REPORT 285

Response to submissions on CP 141 Mortgage schemes: Strengthening the disclosure benchmarks

May 2012

About this report

This report highlights the key issues that arose out of the submissions received on Consultation Paper 141 *Mortgage schemes: Strengthening the disclosure benchmarks* (CP 141) and details our responses to those issues.

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This report does not contain ASIC policy. Please see Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45).

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A Overview/Consultation process

About our consultation

1 In Consultation Paper 141 *Mortgage schemes: Strengthening the disclosure benchmarks* (CP 141), we consulted on proposals for strengthening the benchmarks set out in Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45). The proposals followed on from our review of the unlisted mortgage scheme sector and the key issues and risks identified since RG 45 was first published in September 2008.

2 The proposals in CP 141 were aimed at providing retail investors with better information so they can compare similar products and identify the key features of an investment in an unlisted mortgage scheme. Broadly, these proposals involved:

(a) revising the benchmarks to:

(i) focus on the key features of business models for unlisted mortgage schemes to make them easier for investors to understand; and

(ii) highlight the key risks associated with unlisted mortgage schemes to assist investors to assess those risks;

(b) requiring further disclosure in relation to additional investor risk not currently addressed by RG 45;

(c) clarifying ASIC's expectations regarding disclosure for unlisted mortgage schemes to address current inconsistencies; and

(d) clarifying how the benchmarks and additional disclosure requirements apply to feeder funds.

3 This report highlights the key comments in submissions received on CP 141, and during subsequent industry consultation, and our responses to those comments.

4 This report is not intended to be a comprehensive summary of all responses received, nor is it a detailed report on every question for feedback in CP 141. We have limited this report to the key issues.

5 For a list of non-confidential responses to CP 141, see the appendix. Copies of these submissions are on the ASIC website at www.asic.gov.au/cp under CP 141.

Responses to consultation

6 We received eight written responses to CP 141 from a variety of sources, including responsible entities of mortgage schemes, a consumer agency, an investor ratings provider, an industry body and law firms representing responsible entities of mortgage schemes. One of the responses was confidential. We are grateful to respondents for taking the time to provide us with their comments.

7 The main issues raised by respondents related to:

(a) whether the benchmarks should be updated;

(b) whether the 12-month estimates were useful, given that they rely on assumptions outside the responsible entity's control—other submissions sought clarification on disclosure of the estimates and expressed concerns about director liability;

(c) whether the introduction of an 'as is' basis for the valuation of property development loans was inconsistent with industry norms and would be inappropriate and costly for property development;

(d) the inconsistency between the definition of a 'liquid' scheme in the *Corporations Act 2001* (Corporations Act) and ASIC's proposed Benchmark 8 on withdrawal arrangements; and

(e) difficulties faced by feeder funds in obtaining disclosure from the underlying funds when the responsible entities are unrelated.

8 Following the consultation process, we consider that there remains a reasonable case for updating the benchmarks and additional disclosure requirements to:

(a) improve the quality of disclosure provided to investors on the business model and operation of unlisted mortgage schemes by setting benchmarks that focus on the important characteristics of these business models;

(b) provide investors with clear disclosure of the risks of investing in unlisted mortgage schemes by setting benchmarks that highlight those key risks to make them easier for investors to identify and assess;

(c) encourage a better alignment between the expectations of investors regarding withdrawal rights and the capacity of responsible entities to meet those expectations;

(d) improve confidence in the unlisted mortgage sector of the managed investment industry; and

(e) promote consistency of disclosure.

9 In summary, our response to the more specific issues raised include the following:

(a) *Benchmark 1: Liquidity*—We have extended the period for estimating cash flow and cash needs from three months to 12 months, as proposed in CP 141, because we still consider this to be the better indicator of a scheme's capacity to address the expected cash requirements. In response to submissions, we have clarified that cash flow estimates do not need to be disclosed, but should be regularly reviewed and signed off by directors. We maintain that cash flow estimates are an important risk management tool that should be reviewed by directors. This benchmark continues to apply only to pooled mortgage schemes.

(b) *Benchmark 2: Scheme borrowing*—We have clarified, as requested, the term 'borrowings' by limiting it to current borrowings and current intentions to borrow on behalf of the scheme.

(c) *Benchmark 3: Loan portfolio and diversification*—We have adopted suggestions to reduce the threshold relating to concentration risk from 10% to 5% of the scheme assets. We have also clarified that this benchmark applies only to pooled mortgage schemes.

