The regulation of margin lending in Australia

Overview

Legislation around the practice of margin lending has undergone considerable tightening in Australia in the years following the 2008 GFC. After the Federal Government took over regulation of margin lending from the states and territories in 2008, it incorporated margin loans under the financial product licensing and disclosure rules of the *Corporations Act 2001*.

The Act was again amended in 2011 to include responsible lending rules on margin loans. In 2015, margin lending was further scrutinised, with ASIC raising concerns around the practice of double gearing.

Featured interviewees

“We've got to really make sure we focus on the underlying risks of the investments themselves and then the geared component of that.”

Julie McKay • Senior manager, technical and research • Leveraged

“If you need cash in a portfolio, you probably don't want to have gearing in the portfolio at the same time.”

Daniel Archibald • Curriculum technical consultant • Kaplan Professional

Learning objectives

After reading this article you should be able to:

- Explain the difference between standard and non-standard margin lending facilities
- Discuss the key considerations when advising on margin loans
- Evaluate the risks of margin lending
- Describe the controversy surrounding the practice of double gearing.

Knowledge areas and accreditation

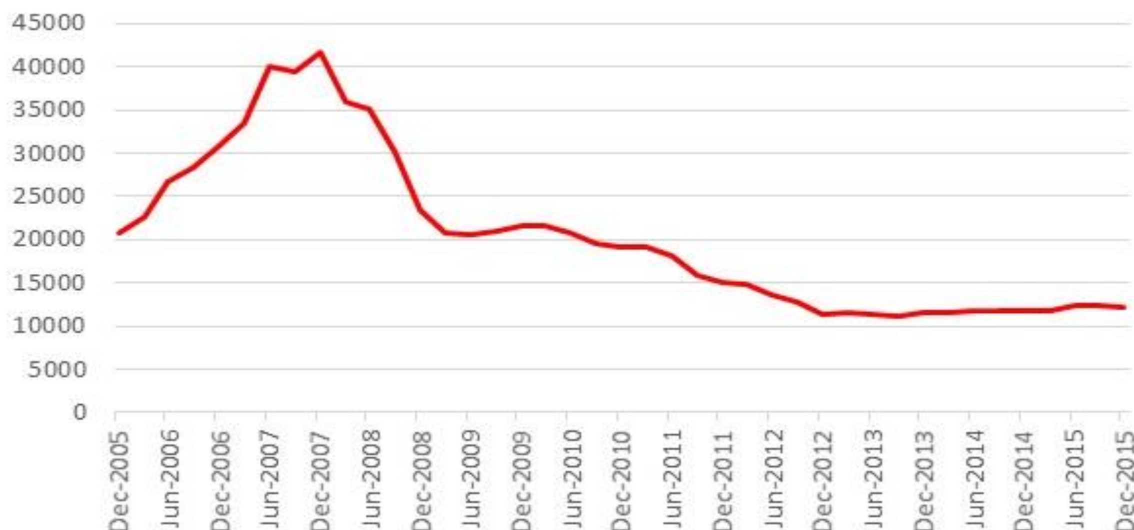
Knowledge area: Margin Lending and Geared Investments — Legal Environment and Compliance (45 minutes/0.75 points).
FPA CPD points 0.75 Dimension: Professional Conduct (FPA 007961).
AFA CPD points 0.75 (AFA 01022009).
CPA Australia CPD points 0.75 (CPA 000055).
FBAA CPD points 0.75.

Understanding margin loans

A margin loan is simply a credit facility used to invest in growth assets such as shares or managed funds, which are then used as security on the loan. Margin loans allow investors to increase their exposure to certain financial products and use the earnings on those products to help pay off the debt.

Margin loans experienced a significant fall in total value in Australia during the 2008 GFC, but had a modest increase across 2015 to end the year at $12.1 billion (see Figure 1).

Figure 1: Total value of margin loans in Australia ($ million), Dec 2005 to Dec 2015



Source: Reserve Bank of Australia (RBA)

Chapter 7 of the Corporations Act

Margin lending in Australia is pursuant to Chapter 7 of the *Corporations Act 2001* (Corporations Act). The Federal Government (Government) assumed responsibility for the regulation of margin lending from the states and territories in July 2008.

