ASIC

Australian Securities & Investments Commission

REPORT 38

High-yield debentures

February 2005

Executive summary

In the later half of 2004, the Australian Securities and Investments Commission undertook a surveillance campaign focussing on high-yield debenture prospectuses. By "high-yield" we generally mean prospectuses offering debentures that return 3% or more above the bank term deposit rate.

We wanted to see whether issuers of high-yield debentures were fully informing investors of the additional risks of investing in them. We were concerned that retail investors might not have been able to discern or adequately price the risks involved. This concern was reinforced as we saw an increased use of debt offerings to retail investors to finance projects that, some years ago, would have been financed by the institutional or wholesale market.

We identified criteria typical of high-yield debentures and, based on this, selected for review nine prospectuses lodged with ASIC during the course of the surveillance campaign. We also took action against two debenture issuers based on their advertisements.

We had disclosure concerns with many of the prospectuses one of which required a final stop order and three of which required interim stop orders (see table on page 3). We also secured improved disclosure in two other cases and put a stop to misleading advertising in two cases.

The most common issues we raised in relation to the high-yield debenture prospectuses reviewed related to:

- *aggressive and misleading advertising* (some advertisements inappropriately targeted retirees and other people looking for low-risk investments);
- *disclosure on related party transactions* (conflicts of interest might arise when debenture funds are on-lent for projects associated with the debenture issuer);
- *property development* (certain defects were more prevalent in the prospectuses of debenture issuers lending for property development, and the specific risks were often not discussed);
- *valuation of property* (if the valuation of a property over which a debenture is secured is inappropriate investors might not have all the protection they think they have);

- *capitalisation of interest* (some issuers are lending debenture funds to borrowers who cannot afford to pay interest out of their own cash flows, but this is not adequately disclosed);
- *type of security* (some debenture issuers did not disclose the type of security by which the debenture funds were secured so investors could not assess the riskiness of the investment); and
- *bad or doubtful debts* (some debenture issuers who on-lent funds failed to disclose that some of these funds were not recoverable).

Table 1: Stop orders issued during the debenture campaign

Company	**Action taken/ results**
Fincorp Investments Ltd	Final stop order
Australian Capital Reserve Ltd	Interim stop order, supplemetary prospectus lodged
Hargraves Secured Investments Ltd	Interim stop order, supplemetary prospectus lodged
Victorian Finance & Leasing Ltd	Interim stop order, supplemetary prospectus lodged

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Section 1 Campaign findings

Our campaign identified the following key areas of risk associated with many high-yield debentures.

Aggressive and misleading advertising

Many of the issuers whose prospectuses were reviewed target retail investors heavily through advertisements in mainstream media. Some of those advertisements are specifically aimed at retirees, with prominent images of happy older couples. The advertisements focus on the desire of many older people to have a fixed, secure income for their retirement.

We found that some advertisements were misleading and consequently took action against two debenture issuers, resulting in amendments to advertisement content.

> One example of advertising that was likely to mislead retail investors compared returns on debentures to returns on term deposits. The different risk profile of term deposits compared with many debentures ordinarily makes a direct comparison of returns misleading, and could lead retail investors to assume that they are similar products in all cases. We took action to ensure the issuer discontinued this advertising.

We consider that heavy, targeted advertising contributes to the risks facing retail investors in making investment decisions in this segment of the market. Investors who rely on advertising to find out about those offers might end up with an investment that has a much higher risk profile than they desired.

We are also concerned that retail investors might not understand the use of the terms *secured* and *guaranteed* in the context of debenture advertisements. While it might be legally correct to describe a debenture as 'secured', investors might not understand the difference between *secured* and *secure* (that there are different types of security and that some types are better than others). Investors also need to be aware that a guarantee by a third party is only as good as the person giving it.

> One advertisement that used security terminology in a misleading manner claimed: "Prudent investors require certainty. They want their investment to yield a high rate with income paid regularly, while providing a strong measure of security so they can sleep soundly at night. [Our] investments are designed to do just that…".

