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FINANCIAL SERVICES AND CREDIT REFORM GREEN PAPER

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1. Executive Summary

The Framework

To begin, we draw attention to the fundamental distinction between standard margin loans and the riskier hybrid arrangements that combine margin loans and stock lending. This difference should be reflected in the regulation of these products.

The market for standard margin loans, which dominates the retail loan market for share financing, performed well during the period of market turbulence over the last year. This was acknowledged during ASIC's Summer School in February and APRA has confirmed that banks have taken a conservative approach to this form of lending. Standard margin lending has been managed by the industry in a responsible manner and has served investors well. This results from existing financial services regulation and a desire on the part of lenders to protect their assets and business reputation. Members' experience is that margin loan investors reacted to market volatility in a measured way. In sum, the standard margin loan market has been resilient under demanding conditions and does not warrant greater regulation.

Hybrid arrangements that combine a margin loan and securities lending facility are offered by some fringe providers and present a different and more serious set of risks for investors than standard margin loans. Retail clients of some firms offering hybrid arrangements have suffered losses (notably Opes Prime) and this problem does warrant a regulatory response.

An Appropriate Regulatory Response

The goal of margin lending regulation should be to protect retail investors by:

1. Promoting prudent margin lending and risk management practices;
2. Ensuring margin lending businesses are adequately capitalised;
3. Achieving consistent, good quality disclosure to retail investors.

Efficient regulation will positively discriminate between business models that pose different levels of regulatory risk; notably in this case differentiating between standard margin loans and hybrid arrangements. We believe that a variant of the options suggested in the Green Paper would achieve this.

In the <u>standard margin loan market</u>, we believe good regulation would be:

1. Normal capital adequacy requirements for APRA regulated groups or ASIC regulated Australian financial services (AFS) licensees;
2. Normal risk management standards applied by APRA or ASIC;
3. An industry disclosure standard that is developed by providers in consultation with ASIC, to ensure investors understand their rights, obligations and risks under a standard margin loan agreement.

In the riskier hybrid market, more stringent steps are needed to protect retail investors. The detail of this requires further discussion but, for example, could include capital obligations, more prescriptive risk management controls and more prescriptive disclosure. Under a risk based approach to regulation, ASIC would apply proportionately more compliance resources to this area.

We note the Green Paper raises issues arising from margin loan facilities held by listed company directors. This presents a market integrity issue that is being managed by ASX through its continuous disclosure regulation and is not a consumer protection matter for reform through a credit reform process.

2. Regulatory Issues Arising From Recent Market Turbulence

Recent share price volatility vividly illustrates the economic risk associated with investment in shares – especially after a five year period of sustained share price increases, during which the S&P ASX 200 index more than doubled. Australia's markets have generally performed effectively under the pressure of the global sub-prime crisis.

However, one effect of the volatility experienced in the share market over the last year has been the emergence of unanticipated weak points in our financial markets. A disciplined approach needs to be taken in identifying the problem areas, with reliance on evidence to support conclusions, in order to place policy makers in a position to craft a regulatory response that will deal with these situations effectively. This approach is especially relevant to margin lending, because some public commentary on the regulatory risks arising from margin lending has not discriminated between business models that have performed well and those that have not.

Therefore, it is necessary to understand the regulatory risks that exist in margin lending before deciding how best to respond. The remainder of this section provides some relevant insights in this regard.

2.1. Regulatory Issue 1: Margin Lending, Securities Lending & Hybrid Arrangements are Not All the Same

The business models for margin lending, stock lending and hybrid arrangements are quite different, as outlined in table 1 (below), and if regulation fails to recognise the different risks that investors encounter in each model, it will be inefficient and potentially ineffective. The relevance of this is highlighted by the fact that recently problems have been incorrectly attributed to margin lending, apparently because of confusion about the nature of business models that combine margin lending and securities lending into one hybrid arrangement.

