ASIC

Australian Securities & Investments Commission

REGULATION IMPACT STATEMENT

Mortgage schemes: Strengthening disclosure under RG 45

May 2012

About this Regulation Impact Statement

This Regulation Impact Statement (RIS) addresses ASIC's proposals for revising the benchmarks and additional disclosure requirements in Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45).

What this Regulation Impact Statement is about

1 This Regulation Impact Statement (RIS) addresses ASIC's proposals for revising the benchmarks and additional disclosure requirements in Regulatory Guide 45 *Mortgage schemes: Improving disclosure for retail investors* (RG 45).

2 On 6 October 2010, we published Consultation Paper 141 *Mortgage schemes: Strengthening the disclosure benchmarks* (CP 141) to consult on how we propose to strengthen the benchmarks under RG 45 for unlisted mortgage schemes.

3 In developing our final position, we have considered the regulatory and financial impact of our proposals. We are aiming to strike an appropriate balance between:

- disclosure that assists investors to make better informed decisions about investing in mortgage schemes; and
- not unduly interfering with the market and the flexibility of the public fundraising process.

4 This RIS sets out our assessment of the regulatory and financial impacts of our proposed policy and our achievement of this balance. It deals with:

- the likely compliance costs;
- the likely effect on competition; and
- other impacts, costs and benefits.

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A Introduction

Background

What is a mortgage scheme?

1 For the purposes of RG 45, a 'mortgage scheme' is a managed investment scheme that has or that is likely to have at least 50% of its non-cash assets invested in mortgage loans and/or unlisted mortgage schemes. Mortgage loans are loans secured by a mortgage over real property (including residential, commercial, industrial or retail property, or vacant land).

The mortgage scheme market

2 There are approximately 168 unlisted mortgage schemes operated by 102 Australian financial services (AFS) licensed responsible entities with approximately $18.2 billion in funds under management[1]—124 of these schemes are pooled mortgage schemes and 44 are contributory mortgage schemes. The key difference between a pooled mortgage scheme and a contributory mortgage scheme is that for pooled mortgage schemes, all investors' investments and returns are linked collectively with a pool of mortgages, whereas for contributory mortgage schemes each investor's investment and return is linked with the performance of a particular mortgage. Based on historical review, we estimate an aggregate of 70% of unlisted pooled mortgage scheme funds were invested in industrial, retail, commercial and residential mortgages, with the balance of investments in specialised vacant land, construction and development mortgages.

3 Mortgage schemes have historically been an important alternative source of financing for real estate owners and developers who have competed with banks for business. They have also provided financing to borrowers such as developers who may not have been able to obtain financing from traditional sources, such as banks. A loss of confidence in mortgage schemes has resulted in investors seeking to withdraw their investment and transfer to safer investments such as term deposits or more liquid investments such as listed securities. The loss of confidence in mortgage schemes has made it more difficult for borrowers such as developers to procure finance to fund their developments.

[1] As at 31 December 2010.

Business models of mortgage schemes

4 A mortgage scheme operates on the basis that:

(a) the scheme raises funds by issuing interests to investors. These funds are either pooled and lent by the scheme to various borrowers (pooled schemes) or lent in relation to a specific property (contributory schemes). In both pooled and contributory schemes, loans are secured by mortgages over real property and security may be a first or subsequent mortgage. For pooled schemes, investors do not have an interest in a particular mortgage loan, but have an interest in scheme property as a whole;

(b) the return to investors is generally generated by interest payments made by the borrowers to the scheme;

(c) investments are either for a fixed term or can be withdrawn following a withdrawal request; and

(d) the value of an investor's investment may be subject to change depending on the asset position of the scheme.

5 Some mortgage schemes may lend funds for construction or property development.

6 For these schemes, the skills and experience of the responsible entity in assessing these activities and selecting appropriate loans are particularly important to the performance of the scheme.

7 Some schemes promote that they can provide investors with a level of capital security by committing to pay investors back their initial investment at the end of their investment term. Other schemes promote fixed rates of return. Some schemes may lend funds to borrowers and 'capitalise' the expected interest payments. This means that the scheme may not be receiving actual cash payments from the borrower over the course of the loan and instead receive the capital and accumulated interest payments at the end of the loan term.

8 Many schemes promote that withdrawal requests will generally be satisfied within a relatively short period.

The key risks of unlisted mortgage schemes

9 Past experience and our analysis of the mortgage scheme market suggests that features of the operations of some mortgage schemes can hold particular risks for investors.

10 The key features and risks are identified in Table 1. These features are not present in every unlisted mortgage scheme that is offered to retail investors. The investment risks described will vary from scheme to scheme and from

business model to business model. However, disclosure about these features and risks, including to what extent they are present in a given offering, is relevant for a broad range of schemes.

Table 1: Risk features of unlisted mortgage schemes

Risk feature	What this means
Liquidity	Liquidity may be at risk because of a mismatch between when the responsible entity represents that they can meet withdrawal requests and cash flows from the underlying businesses or assets to which funds have been lent. Liquidity is frequently heavily dependent on continuing inflows from new investors, borrowings or 'rollovers' by existing investors because the underlying assets of the scheme may not be easily realised within a short period of time.
Scheme borrowing	If a scheme borrows against the assets of the scheme, investors' interests in the scheme's assets will generally rank behind the lender. Investors in schemes with high borrowings face the risk that distributions will not be made or withdrawals will be suspended so that loan payments can be met. Investors also face the risk that they may lose part or all of their investment if the scheme defaults on these loans.
Portfolio diversification	Lack of diversification in the scheme's loan book may mean that an adverse event affecting one borrower or one type of loan will simultaneously affect the majority of borrowers, and therefore put the overall portfolio at greater risk.
Related party transactions	There is an increased risk that these transactions are less likely to be made on arm's length commercial terms and that the responsible entity will not monitor them as robustly as those involving unrelated parties.
Inconsistency in valuations	If valuations are not prepared properly or by appropriately qualified and experienced valuers, it is difficult to assess the risk exposure associated with a loan. It is also difficult to monitor loan-to-valuation ratios on a continuing basis.
Lending principles	Schemes that lend at a higher loan-to-valuation ratio are more vulnerable to the risk of an adverse change in market conditions where the security obtained from borrowers becomes insufficient to cover the loan.
Distribution practices	Where distributions are not sourced solely from scheme income, there is a risk that these distribution practices may not be sustainable over the long term. This risk may be heightened where a scheme promotes a fixed return on investments.
Withdrawal arrangements	This practice creates the risk that investors do not fully appreciate that their right of withdrawal may be refused until a longer period of time has elapsed than the one represented.
Misleading advertising	Even if the Product Disclosure Statement (PDS) highlights risk in an appropriate way, advertising that conveys messages not in line with the regulated disclosure document can undermine the effect of that disclosure.

