# Why Storm may lash planning

By Paul Resnik
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**PORTFOLIO POINT: Issues thrown up by the collapse of Storm Financial might turn out to be a watershed for the planning industry.**

Individuals and their families who choose to pay for the advice of a financial planner should reasonably expect that advice will be in their interests, not the planner's.

Much of what is wrong in financial planning will be found in the very public unravelling of the Storm Financial Group. Several issues have emerged, which leave the financial planning profession and the wider community more than a little concerned:

- The riskiness of the plans and product recommendations seem to have been unrelated to the risk-tolerance of Storm clients.
- Last year's dividend paid to the founders of Storm is mystifying when judged against conventional accounting standards.
- Despite claiming "independence", Storm appears to have had many links to institutional product suppliers.

Each issue in its own way is disturbing but it is the third, relating to independence, that is the most significant because it could easily lead to the view that the industry should be the subject of a full Senate enquiry.

### The Storm story so far

This is what I understand:

- Storm Financial, in various guises, has been in operation for more than 35 years.
- An attempt was made to float the then profitable business in late 2007, but an underwriter could not be found.
- Storm was a principal member of the FPA and employed a number of Certified Financial Planners [CFPs]
- The business charged high initial fees of 6–8% and received moderate trailing commissions from Storm-branded products issued by major investment houses.
- Some client portfolios were maximised for equity exposure using double gearing. Money borrowed against the home was leveraged further through margin loans.
- Margin calls were also subject to initial fee charges.
- Some of the highly geared clients were in their late 70s.
- Increases in investment and home values were crystallised and re-invested incurring further initial fees.
- During or after fiscal 2008 the dividend paid to founders was $24.1 million on a profit of $26 million.
- In the last part of 2008 new business volumes declined.
- The business could no longer meet its financial obligations as they fell due and is now being wound up.

Consequently:

- Many clients have lost more money than they thought was possible or – in many cases – could afford to lose.
- It took ASIC until December 2008 to commence a formal inquiry.
- An FPA inquiry is also under way.
- Clients will now want new advisers or will take legal action or may contract politicians or – importantly – may never trust advisers again.

## 1: Why this failure matters

An unfortunate behaviour that I suspect is common to many other financial planners and planning groups is the projection of the financial planner's risk tolerance on to their clients. This is best exemplified in this exchange reported in the *Townsville Bulletin* on January 7 this year between Business editor Tony Raggatt and Emmanuel and Julie Cassimatis, the founders of the Storm Financial Group.

Question: "What do you say to all those people who have lost or will lose their homes and life savings?"

Answer: "It is important that you know that the founders of Storm, along with most advisers and key staff, are all in the same boat as some of our clients. *We have all followed the same investment and lending within our portfolios, have our homes mortgaged and have suffered the declines in the markets due to the financial crisis.* We are also a large part of the negative equity issue. While this is no consolation, we are sure it proves *we have not acted differently for ourselves*. Being in the front line of course makes us the first casualties, and as such the Storm group accounts for the biggest losses alongside the group of clients that are in that position." [my emphasis].

While it's not unreasonable for a baker to say that he eats his own bread, it is clearly inconsistent for a financial planner to give all clients a similar and very risky strategy even if it is the same one they have adopted themselves.

It seems all in Storm took the same medicine! Everyone, it is claimed, lost money – staff and clients alike. It would appear to an outsider that Storm simply projected its corporate risk tolerance on to its clients. If so, this would show little regard for legal and professional niceties such as "know the client" and "know your product" obligations

### Was there a reasonable basis for advice?

In the Storm case, advice seemed to depend on the clients' financial circumstances alone. I suspect "risk profiling" followed a process that went something like this:-

1. Is the client alive? Check.
2. Can I organise a loan? Check.
3. Can I organise another loan? Check.
4. Can I find a fund manager that will allow me a 6%-plus upfront commission on an index fund? Check.
5. Can I find a fund manager that will give me trailing commission on an index fund? Check.
6. Can I find someone in compliance to check all of the above? Check.

