Financial Planning at the Crossroads?

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Individuals and their families who choose to pay for the advice of a financial planner should reasonably anticipate that advice will be in their interests - not the planner's. They should expect that they will not walk out of a planner's office with a ticking time bomb in their hands. This assumption appears to be ill-founded if you were a Storm client.

Much of what is wrong in financial planning will be found in the very public unravelling of the Storm Financial Group. Time and the courts will tell if there has been any form of illegality. Over the next short time the nature of the Storm business model will become open to public view. In the meanwhile I have no doubt that the community's confidence in the integrity of the financial planning services available to them will continue to be undermined.

There are a number of issues that have emerged to date:-

- First, the riskiness of the plans and product recommendations seem to have been unrelated to the risk tolerance of Storm clients. Rather there are concerns that they have been structured to maximise revenue for the Storm business.
- Secondly, last years dividend paid to the founders of Storm is mystifying when judged against conventional accounting standards.
- Thirdly, despite claiming 'independence' Storm appears to have had many links to institutional product suppliers that appear inconsistent with the ordinary use of the term independent. If that is the case what is the duty of care of those organisations to Storm's clients.

The third issue is the most significant as it could easily lead to the view that the industry needs a full Senate enquiry. However each in its own way is disturbing, combined I have little doubt they leave both the financial planning profession and wider community with substantial concerns in relation to their credibility.

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 trails 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 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 crystalised and re-invested incurring further initial fees.
- During or after fiscal 2008 the dividend paid to founders was $24.1m on a profit of $26m.
- 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 enquiry
- An FPA enquiry is also underway.
- Some clients will be looking for new advisers.
- Some clients will never trust an adviser again.
- Some clients will be taking legal action.
- Some clients may contact their local Member urging a Senate inquiry.

The media is having a field day but this will soon pass as they move onto other matters. But the shame file is growing; just add the Storm debacle to the top of the pile containing Westpoint and the other examples of advice gone wrong. Perhaps its time for something a little stronger than what could be seen as a 'Review' from those on whose watch the problem occurred.

1. Interview with Storm founders reveals risk bias

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 onto 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.

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

"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 bold for emphasis].

Whilst it's not unreasonable for the baker to say that he eats his own bread it is clearly inconsistent for a financial planner to give all his clients a similar and very risky strategy even if it is the same one he has adopted for himself and all of his extended family.

It seems all in Storm ate from the same loaf! Everyone, it is claimed, lost money; staff and clients alike. It would appear to an outsider that Storm simply projected their corporate risk tolerance onto their clients. If so, this shows little regard for legal and professional niceties such as "know the client" and "know your product" obligations and anything remotely similar to matching products to the needs of clients. Indeed, it has been reported that the driver of how much risk the client needed to take was a financial calculator driven by free cash flow to optimise home equity and margin loans which in turn maximised assets and loans under management and consequently Storm revenue. I understand that risk tolerance is never mentioned in the normal Storm Statement of Advice.

Is this a reasonable basis for advice?

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

- Is the client alive? Check
- Can I organize a loan? Check
- Can I organize another loan? Check
- Can I find a fund manager that will allow me a 6% plus up front commission on an index fund? Check
- Can I find a fund manager that will give me trail commission on an index fund? Check
- Can I find someone in compliance to check all of the above? Check
- Is ASIC asleep? Check
- Is the FPA asleep? Check
- Is there anything else I need to take account of? No.

This is somewhat tongue in cheek and is a mere a figment of my imagination but I do hope you get the message. The point is that it's hard to believe that the host of product and service suppliers, statutory and industry regulators and others 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 up-front 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 Friday who borrowed about $660k using equity and then had a margin loan for an additional $600k paid an initial upfront fee of approx **$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% pa 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 monies 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 period’s high cost and high pressure selling. The business appears to have floundered as markets declined when there were fewer new clients and lower numbers of existing clients able to top-up their investments from realised profits and further loans. As business diminished during the second half of 2008 working capital was obviously under pressure. Nonetheless, the business still paid a dividend of $24 million plus 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 up-front fees which were designated to pay for ongoing client service. This looks to be fundamentally inconsistent with the basic accounting standard which demands that 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. The Problem of Agency

One of the more confronting issues that has emerged over recent days is the relationship between lenders, fund managers and Storm. Storm was an ostensibly ‘independent’ financial planning group but had seemingly strong ties to a number of financial institutions which provided investment and lending products and facilities (not unlike those enjoyed by many other ‘independent’ financial planning groups). It is therefore not surprising to read media suggestions that the payments and other support from product suppliers lead to bias.

In particular the grey area of Agency 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 might be difficult to argue that the planner was not an agent for the lender.

- How does this reconcile with a financial planner’s 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?

Amongst 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 persons to clearly differentiate them from those

who are fiduciary financial planners and what are the lending organisation’s ‘duty of care’ obligations to the borrowers in these circumstances.

Why is the FPA defending margin lending in the midst of the closure of Storm?

I have to be careful here as I am relying on a news report from the daily Money Management of 16 January. I risk offending both the editor and the FPA. Nevertheless the comments as reported seem so extreme that they at least deserve to be raised so that they can be clarified.

“Bloch [CEO of the FPA] said while margin lending is a model that has risks, it is one that “people have done extremely well out of”. “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,” Bloch said earlier this week.”

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. The FPA 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; I think people need to go into these things with their eyes wide open.” Bloch 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” Instead of resorting to a ‘nanny state’ defense what will it take for the FPA to condemn the clear abuse of product, process and client?

Giving debt to many of the Storm clients was akin to giving whisky to a 2 year old child. Does society ban whisky? No. But does it condemn and sanction people who would give that whisky to a 2 year old? Yes. That is the argument here – and the FPA it appears is unprepared to engage in it.

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 client’s understanding of the potentially toxic mix of investment risk and margin lending. It’s entirely inappropriate to blame the victim.

Before recommending a margin loan client’s portfolios need to be robustly ‘stress tested’? There are many ways to do this, including:

- Monte Carlo Simulation.
- Back testing of the total client portfolio (home, debt, investment portfolio) through past extreme events, such as 1973, 1980,1987, 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’ 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 undertake such risk evaluation checks, 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 loose everything in year 20!

When dealing with the product manufacturers who promote this strategy, planners need to be very ‘buyer beware’, as product managers have no duty of care to them. So, for example, planners should not rely on 'education' provided by product manufacturers which is an issue I raised in another article late last year. It’s hardly a profession, for instance, if a significant proportion of ongoing education emanates from product suppliers.

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 the FPA, 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. This means savings, investments and insurances will be lower than might otherwise have taken place.

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

- ❖ Properly informed commitment needs to be built on a foundation that encompasses at least 3 of the components that go to make up personal financial literacy. Each client needs to:-

  - Know their own [and any partner’s] financial risk tolerance.
  - Know their capacity to cope with a financial loss in both the longer and shorter term.
  - 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 clients] 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 is 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 enquiry. And remember - that 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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