Current regulation of mortgage schemes

11 The offer of interests in mortgage schemes is regulated under the *Corporations Act 2001* (Corporations Act) (all sections, chapters and parts referred to in this RIS are from the Corporations Act unless otherwise stated).

12 An interest in a mortgage scheme is a financial product, so the obligations for the offer of financial products in the provisions in Pt 7.9 apply to the offer of interests in mortgage schemes, including the requirement to prepare a PDS for the offer of interests in the scheme, and guidance on advertising and publicity for the offer of interests.

13 Chapter 5C imposes various requirements on mortgage schemes, including the requirement to be registered as a managed investment scheme, to be operated by a responsible entity and to have a scheme constitution and compliance plan.

PDS disclosure

14 An offer of interests in a mortgage scheme will generally need to be made under a PDS unless an exemption applies. The PDS must:

(a) include any information that might reasonably be expected to have a material influence on the decision of a reasonable person, as a retail client, whether to acquire the product (s1013E);

(b) make specific disclosures (s1013D); and

(c) be worded and presented in a clear, concise and effective manner (s1013C(3)).

15 The general PDS content requirement in s1013E is designed to:

(a) promote efficiency in the capital markets;

(b) promote disclosure of relevant information;

(c) reduce the likelihood of omitting important information;

(d) focus responsible entities on the information needs of investors; and

(e) be sufficiently flexible to accommodate changes in investors' information needs.

16 We consider that ASIC's guidance on 'clear, concise and effective' disclosure for prospectuses set out in Regulatory Guide 228 *Prospectuses: Effective disclosure for retail investors* (RG 228) is also relevant to PDSs of unlisted mortgage schemes. The purpose of both types of disclosure documents is to help retail investors assess the risks and returns associated with an offer and make informed investment decisions. Accordingly, some of the principles in RG 228 are broadly applicable to achieving 'clear,

concise and effective' disclosure for PDSs. For example, a document will generally be 'clear, concise and effective' if it:

(a) highlights key information (e.g. through an investment overview that gives cross-references to the more detailed information);

(b) uses plain language;

(c) is as short as possible;

(d) explains complex information, including any technical terms; and

(e) is logically ordered and easy to navigate (see RG 228.24).

Requirements for a compliance plan, compliance committee and compliance plan auditor

17 The Corporations Act requires managed investment schemes to have a compliance plan: s601EA. The compliance plan must set out adequate measures for the responsible entity to ensure compliance with the Corporations Act and the scheme's constitution: s601HA. The responsible entity has a duty to comply with the compliance plan: s601FC(1)(h).

18 A scheme is also required to have a compliance committee unless at least half of the responsible entity's directors are external directors: s601JA. The functions of the compliance committee are to:

(a) monitor the extent to which a responsible entity complies with the compliance plan and report its findings to the responsible entity;

(b) report any breach of the law or the scheme's constitution to the responsible entity;

(c) report to ASIC if the compliance committee considers that the responsible entity is not taking adequate action to deal with a matter reported to the responsible entity; and

(d) assess at regular intervals whether the compliance plan is adequate, to report to the responsible entity on the assessment and to make recommendations to the responsible entity about any changes that it considers should be made to the plan (s601JC(1)).

19 The auditor of a compliance plan must give the responsible entity a report that states the auditor's opinion on whether:

(a) the responsible entity has complied with the compliance plan; and

(b) the plan continues to meet the requirements of the Corporations Act.

Restrictions on advertising

20 The Corporations Act provides restrictions on advertising and publicity for offers of interests in mortgage schemes before and after interests are available for acquisition by retail clients: s1018A.

21 There are also general consumer protection provisions in the *Australian Securities and Investments Commission Act 2001* (ASIC Act), including prohibitions against misleading and deceptive conduct, as well as prohibitions against false or misleading representations.

ASIC's role in administering the law

22 ASIC administers the law regulating mortgage schemes, within the powers granted by the Corporations Act. This includes reviewing PDSs, conducting surveillance and undertaking enforcement action in cases of breach of the Corporations Act (as well as the ASIC Act).

23 While PDSs of unlisted mortgage schemes do not need to be lodged with ASIC and ASIC does not approve disclosure documents, ASIC has powers to make a stop order on a PDS if it is satisfied that:

(a) information in a PDS is not worded and presented in a clear, concise and effective manner; or

(b) an offer of securities under a PDS contains a misleading or deceptive statement, or omits information from the PDS that is required under the Corporations Act (s1020E).

24 In administering the law, we are able to exercise our regulatory powers without notice; however, it can be more effective and efficient to provide the market with specific and clear guidance on our view of the existing requirements of the Corporations Act—as they apply to particular financial products. This approach informs the industry as a whole about our views on the requirements of the Corporations Act, rather than communication of these views on an individual basis, which can be disruptive to individual fundraising and inefficient for ASIC.

Disclosure requirements for responsible entities of unlisted mortgage schemes

25 Responsible entities of unlisted mortgage schemes are subject to the disclosure obligations in Ch 7 of the Corporations Act, including the requirement to prepare a PDS for the offer of interests in the schemes.