Margin lending is predominantly a retail business rather than an institutional business. In the standard margin loan, the lender takes security over the assets being financed. In this arrangement the margin loan investor retains the legal ownership of the equities, thus keeping full beneficial ownership. The lender only has recourse on the assets pledged in the event of default or a breach of their obligations under the margin lending contract.

Securities lending, by contrast, is typically a wholesale business involving institutional investors. It is usually governed by an ASLA[1] agreement. A securities lending arrangement involves the outright transfer of title from the lender to the borrower and collateral is taken by the lender. The investor who lends their shares does not retain legal ownership of them.

Hybrid arrangements also exist (eg the Opes Prime model), which are sometimes referred to as margin loans. Under these arrangements the investor borrows funds to purchase shares by way of a margin loan but the loan provider takes legal ownership of the shares acquired, as security for the loan. This is unlike a standard margin loan because the 'margin loan' borrower in this instance is exposed to the credit risk of its lender and the arrangement is more complex for the investor to understand. Hybrid arrangements are unlike standard securities lending agreements because the flow of funds, securities and credit risk are different, also hybrid arrangements are offered to retail clients, rather than the institutional market.

Table 1 Summary Features of Different Lending Arrangements

	Standard Margin Loan	**Securities Lending**	**Hybrid Arrangements**
Margin Loan Market Share*			
Dec 07 (estimated)	*90%+*	*n/a*	*<10%*
Jun 08 (estimated)	*97%+*	*n/a*	*<3%*
Market Focus	*Retail*	*Institutional*	*Retail*
Loan Denomination	*Cash*	*Securities*	*Cash*
Borrower's Use of Loan Proceeds	*Purchase securities*	*Settle transaction/ raise cash/earn fee income*	*Purchase securities*
Collateral Offered for Loan	*Securities financed by loan, cash*	*Cash, other securities*	*Securities financed by loan, cash*
Owner of Collateral Offered	*Loan recipient*	*Loan recipient*	*Lender*
Holder of Credit Risk	*Lender*	*Lender & borrower*	*Lender & borrower*

* Market share estimates are based on member assessments of the market, given RBA data.

The implications of this for the design of regulation are significant, as the level of risk to retail investors in each of the above arrangements is quite different. In particular, investors in standard margin loan arrangements retain ownership of securities they offer as collateral and they do not take a credit risk on the loan provider. Hence, they are exposed to much less risk than investors in hybrid arrangements, who do actually transfer ownership of their securities to their lender. For this and other reasons (eg the complexity of the arrangement), they are more reliant on regulation for protection. This feature should be factored into the design of regulatory reform in this area.

[1] Australian Securities Lending Agreement.

Regulatory implications – Different margin lending arrangements offered to retail clients present different consumer protection issues and require a carefully crafted and targeted regulatory response.

2.2. Regulatory Issue 2: Regulatory Risk Differs Between Business Models

The impact of share market volatility on margin lenders and their retail clients has varied significantly in accordance with the type of business model adopted by the provider of the loan arrangement.

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

In addition, the higher risk lenders were not prudentially regulated, which is in contrast to standard margin loan providers who form part of APRA regulated conglomerate groups. The absence of prudential oversight is considered a factor in the problems encountered in the hybrid market segment and is a fact that increased the risk to investors.

Effective regulation should discriminate between business models that pose different levels of risk to investors. This should be reflected in the design of regulation (eg such that higher risk models are appropriately capitalised) and in the way regulation is administered (ie the regulator's resources should be directed more proportionately towards monitoring of the higher risk models).

Regulatory implications – Capital adequacy, sound risk management practices and effective disclosure are all relevant to meeting regulatory objectives and detailed regulatory measures must be calibrated to contain the relevant risks.

2.3. Regulatory Issue 3: Effective Disclosure Can Occur Without Formal Regulation

It is apparent from recent experience that investors must be cognisant of the business model used by their margin loan provider when making investment decisions, as the lender's creditworthiness is an important consideration in

hybrid arrangements. It is equally important that investors understand all of the costs, risks and benefits of a margin loan arrangement they are contemplating.