(d) *Benchmark 4: Related party transactions*—We have adopted a suggestion for the benchmark to cover loans to the scheme's investment manager. For consistency with Regulatory Guide 76 *Related party transactions* (RG 76), we have also clarified the details of the related party transactions that should be disclosed.

(e) *Benchmark 5: Valuation policy*—We have amended the benchmark on valuation policy in response to concerns that part of the benchmark originally proposed in CP 141 was circular. It now states that valuations are to be obtained within *two months* after directors form a view that there is a likelihood that a decrease in the value of the security property may have caused a *material* breach of loan covenant.

(f) *Benchmark 6: Lending principles—Loan-to-valuation ratios*—We have clarified the benchmark to state that it applies at the time of the most recent valuation. We have also clarified that disclosure of the loan-to-valuation ratio for the scheme relates to both the maximum and weighted average loan-to-valuation ratios as at the date of reporting.

To address the concern raised that the benchmarks and additional disclosure should sufficiently distinguish the risk associated with property development loans from other loans, we have included the following in relation to property development loans:

(i) the requirement to disclose the percentage of a scheme's assets that are in property development loans;

(ii) the requirement to disclose, for each loan, the basis on which the funds are drawn down, the percentage (by value) of the completion

of any property that is under development as at the date of reporting, and the loan-to-cost ratio as at the date of reporting; and

(iii) if a scheme's property development loans exceed a threshold of 20% of the scheme's assets, or any loan-to-cost ratio exceeds 75%, guidance that the scheme is identified as a *development* mortgage scheme, both in the name of the scheme and in disclosure documents.

(g) *Benchmark 7: Distribution practices*—We have clarified that to meet this benchmark a responsible entity will not pay current distributions from scheme borrowings. Previously this benchmark was met if the responsible entity pays distributions in accordance with the scheme's distribution policy.

(h) *Benchmark 8: Withdrawal arrangements*—We have retained the time period of 10 business days for the realisation of assets because we consider this is the appropriate realisation period for a scheme to operate as liquid. We have not changed the 90-day period for withdrawals because this is intended to encourage a concept of liquidity that aligns with investor expectations of a liquid scheme.

(i) *Feeder funds:* We have provided further guidance to responsible entities on how to meet the benchmark and additional disclosure requirements.

10 Following our consultation, the additional disclosure requirements, which appeared under each benchmark in CP 141, are now referred to as 'disclosure principles' and are contained within a separate section of the updated RG 45.

B Strengthening the benchmarks

Key points

In CP 141, we proposed strengthening the existing benchmarks outlined in RG 45 as a result of our review of the unlisted mortgage scheme sector, and to make benchmark disclosure more useful for retail investors.

This section summarises the feedback we received in response to CP 141 and explains the changes we have made to the benchmarks and additional disclosure requirements resulting from the consultation process. In the updated RG 45, we refer to the additional disclosure requirements as 'disclosure principles'.

Benchmark 1: Liquidity

11 In CP 141, we proposed to amend Benchmark 1 to extend the period for estimating cash flow and cash needs from three months to 12 months. We also proposed that estimates should be updated on a monthly basis.

12 We also proposed that, in addition to the existing disclosures on liquidity, a responsible entity disclose the current and future prospects of the liquidity of the scheme, and any significant risk factors that may affect the liquidity of the scheme.

13 Some respondents noted that forecasting over a 12-month period is subject to many broad assumptions outside the responsible entity's control and therefore may not be useful to investors. Another submission noted the risk that the responsible entity may not comply with Regulatory Guide 170 *Prospective financial information* (RG 170) when making the estimates. However, the general feedback was that many schemes already produce 12-month estimates for internal liquidity management.

14 It was also noted by one respondent that information on the significant risks that may affect the liquidity of the scheme was already the subject of disclosure within the Product Disclosure Statement (PDS) and therefore represented unnecessary duplication.

15 In relation to the statement in CP 141 that this proposed benchmark was consistent with the proposals in Consultation Paper 140 *Responsible entities: Financial requirements* (CP 140), two respondents referred to the following differences:

(a) responsible entities of unlisted mortgage schemes under CP 141 are subject to an additional burden to make positive assertions about the cash flows; and

(b) the source of information for estimates made under CP 140 and CP 141 is different—CP 140 forecasts are based on the responsible entity's own

information and direct knowledge, as opposed to CP 141 estimates, which are based on historical information provided by the borrower from the scheme in determining the probability of its future cash inflows materialising.