26 In September 2008, ASIC introduced RG 45, which established eight benchmarks and additional disclosure requirements that responsible entities of unlisted mortgage schemes are expected to disclose against. Responsible entities should disclose against the benchmarks on an 'if not, why not' basis and provide the requested information in relation to the additional disclosure requirements. The 'if not, why not' approach does not require that a benchmark is complied with. However, if the benchmark is not met, the responsible entity should explain why the benchmark is not met and how it deals with the business factors or issues underlying the benchmark.

27 The benchmarks and additional disclosure requirements are intended to assist retail investors understand the key characteristics of unlisted mortgage schemes and assess the risks associated with these schemes to enable them to decide whether an investment in unlisted mortgage schemes is suitable for them. The Corporations Act disclosure requirements are principles based. Mortgage schemes pose different risks from other types of managed investment schemes and these risks should be brought to the attention of investors through the benchmarks and additional disclosure requirements.

28 The benchmarks and additional disclosure requirements in the September 2008 version of RG 45 address the matters summarised in Table 2.

Table 2: Benchmarks for unlisted mortgage schemes in which retail investors invest

Benchmark	Description
1. Liquidity (pooled mortgage schemes only)	Benchmark 1 addresses the scheme's ability to satisfy withdrawal requests and other operational commitments.
2. Scheme borrowing	Benchmark 2 addresses the scheme's policy on borrowing.
3. Loan portfolio and diversification (pooled mortgage schemes only)	Benchmark 3 addresses the scheme's lending practices and portfolio risk.
4. Related party transactions	Benchmark 4 addresses the risks associated with related party lending, investments and transactions.
5. Valuation policy	Benchmark 5 addresses the responsible entity's approach to valuing property over which the scheme holds security.
6. Lending principles: Loan-to-valuation ratios	Benchmark 6 addresses the lending practices of the scheme.
7. Distribution practices	Benchmark 7 addresses the transparency of the scheme's distribution practices.
8. Withdrawal arrangements	Benchmark 8 addresses the transparency of the responsible entity's approach to withdrawals of investments.

29 Since the introduction of RG 45, there have been a number of developments in the unlisted mortgage scheme sector, including:

(a) significant changes in financial market conditions resulting in investors reassessing their risk appetite;

(b) responsible entities of unlisted mortgage schemes not being able to realise sufficient assets in deteriorating market conditions to satisfy requests for redemption within the time set out in the scheme's constitution for redemption;

(c) most pooled mortgage schemes freezing redemptions in or around October 2008 and remaining frozen;

(d) the freezing of the sector highlighting a number of issues with the business models of unlisted mortgage schemes and a significant misalignment between the expectations of investors in relation to, and the actual performance of, these schemes; and

(e) a review of industry disclosures under the current RG 45 conducted from 30 November 2008 to 31 January 2009, demonstrating that many responsible entities do not apply the ‘if not, why not’ approach consistently and that some of the current benchmarks need to be clearer and simplified.

30 As a result of these developments in the unlisted mortgage sector, we published CP 141. To make it easier for investors to understand the characteristics of unlisted mortgage schemes and to assess the risks in relation to them, and for responsible entities to comply with their disclosure obligations, we proposed:

(a) simple and clear ‘business model’ benchmarks in order to focus investors’ attention on the key characteristics and associated risks of unlisted mortgage schemes;

(b) additional disclosure requirements in ‘disclosure principles’; and

(c) further guidance on how to disclose against the benchmarks and apply the disclosure principles.

Assessing the problem

31 The issue is whether the current benchmarks and additional disclosure requirements for unlisted mortgage schemes in RG 45 are adequate to provide an investor with sufficient and appropriate information in relation to mortgage schemes and their risks and whether it would be better to revise the benchmarks and additional disclosure requirements to:

(a) enhance disclosure on the key features of business models for unlisted mortgage schemes by setting benchmarks that focus on the important characteristics of these schemes to make it easier for investors to understand and assess these investments;

(b) improve disclosure about additional investor risk not currently addressed by RG 45;

(c) encourage alignment between investors’ expectations about their investment with the ability of responsible entities to meet those expectations by requiring clearer disclosure on the main features of unlisted mortgage schemes; and

(d) clarify our expectations regarding disclosures for unlisted mortgage schemes to address current inconsistencies.

32 The current RG 45 sets out eight benchmarks and additional disclosure requirements that address liquidity, scheme borrowing, loan portfolio and diversification, related party transactions, valuation policy, lending principles, distribution practices and withdrawal arrangements.

33 Shortly after RG 45 was published, the global financial crisis resulted in a substantial increase in requests by investors to withdraw their investments from unlisted mortgage schemes. This precipitated the widespread suspension of withdrawals, resulting in investors being unable to withdraw their investments.

34 The freezing of the sector has highlighted a number of risks associated with the business models of unlisted mortgage schemes that are not adequately addressed by the existing benchmarks or additional disclosure requirements in the current RG 45, including:

(a) in relation to the benchmarks:

(i) a mismatch between investors' expectations regarding a scheme's liquidity and the capacity of the scheme to meet those expectations;

(ii) the unsustainability of a scheme that depends on borrowings to pay distributions or withdrawal requests in some circumstances;

(iii) the concentration risk associated with a scheme's lack of loan portfolio diversity;

(iv) heightened risk of related party loans being on uncommercial terms;

(v) inappropriate valuation policies resulting in inflated valuations of a scheme's assets or security property;

(vi) loss of investor capital as a result of high-risk lending practices; and

(vii) the misalignment between a scheme having long-term loan assets to support the provision of short-term liquidity to investors; and

(b) in relation to the additional disclosure requirements:

(i) the risks to the liquidity prospects of the scheme;

(ii) the risk associated with differing debt maturities and interest rate and foreign exchange exposure associated with scheme borrowings;

(iii) the risk associated with second ranking mortgages;

(iv) inadequate disclosure about related party transactions;

(v) the lack of availability of key information about valuations;

(vi) the risks associated with high maximum and average loan-to-valuation ratios and development and construction loans;

(vii) the inconsistency of frequency of payment of distributions and a lack of sensitivity analysis for forecasts; and

(viii) the right of responsible entities to suspend withdrawal rights.