The disclosure documentation for a margin loan should provide information to a potential investor in a concise and accessible form that promotes a good understanding of the financial arrangement, their rights and obligations under it, and the risks (eg market risk) associated with it.

One advantage of standard margin loans in this context is their relative simplicity to disclose. In particular, a margin loan is a product that merely provides finance to enable the purchase of an asset, like shares or managed funds. While the asset purchased will typically present market risk and other risks for investors that involve complex disclosure issues, these are already dealt with under Chapter 7 of the Corporations Act. Therefore, within the framework of the regulatory system, it is the contractual terms of a margin loan that is relevant to regulation. In practice, the terms of standard margin loans are relatively simple and easy to explain compared to other financial products; for example, managed investment funds whose performance will be influenced by a myriad of risk factors. In contrast, hybrid arrangements are inherently more complex and present a more significant disclosure challenge.

There are important commercial incentives for entities with a strong business presence and a significant reputation asset to protect their client relationships by providing disclosure in a form that enables their clients to understand these matters. Consequently, standard margin loan providers have developed documents to explain the concepts and risks that underpin margin lending, which are of a high standard and have proven to be effective. In effect, this approach blends the benefits of good product disclosure and investor education. This is based on the principle that if a potential client understands and feels comfortable with a product, then they are more likely to acquire it.

It is estimated that nearly 70 percent of margin loans originate from stockbrokers and financial planners who, like banks, must structure their businesses to comply with financial services regulation in the Corporations Act. We understand that financial planners generally include advice on the margin loan as part of a financial plan or financial advice. Thus, the broader business framework within which margin loans are provided to retail clients supports effective advice and disclosure.

In addition, banking groups are prudentially regulated, and thus their members are expected to operate their business in an efficient manner, with

"integrity, prudence and professional skill"[2]. These entities also have a capital incentive to minimise operational risk. Further, banks that adhere to the Code of Banking Conduct are required to offer a dispute resolution service to their clients. Consequently, banks operating in the standard margin loan market have typically operated their business to a high regulatory standard in respect of disclosure and sales, even though they are not formally regulated for this purpose.

To explore the effectiveness of standard margin loan disclosure and business operating standards, we asked member firms who are the leading standard margin loan providers for information on client complaints since the beginning of 2008. In summary, members have reported that:

- The number of complaints they have received from margin loan clients is on average about 1 per 1,000 margin calls made;
- Of the complaints received, many were with regard to matters that did not relate to the investor's understanding or expectations of the product;
- The rate of client complaints about margin lending is generally not considered to be high.

These results support the view that standard margin loan disclosure to retail investors is adequate. Investors understand the product and they accept the need to actively manage their portfolios in the face of market volatility.

There may still be room for improvement. In particular, there is no industry standard for disclosure to retail clients who obtain standard margin loans. Thus, it is difficult to benchmark a particular bank's performance and to check the ongoing consistency and quality of disclosure. Moreover, there is no guidance to assist providers in designing their disclosure programs. However, there is significant support within the industry for the development of an industry standard; especially as an alternative to formal regulation that could be less discriminating, more prescriptive and less dynamic over time.

Finally, we note that the above commercial and regulatory motivations for good disclosure do not exist to the same extent for all margin loan providers. Moreover, because hybrid arrangements are more complex, they present greater disclosure challenges than standard margin loans. Hence, there may be some unevenness in the quality of the disclosure information provided to investors in these instances more formal guidance might be necessary, given

[2] See sections 5 and 11B of the Banking Act 1959.

the risks involved for investors. However, this should not impact on the standard margin loan market.

Regulatory implications – An industry standard would provide a consistent and helpful framework for borrowers and lenders, avoiding the need for prescriptive, official regulation. Hybrid margin loans present more complex issues and require greater regulatory oversight.