16 There was one suggestion that estimates should be based on a set of predetermined assumptions and criteria to ensure consistency and comparability.

17 Another respondent suggested including an additional benchmark relating to the responsible entity's track record in paying withdrawal requests. This respondent also suggested that cash flow estimates exclude the projected level of new applications because these are not a predictable measure.

18 A respondent sought clarity on what is meant by the current and future prospects of liquidity of the scheme.

19 Two respondents asked for clarification on the requirement to update the estimates on a monthly basis. We consulted further with a number of respondents on amending this benchmark to require an update at least every three months to reflect any material changes.

20 Guidance was also requested on whether disclosure of a scheme's policy on balancing the maturity of its assets and liabilities referred to meeting future withdrawals.

21 There was some confusion about whether the responsible entity would be obliged to disclose the 12-month estimates to investors. One respondent was concerned that, if the estimates were required to be disclosed to investors and/or signed off by directors, there would be the potential for litigation and this would result in additional auditing costs. We consulted further with industry on these issues, including proposals to require director sign-off without the need to disclose to investors.

ASIC's response

We remain of the view that 12 months rather than three months is the appropriate timeframe to estimate a scheme's capacity to address expected cash requirements.

Although we acknowledge that cash flow estimates involve making assumptions outside the control of a responsible entity, it is important for responsible entities to regularly assess the capacity of a scheme to meet future redemption requests in order to manage investor expectations regarding liquidity, particularly when a scheme is being offered as liquid or as providing regular withdrawal opportunities.

We consider that this assessment should occur at least every three months to ensure that the cash flow estimates are up to date and reflect any material changes.

We have clarified in the updated RG 45 that cash flow estimates do not need to be disclosed to investors but should be signed off by directors at least every three months. We maintain that cash flow estimates are an important risk management tool that should be reviewed by directors regularly.

In response to concerns about the use of historical information provided by borrowers in making cash flow estimates, we expect the responsible entity would need to rely on this information given that the estimates would initially be based on a contractual obligation to make payments to the scheme (and the assumption that borrower payments would be made on time for the next 12 months). This would then be adjusted if the borrower defaulted on the loan. We note that CP 141 focuses on the scheme, while CP 140 focuses on the responsible entity. Our proposals in CP 141 are intended to align investor expectations about liquidity and the capacity of the scheme's assets to be realised to meet those expectations.

We have not included in the benchmark a set of predetermined criteria for cash flow estimates because this may be too inflexible and not appropriate for all responsible entities.

We have clarified in the additional disclosure requirement (referred to as Disclosure Principle 1 in the updated RG 45) that the disclosure of the scheme's policy on balancing the maturity of its assets and liabilities includes an investor's ability to withdraw from the scheme.

We do not intend to require disclosure of a responsible entity's track record in paying withdrawal requests because it might suggest a link between the historical availability of withdrawals and their future availability.

We have provided further guidance in the updated RG 45 on the disclosures of the current and future prospects of liquidity of the scheme.

We acknowledge that the liquidity risks may already be disclosed in a PDS—however, we note that one of the purposes of the benchmarks and the disclosure principles is to promote consistency and comparability between different unlisted mortgage schemes.

We note that this benchmark continues to apply only to pooled mortgage schemes.

Benchmark 2: Scheme borrowing

22 In CP 141, we proposed amending Benchmark 2 to provide that a responsible entity of an unlisted mortgage scheme will meet the benchmark if the scheme does not have any borrowings.

23 Generally, there was support for this benchmark. One respondent asked for clarity on whether the benchmark relates to past, present or future borrowings.

24 Two respondents raised concerns that failure to meet the benchmark would be viewed as a high risk when this may not automatically be the case. They noted that borrowings can be used to reduce concentration and liquidity risk. One suggestion was to include a materiality threshold or an exception that allows borrowings for certain purposes, such as funding withdrawals on a short-term basis.

25 One respondent suggested that disclosure of any loan covenant breach should be limited to any material loan covenant breaches.

ASIC's response

We have amended the benchmark to state that 'the responsible entity does not have current borrowings and does not intend to borrow on behalf of the scheme'.

We have not included a materiality threshold because we consider that details of all borrowings and credit facilities entered into by a scheme are important information for investors. We have also not included an exception for borrowings used to fund withdrawals. We are concerned that withdrawals paid from borrowings rather than cash flows may not be sustainable.