Disclosure on related party transactions

Significant conflicts of interest arise in circumstances where the debenture funds are lent to related parties of the debenture issuer. Issuers should fully disclose any possible conflicts of interest in lending to non-arm's length parties and the risks typically associated with such transactions.

Investors need to be aware that this situation increases the risk that arm's-length lending procedures and policies might not be employed, thereby increasing the credit risk associated with the debenture investment. Often this risk was not fully disclosed by debenture issuers, nor understood by many retail investors.

> In one case the interest rate charged to related parties was 1.5% pa less than the rate for other borrowers. However the prospectus stated that loans to related parties were on "normal commercial terms and subject to normal arms length conditions". This was obviously not true.

There was also insufficient prospectus disclosure about the risks associated with the lack of diversification that can result from lending only to related parties. Where an issuer lends to a single borrower, a default by that borrower will impair the issuer's ability to repay debenture funds more significantly than if it had lent to a range of borrowers.

Property development

A number of debenture issuers offering high yields are involved in property development. We found that disclosure problems were more prevalent in their prospectuses.

Risks specific to property development must be disclosed because they affect the risk profile of the debentures being offered. ASIC has a number of specific concerns about property development debenture prospectuses.

For example, many investors (especially those targeted by some of the offers) would not fully understand the specific risks associated with 'secondary' lending (ie behind higher ranking lenders) for property development. Our surveillance campaign found that prospectus disclosure about these risks was generally either absent or minimal.

To ensure that investors were fully informed about these risks, prospectus disclosure about the type of mortgage taken by the issuer needed to be improved. In some cases the disclosure of this risk was so inadequate it was misleading.

Another concern was insufficient disclosure about the risks associated with the lack of diversification that can result from lending in a single market segment, such as property development.

Investors might not realise that in lending to debenture issuers that on-lend to property developers, they are exposed to some of the property development risk. This is especially the case where second or subsequent mortgages are taken as security.

Valuation of property

The worth of a security in a property development financing arrangement is based on the value of the project being undertaken. Inappropriate or overly optimistic valuations are therefore a key risk area for investors. We raised concerns with valuations in a number of the surveillances.

Reliance on 'value as if complete'

Of particular concern was the reliance in prospectuses on valuations done on a *Value As If Complete* basis. Valuing on a *Value As If Complete* basis carries with it many risks because there is no guarantee that the project will actually be completed or that it will ultimately be worth the value attributed to it at the outset.

One of the issues that emerged in the property collapse of the late 1980s and early 1990s was that where a development failed during its construction phase, investors faced the difficult prospect of selling the site and usually received significantly less than the disclosed *Value As If Complete*. The collapse of the Estate Mortgage Trusts is instructive. A significant factor contributing to that collapse was that the original advances to developers were made on the basis of *Value As If Complete* or similar estimates which were determined during a property boom. The projects turned out to be worth much less than the *Value as if Complete* estimates, resulting in huge losses to retail investors once liquidity problems arose.

ASIC considers that it is best practice for debenture issuers to disclose:

- the market value at or about the date of the prospectus or, failing that, the most recently determined market value of the property; and
- the purchase price of the property.

The *General Valuation Standards and Concepts* issued by the International Valuation Standards Committee defines *Market Value* as:

> *… the estimated amount for which a property should exchange* ***on the date of valuation*** *between a willing buyer and a willing seller in an arm's-length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion.* (emphasis added)

Australian Property Industry Practice Standard 2, "Valuations for Mortgage and Loan Security Purposes", reinforces the significance of the current market value of a property by providing at paragraph 2.1 that "[t]he basis of a mortgage and loan security valuation shall be Market Value …".

We recognise that a debenture issuer might want a *Value As If Complete* valuation to be undertaken in addition to *Market Value*. In some cases, the issuer might want to disclose the *Value As If Complete* in a debenture prospectus. However, we consider that undue emphasis should not be given to the *Value As If Complete* in a prospectus and the nature of any such valuation must be clearly identified.