2.4. Regulatory Issue 4: APRA Prudential Regulation Reduces Investor Risk

The Green Paper does not make specific reference to the positive impact of APRA regulation on the quality of the margin loan market and the reduced risk for investors. However, it has played an important role in protecting investors during the recent extended bout of stock market volatility, given the prominence of bank groups in the provision of standard margin loans.

APRA's approach to margin lending supervision was summarised by its Chairman, Dr John Laker, as follows:

> *"APRA expects banks that provide margin lending to manage their lending exposures within a comprehensive risk management framework which, amongst other elements, focuses on the capacity of the borrower to service the loan and on the value of security. Banks have generally taken a conservative approach to this form of lending, with relatively prudent criteria for shares they will lend against and low loan-to valuation ratios around 50 per cent or lower.*
>
> *APRA monitors the banks' approach to this form of lending but does not set detailed prudential requirements. Decisions, for example, regarding the timing and need for margin calls are made by the bank as part of its normal business practices. APRA expects banks to have clear policies around these aspects of their margin lending activities. For those banks with material margin lending portfolios, APRA assesses the adequacy of lending policies and controls during regular on-site credit risk reviews. However, APRA does require ADIs to hold regulatory capital against their margin loans as a buffer against unexpected losses. In fact, APRA recently exercised its national discretion and departed from the new Basel II framework, which does not include any capital on margin lending because of the historically very low risk in this activity. APRA imposes a 20 per cent risk weight, equivalent to a 1.6 per cent capital requirement on ADI margin lending."*[3]

[3] Dr John Laker, Chairman, APRA – Senate Economic Committee, 4 June 2008.

Dr Laker's comments serve to illustrate the responsible approach adopted by banks in their margin lending business, the effect of which has been to reduce the risk for investors and enable them to endure the consequences of market volatility. Margin call volumes did increase significantly, consequent to the market volatility. However, bank margin loan providers operated prudent businesses and made the margin calls in a timely manner. As investors on average were conservatively geared the market fall was generally absorbed without the need to sell securities or by managing the sale of securities in an orderly manner.

The operation of the standard margin loan market has a real time focus, with share price movements followed on an ongoing basis to assess the need for margin calls. Hence, there are no latent market risk issues to creep up on investors over the course of time. Amongst other things, the efficient management of the margin call process in this manner provides a helpful framework for investors to manage their risk.

Apart from the regulatory obligation to contain risk, APRA regulated entities are typically providers with a large business and a sound reputation, who have a significant commercial interest in ensuring that their clients are treated in a fair and conscientious manner. They would not want to risk their standing in the market and with their clients given the commercial consequences. Hence, they have a strong natural bias to conduct their business in a proper manner.

Regulatory implications – The benefit of APRA regulation of a margin loan provider should be reflected in the design and administration of margin lending regulation.

2.5. Regulatory Issue 5: Directors' Margin Loans are a Continuous Disclosure Issue

Market volatility has highlighted the business and market implications of directors whose share holdings in their company are, to a significant extent, financed by borrowings. Issues that have surfaced have been in relation to large loans to directors whose securities have been affected by price falls. Consequently, concern about company directors holding shares tied to margin loans have been raised.

A potential problem with margin lending arises when shareholders are unaware of situations where directors are facing possible margin calls on their own shareholding in the company, which can often be substantial. This can

create pressure on a company's share price and, amongst other things, potentially increases the risk of insider trading.

This is a continuous disclosure matter for ASX to manage and in February ASX released a statement on director-shareholder margin loans, which stipulated that such arrangements may be of material significance under Listing Rule 3.1 and subject to market disclosure requirements. Given the regulatory and potential reputation issues involved, it is expected that lenders will have, in future, a reduced appetite for these types of loans.

Regulatory implications – Directors' margin loans is an ASX continuous disclosure issue, rather than an AFS licensing or product disclosure matter.