We have amended the additional disclosure requirements (referred to as Disclosure Principle 2 in the updated RG 45) to require disclosure of *material* loan covenant breaches.

Benchmark 3: Loan portfolio and diversification

26 In CP 141, we proposed amending Benchmark 3 to provide that a responsible entity of an unlisted mortgage scheme will meet the benchmark if the scheme's investment portfolio consists of the following features:

(a) assets diversified by size, borrower, class of borrower activity and geographic region;

(b) no single asset in the scheme portfolio exceeding 10% of the total scheme assets;

(c) no single borrower exceeding 10% of the scheme assets; and

(d) all loans made by the scheme secured by first mortgages over real property.

27 We also proposed that, in addition to the existing disclosures on portfolio diversification, the responsible entity disclose information on the scheme's diversification policy and how the assets correlate with that policy.

28 Two respondents considered the 10% threshold too generous and advocated 5% as the appropriate indicator of concentration risk. We consulted further on this issue.

29 One respondent sought clarity as to whether ‘real property’ includes freehold and leasehold property.

30 Respondents put forward a number of suggestions, including:

(a) that the reference to ‘borrower’ should cover ‘borrower groups’—the respondent noted that the current practice within the banking and finance sector is for loan exposures to be aggregated at group level;

(b) that disclosure of the loans in arrears and/or default should be limited to those greater than 30 days;

(c) that disclosure of the scheme’s hedging strategies *should* be required as part of the disclosure of the interest rates; and

(d) that disclosure of non-loan assets should *not* be required.

31 The general feedback we received was that the disclosures were not appropriate for contributory mortgage schemes.

ASIC’s response

We have amended the benchmark to reduce the threshold for a single borrower to 5% of a scheme’s assets.

We have clarified in the benchmark that ‘real property’ includes leasehold when it is a registered leasehold title. We have also clarified that the reference to ‘borrowers’ includes ‘borrower groups’.

We have amended the additional disclosure requirement (referred to as Disclosure Principle 3 in the updated RG 45) to include loans that are in default or arrears for more than 30 days.

We agree that disclosure of the foreign exchange and interest rate hedging policies of the responsible entity is also relevant information and have clarified that there should be disclosure about these policies.

We have not removed the disclosure of non-loan assets because we consider that the details of all investments by the scheme (such as investments in other unlisted mortgage schemes) are important information for investors.

We have clarified that this benchmark applies only to pooled mortgage schemes.

Benchmark 4: Related party transactions

32 In CP 141, we proposed amending Benchmark 4 to provide that a responsible entity will meet the benchmark if it does not lend to related parties of the responsible entity or its directors.

33 We also proposed that, in addition to the existing disclosures on related party transactions, the responsible entity disclose the following information:

(a) the nature of the relationship;

(b) whether the arrangement is on arm's length terms, is reasonable remuneration or some other Ch 2E exception applies; and

(c) whether member approval for the transaction has been sought and, if so, when.

34 One respondent suggested that the benchmark cover related party loans to a fund manager because the fund manager may not be the same entity as the responsible entity.

35 Two respondents considered the related party disclosures unnecessary duplication because they are already disclosed either in the annual report or a PDS.

36 One respondent was concerned about the potential breach of commercial confidentiality in disclosing the related party transactions.

37 Another respondent suggested a materiality threshold for disclosure of related party transactions on the basis that immaterial transactions would not influence the decision of retail investors.

ASIC's response

We have adopted the suggestion to amend the benchmark to cover loans to the scheme's investment manager.

We acknowledge that some related party disclosures may already be found in an annual report and/or a PDS. However, as noted above in our response to Benchmark 1, one of the purposes of the benchmarks and disclosure principles is to promote consistency and comparability between different unlisted mortgage schemes.

We note that related party transactions were required to be disclosed in the original RG 45. In response to concerns relating to commercial confidentiality, we remain of the view that information about related party transactions is information that investors reasonably require to make informed decisions about whether to invest in the scheme and should therefore be disclosed.

We do not intend to include a materiality threshold because we consider that the responsible entity can explain the materiality of the related party transactions in its disclosure.

We have also clarified in the additional disclosure requirement (referred to as Disclosure Principle 4 in the updated RG 45) the

details of the related party transactions that are to be disclosed for consistency with RG 76.