35 These risks are discussed in more detail below.

Benchmarks

Liquidity

36 The current liquidity benchmark contains a requirement that pooled mortgage schemes have cash flow estimates for the next three months and sufficient cash (or cash equivalents) to meet the scheme's projected cash needs over the next three months. Cash flow estimates over a three-month timeframe have proven inadequate to ensure the liquidity needs of unlisted mortgage schemes are met.

37 There is a risk of mismatch between investors' expectations regarding a scheme's liquidity and the capacity of the scheme to meet those expectations where cash flow is not responsibly managed.

38 The liquidity of a scheme is its ability to meet its ongoing commitments and its representations that investors can withdraw from the scheme. A scheme faces liquidity problems if there is a mismatch between its cash flow needs and inflows, particularly as the underlying assets of the scheme (i.e. loan assets) cannot be easily realised within a short period of time.

39 To assess the scheme's liquidity, a responsible entity should prepare, rigorously assess and regularly update cash flow estimates that cover a sufficient time horizon (e.g. 12 months) to enable its directors and management to responsibly manage the cash flow needs of a scheme.

Scheme borrowing

40 The current benchmark for scheme borrowing provides that responsible entities should disclose details of the scheme's borrowings. Schemes that depend on borrowings to pay distributions or withdrawal requests may be unsustainable, particularly in poor market conditions.

41 Some schemes borrow against the assets of the scheme to pay distributions, withdrawal requests or for scheme operations, normally on the basis of smoothing out any short-term imbalance between cash needs and available cash. Where scheme borrowings are unsustainable over the long term, responsible entities have had to freeze withdrawals and distributions to repay loans. There should be sufficient disclosure to investors to enable them to fully assess the risks associated with scheme borrowings used to pay distributions.

42 Over the long term, the income produced by a scheme should be capable of supporting distributions to members, withdrawals and the scheme's operations.

Loan portfolio and diversification

43 The current benchmark for loan portfolio and diversification provides that a responsible entity should disclose details of the nature of the scheme's investment portfolio, its policy on portfolio diversification and how the scheme will lend funds generally, as well as its approach to investing in other unlisted mortgage schemes.

44 There is a higher concentration risk in schemes that lack an appropriate level of portfolio diversification.

45 Lack of diversification heightens the risk of significant loss to investors when a risk event occurs. For example, an adverse event affecting one borrower is likely to affect the majority of other borrowers, where loans are concentrated on specific types of commercial activities, geographic locations or borrowers.

46 Given that schemes will have variable criteria and portfolios, investors find it difficult to compare different schemes, particularly when responsible entities have adopted inconsistent approaches to applying the 'if not, why not' approach to disclosure of information about the scheme's portfolio diversification. Disclosure would be more effective if investors could more easily compare the level of diversification and concentration risk between different schemes.

Related party transactions

47 The current benchmark for related party transactions provides that a responsible entity should disclose its approach to these related party transactions.

48 The interests of a related party can influence the responsible entity's decision making to the detriment of investors. In particular, there is a heightened risk that related party loans will be made on uncommercial terms.

49 Some responsible entities lend, invest scheme assets and transact with their associated companies or businesses. There is a risk that these transactions will not be made on arm's length commercial terms, there will be a lack of transparency regarding the transactions and the responsible entity will not monitor such related party transactions as robustly as those involving unrelated parties. There are also substantial conflicts when impairment and loan recovery decisions need to be made.

50 Disclosure on related party transactions should elucidate these related party risks so that investors are able to make an informed investment decision.

Valuation policy

51 The current benchmark for valuations provides that the responsible entity should have a clear policy on how often valuations are obtained, including how recent a valuation has to be when a new loan is made. However, responsible entities retain discretion and investors are not receiving sufficient or consistent disclosure on valuations.

52 Valuation polices that are inappropriate result in inflated or flawed valuations of a scheme's mortgage loan assets or the underlying security properties for those loan assets.

53 The valuations that schemes rely on are carried out on a variety of bases, with differing assumptions and instructions. These valuations are fundamental to determining how much the scheme may lend. If valuations are not prepared properly or by appropriately qualified and experienced valuers, it is difficult to assess the risk exposure associated with a loan.

54 The importance of valuations means that investors should receive disclosure that allows investors to readily determine how rigorous and transparent the responsible entity's valuation policies are on topics including the use of suitably qualified and independent professional valuers, procedures to deal with conflicts, rotation and diversity of valuers, the valuation of security property for loans before the issue of a loan and on renewal of the loan, and the updating of valuations if directors view that there may be a breach of a material loan covenant due to a decrease in the value of security property.

Lending principles: Loan-to-valuation ratios

55 The current benchmark for lending principles provides that a responsible entity should disclose whether it maintains up to a maximum of a loan-to-valuation ratio of 70% for property development loans on the basis of the latest 'as if complete' valuation and 80% on the basis of the latest 'as is' market valuation in all other cases. This requirement does not draw out the risks associated with high gearing levels for construction and development loans against costs or the level of development and construction risk within a loan portfolio.

56 A scheme's loan-to-valuation ratio is an important indicator of how conservative or aggressive its lending practices are. The maximum proportion of a property's value against which schemes are willing to lend indicates how vulnerable the scheme is to changes in market conditions, particularly the risk to the scheme's ability to fully recover the money it has lent to borrowers and the risk that the security obtained from borrowers is insufficient to support the loan. For example, a scheme that lends to a loan-

to-valuation ratio of 90% would be at risk of investor capital loss if the property market dropped by more than 10%.

57 There is a greater risk of loss of investor capital as a result of schemes engaging in high-risk or aggressive lending practices. Loans for different purposes can bear different risks. For example, loans for development or construction purposes involve substantial additional risk that is not present in a loan to acquire an existing building.

58 While we are not proposing to change the existing benchmark, further disclosure is required to highlight the heightened levels of risk associated with construction and development loans: see paragraph 79.

