ASIC

Australian Securities & Investments Commission

REPORT 200

Response to submissions on CP 123 Debentures: Strengthening the disclosure benchmarks

June 2010

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 123 *Debentures: Strengthening the disclosure benchmarks* (CP 123) and details our responses in relation to those issues.

About ASIC regulatory documents

In administering legislation ASIC issues the following types of regulatory documents.

Consultation papers: seek feedback from stakeholders on matters ASIC is considering, such as proposed relief or proposed regulatory guidance.

Regulatory guides: give guidance to regulated entities by:

- explaining when and how ASIC will exercise specific powers under legislation (primarily the Corporations Act)
- explaining how ASIC interprets the law
- describing the principles underlying ASIC's approach
- giving practical guidance (e.g. describing the steps of a process such as applying for a licence or giving practical examples of how regulated entities may decide to meet their obligations).

Information sheets: provide concise guidance on a specific process or compliance issue or an overview of detailed guidance.

Reports: describe ASIC compliance or relief activity or the results of a research project.

Disclaimer

This report does not constitute legal advice. We encourage you to seek your own professional advice to find out how the Corporations Act and other applicable laws apply to you, as it is your responsibility to determine your obligations.

This report does not contain ASIC policy. Please see Regulatory Guide 69 *Debentures and unsecured notes: Improving disclosure for retail investors* (RG 69).

Contents

A Overview/Consultation process

1 In Consultation Paper 123 *Debentures: Strengthening the disclosure benchmarks* (CP 123), we consulted on proposals for strengthening the disclosure benchmarks set out in, as titled then, Regulatory Guide 69 *Debentures: Improving disclosure for retail investors* (RG 69). The policy proposals follow on from our second review of the unlisted, unrated debenture sector and aim to make benchmark disclosure more useful for investors.

2 This report highlights the key issues that arose out of the submissions received to CP 123 and our responses to those issues.

3 This report is not meant to be a comprehensive summary of all responses received. It is also not meant to be a detailed report on every question from CP 123. We have limited this report to the key issues.

4 For a list of the non-confidential respondents to CP 123, see the Appendix. Copies of the submissions are on the ASIC website at www.asic.gov.au/cp under CP 123.

Responses to consultation

5 We received 22 responses to CP 123 from debenture issuers (both large and small), relevant industry bodies, and an investor association. Of the responses, 3 were confidential. We are grateful to respondents for taking the time to send us their comments.

6 Responses were varied in their support for the proposals in CP 123.

7 The main issues raised by respondents related to:

(a) the benchmarks and whether they should be extended or clarified;

(b) issues associated with the disclosure of the benchmarks; and

(c) issues associated with the naming of debentures.

B Strengthening the benchmarks

Key points

In CP 123, we proposed strengthening the existing benchmarks outlined in RG 69 as a result of the findings of our review of their effectiveness in our second review of the unlisted, unrated debenture sector: see Report 173 *Debentures: Second review of disclosure to investors* (REP 173).

Benchmark 1: Equity capital

8 In CP 123, we proposed to amend Benchmark 1 to provide that, in addition to disclosing their current equity ratio, issuers should disclose a comparative equity ratio from the prior year. There was a high level of support for this proposal.

9 We also proposed that, for the purpose of calculating 'total equity', issuers should exclude from their total assets any amounts owing to the issuer or associates of the issuer. Several respondents did not support this proposal, submitting that:

(a) there was uncertainty as to how related party adjustments could be made and how 'related parties' should be defined;

(b) the justification for excluding related party transactions was unclear, except where those amounts were impaired, and the proposal was too onerous; and

(c) there was an alternative way to convey an issuer's exposure to related party transactions.

10 Rather than excluding amounts owed by related parties, some respondents preferred, as an alternative measure, to amend the related party benchmark to require issuers to disclose the proportion of related party loans compared with total assets.

ASIC's response

Equity is currently a simple calculation to assist investor understanding. We intend to adopt the proposal to include a comparative equity calculation. We consider the disclosure of a comparative equity ratio from the prior year will help investors to identify any change in the issuer's equity capital over the past year.

Some respondents, however, expressed concern with our proposal for issuers to exclude related party transactions in the calculation of equity, including how such adjustments could be made.

> For simplicity, we think it is better not to amend the benchmark to exclude related party transactions. Instead, we will amend the related party benchmark to require issuers to disclose the proportion of related party loans compared with total assets. This will still help investors to understand the risk and exposure of the transactions.