Benchmark 5: Valuation policy

38 In CP 141, we proposed to amend Benchmark 5 to provide that a responsible entity will meet the benchmark if the board of the responsible entity appoints valuers in accordance with the valuation policy of the responsible entity. We proposed that the valuation policy include, among other things, that the responsible entity obtain an independent valuation in relation to security property for a loan, and within a month after there is a decrease in the value of the security property, if the decrease is likely to have caused a breach of loan covenant.

39 We also proposed that the responsible entity disclose the following additional information:

(a) where investors may access the scheme's valuation policy; and

(b) whether there are any material inconsistencies between any current valuations of security property and the scheme's valuation policy.

40 We received suggestions to disclose the frequency of valuations and that valuation policies should include a minimum frequency for valuations.

41 Some respondents were concerned about the costs of additional valuations, which would be borne by either borrowers or investors in the form of lower distributions.

42 Two respondents submitted that mortgage funds would be placed at a competitive disadvantage because other lenders such as banks are not compelled to value their assets in a similar manner.

43 One respondent was of the view that issues associated with the decline in value of security property are already adequately addressed by current accounting standards on the impairment of assets.

44 Four respondents queried how responsible entities would know that there has been a decrease in the value of the underlying security without first carrying out a valuation.

45 We consulted further on proposals to amend the benchmark to require valuations to be obtained within *two months* after directors form a view that there may be a decrease in the value of the security property, if the decrease is likely to have caused a *material* breach of a loan covenant.

ASIC's response

We do not intend to include a minimum valuation frequency because we consider that valuations are only required when there is a likelihood that a decrease in the value of the property may have caused a material breach of loan covenant, or before the

issue of a loan and on renewal. However, we have included disclosure of the frequency of valuations of security property in the additional disclosure requirement (referred to as Disclosure Principle 5 in the updated RG 45): see also below.

In relation to concerns about the cost of additional valuations, we consider that these costs would be more likely to be incurred in a downward market phase and this is the time when the responsible entity should disclose the value of underlying property.

We consider that the benchmark addresses the inconsistencies in the valuation practices of responsible entities, particularly in declining markets, which is a key risk feature of these products.

We consider that accounting standards address the impairment of a scheme's assets (i.e. mortgages) rather than a decline in the valuation of the underlying security.

In response to our consultation process, we have amended this benchmark to require valuations to be obtained within *two months* after directors form a view that there is a likelihood that a decrease in the value of the security property may have caused a *material* breach of a loan covenant.

For simplicity, the two aspects of the benchmark have been combined, as follows:

> In relation to valuations for the scheme's mortgage assets and their security property, the board of the responsible entity requires:
>
> (a) a valuer to be a member of an appropriate professional body in the jurisdiction in which the relevant property is located;
>
> (b) a valuer to be independent;
>
> (c) procedures to be followed for dealing with any conflict of interest;
>
> (d) rotation and diversity of valuers; and
>
> (e) in relation to security property for a loan, an independent valuation to be obtained:
>
> (i) before the issue of a loan and on renewal:
>
> (A) for development property, on both an 'as is' and 'as if complete' basis; and
>
> (B) for all other property, on an 'as is' basis; and
>
> (ii) within two months after the directors form a view that there is a likelihood that a decrease in the value of security property may have caused a material breach of loan covenant.

We have adopted the suggestion to require disclosure of the frequency of valuations of security property. In addition, we consider it important that investors receive the following information under Disclosure Principle 5:

- where investors may access the scheme's valuation policy;
- the processes that the directors employ to form a view on the value of the security property; and

- any material inconsistencies between any current valuations over security property and the scheme's valuation policy.

Benchmark 6: Lending principles—Loan-to-valuation ratios

46 In CP 141, we proposed amending Benchmark 6 to provide that a responsible entity will meet the benchmark if:

(a) where the scheme directly holds mortgage assets, the scheme does not lend more than 70% of the 'as is' value of property over which security is provided; and

(b) where a loan relates to property development, funds are provided to the borrower in stages based on independent evidence of the progress of the development.

47 We also proposed that, in addition to the existing disclosure on loan-to-valuation ratios, the responsible entity disclose the following information:

(a) the loan-to-valuation ratio for the scheme; and

(b) the basis on which funds lent for property development are drawn down.

48 Most respondents did not support the 'as is' valuation basis for development properties.

49 Two respondents considered that the valuation basis in the existing benchmark (i.e. 'as if complete') was appropriate, particularly given that funds are advanced in line with the completion of various stages of progress of the development. It was also noted that the existing benchmark is consistent with the benchmark loan-to-valuation ratios that apply to debenture issuers.