Distribution practices

59 The current benchmark for distribution practices provides that responsible entities should disclose details of the scheme's source of current and any forecast distributions, and if the distributions are not solely sourced from income, the reasons for this and whether this is sustainable over the next 12 months. Investors did not necessarily appreciate the risks inherent in a scheme that relies on borrowings to pay distributions.

60 Schemes that rely on borrowings to pay distributions can be unsustainable. Such schemes are effectively borrowing against assumptions about future income and new investor inflows to pay current distributions. If the assumptions prove incorrect (and there is always a risk that assumptions will be incorrect), investor capital loss can result.

61 A lack of confidence in frozen mortgage schemes has resulted in new investor inflows drying up. The schemes also came under immense pressure from lenders to repay loans. Schemes often have to sell assets at discounted prices to repay loans, resulting in loss of investor capital. Such schemes also often have to suspend distributions and withdrawals to repay lenders. Investors who invested in mortgage schemes for, and are completely financially dependent upon, regular distributions end up severely disappointed when distributions cease and they are unable to withdraw their investment because capital is being used to repay lenders.

62 Over the long term, the income produced by a scheme should be sufficient to support distributions and schemes should not rely on borrowings to pay distributions. While borrowings may address short-term imbalances between distributions and available income, the global financial crisis highlighted that such practices are unsustainable over the long term. Where a scheme borrows to pay distributions, investors should have access to sufficient disclosure regarding the risks associated with such a practice.

Withdrawal arrangements

63 The current benchmark for withdrawal arrangements requires disclosure on the maximum withdrawal period allowed under the scheme's constitution, any factors affecting withdrawal rights and how withdrawals will be funded.

64 The assets of mortgage schemes are largely long-term loan assets. Such assets often take considerably longer to realise than the time within which investors expect to be able to withdraw. This results in a misalignment between the non-liquid nature of the loan assets in the short term with the provision of short-term liquidity to investors.

65 The global financial crisis highlighted a clear misalignment between investors' expectations regarding their capacity to withdraw their capital (as represented by responsible entities) and the investor's legal right to withdraw as set out in the constitution.

66 Some schemes promote a short withdrawal period, often daily, to attract investors, although the maximum period allowed in the scheme's constitution for the responsible entity to satisfy these requests could be much longer, possibly up to three years. Such inconsistencies result in investors' misunderstanding their right of withdrawal. It is also common for scheme constitutions to include a right for responsible entities to indefinitely suspend withdrawals. This can result in investors being unable to withdraw their capital for a long period of time.

67 Under the Corporations Act, a 'liquid' scheme is one in which 'liquid assets' account for at least 80% of the value of scheme property. Other than assets that are readily convertible into cash, s601KA(6) provides that any other property is a 'liquid asset' if the responsible entity reasonably expects that the property can be realised for its market value within the period specified in the constitution for satisfying withdrawal requests while the scheme is liquid. Assets such as mortgage loans are unlikely to be liquid in a commercial sense and are generally not readily convertible to a liquid asset.

68 Responsible entities may nevertheless treat such assets as liquid assets if the responsible entity reasonably expects to realise these assets for market value within the period specified in the constitution. That specified period could be much longer than the period within which investors expect to be able to withdraw from a scheme. For example, a scheme that largely holds mortgage loans with a three-year term is unlikely to be able to rely solely on the realisation of those assets to fund daily redemptions. However, the scheme could be technically 'liquid' because the period for realisation of three years is specified in the constitution, despite the scheme not being truly liquid in any commercial sense.

69 The liquidity crisis in the sector highlights that the statutory concept of a 'liquid' scheme does not always align with investors' common

understanding that a liquid scheme is one that has sufficient realisable assets to meet withdrawal requests on demand. It is important that any disclosure to investors does not confuse the statutory and commercial concepts of what a liquid scheme means. Based on the representations made by responsible entities, investors expect that their investment is liquid and it is important that investors have access to disclosure regarding their withdrawal rights, and, in particular, any restrictions that may prevent them from exercising those rights.

70 In addition, mortgage loan assets are typically 'lumpy' to realise in good market conditions and often impossible to realise in deteriorating markets. These assets are not liquid in all market conditions to be able to support on-demand withdrawal over the long term. While the non-liquid nature of mortgage loan assets can be smoothed over through cash flow management (e.g. through the receipt of new investor funds), the risk is that when withdrawal requests exceed available cash in poor market conditions, schemes have to freeze withdrawals.

71 Accordingly, better disclosure regarding suspension rights of responsible entities and their effect on an investor's right to withdraw will assist in aligning:

(a) an investor's expectations of liquidity and a scheme's obligation to provide such liquidity; and

(b) the normal concept of liquidity and representations by responsible entities that a scheme is liquid.

72 Further, responsible entities should have clear guidance on what constitutes a 'liquid scheme' for the purposes of disclosure against the benchmark.

Disclosure principles

Liquidity

73 The ability of investors to withdraw from a scheme is a strong influence on an investment decision. Responsible entities should disclose the current and future prospects of liquidity of the scheme, as well as any significant risk factors that may affect the liquidity of the scheme. The additional disclosure requirements in the existing RG 45 do not require all of this information.

Scheme borrowing

74 The global financial crisis highlighted the risks associated with scheme borrowings, particularly those with short-term maturities. The existing RG 45 disclosure requirements do not provide enough emphasis on the additional risks associated with short-term debt. Under the proposed disclosure principle, the disclosure requirements would be modified so that

additional information should be disclosed for borrowings due in less than two years (e.g. the undrawn credit facility and whether financing or sale of assets is likely during this period). For borrowings due in between two and five years, the undrawn credit facility should also be disclosed. This will result in more detailed information being provided for borrowings that will mature in five years or less.

75 The current disclosure requirements in RG 45 do not require any disclosure about the responsible entity's interest rate and foreign exchange hedging policies. A scheme with exposure to unhedged variable interest rates and foreign exchange movements has a heightened risk of capital loss in certain market conditions. Under the proposed disclosure principle, responsible entities should disclose the scheme's policy on these issues and whether the actual position of the scheme is in conformity with its policies.

