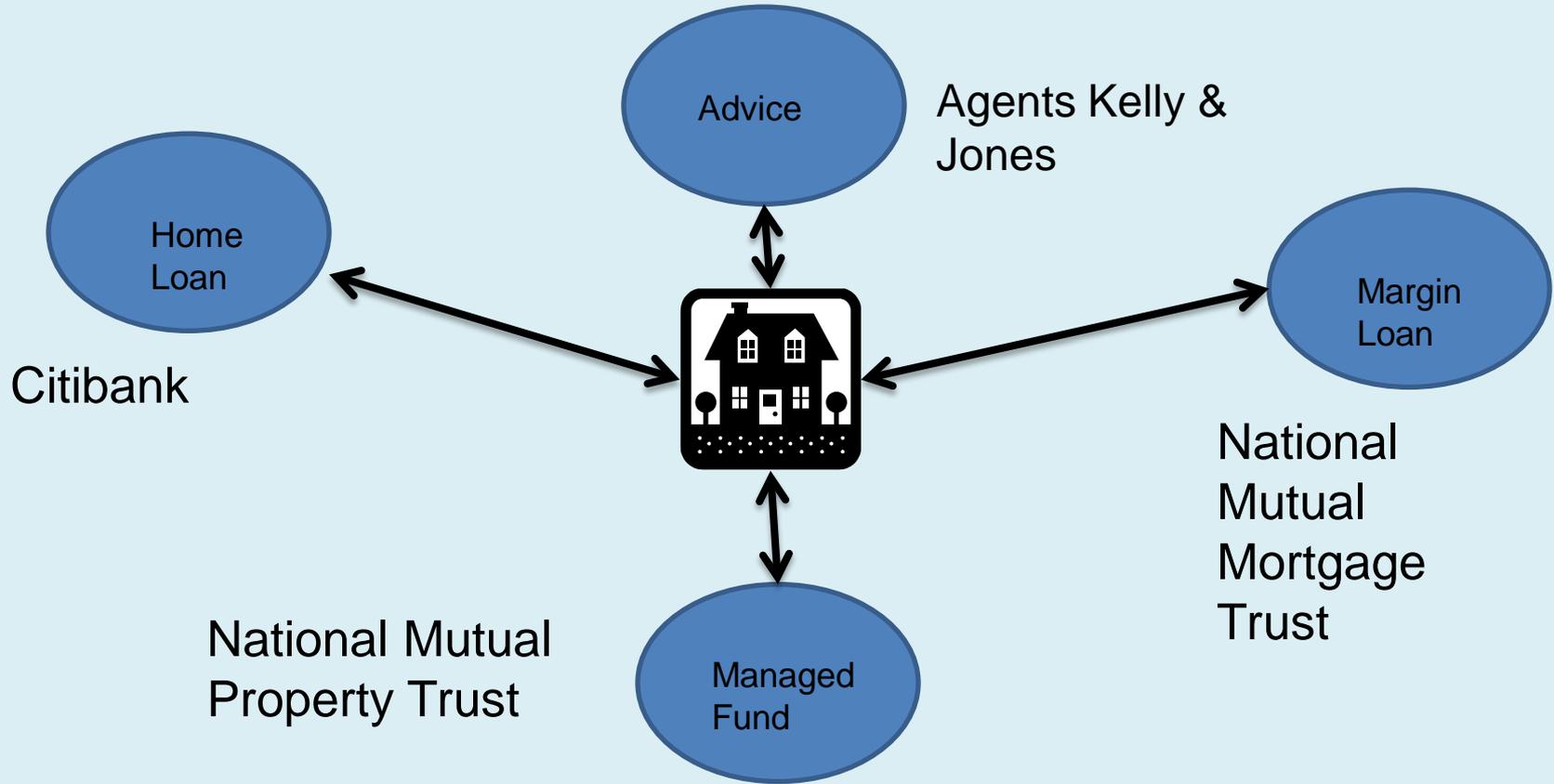
This is also a risky deal for lenders and advisors

- Commonwealth Bank and ANZ compensation schemes (\$200m?)
- ASIC suing BoQ and Macquarie for unconscionable conduct
- ASIC suing Comm Bank, BOQ, & Macquarie for participating in an Unregistered MIS (1 billion?)
- Reputational damage (value ?)
- Bad debts

Deja vu all over again?