50 One respondent raised concerns that ASIC should not place mortgage funds in an uncompetitive position in relation to funding for developments. It was submitted that it is standard banking practice to lend a maximum of 80% of the development costs and no more than 70% of the end valuation.

51 Two respondents suggested an assessment of development loans on a 'cost to complete' basis and that 75% would be an appropriate indicator.

52 A concern raised by one respondent was that the proposed benchmark may result in the restructuring of scheme portfolios to meet the benchmark and, consequently, significant costs would be incurred. One respondent noted that they would need to reconsider whether it was worthwhile supporting development loans if it meant they would not meet the benchmark.

53 Two respondents were concerned that schemes that exceed the ratio for property development set out in the benchmark would not be viewed as

having conservative lending practices, which is contrary to the opinions of rating agencies and external auditors.

54 Respondents sought clarification on the following:

(a) whether the test applies at the time of the loan approval or at the most recent valuation; and

(b) the disclosure of the overall loan-to-valuation ratio for the scheme—for example, whether it relates to the maximum or weighted average loan-to-valuation ratio as at the date of reporting.

55 One concern raised was that reporting on the overall loan-to-valuation ratio of the scheme may mislead investors because the valuations underpinning disclosure would not have been undertaken at the same time. If there is a requirement to conduct regular valuations on all security properties, this would add significant costs.

ASIC's response

We have decided to retain the loan-to-valuation ratios in the original RG 45, in light of the responses, and have also clarified that the benchmark only applies where the scheme directly holds mortgage assets.

For property development loans, we consider it is more appropriate for the responsible entity to disclose the scheme's exposure to development risk. We have amended the additional disclosure requirement (referred to as Disclosure Principle 6 in the updated RG 45) to include:

- the percentage of a scheme's assets that are property development loans;
- the loan-to-cost ratio of each property development loan; and
- the extent (by percentage value) to which any property development is completed.

We have also given guidance in the updated RG 45 that, if the loan-to-cost ratio exceeds 75%, this should be highlighted by responsible entities. Further, if the property development loans exceed 20% of the mortgage scheme's assets, the scheme is identified as a scheme that invests significantly in property development loans—for example, by including the word 'development' in the name of the scheme as well as in disclosure documents.

We have responded to requests for clarification by:

- amending the benchmark to state that it applies at the time of the most recent valuation; and
- specifying in Disclosure Principle 6 that disclosure of the loan-to-valuation ratio for the scheme refers to both the maximum and weighted average loan-to-valuation ratios as at the date of reporting.

We acknowledge that the valuations used in determining the overall loan-to-valuation ratios may not have been undertaken at

the same time. We have clarified that valuations are the most recent valuations as at the reporting date. We expect that valuations will be undertaken where there is a decrease in the value of the security property in accordance with Benchmark 5.

Benchmark 7: Distribution practices

56 In CP 141, we proposed amending Benchmark 7 to provide that a responsible entity will meet the benchmark if it pays distributions in accordance with the scheme's distribution policy.

57 We also proposed that, in addition to the existing disclosures on distribution practices, the responsible entity disclose:

(a) when distributions will be paid and the frequency; and

(b) where the scheme promotes a particular return on investments, a table identifying three to five main factors that would have the most material impact on forecast distributions, the risks of changes to those factors on distributions and a sensitivity analysis based on changes to those factors. It must also explain how any excess return actually earned by the scheme will be applied.

58 One respondent noted that limiting the disclosure in the benchmark to the existence of a policy would not achieve the benchmark's objective of providing a meaningful comparison. A suggestion was to include an additional benchmark capturing the key risk that distributions are not funded from income—for example, by asking: 'Are distributions sourced solely from the net income earned from the scheme?'

59 There was concern from one respondent that disclosure of any future forecasts (such as the source of any forecast distributions) would be subject to many factors outside the responsible entity's control and therefore may not satisfy RG 170.

60 One respondent was concerned that the disclosure may confuse investors, and noted that current distributions or target distribution rates are distinct from forecast distributions.

61 It was noted by a respondent that there is only one risk factor that will affect a scheme's ability to pay a distribution—namely, the borrower's failure to pay on time. Therefore, a sensitivity analysis is not necessary.

62 One respondent suggested that the sustainability of distributions be changed from 'the next 12 months' to 'the next 12–24 months'.