3. Reform of Margin Lending Regulation

While the Green Paper sets out some issues arising from recent market volatility, it does not spell out in clear terms the regulatory shortcomings to be addressed through reform. We think it is important to be precise about the objectives of the reform process.

Matters arising that the Green Paper identifies as being relevant include:

- *Retail investors may not understand margin lending and how margin loans work (eg LVR and changes to it)* – There is evidence to the contrary in relation to standard margin loans;
- *Retail investors have been alarmed by recent volatility* – It is not evident that standard margin loan investors were more affected than other investors by the share market volatility – to the extent there is an issue, it needs to be addressed by investor education;
- *Concern about the viability of the margin lending industry, suggesting standardising of margin calls and disclosure* – The viability of the market for standard margin loans is not in question but the hybrid business model is under scrutiny;
- *Company directors may not disclose trading in company stock in a timely manner* – This is an ASX continuous disclosure issue.

Based on our analysis in Section 2, we believe there are other, more pressing issues that are relevant to regulatory reform. In particular, the hybrid model poses significantly greater risk to investors through complexity and credit risk, while different disclosure is required for standard margin loans and hybrid arrangements. In addition, APRA does not prudentially regulate all providers.

Therefore, taking account of all of the information considered, we believe that regulation should be targeted at the areas of greatest need and the purpose of regulatory reform should be to:

1. Promote prudent risk management practices by margin lenders;
2. Ensure margin lending businesses are adequately capitalised;
3. Support consistent, good quality disclosure to margin loan investors.

4. Targeted Regulatory Reform

Good regulation is based on a fundamental principle that it only exists to address a demonstrated market failure that is material and to which there is no market based solution. We do not believe that evidence has been presented to suggest that there is a market failure in respect of standard margin loans. This is because the mainstream providers conduct their business in a prudent manner, as outlined by APRA and discussed above. Nevertheless, the market is capable of delivering even better disclosure by adopting an industry standard if there is a desire for greater regulatory oversight of this part of the market.

There is evidence from losses incurred by investors to suggest that hybrid arrangements do pose issues for regulators that require attention. The regulatory response could be in the form of legislation to sharpen the regulatory tools available to protect retail investors and focussing of the administration of the law (eg through compliance checks) towards the areas and entities that pose greatest regulatory risk.

The Green Paper contains three options to reform margin lending regulation, but it does not overtly seek to discriminate between standard margin lending, which is the dominant part of the market, and the marginal and declining hybrid loan segment. Nor does it consider how the administration of the law might be improved to increase retail investor protection.

We present a model for regulatory reform that we believe would deliver more efficiency and effective regulatory outcomes for investors who use margin loan facilities of any type. This is summarised in table 2 (below) and builds on elements contained in options 1 and 2.[4]

[4] With respect to Option 3, we agree with the conclusion in the Green Paper that the creation of a specific regulatory regime would generate overlap and introduce unwelcome inefficiency into the regulatory system. Hence, we think it is unlikely there will be any support to give it serious consideration.

Table 2 Summary - Recommended Regulation of Retail Margin Loan Business

	Standard Margin Loan		*Hybrid Arrangements*
	APRA Regulated Group Entity	AFS licence holder	AFS licence holder
1. Capital Adequacy	*APRA regulation*	*Apply RG 166 principles*	*Enhanced RG 166 obligations*
2. Risk Management	*APRA regulation*	*Apply RG 104 principles*	*Enhanced RG 104 obligations*
3. Disclosure	*Industry standard*	*Industry standard*	*ASIC regulation*

Note: ASIC regulatory guide RG 166 places a capital requirement on AFS license holders, while RG 104 addresses the adequacy of risk management controls.

4.1. Recommended Regulation of Retail Standard Margin Loans

Operating Authority

Providers of retail standard margin loans (defined for this purpose as arrangements under which the investor retains ownership of the securities provided as collateral) should be a member of an APRA regulated group or hold a licence from ASIC.