The Corporations Legislation Amendment (Financial Services Modernisation) Bill 2009, which was passed in June 2009, defined margin loans as “financial products” under Chapter 7 of the Corporations Act.

Leveraged’s senior manager, technical and research Julie McKay explained that the 2009 amendment significantly tightened the regulation of margin lending in Australia.

“The funny thing about margin loans is that they sort of sit between the two worlds. A margin loan is obviously a loan — you’re borrowing money — but you’re also investing in shares or managed funds [for instance],” she said.

“What happened in 2009 with the reforms [was that the Government] basically decided, instead of having margin lending sit in both camps to put it definitively in one camp. They decided to put it into the Chapter 7 regulations.

“So, all of the controls and licensing and disclosure regimes that are naturally a part of Chapter 7, and that advisers know very well for all of the other products they deal with, now apply to margin loans.

"But interestingly, even though it is a loan, it is specifically excluded from the NCCP Regulations [*National Consumer Credit Protection Regulations 2010*]. So, it's been firmly put in one camp and it's been regulated in that way."

Standard versus non-standard margin lending facilities

Margin lending facilities may fall under one or more of three main categories under Chapter 7 of the Corporations Act:

- A standard margin lending facility
- A non-standard margin lending facility
- A facility declared by ASIC to be a margin lending facility, unless ASIC declares it not to be a margin lending facility.

Consider

McKay noted that the third category is designed to cover any future product innovations that are outside the definition of standard or non-standard margin lending facilities.

McKay added that the key difference between standard and non-standard margin lending facilities is how the securities are held as collateral for the loan.

"For a standard margin loan, the borrower remains the beneficial owner of the securities and they pretty much just offer a mortgage to the lender. That's the typical way everybody does margin loans," she said.

"A non-standard margin loan is where the investor gives the securities to the lender… under what's called a 'security lending arrangement', so it is a little bit different [to a standard facility].

"They are like the old Opes Prime loans. The difficulty there was that once the lender owned those securities they could make extra money by actually lending those securities on. They do [still] occur in the market … but they're not typical. Most of the margin loans that advisers will see are the standard margin loan."

Features of a standard margin lending facility

There are four key terms for a standard margin lending facility under section 761EA(2) of the Corporations Act:

(a) credit is, or may be, provided by a person (the provider) to a natural person (the ***client****); and*

(b) the credit provided is, or must be, applied wholly or partly:

(i) to acquire one or more financial products, or a beneficial interest in one or more financial products; or

(ii) to repay, wholly or partly, another credit facility, the credit provided under which was applied, wholly or partly, to acquire one or more financial products, or a beneficial interest in one or more financial products; and

(c) the credit provided is, or must be, secured by property (the ***secured property****); and*

(d) the secured property consists, or must consist, wholly or partly of one or more marketable securities, or a beneficial interest in one or more marketable securities.

McKay noted that although the legislation stipulates that the borrower must be a “natural person”, which excludes trusts and companies, margin lenders will still lend to these entities under the expectation that ASIC will use its power to declare the loans as margin lending facilities.

“Pretty much most margin lenders will still treat trusts and companies in the same way they do natural persons,” she said.

In relation to section 761EA(2)(b), which states that a margin loan must be used “wholly or partly” to buy a financial product, McKay underscored that investors are entitled to use the funds for other purposes.

“You could use part of the loan to go buy some managed funds and use part of the loan to, say, go and do some renovations on an investment property, for example,” she said.

Key considerations when advising on margin loans

Considerations for financial advisers when discussing margin loans with clients include:

- Responsible lending obligations
- Client risk appetite and time horizon
- Assessment of unsuitability
- Gearing ratios
- Clients’ behavioural biases.

Responsible lending obligations

The Corporations Act was amended in January 2011 to incorporate responsible lending obligations for financial services providers when issuing a margin lending facility to a retail client, or increasing the limit of a margin lending facility to a retail client.

McKay commented that some margin lenders apply the obligations to all clients across the board, despite the legislation only stipulating retail clients.

“The margin lender has to check whether the loan is unsuitable for a client. It’s a very different thing to what advisers have to do,” she said.