Loan portfolio and diversification

76 Second-ranking mortgages are often an indicator of high gearing levels and risk of loss of investor capital in deteriorating property market conditions. Under the proposed disclosure principle, responsible entities should disclose the percentage of loans that are secured by second-ranking mortgages so that investors can assess whether this is a risk they are willing to take. The responsible entity should also disclose the scheme's diversification policy and how the scheme's assets correlate with that policy.

Related party transactions

77 In March 2011, we released revised Regulatory Guide 76 *Related party transactions* (RG 76). It is important that there is consistency of requirements between regulatory guides. The proposed disclosure principle updates the requirements in RG 45 for consistency with RG 76 and describes, in more detail, the type of information that should be provided by responsible entities.

Valuation policy

78 Valuation information is critical for assessment of the value of an investment. The approach a responsible entity takes to procuring valuations can significantly influence the transparency, and dependency, of security property values. For example, if a responsible entity's policy is to only value security property every three years, the actual market values of a security property can be significantly below the loan amount in deteriorating market conditions. Where the borrower defaults on the loan, substantial investor capital loss can result. A responsible entity should disclose if and where investors may access the scheme's valuation policy, the processes that the directors will adopt to form a view on the value of security property, the frequency of valuations and any material inconsistencies between current

valuations and the scheme's valuation policy so that investors can assess the reliability of scheme valuation information. The existing RG 45 does not require disclosure of all of this information.

Lending principles: Loan-to-valuation ratios

79 Loan-to-valuation ratios provide investors with an indication of the riskiness of the lending practices of responsible entities. Responsible entities should disclose the maximum and weighted average loan-to-valuation ratio for the scheme overall and the basis upon which funds that are lent for property development are drawn down. Some mortgage schemes have a combination of passive and development-related loans. The risk profile of these two types of loans is significantly different. So that investors are aware of, and can assess, the development risk within a scheme, responsible entities should disclose by value the percentage of the scheme's assets that are secured by development construction properties, the extent to which each development property is completed and the loan-to-cost ratio of each development loan as at the date of reporting. Disclosure on all of these issues is not currently required by RG 45.

Distribution practices

80 Some investors have a high reliance on the consistency of distributions and their frequency. Responsible entities should disclose when they will pay distributions and the frequency of payment. Some responsible entities make forecasts regarding distributions in response to investor demand. It is important for investors to appreciate that forecasts may not be met and to be aware of the risks that may result in forecasts not being met. Responsible entities should provide investors with a sensitivity analysis to enable them to understand the risks to their distributions and what may happen to the amount and frequency of their distributions if assumptions made by the responsible entity are incorrect or change. The existing RG 45 does not require sufficient disclosure on these issues.

Withdrawal arrangements

81 Responsible entities usually have *discretion* to indefinitely suspend withdrawal requests. This means that withdrawal conditions can change at any time and investors may not be able to withdraw for indefinite periods of time. This critical information for investors is not currently separately required to be disclosed by RG 45.

Clarifying the benchmark disclosure requirements

82 At the time RG 45 was published, we indicated that we would review the disclosures made by each responsible entity in the unlisted mortgage scheme

sector to check that the benchmark information in RG 45 was adequately disclosed to investors on an 'if not, why not' basis.

83 From our review of the disclosures provided by the responsible entities for 124 schemes, we found there was a high level of inconsistent disclosure against the 'withdrawal arrangements' benchmark. The responsible entities adopted different interpretations of what constitutes a 'right to withdraw', particularly in relation to frozen schemes and contributory mortgage schemes. Excluding this benchmark, we also found that the responsible entities for 47 out of the 124 schemes disclosed against the remaining seven benchmarks on an 'if not, why not' basis, including 26 schemes that met all seven benchmarks. The remaining 77 schemes disclosed against some of the seven benchmarks on an 'if not, why not' basis.

84 Out of these 77 responsible entities, some explained why the benchmark was not met. Explanations were provided for Benchmark 1 (7%), Benchmark 5 (19%) and Benchmark 6 (12%). For the other benchmarks, there were no explanations as to why the benchmarks were not met.

85 The four main reasons why the 77 schemes were assessed as not providing disclosure on an 'if not, why not' basis for all the benchmarks were:

(a) responsible entities did not address all the requirements of the benchmark;

(b) responsible entities that did not meet a benchmark did not explain 'why not';

(c) responsible entities did not apply a consistent approach in disclosing how they met or did not meet the benchmark (e.g. some used the concept of 'partially met') which undermines the aims of comparable disclosure; and

(d) feeder funds did not provide separate disclosure at the feeder fund level, but relied on the fact that the underlying funds in which they invest had already provided disclosure.

86 Disclosure would be more effective if the benchmarks were simpler. This would make assessment against each benchmark more clear and accurate. Further clarification is required to ensure responsible entities understand that a benchmark is not met if all components are not satisfied and additional disclosure to investors is required to explain why the benchmark is not met and so feeder funds understand their obligations.

ASIC's objectives

87 In developing the proposals, we have been mindful of the fundamental purpose of the benchmarks in RG 45, which are to help retail investors

receive adequate disclosure on the risks and rewards being offered to help in their decision of whether or not to invest in unlisted mortgage schemes. We have focused on the need to encourage robust disclosure of the characteristics of the business models and the associated risks in the unlisted mortgage scheme sector, and to encourage responsible entities to adopt a consistent approach to disclosing those characteristics and risks to assist investors to more easily compare the features of different mortgage schemes.

88 Specifically, the proposals seek to:

(a) ensure that investors have better disclosure on the business model and operation of unlisted mortgage schemes by setting benchmarks that focus on the important characteristics of these business models;

(b) ensure that investors receive 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) ensure that the key risks are disclosed to investors by enhancing the issues upon which disclosure is required in the disclosure principles;

(d) align investors' expectations about their investment in the scheme with the ability of responsible entities to meet those expectations by requiring them to disclose against the benchmarks and apply the disclosure principles that illuminate the main features of unlisted mortgage schemes;

(e) set benchmarks and disclosure principles that are framed as clearly and simply as possible, with all benchmarks being located together and all disclosure principles being separately located from the benchmarks, to encourage consistency of information so that it is easier for investors to compare investments; and

(f) provide further guidance to responsible entities to ensure our expectations are clear regarding how to disclose against the benchmarks and apply the disclosure principles.