Benchmark 2: Liquidity

11 In CP 123, we proposed to amend Benchmark 2 to provide that, in addition to their existing disclosure on liquidity, issuers should disclose the results of any 'stress testing' done on their cash flow estimates. This should include an explanation of whether the issuer would have cash on hand or cash equivalents sufficient to meet their projected cash needs if:

(a) the percentage of debenture funds to be rolled over during the next three months were 20% less than the percentage that was rolled over in the past three months; and

(b) for debenture funds that are held on an 'at call' basis—the amount of debenture funds retained during the next three months were 20% less than the amount that was retained for the past three months.

12 A number of respondents did not oppose mandatory assumptions for stress testing and noted that they already stress tested their liquidity levels. Some noted, however, that a 20% assumption was too high and not reflective of market conditions over the past two years.

13 A number of respondents also preferred to maintain a degree of flexibility in stress testing, rather than being required to use mandatory levels. In general terms, these respondents were of the view that a 'one-size-fits-all' approach was not appropriate or conducive to an effective form of market disclosure. However, there was also support for us requiring regular stress testing against relevant static thresholds or data.

14 One respondent also noted that 20% was not sufficient if there was a run on redemptions and may either be misleading or not useful for investors.

15 Respondents were generally comfortable with a three-month period for cash flow projections for stress testing of liquidity. One respondent did express concerns regarding the reliance on forward looking and past performance information.

16 We also consulted on whether we should consider any additional measures to strengthen Benchmark 2. An example provided in CP 123 was for issuers to hold an additional cash margin of 10% of their total debenture liabilities. Generally, respondents did not support the proposal to impose an additional cash margin. The majority of respondents noted that the proposed criteria

were too prescriptive and should instead depend on the circumstances of the issuer to ensure commercial flexibility. Some respondents noted other methods of maintaining liquidity—for example, by reducing lending when rollovers are high, or by relying on alternative sources of funding.

ASIC's response

We consider that a 20% assumption for stress testing is an appropriate threshold. This sensitivity analysis will 'stress' an issuer's cash flows beyond the level most issuers have experienced over recent years. We acknowledge that certain issuers 'stress' their cash flow estimates beyond the levels of a 20% assumption. Fixed assumptions are intended to promote greater consistency in the preparation of cash flow projections between different issuers and to help investors understand how a low rollover rate would affect the liquidity of the issuer.

We do not intend to expand Benchmark 2 to include an additional cash margin requirement at this point in time.

17 In relation to Benchmark 2, we also proposed that issuers disclose:

(a) the maturity profile of debentures on issue as well as the loan portfolio term details;

(b) the assumptions about the level of rollovers that the issuer has used in forecasting its cash flows, and how this compares with historical rollover rates; and

(c) the level of liquid assets maintained by the issuer under the terms of the debenture trust deed and/or the issuer's internal policies.

18 There was some support from respondents for the disclosure of maturity profiles and assumptions about the level of rollovers that the issuer has used in forecasting its cash flows.

19 Generally, respondents did not support the proposal to disclose the level of liquid assets maintained by the issuer under the debenture trust deed and/or internal policies.

20 In relation to internal policies, many issuers noted that, while they do implement internal policy on liquidity, it would be commercially impracticable to disclose such policy in a prospectus. There was concern that disclosing the policy might impose an obligation on the issuer to maintain the policy for the life of the prospectus, whereas it was preferable for such policies to be flexible.

ASIC's response

We acknowledge that information about maturity profiles and assumptions about rollover rates may be disclosed via appropriate cross-referencing.

> With respect to internal policies, we recognise the practical difficulties involved in issuers disclosing the level of liquid assets they maintain under internal policies. We also note that trust deed requirements are already disclosed. We therefore do not intend to adopt this part of our proposal.

Benchmark 4: Credit ratings

21 In CP 123, we consulted on whether:

(a) Benchmark 4 should be retained; and

(b) whether we should make any adjustments to Benchmark 4.

Respondents generally advocated the removal of Benchmark 4. Some noted that the ratings were no longer available to retail investors because of developments in the market. Some respondents noted that the cost of a credit rating outweighs the benefit of retaining one. Other respondents questioned the value of obtaining a rating.

> *ASIC's response*
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> Our recent review of the unlisted debenture sector showed that, of the 63 issuers we reviewed, only one had a current credit rating. Based on this assessment, and the unavailability of ratings for retail investors, we are removing Benchmark 4: Credit ratings.

Benchmark 5: Loan portfolio

22 In CP 123, we proposed to amend Benchmark 5 to:

(a) clarify which loans should be viewed as 'in arrears' for the purposes of Benchmark 5—we proposed that a loan would be considered to be 'in arrears' if an expected payment under the loan, whether of principal or interest, had not been received by the issuer within 30 days of the date on which the payment was due;

(b) require disclosure of the number, value and proportion of loans where the issuer has commenced legal proceedings to recover outstanding amounts that they have on-lent; and

(c) require the disclosure of the range of interest rates payable under loans made by debenture issuers compared with the interest rates offered to investors.