“A margin lender also has to make reasonable enquiries about the client’s financial circumstances. The regulations do allow the lender to rely on the information that’s in the SOA [statement of advice] [to prevent potentially conflicting information coming in from both the client and their financial adviser].”

McKay added that the legislation requires an SOA to be no more than 90 days old from when the margin loan is opened.

“It sounds like a long time. It is, but actually in the context of the production of SOAs and the real level of detail that advisers often have to do to get that produced for clients, often 90 days is not long enough,” she said.

“What tends to happen is that the lenders collect additional information to verify the client’s financial position. They will collect things like pay slips and bank statements and so forth. That can vary from lender to lender, but there is that additional requirement there.”

Client risk appetite and time horizon

Kaplan Professional's curriculum technical consultant Daniel Archibald explained that client risk profiling will generally determine whether margin lending is an appropriate product for their circumstances.

"Traditionally, an adviser will go through a risk profile with a client [to assess] how much investment risk a client is willing to take on. For those clients that are at the aggressive end of the scale, gearing starts to become part of the conversation," he said.

"For older retirees, gearing probably won't be considered. But for the younger generation that don't need to rely on the income from investments and have a longer timeframe for that investment to grow, these types of clients would be prime candidates for the gearing conversation."

McKay recounted that although she has margin lending clients ranging from 18 to 90 years of age, margin loans are not appropriate for everyone, particularly those with short time horizons.

"We've got clients who are just doing very small loans with regular savings plans. We've got clients who've got $5 million, $10 million loans. So, to try and find a typical margin loan user is really quite difficult to do," she said.

"However … I would be very reluctant to suggest a margin loan as suitable for somebody with short-term goals because you need time in the market to be able to earn the sorts of capital gains that really make gearing sensible — you're talking five-, seven-, 10 year-goals. If somebody has got a three-year goal, it's maybe not right for them.

"The other difficulty with gearing for a lot of clients is wanting to play catch-up. You might have somebody who's maybe a couple of years off retirement and they're all of a sudden realising that they haven't saved enough, or they've got other big [investment] goals.

"It's tempting [for advisers] to put them into a risky investment like a margin loan. Gearing does have additional risks, there's no denying that, and that is not necessarily the best thing for them.

"If you're going into these things with a sense of hope or desperation about achieving your goals, then you're more likely to take inappropriate risks. I'm not saying that a margin loan isn't appropriate for somebody five, 10 years out from retirement, I'm just saying you've really got to look at the overall risk appetite and perhaps playing catch-up is a red flag for understanding those risks."

Archibald suggested that margin loans may also not be appropriate for clients who need ready access to cash in their portfolio.

"If you have a look at the overall theory on portfolio construction, for most clients, gearing would likely not be in the conversation. Because of the liquidity needs that a lot of clients have, especially retirees, they're going to need to have a portfolio that has cash in it," he said.

"If you need cash in a portfolio, you probably don't want to have gearing in the portfolio at the same time because they're really the same thing — that is, the loan is effectively negative cash — except for the fact that if you hold cash, you're earning less than what you would be paying from a loan, especially a margin loan. So, clients that need to hold cash probably aren't going to be suitable for a geared loan."

Assessment of unsuitability

The assessment of unsuitability under the Corporations Act requires margin lenders to determine whether the margin lending facility will be unsuitable for a retail client if the facility is issued or the limit is increased.

McKay highlighted the importance of financial advisers understanding the concept so they can convey it to clients.

"The unsuitability test is actually a different test to what the advisers have to do under their best interest obligations. Unsuitability could be considered to be a lower threshold. Really what the lender has to do is simply look for any sort of red flag that says, 'This client really shouldn't be doing this'," she said.

"Perhaps the client doesn't have enough income to service the interest costs, or there's something that says 'No, this is really not suitable for them'. They don't have to do what advisers need to do, which is to check all of their circumstances and their goals etc. to make sure it is actually suitable for their circumstances.

"It sounds really odd, you know, the lender has to say that the loan is not unsuitable, but the adviser has to say yes it's suitable. It sounds very convoluted but they are in fact different steps that are required to be done here."