- *Haven't I seen this somewhere before ?*
 - *Double Gearing Packages*

National Mutual & Citibank (1989-1992)



National Mutual & Citibank 1989-1992

NMFM Property Pty Ltd V Citibank (no 10) [2000] FCA 1558

- National Mutual paid approximately \$16 million in compensation to a group of investors
- Then NM sued Citibank for contribution towards the compensation payments
- Investment advisors were subsequently banned by ASC

How serious a problem is mis-selling risk?

- Pensions Mis-selling
- WP Endowment assurances
- PIP policies
- Reverse Mortgages
- AMP 80/20 policies
- Swiss currency loans
- Sales to Aborigines
- Homefund
- ANZ – NZ investment
- Vanishing Premiums
- Prudential Bache
- Ameritrust
- Allianz variable annuities
- LOTS of US insurers

Q. Do you think Consumer Protection legislation is becoming more lenient? (FSA)

ERM for Mis-selling Risk

- Product Features
- Customers
- Sales Force Selection and Training
- Marketing Materials and Illustrations
- Explanation of Risks to the Investor
- Supervision of the Sales Force
- Delivery of Promised Services
- Complaints Handling Process
- Relationship with the Lenders / Effect on Loan Approvals
- Diffusion of Responsibility

1. Product Features

1. “Time Bomb Products” = will blow up your customers

You can sell high risk products as long as you can successfully communicate the risks to customers

2. Complexity

- * Customers Understand?

- * Agents / Intermediaries Understand?

NM Product Features

- Borrow $X = 80\%$ of the value of the home
 - From Citibank
 - Use this to buy Property Trust Units
 - Borrow 4X from Margin Lender
 - Use this to buy more Property Trust Units
 - Margin Loan 4X secured by all Units 5X
 - (Loan to Value Ratio 80%)
 - Expected Long Term Return on Property
- At 17.5%
 - At 17.5%
 - 16%

2. Suitability for Customers

THEORY: Products should be suitable for the customer

The NM Gearing Package was (perhaps??) **suitable** for customers who

- were on high marginal tax rates (for tax benefits)
- had sufficient income to cover the difference between interest payments and investment income (NB negative gearing only applies if early cash flow is negative)
- had had sufficient liquidity to ride out any market downturns
- understood the risks of investing

2. Suitability for Customers

Q. So who did NM sell the Package to?

The Court found that the NM Investors in this case

Had virtually no investment experience (1,s386)

Were not in receipt of high levels of income (typical jobs were bricklayer, mechanic, forklift driver, store packer, secretary, schoolteacher, etc)

Not paying high marginal rates of tax

The monthly interest bills of some of the investors exceeded their monthly after tax income. (1, s404&422)

2. Suitability for Customers

“What is clear from the evidence is that NM instructed and prepared its agents to promote the NMAM negative gearing arrangement, according to a pattern or formula, to as many people as possible, without qualification and on the basis that it was suitable for everyone, and NM agents acted accordingly.”
(1320)

2. Suitability for Customers

*“NM provided its agents with a constant stream of positive propaganda, praising the merits of the Property Trust and the NMAM gearing arrangement. While there were some cautionary notes, such as a statement that the NMAM gearing package was best suited to persons who enjoyed higher income levels and paid higher marginal tax rates, **the general tenor of the material was that it was suitable for everyone and should be promoted at every opportunity.**”*

(1321, emphasis added)

2. Suitability for Customers : Storm

Note: similarity to complaints against Storm

“One Size Fits All” Advice

(Ripoll Enquiry and ASIC Complaints Against Cassimatis)

2. Suitability for Customers : Storm

Similarly, Storm Financial recommended their products to many people who had little investment experience and simply trusted their advisors (after all, that is why they needed an advisor!)