If a recent market valuation is not disclosed in a prospectus, we may look at the reasonableness of the alternative valuation and might request disclosure about the absence of a market valuation.

Failure to disclose purchase price

A related concern was the failure of issuers to disclose the purchase price of properties when discussing valuations. This disclosure enables investors to assess the reasonableness of a valuation.

> In one case, a property that had been purchased for $3.5 million was valued at $120 million soon after. Because the issuer did not disclose the purchase price, investors could not properly assess the reasonableness of the valuation. We took the view that not to disclose the increase in value of 3,325% would be misleading, especially because it was extraordinarily large. We placed an interim stop order on this prospectus because of this concern, amongst others.

Use of same valuer

We were also concerned that some debenture issuers were using the same valuer to value all properties over which they were taking securities. This concentration of valuation work can lead to lack of independence and conflict of interest issues similar to those that have arisen in the audit field. We believe that best practice would be to use several valuers to reduce the risk that those issues could compromise the accuracy of the valuations.

Capitalising interest

Capitalising interest on a loan occurs where the lender does not require the payment of interest by the borrower on a regular basis (unlike under a normal loan where interest is paid regularly). Instead, an amount representing the interest that would normally be paid is regularly added to the amount owing so that the debt keeps growing, rather than reducing. Generally, with those types of loans the borrower is under no obligation to pay any interest until the end of the loan.

In a number of cases, we found that money invested with debenture issuers was on-lent to property developers who did not have an income stream to pay interest on the loan until the development was completed. Therefore, their interest payments were capitalised. Where the nature of the projects to which the issuer proposes to lend money makes it likely that interest will be capitalised, this should be clearly disclosed to investors.

Capitalised or pre-paid interest loans are riskier than standard loans because they do not provide genuine cash flow to debenture issuers to meet interest payments to investors until the development is completed. Investors in those debentures are generally paid their interest from the cash raised from other investors, not from interest payments made by the borrower.

Because returns on this kind of investment are paid out of incoming investment funds, the development must be profitable enough to cover all capital lent and interest accumulated. Disclosure of the risk that profits might not be sufficient to cover both the capital and accrued interest was generally poor. Investors need to know how their funds are to be used and to have full disclosure of all risks involved in the investment.

> One prospectus that failed to disclose this issue had a final stop order placed on it so that no funds could be raised under it. Another had an interim stop order placed on it, which was only lifted after supplementary disclosure was made.

Type of security

Some debenture issuers are reluctant to provide clear prospectus disclosure about the lack of a first ranking mortgage over real property. There was also a lack of transparency in the naming of products, with issuers tending to suggest their debentures were backed by greater security than in fact they were.

> One prospectus said that registered first mortgages were "the preferred form of security" when, in fact, the issuer did not hold any registered first mortgages as security for loans.

Bad or doubtful debts

In some prospectuses, the existence of, and provision for, bad or doubtful debts was not disclosed. In one example, we discovered that a significant number of the issuer's borrowers had repeatedly failed to meet scheduled repayments. The issuer failed to disclose that it had not made any provision for doubtful debts involving those borrowers. Two prospectuses with this disclosure defect had interim stop orders placed on them. Information on bad and doubtful debts is important for investors in assessing the risk faced by (and prospects of) a debenture issuer. It must therefore be included in a prospectus for the offer of those debentures.

> One prospectus failed to disclose amounts outstanding in past due loans of $3.14 million, and another failed to disclose amounts outstanding of $2.42 million.

What can be called a debenture?

Section 283BH of the Corporations Act prescribes the conditions on which a product can be called a 'debenture'.