In assessing a client's unsuitability for a margin loan, section 985k of the Corporations Act stipulates that a margin lending facility should be deemed unsuitable for a retail client if, in the event that the facility goes in to a margin call, the retail client:

(i) would be unable to comply with the retail client's financial obligations under the terms of the facility; or

(ii) could only comply with substantial hardship

McKay noted that "substantial hardship" can be difficult to quantify.

"Would this client, for example, lose their house if they experienced a margin call? It's really that level of substantial hardship," she said.

"But still the lender has to be satisfied that the client won't suffer substantial hardship if a margin call occurs. A lot of lenders … do a bit of modelling on a clients' intended portfolio. They stress test it to see what might happen in different market circumstances to see if the client has the financial resources to meet the margin call that might occur."

Notification rules in relation to margin calls

Margin lenders are also obligated to find loan applications or credit limit increases unsuitable if they have no way to regularly contact the client.

McKay explained that the legislation allows for a financial adviser to be the point of contact on behalf of a client for a margin call, for instance.

"The adviser can become, in effect, the client's margin call agent. It's an agreement that says a lender can notify the adviser and then the adviser will notify the client. So, while that's in the regulations, I am not aware of any adviser that wants to take on those responsibilities because it's quite onerous," she said.

Gearing ratios

Archibald suggested that margin lending need not necessarily be a risky venture for investors if gearing ratios are set responsibly and portfolio diversification is maintained.

For example

"Let's say you have a 70:30 portfolio — 70% equities and 30% bonds. To get more aggressive most advisers would think, 'Okay, I need to increase my equities, reduce my bonds', so they might start looking to do that until they get to 100% equities and 0% bonds," he said.

"Then they would start to think 'Okay, if I want to get more invested than this, now I'll start to gear'.

"If you have a look at the theory, it doesn't actually work like that. Looking to maintain that 70:30 split and gear on top of that is the more efficient approach. Instead of reducing your bonds and increasing your equities, what the theory says is borrow and increase both.

So what you're doing is maintaining the diversification benefits that you get out of equities and bonds and at the same time gearing those potential returns up."

McKay added that with a modest gearing ratio of around 50%, it will generally take a significant economic event before an investor receives a margin call.

"You may want to gear right up — 60% or 70% even — but you've really then got to understand that it only takes a smaller market move to potentially push you into a margin call situation," she said.

"Whereas somebody who's 50% geared — which is fairly typical for your average client — against a quality portfolio is going to need a GFC-style event to experience a margin call. It is really important for advisers to think about what level of gearing is appropriate, given a client's risk appetite and market volatility, but also the goal the client is trying to achieve."

Clients' behavioural biases

McKay suggested that financial advisers should ensure clients are cognisant of the potential behavioural biases that can be associated with geared investment and the need to establish an exit strategy.

"Often when people have borrowed money to invest in something, they think about it as their entire portfolio. It's the same way you think about your mortgage for your house — you think of the house as all yours and you become possessive about it or you become attached to it. The same often happens with investment portfolios, and that can lead to a lot of issues," she said.

McKay added that such behavioural bias means that a firm exit strategy should be in place should the investor ultimately be best served by cutting their losses.

"It might actually be in the client's best interest to get out of the investment, or at least out of the geared portion of that investment," she said.

"If they're not mentally prepared for that need — possibly in a really major market event like a GFC — to have to maybe crystallise a loss, then they're really going to be reluctant to do so.

"So, we've got to really make sure we focus on what are the underlying risks of the investments themselves and then the geared component of that. Is it going to be enough to return what [clients] need? Also, making sure clients are prepared to really act if necessary to respond to those market moves."

Margin loan risks

The key risks of margin loans for retail investors include:

- Volatility of the underlying market
- Interest rate risk.

Volatility of the underlying market

McKay believed that the main risk associated with margin lending is the market risk from the volatility of the underlying security, rather than the margin lending facility itself.

"The key risk, ultimately, is that you borrow to invest in something and it doesn't return adequate amounts to cover the costs and give you a decent return. To me, that's all about volatility," she said.

Interest rate risk

Archibald noted that holders of margin loans are also exposed to the risk of rising interest rates increasing the costs of servicing the loan.