“This was our first venture into investing in the stock market and it was all new to us by Mr Dalle Cort advised us we were in safe hands...” (5, 3.41)

3. Sales Staff Selection and Training

The Court found that: (s1330)

“The training provided to NMAM representatives did not teach them how to give competent investment advice. Rather, it simply trained them to sell units in the Property Trust...”

3. Sales Staff Selection and Training

The Court found that the training material given to agents: (s1306)

- provided projections based on certain assumptions
- (16% return on property)
- with no references to financial risk
- with no qualification about the assumptions
- with no limitations on which clients the Package would be appropriate for (other than high tax bracket)

Rogue Agent or Ideal Employee?

-> If the agents did a poor job, this was NM's fault.

The things said by Kelly, Jones, and the other advisors to prospective investors about the merits of the Package, the use they made of the prospectuses, the things they said about the desirability of the commercial properties that underlay the Trust, the projections of capital growth and income returns... Were all totally in line with what the NM organisation had encouraged them to say.” (1,s1338)

4. Marketing Materials

- Marketing Brochure provided illustrations / projections
- Past Returns were 22.26% (1987),
- 24.3% (1988),
- 21.0% (1989)
- Product launched in 1989
- Assumptions used in projections were described as “conservatively based”: Property Returns 16% p.a.

4. Marketing Materials

“Even when the value of the Trust’s assets, the value of the units and the rate of return to unit holders all fell, NM maintained an unfailingly optimistic note.” (1322)

4. Marketing Materials : Redemption Issue

- During “the recession we had to have” some Property Trusts had liquidity problems.
- NM provided reassurance to its investors: 7 days redemption.
- They kept accepting new investments which promised a 7-day redemption period.
- However, at the same time they were busy lobbying the government to impose a 12 month freeze on redemptions. (1, 1326ff)
- The freeze was imposed in July 1991 -> hardship for some investors.
- This earned some negative publicity.

4. Advice Provided by Agents

THEORY

The agents had a duty to warn the Investors of the risks.

IN PRACTICE

The NM agents did whiteboard presentations to investors.
(which it seems they generally did not understand)

“The presentation was very baffling as he went through a lot of figures very quickly and the presentation did not follow any logical sequence. I gained the impression that the presentation was designed to baffle.”

4. Advice Provided by Agents : NM

Court conclusion (1,s1165)

“Either, like the worst of teachers, he (Kelly) was simply incapable of appreciating his listener’s lack of understanding and giving a slow, step by step explanation, or it suited his purposes that his listener should not fully understand what he was saying.”

4. Advice Provided by Agents : NM

Even if the whiteboard explained some of the risks (doubtful), this would have been offset by the assurances provided by the agents.

- *This is a sure fire deal. You cannot lose.*
- *There is no risk in these investments.*
- *The property trusts and the investment scheme is a completely risk free investment.*
- *It is backed by National Mutual. They won't see one of their investment schemes go down.*
- *This scheme will make you millions (1, s138)*
- *The statistics show that you cannot lose when you invest in property. There is no better investment than property. (1,s414)*

Storm Education

Storm apparently provided much more information about the risks.

“Storm went through due process when recruiting customers. Nearly all the victims attended several meetings and consultations before parting with their cash. ... When an investor decided to commit, Storm sent a statement of advice which ran to more than 100 pages.”

(Sykes p 287)

Storm Education

However it seems some investors simply did not understand.

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

Was the right information being provided?

SICAG survey

Only 4.8% of investors claim to have been advised that there was a risk of losing the family home should markets drop.