89 The proposed introduction of revised benchmarks in RG 45, together with separate disclosure principles, is also consistent with the approach we have taken for other types of managed investment schemes such as infrastructure funds and agribusiness schemes.

90 The proposals do not seek to:

(a) prevent schemes from failing due to poor business models and cash flow problems;

(b) require all unlisted mortgage schemes to adopt the standards represented by the benchmarks; or

(c) protect investors from investment risk.

91 As outlined in RG 45, disclosure is not designed to stop retail investors from taking investment risks, but rather to provide adequate and appropriate information to enable them to understand the risks involved in any particular investment or type of investment and to make more informed decisions.

B Options and impact analysis

92 We consider the options are:

Option 1: Update RG 45 to include revised benchmarks and separate disclosure principles, provide guidance on how disclosure should be made under those benchmarks and disclosure principles, and update ASIC's companion investor guide on unlisted mortgage schemes to reflect the changes to RG 45 (preferred option).

Option 2: Maintain the existing benchmarks in RG 45 in their present form (status quo).

Option 1: Update RG 45 to include revised benchmarks and separate disclosure principles, provide guidance on how disclosure should be made under those benchmarks and disclosure principles, and update ASIC's companion investor guide on unlisted mortgage schemes to reflect the changes to RG 45 (preferred option)

93 Under this option, we would:

(a) revise the benchmarks in RG 45 to:

(i) create clearer and simpler benchmarks focusing on important elements of the business models of unlisted mortgage schemes which highlight the fundamental risks investors need to assess to better align the expectations of investors with the key features of unlisted mortgage schemes (i.e. 'business model' type benchmarks); and

(ii) enhance the additional information under separate disclosure principles that responsible entities should address to ensure that key risks are being disclosed;

(b) provide additional guidance on how we expect responsible entities to address the 'if not, why not' benchmarks to enhance consistency of disclosure among unlisted mortgage schemes, and provide further detail on how we expect feeder funds to address the benchmarks and apply the disclosure principles at the feeder fund level; and

(c) update the investor guide *Investing in mortgage funds?* to reflect the changes to RG 45.

94 Instead of Option 1, we considered updating RG 45 to provide additional guidance on how to comply with the 'if not, why not' disclosure model and for the existing benchmarks in RG 45 to continue to apply in their present form. However, we do not consider this would adequately address ASIC's

policy objectives of ensuring investors receive better disclosure on business models and their risks in a simple and comparable format to better align an investor's expectations regarding mortgage schemes with the characteristics of those schemes.

Revised benchmarks

95 The existing benchmarks would be revised to 'business model' benchmarks that provide a standard against which schemes disclose important features of the business model of unlisted mortgage schemes so that investors can better assess the degree of risk in these types of schemes. Such an approach does not preclude a responsible entity from adopting alternative features, but it is expected that responsible entities would be more inclined to incorporate features that allow the benchmarks to be met, unless the scheme is able to better address the risk area covered by the benchmark(s) with alternative features.

96 The proposals require responsible entities to disclose against the benchmarks and, if a benchmark is not met, to explain why it is not met. In summary, the proposed benchmarks are:

(a) **liquidity**—for a pooled mortgage scheme, the responsible entity has cash flow estimates that demonstrate the scheme's capacity to meet its cash needs for the next 12 months and that are updated and approved by directors at least every three months;

(b) **scheme borrowing**—the responsible entity does not have current borrowings and does not intend to borrow on behalf of the scheme;

(c) **loan portfolio and diversification**—for a pooled mortgage scheme:

  (i) the scheme has a diversified portfolio of assets with no single asset exceeding 5%; and

  (ii) all scheme assets are secured by first mortgages over real property;

(d) **related party transactions**—the responsible entity does not lend to related parties of the responsible entity or to the scheme's investment manager;

(e) **valuation policy**—the responsible entity requires security property to be valued:

  (i) by independent professional valuers;

  (ii) on a rotational basis;

  (iii) in a manner that addresses any conflicts of interest; and

  (iv) before the issue and on renewal of a loan and where there is a risk that a decrease in the value of the security property may have caused a material breach of loan covenant;

(f) **lending principles: loan-to-valuation ratios**—the scheme does not lend more than:

(i) for property development, 70% on an 'as if complete' basis; and

(ii) in all other cases, 80% on an 'as is' basis;

(g) **distribution practices**—the responsible entity does not pay distributions from scheme borrowings;

(h) **withdrawal arrangements**—for liquid schemes, the responsible entity will:

(i) pay withdrawal requests within 90 days; and

(ii) only offer withdrawal rights if 80% of its assets is money in an account, available for withdrawal within 90 days, or the responsible entity can reasonably be expected to realise the assets for market value within 10 business days; and

(i) **withdrawal arrangements**—for non-liquid schemes, the responsible entity intends to make withdrawal offers at least quarterly.

Liquidity

97 The revised benchmark provides that the responsible entity of a pooled mortgage scheme has cash flow estimates for the scheme that:

(a) demonstrate the scheme's capacity to meet its expenses, liabilities and other cash flow needs for the next 12 months;

(b) are updated at least every three months and reflect any material changes; and

(c) are approved by the directors of the responsible entity at least every three months.

98 Under the revised benchmark, the period over which cash flow estimates for the scheme are required will effectively be extended from three months to 12 months and will be subject to directors' sign-off at least every three months. Cash flow estimates should be updated at least every three months and reflect any material changes, and be made available to ASIC upon request.

99 The revisions to the benchmark are intended to ensure that cash flow estimates are properly prepared to provide reliable information for the purposes of the responsible entity's management of the scheme's liquidity.