"You have to pay your debts. You have to pay interest sooner or later. That risk-free liability that you have ensures that at some stage, you've got these added burdens that are pushing upon the portfolio. So, if the portfolio isn't growing enough to cover those costs, then you'll start to see losses build up in your portfolio," he said.

"If the earnings in your portfolio, the capital growth or the income, isn't high enough or isn't higher than the margin loan cost, then you're going to be going backwards."

Archibald added that when the client's overall percentage of equity falls below a certain limit, the loan-to-value ratio (LVR), they will inevitably receive a margin call.

"The margin call doesn't necessarily need to be seen as a risk because it's really a mechanism by which you can start to pare back some of the excessive gearing that you might have in your portfolio, but it might be at the wrong time to be selling your securities," he said.

The controversy around double gearing

A 2015 ASIC review of the margin lending operations of six major lenders, accounting for 90% of the market, found that five of the six were exposing clients to an excessive level of risk by not adequately verifying clients' circumstances. The regulator was particularly concerned about the practice of "double gearing".

McKay emphasised that double gearing is not prohibited under the current legislation, and provided the following example of how double gearing may play out.

For example

"Double gearing is where a client might open a margin loan and borrow say 70% of what they're going to invest and contribute 30% of their own capital," she said.

"The client then goes to another loan facility — usually something like a home redraw facility — they borrow that 30% that they need and put that into the margin loan

account. They then borrow the other 70% under the margin loan. So, in effect they are 100% geared for the investment that they then make."

McKay noted that ASIC also raised concerns about the practice of asset lending among margin lenders engaging in double gearing.

"Asset lending is where the client might not have income from other sources, like from wages or salaries or investment properties. Essentially, what they're doing is they're relying on the dividends from the share portfolio or the managed funds portfolio to meet the interest costs, or possibly looking for the capital gains on the investment to meet their ongoing interest costs," she said.

"There were only a few lenders that did both double gearing and asset lending together. The ASIC review has prompted those lenders not to do that anymore. Overall, I think ASIC found that the industry was acting in a professional manner and in a manner consistent with what it wanted under the responsible lending obligations in Chapter 7 of the Corporations Act, but really it probably just needed to tighten up some of the review processes that the lenders needed to do."

McKay explained that margin lenders engaging in double gearing have taken a number of steps to improve the integrity of their internal systems since the ASIC review.

"What most of them are heading towards is … stress scenarios into the client's circumstances. What I mean by that is actually testing their [clients'] ability to meet interest costs using a higher interest rate than actually applies at the current time. Also increasing the expenses that the client might have in there," she said.

"They're also … lowering the credit limit that a client who double gears might be able to apply for, so just reducing the actual maximum exposure they can have in the market.

"What ASIC are also suggesting is that [the lenders] change the LVR, the maximum amount that a client could borrow against a given security. Usually that's about 75% against quality shares like BHP. What ASIC is suggesting is maybe they need to lower that. But in my mind, the first two steps … are really more than sufficient. You don't actually need to change the LVR, but it's certainly something that the industry is looking at."

Conclusion

Margin lending provides investors with the opportunity to magnify returns over the medium to long term with an acceptable level of risk. The ultimate risk level is determined by the borrower's capacity to repay the loan. Financial advisers can play a key role in mitigating client risk by conducting thorough due diligence of their clients' financial circumstances prior to recommending margin lending and encouraging modest gearing ratios.

To give advice on the product(s) referred to in this article you must be licensed or accredited by your licensee and operating in accordance with the terms of your/their licence. Kaplan Professional recommends consulting a tax adviser on matters relating to tax advice and a legal professional for legal advice.

DISCLAIMER
This document was prepared by and for Kaplan Education Pty Limited ABN 54 089 002 371. It contains information of a general nature only and is not intended to be used as advice on specific issues. Opinions expressed are subject to change. The information contained in this document is

gathered from sources deemed reliable, and we have taken every care in preparing the document. We do not guarantee the document's accuracy or completeness and Kaplan Education Pty Limited disclaims responsibility for any errors or omissions. Information contained in this document may not be used or reproduced without the written consent of Kaplan Education Pty Limited.