There are three permitted descriptions for debenture-type products:

- *Mortgage debenture* – a product can only be called a *mortgage debenture* if a debenture trustee has been given a registered first mortgage over land vested in the issuer. The total amount secured by the mortgage must not exceed 60% of the value of the issuer's interest in the land.
- *Debenture* – a product can only be called a *debenture* if:

a. the test for *mortgage debentures* can be satisfied; or

b. the repayment of debenture money has been secured by a charge in favour of a debenture trustee over tangible property of the issuer. The value of the tangible property that makes up the security for the charge must be sufficient to repay the debentures and any other liabilities of the issuer that rank in priority or have equal priority to the debentures.

- *Unsecured note* – if none of the abovementioned tests can be satisfied, the term *unsecured note* or *unsecured deposit note* must be used to describe the product.

A key determinant of whether a product may be called a debenture therefore depends on whether the obligation to repay the principal is secured by a charge over *tangible property*.

What is tangible property?

ASIC has identified a divergence of views about the meaning of *tangible property* (which is not defined in the Corporations Act). On the narrow view, it means only assets having a physical existence and excludes 'choses in action' like money, a receivable, a leasehold interest and even a mortgage over real property (but not the real property itself) (see definition on page 13). On the wider view, tangible property is taken to be equivalent to the accounting concept of 'tangible assets', which broadly means all assets except intangibles. The wider view treats cash and receivables as tangible property.

Following discussions with market participants during the campaign, ASIC accepts that excluding the value of property as security merely because it is not "capable of being touched" can lead to some peculiar results. It means, for example, that an issuer that on-lent to creditworthy borrowers (on a fully secured, first-ranking basis) to finance the purchase of equipment, vehicles and even land, could not call its debt offerings 'debentures' because the issuer's assets would only consist of the receivables and security interests created by that on-lending. In our view, this reduces the usefulness of the term *debenture* as an indicator of the type of security behind it.

Our new policy on naming

We propose to raise the issue of the application of s283BH with Treasury with a view to consideration of law reform in this area. In the interim, we will take no action in relation to non-compliance with s283BH on the basis of an interpretation of *tangible property* that would only include property that has an actual physical existence.

However, we will continue to take action against debenture issuers for misleading or deceptive statements or conduct that does not comply with Chapter 2L. When we review a debenture prospectus, we will examine whether the property that constitutes security for a charge is sufficient to meet the relevant liabilities of an issuer. We will also pursue other breaches of s283BH (eg where an issuer is not entitled to describe a product as a 'debenture' for reasons unrelated to the meaning of *tangible property*).

Important note: The examples in this report are illustrative only and should not be taken to apply to all circumstances of the same or a similar nature. Nor should the examples be taken to be exhaustive or to establish general rules.

Section 2 What are debentures?

How debentures work

By investing in debentures an investor is lending money to the issuer of the debentures.

The Corporations Act defines a debenture as a "chose in action that includes an undertaking by the body to repay as a debt money deposited with or lent to the body" in s9.

Note: A 'chose in action' is a right or intangible thing that is legally enforceable.

In general, the key financial obligations of a debenture issuer to the debenture are:

- the obligation to repay the principal amount that was paid for the debenture at the expiration of its term; and
- the obligation to pay interest on the principal amount that was paid for the debenture.

Those obligations may (but need not) be secured by a charge over property of the issuer. A debenture issuer will usually need to hold an Australian financial services (AFS) licence.

Note: For more information on AFS licensing requirements, see QFS 121 on our website at www.asic.gov.au/fsrfaq

The current environment

Many high-yield debentures are being actively marketed to investors through print, television and radio advertisements.

It appears that the following two factors have resulted in an increase in investment in high-yield debentures:

- the interest rate that is offered on these debentures is generally 3%-5% p.a. higher than term deposit interest rates offered by banks, which is attractive to many investors, given the low interest rate environment in Australia in recent years; and
- the increased use of self-managed superannuation funds.

An increase in investment in debentures might result in certain debenture issuers having excess funds. In the context of mortgage trusts, excess funds have driven some issuers into second-grade developments in order to maintain returns to investors. This might also occur with debenture issuers.