63 Another suggestion put forward was to expand the disclosure requirements to include:

(a) any loans written down over the past three years that have reduced distributable income;

(b) historical distributions (up to three years) because this information provides investors with details about the level of risk in the portfolio; and

(c) any 'write-downs' in asset values or loan losses that are processed through income during the financial year.

64 We consulted further on amending the benchmark to state that the responsible entity will not pay current distributions from scheme borrowings.

ASIC's response

We have amended the benchmark in the updated RG 45 to state that 'the responsible entity will not pay current distributions from scheme borrowings'.

We have retained the requirement for a sensitivity analysis because we consider that there may be factors additional to the borrower's failure to pay on time that may have a material impact on the forecast distributions. This will depend on the source of the forecast distributions.

We have not extended the timeframe for the sustainability of distributions. The period of 12 months is consistent with the timeframe for making cash flow estimates in Benchmark 1.

We have not included the suggested disclosures relating to the loan write-downs because this should be covered in the financial accounts.

Benchmark 8: Withdrawal arrangements

65 In CP 141, we proposed to revise Benchmark 8 to address the withdrawal arrangements that apply when a mortgage scheme is liquid and when it is illiquid.

66 We proposed that a responsible entity of a liquid scheme will meet the benchmark if:

(a) the period allowed for in the constitution for the payment of withdrawal requests is less than 90 days;

(b) the responsible entity will pay withdrawal requests within the period allowed for in the constitution; and

(c) the responsible entity only provides members with withdrawal rights if at least 80% (by value) of the scheme property is:

(i) money in an account or on deposit with a bank and is available for withdrawal immediately, or otherwise upon expiry of a fixed term

not exceeding 90 days, during the normal business hours of the bank; or

(ii) assets that the responsible entity can reasonably expect to realise for market value within 10 business days.

67 For illiquid schemes, we proposed that a responsible entity will meet the benchmark if it intends to make withdrawal offers to investors at least quarterly.

68 We also proposed that, in addition to the existing disclosures on withdrawal arrangements, the responsible entity disclose the following information:

(a) the fund's withdrawal policy and any rights that the responsible entity has to change the policy;

(b) the ability of investors to withdraw from the scheme when it is liquid;

(c) the ability of investors to withdraw from the scheme when the scheme is not liquid;

(d) how investors can exercise their withdrawal rights, including any conditions on exercise;

(e) any rights the responsible entity has to refuse withdrawal requests;

(f) the policy of the scheme on balancing the maturity of its assets and the maturity of its liabilities;

(g) if the responsible entity makes representations to investors about their future ability to withdraw, the grounds, supporting assumptions and the basis for the statement; and

(h) any significant risk factors that mean that withdrawal requests might not be satisfied within the expected period.

69 The submissions generally did not support the revisions to this benchmark.

70 The main concerns related to the 90-day period for the payment of withdrawal requests for liquid schemes, and the asset composition of liquid schemes that offer withdrawal rights. Respondents provided the following comments:

(a) Three respondents referred to the inconsistency between the benchmark and the definition of a liquid managed investment scheme in the Corporations Act. They noted that it may be confusing for investors where the scheme is 'liquid' under the Corporations Act but illiquid under the benchmark.

(b) One respondent raised concerns that the 90-day period may not always be appropriate, and that imposing this timeframe could be costly and inconvenient for industry and consumers.

(c) One respondent noted that mortgage schemes should not be treated differently from other schemes.

(d) Two respondents expressed concerns that schemes that meet the benchmark would be akin to a cash trust and would therefore not be subject to RG 45. They queried the relevance and meaningfulness of such disclosure.

(e) Three respondents were of the view that most, if not all, liquid mortgage funds would not meet this benchmark, which would reduce the benefits of any meaningful comparison.

71 One respondent queried why responsible entities are allowed 90 days in which to satisfy withdrawal requests but are required to realise assets for market value within 10 business days. Two respondents noted that, if the 90-day period is mandated, a transition period should apply to existing unlisted mortgage schemes.

72 In relation to the benchmark for illiquid schemes, one respondent was concerned that quarterly withdrawal offers may exceed what the responsible entity can offer, and may be costly and inconvenient for industry and consumers.

73 In relation to the additional disclosure proposed, one respondent queried why unlisted mortgage schemes are taking a different approach to other asset classes, which are moving towards more targeted and key issue disclosures under the shorter PDS regime.