4. Advice Provided by Advisors: Storm

- Provision of accurate information is not enough
- **Accurate** information can easily be undermined by **inaccurate** information.
- *“The committee has been told that Storm advisors strongly downplayed the risk of losing the family home” (5, 3.39)*
 - *“Storm told the victims their family homes would be safe....*
 - *Words to this effect appear in the submission of almost every victim.”*
 - (Sykes page 287)

Monitoring and Enforcement of Standards

THEORY

- Monitor the activities of agents
- Check to see that they are complying with legal and ethical standards
- Takes steps to rectify any mis-selling activities

Monitoring and Enforcement of Standards: NM

IN PRACTICE

Agents who provide the most optimistic advice are often the most “successful” salesmen (in terms of volume sold).

- *“The two leading sellers were Kelly and Jones, both of whom were **highly regarded** within the NM organisation.*
- *They received **awards** over the years in question, based on their sales.*
- *They were encouraged to **train other agents.**”*
- *Told clients: “He was National Mutuals’s number 1 salesman”^(1, s853)*

The Award Winning Agent

Former National Mutual agent, Dennis Lloyd Jones, has been banned by the Australian Securities Commission (ASC) from acting as a representative of a dealer or of an investment adviser for 10 years.

Mr Jones became a licensed representative of National Mutual Assets Management Ltd (NMAM) in 1987 and was issued with a proper authority by NMAM in 1989. NMAM withdrew this proper authority in January 1993.

The ASC alleged that Mr Jones had contravened securities laws in making securities recommendations for which there was no reasonable basis, contrary to section 851 of the Corporations Law; and that he had failed to give particulars of commissions, fees and other benefits or advantages, contrary to section 849 of the Law.

The Award Winning Agent

- *Two more former National Mutual agents, one based in Melbourne and the other in Sydney, have been banned by the Australian Securities Commission from operating in the securities industry for up to 10 years for their part in a negative gearing scheme that put investors' homes at risk.*
- *Kelly was banned for 10 years and Roberts for two years after they made investment recommendations to clients which were inappropriate to the clients' needs and which breached the commission and benefit disclosure requirement.*
- *Yesterday the ASC's NSW regional commissioner, Mr Michael Braham, said the scheme had been promoted by a number of NM agents who had cold canvassed people of modest means and persuaded them to borrow substantial amounts using their family homes as loan security and then investing the funds raised in National Mutual property trusts and insurance policies.*
- *"The financial projections and assumptions behind these schemes were at best highly optimistic," Mr Braham said. "Risks were not discussed." The ASC's investigations revealed that several hundred investors had incurred substantial losses, some facing the loss of their homes. (ref 6)*

8. Delivery of Services

- The Investors bought units in the NM Property Trust.
- Returns were very poor.
- Income from the Property Trust fell steadily(1,s429)
 - 3.27 cents per unit Sept 1990
 - 2.43 cents per unit March 1992
- The property market was doing very badly over this period,
- But there were allegations (from Citibank) that the NM Property Trust's returns were adversely affected by other factors:

8. Delivery of Services

Firstly:

“NM attributing excessive values to properties held in the Property Trusts with the effect that the purchase price paid for the units in the Property Trust was excessive”. (1, s113)

8. Delivery of Services

Secondly

“A fundamental cause of the Investors’ losses was the fact that two of the major assets of the Property Trust....were purchased from companies within the NM group for prices which were, as it was ultimately recognised, considerably above their true market value”

Note: The Court did not deal with these allegations in its judgement. They were part of Citibank’s refutation of its responsibility for losses.

9. Responding to complaints

THEORY

- Complaints should be dealt with fairly and promptly
- Complaints should be analysed for patterns
- Hence identify any systemic problems

Responding to complaints

IN PRACTICE

From December 1990 to December 1992 NM received complaints from dissatisfied investors, complaining of misleading sales techniques which NMAM representatives had used in relation to the NMAM negative gearing arrangement, and of the inappropriateness of the financial advice that they had been given, Yet until December 1992, NM management did not question the appropriateness of their conduct.