Standard margin loan borrowers do not have credit risk exposure to the lender, as their collateral always remains in their own name. Hence, it is not necessary to impose additional capital and risk management requirements on the lender for this purpose if the business is done either through an entity that forms part of an APRA regulated group or an entity that holds an AFS licence. For clarity we note that normal RG 166 and RG 104 controls should apply to the margin lending business (ie this business is not outside the scope of this regulation). This approach is sufficient to ensure that investors in standard margin loans are not unduly affected in the event that the lending entity is wound up.

Disclosure

Providers of standard margin loans should be required to adhere to a minimum industry standard agreed by providers in consultation with ASIC, to ensure investors understand their rights, obligations and risks under the margin lending loan agreement.

The purpose of this form of industry self-regulation is to ensure that investors in a standard margin loan understand the product and are given the information necessary to manage their risk on a regular basis. It will enable

benchmarking of a particular bank's performance, provide a check for the ongoing consistency and quality of disclosure, and promote peer review to identify any weaknesses that may emerge.

Chapter 7 disclosure documents have been criticised as being too long and complex. The Minister for Superannuation and Corporate Law has decided that further work needs to be done to deliver product disclosure to retail investors in a simpler and more readable form and he has established a working group with this objective in mind. It will be some time before this work is applied across the full range of financial products. Against this backdrop, we believe an industry standard would provide a measured and sensible benchmark for practical purposes.

4.2. Recommended Regulation of Retail Hybrid Arrangements

Providers of retail hybrid arrangements, where the investor transfers legal ownership of securities offered as collateral to the lender, should be required to address the following matters:

- Licensing – Hold a licence from ASIC to cover their retail hybrid business or be an APRA group regulated entity;
- Risk management – Have in place specified, stringent risk management controls for their retail margin lending business and otherwise meet an equivalent standard to that in ASIC's RG 104;
- Capital adequacy – The lender should hold a specified minimum amount of capital for their margin lending business, in addition to the normal financial resource requirement to comply with RG 166. We note that RG 166 is not intended to ensure that a licensee will meet its financial commitments; thus, it is not focussed on protecting clients against credit risk that exists in a hybrid loan arrangement;
- Disclosure – In respect of retail business, adhere to a disclosure standard that is set out by ASIC for this type of business and which highlights in clear form the credit risk absorbed by the client.

These obligations should apply in respect of <u>all</u> aspects of the hybrid arrangements (ie to both the margin loan and stock lending components) that are offered to retail clients.

However, we would emphasise that there is no need to further control or restrict stock lending that involves wholesale market participants for the purpose of margin lending regulation (ie the market should not be subject to greater regulation). The players involved in this market are sufficiently

sophisticated to negotiate terms to protect their interest and there is no apparent systemic risk arising from stock lending.

Finally, we note that the Chapter 7 disclosure obligation, which seems to be the main focus of the Green Paper, will not of itself address the risks to investors from hybrid margin lending, as it will not necessarily prevent a repeat of the recent failure of hybrid margin lenders at the fringe.

5. Concluding Comments

Further policy work may be required to build in the feedback received through this consultation process and more thoroughly define the margin lending issues that require attention. In addition, there should be consultation on the drafting of any regulatory instruments that are contemplated, given the potential technical complexity of the task. AFMA would welcome an opportunity to provide further input at the appropriate time, as industry input is necessary to deliver an effective outcome and to minimise the risk of unintended consequences.

AFMA is not commenting on other matters considered in the Green Paper, except to note that care should be taken to ensure that reforms to retail debenture regulation should not inadvertently impinge on the wholesale market space. Consultation on draft legislation would provide the opportunity to identify any potential issues in this regard.

We appreciate the opportunity to respond to the Green Paper and are happy to meet at Treasury's convenience to discuss any matters raised in this submission.

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