23 We have received varied responses on how 'in arrears' should be defined. These include:

(a) differing views regarding whether ‘in arrears’ should refer to loans in default for 30, 60 or 90 days; one respondent agreed that ‘in arrears’ could be amounts exceeding the 30 days past due; another respondent preferred one month rather than the number of days;

(b) one respondent noted that a ‘workout agreement’ should not be included in the definition of arrears; another respondent questioned the relevance of disclosure where there have been part payments; and

(c) one respondent raised concerns that reporting arrears is easy to avoid by capitalising loans.

24 We have received some responses on the requirement to disclose legal proceedings to recover amounts in arrears. Generally, respondents were not opposed to the proposal but asked for more clarity on what we mean by ‘legal proceedings’. Some respondents were concerned that disclosure of legal proceedings could raise privacy concerns, particularly in small country towns.

25 We have received some support for the disclosure of interest rates payable under loans made by debenture issuers compared with the interest rates offered to investors. One respondent supported the proposal but noted that the range of interest rates payable under loans made by debenture issuers compared with the interest rates offered to investors could be expressed as a simple margin. Some respondents noted that this proposal might be problematic in that at-call rates may be very sensitive and some may be subject to frequent changes in interest rates.

ASIC’s response

We consider that our proposals in relation to Benchmark 5 will provide more clarity about what we mean by ‘in arrears’. We have based our definition of ‘arrears’ on the Australian Accounting Standards.

We also intend to define ‘legal proceedings’ to avoid uncertainty and promote consistency in disclosure against this benchmark.

We feel that the disclosure of average interest rates payable on the issuer’s loan portfolio, together with average interest rates payable by the issuer, will help investors to gauge the performance of the issuer’s business. We do not expect issuers will need to update this information on a regular basis unless there is a material adverse change for investors.

Benchmark 7: Valuations

26 In CP 123, we proposed to amend Benchmark 7 to provide that issuers should:

(a) obtain valuations every 12 months for loans related to development properties; and

(b) disclose a ‘forced sale’ value of the property where a property or a loan secured against a property accounts for 5% or more of the total property assets or total loan book of the issuer.

27 Generally, respondents did not support a broad requirement to obtain valuations every 12 months for all loans related to development properties. Some respondents noted that this proposal was unnecessary as funds were often retained by the issuer and only released in stages, to cover project completion costs, based on external evidence of the progress of the development (e.g. quantity surveyor report). A number of respondents also noted that this proposal was costly, particularly for non-residential properties, and would not provide much assistance to either lender or investor.

28 Respondents also did not support disclosure of a ‘forced sale’ value of the property. Many respondents were concerned with the imprecise nature of a ‘forced sale’ value as it was likely to change over time due to economic conditions. Some respondents noted that lenders would normally rely on market value as a more accurate measure in managing their security during different economic conditions.

ASIC’s response

We note that, in relation to development properties, some issuers advance funds in stages and only release funds to cover completion costs. We do not think it is necessary for these issuers that lend funds in stages to obtain valuations every 12 months. However, we feel that it is appropriate for development properties to be re-valued every 12 months where funds are not lent in stages, in order to reduce the risk that issuers do not have adequate security.

We do not intend to require disclosure of the ‘forced sale’ of development properties due to the imprecise nature of such valuations.

Benchmark 8: Lending principles

29 In CP 123, we proposed to amend Benchmark 8 to clarify that, for the purposes of their loan-to-valuation ratios (LVRs), issuers should only use valuations that have been obtained in accordance with the approach set out in Benchmark 7.

30 Respondents were generally unsupportive of this proposal if our proposed changes to Benchmark 7 were adopted as this could affect other areas of

disclosure or result in inconsistencies. One respondent noted that if the LVR was based only on valuations that were obtained in accordance with Benchmark 7, the disclosure might not provide a true measure of the overall LVR. For instance, a number of issuers use valuations on an 'as is' basis for development property, compared to an 'as if complete' basis, and would therefore be excluded from the disclosed LVR.

31 One respondent was willing to accept this proposal if Benchmark 7 was not amended as proposed in CP 123.

ASIC's response

We have adjusted the changes to Benchmark 8 in light of these responses. We consider it is more appropriate for LVRs to be based on either:

- a valuation that complies with Benchmark 7(a); or
- a value ascribed to a property (e.g. capital improved value) in a municipal rates valuation.