Many debenture issuers are small finance companies that lend to property developers. Investment in these debentures might carry more risk than investors are aware of, as the property market softens and building costs rise.

In the 2004 financial year, there were 93 debenture prospectuses lodged with ASIC which raised just over $3 billion. Significantly, the amount of funds raised for on-lending has increased by 35% in comparison to the 2003 financial year. The table below outlines the 2004 figures.

Table 2: Debenture prospectuses lodged with ASIC

Purpose	**Number of documents**	**FY2004**
On-lending	42	$930,285,476
Own-funding	27	$1,237,785,929
Agriculture	10	$35,344,494
Subsidiary of major company	4	$513,738,000
Collateralised debt obligations	3	$309,000,000
Documents subject to final orders	5*	N/A
Information not available	2	N/A
TOTAL	93	$3,026,153,898

*Note: The five documents subject to final orders were not all a part of this surveillance project. Only one final stop order was made as part of this project.

Specific debenture regulation

As a general rule, an issuer may only offer debentures to investors under a prospectus. There are some limited exceptions to this rule, for example offers to sophisticated investors and current holders of the debentures.

Chapter 2L of the Corporations Act has requirements that are unique to the regulation of debentures, including the requirement to enter into a trust deed and appoint a trustee for the debenture holders. Section 283BB imposes a duty on the borrower to carry on and conduct its business in a proper and efficient manner. Debenture issuers also need to provide quarterly reports to the trustee and to ASIC.

Section 283DA imposes a duty on trustees to exercise reasonable diligence to see whether the property of the borrower and guarantor(s) will be sufficient to repay the amount deposited under the debentures and whether there have been breaches of the terms of the debentures or the trust deed. Trustees also owe fiduciary duties to debenture holders.

Section 3 Conducting the campaign

Objectives

ASIC has previously raised concerns about the quality of prospectus disclosure for debentures. In 2003-2004 we put out four media releases relating to debentures.

Some of these media releases alerted investors to the greater risks of high-yield debentures, others highlighted the following common defects in debenture prospectuses on which ASIC conducted surveillances:

- no debenture trust deed or trustee;
- poor disclosure of bad and doubtful debts;
- inadequate disclosure of lending policies;
- inadequate financial information;
- inadequate disclosure on use of funds;
- insufficient disclosure of the issuer's prospects;
- insufficient information about security for debentures; and
- incorrectly describing debentures.

Note: For more information see [MR 03-158], [MR 04-002], [MR04-124] and [MR 04-242] at www.asic.gov.au/mr

We also had concerns about a lack of consumer understanding of the risk profile of the various types of debentures being marketed. Our consumer education website "Fido" (www.fido.asic.gov.au/fido/) discusses high yield property debentures and rates of return and risk.

We initiated the surveillance campaign in 2004 to assess the validity of our concerns about high-yield debentures.

The main objectives of the campaign were:

- examining whether there were contraventions of the prospectus disclosure requirements. In particular, to determine whether debenture issuers had properly and fully disclosed the nature of their business and associated risks;
- assessing whether previous ASIC guidance on debenture prospectus disclosure was being followed; and

- pursuing suitable enforcement action against issuers in the case of material and significant contraventions of the prospectus, debenture or other provisions.

Methodology

The campaign was conducted in four phases – issuer targeting, desktop review of prospectuses, information gathering and corrective action.