7. Is ASIC asleep? Check.
8. Is the FPA asleep? Check.
9. Is there anything else I need to take account of? No.

While this is somewhat tongue-in-cheek and is a mere a figment of my imagination, it's hard to believe that the host of product and service suppliers, statutory and industry regulators and other associates did not know what was happening to clients in the Storm business process.

## 2: Storm's fee structures and accounting anomalies

Storm's policy was to encourage clients to take on the high upfront fee and relatively low ongoing fee structure claiming that in the long term it provided better value for clients than the more traditional low establishment and higher ongoing fee structure of competing planners.

An example shared by a financial planner after a visit from an ex Storm client.

"I'm not sure what the usual practice for fees was with Storm, but the clients I saw, who borrowed about $660,000 using equity and then had a margin loan for an additional $600,000, paid an initial upfront fee of about $128,000, which they were told included both the entry fee for investing into Challenger and Colonial and also the ongoing fees 'for the rest of their term of having investments with Storm'.

"The clients then paid no ongoings at all and when I checked their statements from Colonial and Challenger it did have a rebate on some ongoing management fees that were tied into the MER, although it didn't go as far as detailing the actual fees charged. It just noted a $600 fee rebate on the fund that I looked at."

Of course, this may not have been standard practice, nevertheless examination is instructive as it shows how poorly at least this client understood the Storm fee structures. As far as I can tell the ongoing fees charged are in the vicinity of 1.15% a year, with a trail of just less than half. For an index fund, many would argue was a little on the high side. .

I understand that the initial fee in some cases was not paid by the fund manager but as a direct reduction from any moneys borrowed.

### Accounting and Audit 101 Failure: mismatch of income to expenses?

In essence, the Storm business model could only work in good markets. I suspect the Storm founders, children of the financial services industry prior to 1987, simply replicated the worst aspects of that periods high cost and high pressure selling.

The business appears to have floundered as markets declined. Nonetheless, in the second half of 2008 the business still paid a dividend of $24 million to its founding owners, a surprising payment given the apparent cash flow issues. Would Storm have become insolvent so quickly if the "profit" and ensuing "dividend: had been accounted for in a more orthodox manner?

Clearly the "profit" was based on the high upfront fees that were designated to pay for ongoing client service. This looks to be fundamentally inconsistent with the basic accounting standard that demands revenue should be matched to future expenses. A more traditional treatment would have been to view the majority of the initial fees not as revenue but to record it as a future liability. How many people who should have known better allowed this to happen without comment?

## 3: Agency: Which side are you on?

One of the more confronting issues to emerge in recent days is Storm's relationship with lenders and fund managers.

Crucially, there is grey area of agency: is the planner working for the product manufacturer or the investor? In Storm's case, whether the planner acting for the client or the bank now needs to be explored with some care. The client's financial plans often demanded that at least one loan be taken out. On the face of it, if the planner helped in processing an application and received any form of remuneration it is difficult to argue that the planner was not an agent for the lender.

. How does this reconcile with a financial planners professional and fiduciary obligation to the client?
. What level and type of disclosure of allowances, commissions, royalties, etc, is sufficient to allow the defence of "buyer beware" to stand?
. Who are planners like Storm representing and how is the client to know?

Among other things, we arrive at a core structural problem in the industry. Once more I suspect that we will need to look as to whether we label those who are obviously product sales people to clearly differentiate them from those who are fiduciary financial planners, and to clarify the lending organisation's duty of care obligations to the borrowers in these circumstances.

Why is the FPA's chief executive Jo-Anne Bloch defending margin lending in the midst of the closure of Storm?

Bloch was quoted in last month's *Money Management* magazine as saying: "If you start pointing fingers at Storm and their business model then you're going to have to start looking at a whole range of other issues like hedge funds and all sorts of other instruments."