74 Some of the suggestions put forward included:

(a) aligning the benchmark with the definition of a liquid scheme in the Corporations Act;

(b) extending the proposed time period for realising other assets from 10 business days to 30 business days; and

(c) adding an additional benchmark on the question of whether a responsible entity has met all withdrawal requests over the past 12 months.

75 One respondent suggested that product structures, such as term investments or early redemption penalties, could be a way of addressing or reducing the mismatch between assets and liabilities.

76 In relation to contributory mortgage schemes, one respondent noted that the benchmark was inappropriate because operators already advise investors that their right to be repaid is totally dependent on the borrower repaying the principal investment of the loan, and that the investor has no right to have their investment redeemed until the borrower has repaid the loan.

ASIC's response

We acknowledge that the 90-day period in the benchmark does not mirror the definition of a liquid scheme in the Corporations Act. However, the intention of the benchmark is to encourage a concept

of liquidity that aligns with investor expectations of a liquid scheme. Therefore, we have not changed this 90-day period.

We have retained the time period of 10 business days for the realisation of assets for liquid schemes. A scheme offered as liquid with at-call redemptions should be capable of meeting withdrawal requests from investors in most circumstances. To meet withdrawal requests which exceed available cash, assets should be realisable as soon as practicable—that is, within 10 business days.

We note that the cost of quarterly withdrawals can be minimised by seeking 'rolling withdrawal offer' relief: see Media Release (09-269MR) *ASIC grants conditional relief to improve access to capital for investors in frozen mortgage funds* (23 December 2009).

We have clarified in the updated RG 45 that a transition period will apply to existing unlisted mortgage schemes.

We have also clarified that for contributory mortgage schemes, the benchmark would generally not apply if operators have disclosed that investors have no ability to withdraw from the scheme until the loan to which the mortgage relates has been repaid.

In response to comments about the differing approaches between disclosures under the shorter PDS regime and for unlisted mortgage schemes, we note that the shorter PDS regime is not intended to apply to unlisted mortgage schemes.

C Feeder funds

Key points

In CP 141, we proposed that feeder funds provide separate disclosure.

There were some inconsistent comments concerning whether separate disclosure was appropriate and whether the information would be accessible for disclosure.

The updated RG 45 gives additional guidance on how the disclosures apply to feeder funds, taking into account the responses received.

77 In CP 141, we proposed to revise RG 45 to ensure that:

(a) investors in a feeder fund (a scheme that invests all or most of its assets in other unlisted mortgage schemes) receive disclosure of how the benchmarks apply at the feeder fund level; and

(b) where the disclosure will be the same for the feeder fund and the underlying fund(s), the responsible entity of the feeder fund incorporates by reference the disclosure for the underlying fund(s).

78 Three respondents supported separate disclosure by feeder funds. One respondent suggested that it would be useful for feeder funds to disclose additional information on the differences between the risk–return characteristics of the feeder fund and the underlying fund(s).

79 Two respondents did not support separate disclosure. One respondent submitted that feeder funds should be treated on a 'look-through' basis and, as a result, disclosure for the feeder fund should mirror the disclosure in the underlying fund(s).

80 Two respondents noted the difficulties faced by feeder funds obtaining disclosure from underlying funds when the responsible entities are not related parties. This is because feeder funds are dependent on the underlying fund to provide disclosure that is reliable and timely. One suggestion was that the feeder fund should provide investors with a copy of the benchmark disclosure from the underlying fund.

ASIC's response

In the updated RG 45, we have clarified that the benchmarks apply to feeder funds in the following way:

- if a benchmark is not relevant to the particular feeder fund, the responsible entity discloses this and does not have to 'look through' to the underlying fund; and
- if information on the underlying fund is relevant to the disclosure by the feeder fund, we expect that the feeder fund

will make reasonable endeavours to procure the information from the underlying fund. If the information is not available, the responsible entity discloses this and states why it is not available.

We have not changed our guidance to require responsible entities of feeder funds to disclose information on the differences between the risk–return characteristics of the feeder fund and the underlying fund(s). We consider that the risks of investing in feeder funds should be covered by a PDS.

Appendix: List of non-confidential respondents

- AXA Asia Pacific Holdings Limited
- Financial Services Council
- McCullough Robertson Lawyers
- McMahon Clarke Legal
- National Information Centre on Retirement Investments Inc.
- Simon Romijn
- Standard & Poor's