Phase 1 - Choice of issuers

We selected nine debenture issuers for targeted surveillance (two additional issuers were queried during the campaign due to advertising that came to our attention). These issuers were chosen based on a combination of the following factors:

- *Interest rate yield on the debentures.* Several of the debenture issuers were offering interest rates that were 4% p.a. higher than bank term deposit rates for an equivalent term. Yield was a major factor in selecting issuers for surveillance.
- *Prior regulatory action* (if any) indicating likely current issues with either the prospectus or debenture provisions in the Corporations Act. Not all of the issuers were previously subject to regulatory action by ASIC.
- *Use of debenture funds by issuer.* All of the issuers on-lent funds to either related or unrelated parties. On-lending might decrease the level of control the debenture issuer has over the return of funds to investors at the expiry of the investment.
- *Location of the issuer.* To gain a broader perspective, we conducted surveillances on issuers located in capital cities and regional centres in New South Wales, Victoria, Queensland and South Australia.
- *Level of advertising by issuer.* Many of the issuers conducted high levels of debenture advertising and marketing through the mainstream media.
- *Financial position of the issuer* as disclosed in the latest set of yearly or half-yearly financial reports.

The following table outlines the locations of the issuers and the types of loans they use debenture funds for.

Table 3: Location of issuers and types of loans

	NSW	VIC	SA	QLD
Property development loans only	3	0	0	0
Various loans (including property development)	3	3	1	1

Phase 2 – Review of prospectuses

After the issuers had been selected, we reviewed their prospectuses in detail to determine the areas most likely to give rise to regulatory concerns.

Phase 3 - Information gathering

Notices under ss30 and 33 of the *Australian Securities & Investments Commission Act 2001* were served on the issuers and any other person identified as having information relevant to the surveillance.

Each notice was tailored to suit the particular concerns we had about the issuer in question. Most notices requested documents on:

- loans by the issuer to related parties;
- the financial position and performance of the issuer; and
- correspondence between the issuer and its debenture trustee.

We inspected these documents at the premises of the issuer. During and after the inspections, we sought clarification on various issues in discussions and correspondence with the issuers.

Phase 4 – Corrective action

If we continued to have concerns after discussions and correspondence with the issuers (and it was in the public interest to do so) we placed interim stop orders on the prospectuses. A number of the stop orders were revoked after issuers lodged supplementary or replacement prospectuses dealing with our concerns. One final stop order was made in the course of the campaign.

> Note: ASIC has the power to make stop orders that prohibit the offer, issue, sale or transfer of securities under the prospectus while the order is in force. ASIC uses stop orders to ensure that investors do not invest based on defective fundraising documents, but have all the information they need before deciding whether to invest.

A stop order can be interim or final in nature. An interim order is made if we think that it is in the public interest to stop the use of a document before there has been time for a hearing to be held. An issuer may deal with our concerns and have an interim order lifted. A final order can only be made after a hearing at which the issuer can make submissions. A final order permanently prevents the prospectus from being used to raise funds.

Table 4: Stop orders issued during the debenture campaign

Company	**Action taken/ results**
Fincorp Investments Ltd	Final stop order
Australian Capital Reserve Ltd	Interim stop order, supplemetary prospectus lodged
Hargraves Secured Investments Ltd	Interim stop order, supplemetary prospectus lodged
Victorian Finance & Leasing Ltd	Interim stop order, supplemetary prospectus lodged

Where appropriate, we will take enforcement action on any of the breaches uncovered during the campaign.

Section 4 Future action

Although we have completed our intensive targeted surveillance of high-yield debentures, we will continue to:

- Undertake ad hoc surveillances in relation to high-yield debenture prospectuses as part of our routine work. (If any of the prospectuses we look at contain the defects identified in this report we may take action to ensure those defects are corrected.).
- Examine debenture advertising as part of the general monitoring of advertising in the financial services marketplace that we undertake. (We may seek to have misleading advertising withdrawn or corrected.).
- Undertake consumer education in this area to improve consumer understanding of the risks of investing in high-yield debentures.

Related information

ASIC media releases

[MR 03-158] *Fixed interest products higher returns mean higher risks* (19 May 2003)

[MR 04-002] *ASIC focuses on defective debenture prospectuses* (6 January 2004)

[MR 04-124] *ASIC scrutinises recent debenture prospectuses* (29 April 2004)

[MR 04-242] *$1.8 billion at stake: warning to investors in high-yield debentures* (27 July 2004)