Well, I believe those fingers are already being pointed, and will soon start waving disapprovingly. If I'm right, the industry should be worried because those fingers are attached to the arms of REGULATORS. That's right – not the lowercase, namby-pamby regulators of the last decade and a half. I'm talking about black-letter law, hard-edged, go-to-jail REGULATION. Bloch seems to see it quite differently.

"I don't think we're quite close to running a nanny state just yet, where we determine what's good and what's bad," she said. "I think people need to go into these things with their eyes wide open." She also said it's important for investors to understand that "for all the risk and return there are ups and there are downs, and that's what we're facing at the moment".

What will it take for the FPA to say, "This has to STOP!"

A significant number of Storm's clients were aggressively double geared, which is widely regarded as a very risky strategy. What's in question here is the quality and integrity of advice, not the clients' understanding of the potentially toxic mix of investment risk and margin lending. It's clearly entirely inappropriate to blame the victim.

Before planners recommend a margin loan, they should conduct a robust "stress test" on the client's portfolio. There are many ways to do this, including:

- Monte Carlo Simulation. A common exercise in this area that identifies outcomes and probabilities and generates possible scenarios. To find out more, click here.
- Back testing of the total client portfolio (home, debt, investment portfolio) through past extreme events, such as 1987, 1994, 1998, 2000 and now 2008!
- Mean variance analysis with correlations between markets being increased towards 1.00, reflecting the effects of contagion across markets at times of extreme stress.

- Creating hypothetical “black swan” (unexpected) events, and examining the impact on the total client portfolio.

I suspect that 90% of financial planners would be unaware of these processes, let alone undertaking such risk evaluation checks and sharing the results with their clients. Perhaps financial planners need a specific professional qualification and proven experience before being able to promote gearing.

Margin lending may not be such a good idea if clients make extra returns for 19 years and then lose everything in year 20!

When dealing with the product manufacturers who promote this strategy, planners need to be very "buyer beware", because product managers have no duty of care to them.

And where were the educators in all this? The aggressive gearing strategy only works if clients are very fortunate and they luck into a period of good returns or if they can time the market. Did Storm and its planners understand the risk clients were taking? Did their compliance officers understand? Or did they, like Jo-Anne Bloch, think that the strategy was viable?

## What will happen?

The community will continue to lose confidence in the players of the financial system, particularly bankers, fund managers and financial planners.

What I have seen of rules over the years is that they can so easily replace personal integrity. The norm has become: “If the rules don’t disallow something explicitly then it’s OK to do it.” Somehow we need to find and apply a higher standard of personal behaviour. I suspect that can be found in the process of seeking clients’ properly informed commitment to both their financial plans and the riskiness of the products, which is the core of a robust financial planning process.

Properly informed commitment needs to be built on a foundation that encompasses at least three of the components that go to make up personal financial literacy. Each client needs to:

1. Know their own (and any partners’) financial risk tolerance.
2. Know their capacity to cope with a financial loss in both the longer and shorter term.
3. Have at least a basic understanding of money, investment and tax issues.

Prospective clients need to understand whether their planner is an agent for a product manufacturer or represents their (the client’s) interests solely.

Perhaps the most important learning from the Storm case is that most of the players were either financially illiterate or behaved in an amoral manner. The former can be remedied by education the latter by jail.

## Who should be concerned?

As far as I can tell there are a pretty broad spectrum of people and organisations that need to be looking with some concern at their role in the Storm imbroglio.

- The various Storm lenders.
- The various Storm white label product issuers.
- The Storm principals.

- The Storm financial planners.
- The Storm compliance managers.
- The Storm accountants and auditors.
- The Storm professional indemnity insurers.
- ASIC and the FPA.

It's far from a storm in a teacup. It just might be a storm that leads to a Senate inquiry. And remember: the Senate is no longer controlled by a finance-sector friendly Liberal government and any inquiry will occur in an environment where "good government" just might be "heavy-handed regulation" government.

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