(ref 1, 1332)

Responding to complaints

Late 1992 – NM begins to make margin calls

1. Complaints to the ASC; ASC commences investigation
2. Media Stories about investors suing NM
3. Four Corners Program

NM stopped sales of the product in January 1993

Settlement

- NM paid compensation to the Investors.
- Purportedly done in order to dissuade the ASC from conducting further investigations (1, s106)
- NM then sued Citibank, alleging Citibank was partly responsible and should pay part of the costs

Lender's Role

- Two issues for the banks making the home loans:
- A. Did the advisors “stand between” the lenders and the customers? And if so what effect did this have?
- B. Did the lenders apply responsible lending standards when making the loans?

Lender's Role:NM

- The NM agent (Kelly) filled in application forms on behalf of the clients and gave them to Citibank.
- He assured his clients that he could make sure they got the loan, no problems.
- It seems this resulted in some weaknesses in lending:
 - The borrowers were supposed to get advice from a solicitor (who was supposed to sign the forms)
 - The person who signed as the “solicitor” was a woman who worked in Kelly’s office (who was not a solicitor and gave no advice to the clients)

Lender's Role: Storm

- Investors say that Storm Financial filled in loan application forms on behalf of the investors
 - Investors say the information on the forms was not always accurate (i.e. revised to increase the amount they could borrow). (5, 3.57)

Lender's Role: NM

- Citibank made Mortgage loans to the NM investors
- They did not check the borrower's ability to pay at all (until 1991)
- Loans were made based solely on the value of the collateral.
- Court criticised their lending standards

Lender's Role: Storm

Suggestions that the close relationship between Storm and the Banks led to inappropriate, unethical, imprudent lending (see 5, 3.63)

- *“The banks made high mortgage loans to Storm clients with a minimum of checking. Jelich noted that the relationship between the Cassimatis and the lenders, particularly CBA, was ‘seamless, very close’. Jelich said ‘The intimate relationship was very rewarding for both parties and in my belief led to a **relaxation of prudential standards and creative handling of clients’ paperwork in relation to asset valuations and loan applications.**”*
 - (Sykes, p288, citing submission to Ripoll inequiry)

9. Who was Responsible?

NM Example:

There were many entities involved in the NM Packages.
-> Everyone blamed everyone else.

NM Sues Citibank

The legal proceedings were incredibly complicated with dozens of parties involved, all claiming against each other and then cross-claiming against each other.

9. Who was Responsible?

Court case against Citibank (1340)

- *Citibank did not encourage the Advisers to say the things they said about the Package.*
- *It was a bystander.*
- *It's (hypothetical) error was to think that these matters were no concern of Citibank's and that it was entitled to treat them exclusively as a concern of NM's.*
- *What it could have done was cease to make (their loans) available, at least until the Advisers mended their ways to its satisfaction.*

9. Legal Costs?

After a long drawn out battle, the Court ultimately decided that Citibank should NOT have to pay compensation to the NM investors

However,

“the total of all parties’ legal costs, witness expenses, and the cost of NM and Citibank executive time must surely exceed the sum of \$4,125,355” (amount suggested for settlement of the case) (ref 1, s18)

So Citibank’s involvement with NM did have a downside.

9. Who Was Responsible ? Storm

Storm Example:

There were many entities involved in the Storm Financial fiasco.
-> At Ripoll enquiry, everyone blamed everyone else.

- Who was responsible for loan approvals ?
- Who was responsible for making margin calls?