This will provide a source of information about value to investors that is independent of the issuer. We feel that this is preferable to relying solely on directors' valuations to calculate LVRs for the purposes of the benchmark.

C Promoting investor understanding

Key points

In CP 123, we proposed to amend our benchmark disclosures to provide that:

- all issuers should provide additional disclosure explaining the importance of each of the following benchmarks: Benchmarks 1, 2, 5, 6, 7 and 8 (i.e. equity, liquidity, loan portfolio, related party transactions, valuations and lending principles);
- the additional disclosure provided by issuers should be based on text that has been extracted from our investor guide, *Investing in debentures?*; and
- the benchmark disclosure contained in a prospectus should generally be located in a separate section of the prospectus.

32 We received some support for additional information to be disclosed regarding the benchmarks. One respondent suggested that a 'key' or 'interpretation' statement could accompany the benchmarks to assist investors in determining how important a benchmark might be to their investment decision.

33 Some respondents did not oppose additional disclosure, but believed that sections of the investor guide should not have to be included verbatim. They noted that any proposal should also take into account appropriate carve-outs where benchmarks do not apply.

34 We also received some responses that did not support additional disclosure. Many of the respondents commented that additional disclosure was unnecessary and would add to the complexity and length of a prospectus.

35 We also received some general support for a requirement that the disclosure of benchmarks be contained in a separate section of the prospectus. Many issuers already do this.

ASIC's response

We consider that it is important that investors have sufficient information to understand the issuers' benchmark disclosures. We feel that the proposed explanations, which are extracted from our investor guide, '*Investing in debentures?*', are consistent with the disclosure expected in a prospectus to alert people to the risks associated with a particular business model. We do not expect issuers to replicate the explanations word for word.

We do not propose to include an express requirement for benchmarks to be disclosed in a separate section of the prospectus. However, we note that, where the benchmark disclosure is scattered throughout the document, it is more likely that the document will not be clear, concise and effective. We think that disclosure of compliance with the benchmarks up-front in a prospectus is an effective form of disclosure and promotes better understanding by investors. It is more likely we will closely review prospectuses that do not meet this standard.

D Naming of products as debentures

Key points

In CP 123, we proposed to discontinue the interim no-action position announced in 2005 in relation to certain non-compliance with the naming restriction under s283BH of the *Corporations Act 2001* limiting which financial products may be called 'debentures'.

36 Issuers and their representative groups were unsupportive of this proposal. The main concerns were that the change in our policy would affect longstanding naming conventions for a number of issuers and result in an artificial distinction between certain assets and an underlying security position. Some specific comments include:

> 'The requirement to name some products as 'unsecured notes' or 'unsecured deposit notes' will cause confusion with a lot of investors. This is because the term is not well understood and conveys high risk and without a promise to pay. Some respondents believe that such confusion may cause a run in redemptions.'
>
> 'The proposal implies that assets with no physical existence have no value.'
>
> 'Renaming products as 'unsecured notes' would be detrimental to the debenture industry's ability to compete with banks.'

37 We did receive support from some lawyers, trustees and an investor association. Of the respondents who supported the proposal, one suggested that there should be a clear date from which the new nomenclature would apply and that ASIC should give consideration to a legislative amendment or binding provision to this effect as issuers would need to amend trust deeds and possibly other documentation.

ASIC's response

We remain concerned that some of the issuers that failed over the past two years had described their products as 'debentures', even though the charge in favour of the trustee was not over tangible property with a physical existence. In cases where the products are not secured by a charge over tangible property, there is a possibility that an issuer's structure, operations or security interests (including competing interests) will reduce the protection afforded to retail investors. We consider that the term 'unsecured notes' more accurately describes the nature of these products than 'debentures' and, therefore, we will discontinue our interim no-action position.

We consider it is appropriate to allow issuers a transition period before they will be required to comply with the naming restriction in the law. The transition period means that issuers will be required to comply with the law in all prospectuses and documents relating to an offer from 1 July 2011.

We think that these changes will increase consistency in how the products are described and promote better investor understanding of these products.

Appendix: List of non-confidential respondents

- Australian Finance Conference
- Australian Unity Finance Limited
- Balanced Securities Limited
- Banksia Securities Limited
- Bell Potter Securities Limited
- CapMX Pty Ltd
- Eurofinance Capital Limited
- McCullough Robertson Lawyers
- McMahon Clarke Legal
- National Information Centre on Retirement Investments Inc
- Northstate Finance Limited
- PROVIC
- Provident Capital Limited
- RAC Finance
- RACV
- Rivwest Finance Limited
- Southern Finance Limited
- Trustee Corporations Association of Australia
- Westlawn Finance Limited