9. Who Was Responsible ? Storm

The Banks say (ref 3):

- The problem were caused by the Storm Financial advisors
- The Banks did not provide any advice to investors
- The Banks did not take any commissions from Storm

9. Who Was Responsible ? Storm

ASIC says (ref 4)

* ***unconscionable conduct***: ASIC alleges that BoQ and Macquarie were aware of enough facts about the investors to know they were in a position of disadvantage, and in that situation BoQ and Macquarie's conduct was unconscionable; and

* ***linked credit providers***: ASIC alleges that BoQ and Macquarie were 'linked credit providers' of Storm and therefore are jointly liable with Storm for loss and damage suffered by the two investors.

9. Moral of the Story?

*There are **reputational and legal risks** involved in doing business with another company, when you are aware that that company is not treating its customers fairly.*

Why do customers buy these products?

- 1. The Psychology of the Investors*
- 2. Impact of the Social Security Safety Net*
- 3. Is Education the Answer?*
- 4. Reassurance*

The Psychology of the Investors

Q. What is the REAL utility function for these investors?

Theoretically: upward sloping concave curve.

-> People who have very little money
should be unwilling to take risks with the small amount they have.

Advice: “Don’t invest money that you can’t afford to lose”

But in practice ?

The Psychology of the Investors

Sales Pitch:

Your current situation is bleak.

*If you do nothing, you will have to rely on the old age pension
which will not provide enough to make your life happy.*

So to avoid this awful possibility you should invest with us.

You must to take a small risk in order to avoid misery.

Statement of Advice

The Ripoll Enquiry: 2 clauses appear on every statement of advice

We have identified that your current asset base is not large enough to fund the lifestyle that you desire now or in the future. You have sought our advice on ways to expand your income streams so that you can become financially independent from work and have lifestyle choices in the future.

Statement of Advice

The Ripoll Enquiry: 2 clauses appear on every statement of advice

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

Impact of Safety Net

Many people who invest in double geared schemes are of pension age or nearing pension age.

- have paid off, or have significant equity, in their home

The old age pension is means tested.

- > So any losses are ameliorated by an increase in old age pension
- > e.g. 25% of SICAG members will rely on Centrelink

Economic Theory

- > This provides an incentive for risky investment

In Practice?

*“I might as well take a punt on this risky investment,
because if it goes well I’ll be rich,
And if it goes bad I can just rely on the old age pension.”*

In practice,
there is not much evidence to suggest that investors think this way.
-> Not in sales pitches or member submission.

On the contrary, the possibility of large losses was apparently disregarded – people believed their investments were quite safe.

Provision of Education

In both the NM case and the Storm case, investors were provided with “education”.

NM Case -> Education via whiteboard presentations.
Court found that the financial advisors did not explain the risks.

Storm Case -> Investors were required to attend extensive educational sessions which presumably explained the risks.
And given extensive paperwork.

Does Education Work?

Investors later claimed that they did not understand the risks.

- Is the right information being provided?
 - Is “Provision of Information” the same as education?
- Are some products simply too complicated for the average person to understand?
- Or is this information undermined by the inaccurate assurances of “safety” which are repeatedly stressed by advisors?

IAAUST Submission to Ripoll enquiry.

Mandatory Personal Stress Tests

“Would show the potential impact on the customers wealth and income/outgo following specified stress scenarios”

- Scenarios based on historical events
- (stock market crashes, property market crashes,
 - spikes in interest rates, exchange rates, etc)
- Showing impact on customer’s assets, income, and lifestyle

IAAUST Submission to Ripoll enquiry.

Restrictions on the sale of certain structured products

- Only to investors who can demonstrate some financial qualifications
 - (e.g. through wholesale investors)
- Only through advisors with specialist qualifications
 - Only following prudential scrutiny of the issuer

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Key Message 1

*If this product is risky for your customers,
then it is risky for you.*

Key Message 2

Mis-selling risks should be managed using an ERM approach.

Key Message 3

If a reputable company gets involved with a disreputable company, then there will be reputational and legal risks

(even if “we didn’t do anything wrong ourselves”)

Key Message 4

Six Months of Panic

How the Global Financial Crisis Hit Australia

By Trevor Sykes

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