Scheme borrowing

100 The revised benchmark provides that a responsible entity does not have current borrowings or intend to borrow on behalf of the scheme. If there are borrowings, the benchmark will not be met and additional information about these borrowings should be disclosed.

101 Schemes that rely on borrowings are unlikely to be sustainable in the long term (particularly if these borrowings are used to fund distributions and withdrawals). Further, investors face the risk that they may lose all or part of their investment if the scheme defaults on these loans.

Loan portfolio and diversification

102 The revised benchmark provides that a pooled mortgage scheme holds a portfolio of assets that is diversified by size, borrower, class of borrower activity and geographic region, has no single asset and no single borrower that exceeds 5% of the scheme assets, and all loans made by the scheme are secured by first mortgages over real property.

103 This benchmark highlights concentration risk and would make it easier for investors to compare concentration risk in different schemes.

Related party transactions

104 The revised benchmark provides that the responsible entity does not lend to its related parties or to the scheme's investment manager. If such lending occurs, the benchmark is not met and additional information about these borrowings should be disclosed.

105 Responsible entities should have firm policies on how and when they will lend and invest funds. These policies should be consistent with the provisions of the Corporations Act and ASIC's guidance (RG 76) that govern related party transactions. Some responsible entities lend, invest scheme assets and transact with related parties. There is a risk that the interests of the related party can influence the responsible entity's decision making to the detriment of investors, particularly in the case of related party lending.

Valuation policy

106 The revised benchmark provides that the responsible entity's board requires:

(a) the valuation of scheme assets and their security property to be undertaken by an independent valuer who is a member of an appropriate professional body in the jurisdiction in which the relevant property is located;

(b) procedures for dealing with any conflict of interest;

(c) the rotation and diversity of valuers; and

(d) an independent valuation of security property for a loan to be obtained:

  (i) before the loan is issued and on renewal; and

(ii) within two months after the directors form a view that there is a likelihood that a decrease in value of the security property may have caused a material breach of a loan covenant.

107 Valuations should be conducted by qualified members of an appropriate professional body in which the security property is located. Valuers should be rotated regularly to minimise the risk of conflict, and all other possible conflicts in relation to a valuation should be addressed before a valuation is provided.

108 A valuation should be obtained before the issue of a loan, on renewal of a loan, and within two months after the directors form a view that there may be a decrease in value of the security property if the decrease is likely to have caused a material breach of a loan covenant. These trigger points are intended to require the use of current valuations when responsible entities make the important decision to lend or renew loans. Further, a decrease in the security property's value may result in a material breach of a loan covenant. It is not possible for the responsible entity to assess whether any action is appropriate without procuring an updated valuation.

109 If a responsible entity is unable to meet the benchmark, this may indicate a lack of a rigorous and transparent valuation policy. The likely consequences of this are unreliable valuations of the scheme's loan assets and underlying security properties. Further, where market conditions have deteriorated, the failure to obtain updated valuations on a timely basis means there is insufficient information to determine the extent of any impairment of loan assets and whether any material breach of loan covenants has occurred.

Lending principles: Loan-to-valuation ratios

110 The current benchmark in RG 45 will remain unchanged other than to clarify that it applies only where the scheme directly holds the assets. It provides that:

(a) the scheme does not lend more than 70% of the value of the 'as if complete' valuation of development property;

(b) the scheme does not lend more than 80% of the latest 'as is' market valuation of non-development property; and

(c) loans relating to property development are provided to the borrower in stages based on independent evidence of the progress of the development.

111 However, there will be additional disclosure under the relevant disclosure principle to enhance investor understanding of development and construction risk with unlisted mortgage schemes: see paragraph 126.

Distribution practices

112 The revised benchmark provides that a responsible entity will not pay current distributions from scheme borrowings. If distributions are paid from borrowings, the benchmark will not be met and additional information on the source of distributions and the risks associated with such a practice should be disclosed.

Withdrawal arrangements

113 The revised benchmark will distinguish between the different withdrawal arrangements that apply when the scheme is liquid and when it is not liquid.

114 For 'liquid' schemes, the revised benchmark provides that:

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

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

(c) the responsible entity only permits members to withdraw at any time upon request if at least 80% (by value) of the scheme property comprises either:

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

115 For 'non-liquid schemes, the benchmark provides that the responsible entity intends to make withdrawal offers to investors at least quarterly.

116 If a scheme holds assets that are 'liquid assets' as defined under s601KA(5) of the Corporations Act, this does not necessarily mean the scheme is in a position to offer withdrawals in all market conditions or is able to fulfil withdrawal requests on demand because the assets may not be realisable in the short term. This is particularly the case for mortgage loan assets. The effect of the proposed benchmark is that if a scheme purports to be 'liquid' and makes representations that it intends to meet investors' withdrawal requests on demand, the scheme's assets should predominantly be held as bank deposits or other assets that investors would commonly understand to be liquid assets.

117 If a responsible entity reasonably expects that the property can be realised for its market value within the period specified in the constitution for satisfying withdrawal requests (even if that period may well exceed 90 days), then while the scheme is technically 'liquid' in a statutory sense, the scheme would not meet the benchmark. In such cases, the scheme would

be more appropriately classified as 'non-liquid' for the purposes of the benchmark, and this is more consistent with the meaning of a liquid scheme as understood in a commercial sense.

118 RG 45 would also be updated to include separate disclosure principles for each of the eight areas that are addressed by the revised benchmarks. The existing benchmarks in RG 45 would effectively be delineated into two parts, being: (a) the actual benchmark based on the 'if not, why not' model; and (b) the additional information that should be disclosed. For clarity, most of this additional disclosure information is currently required by RG 45, but we consider these are better cast as 'disclosure principles' rather than as benchmarks.

Separate disclosure principles

119 As noted above, most of the information under the disclosure principles is information that is already required to be disclosed under the existing benchmarks in the current RG 45. These requirements have been moved into the separate disclosure principles section and have been supplemented with further disclosure requirements. In summary, under the disclosure principles, the responsible entity should disclose the additional risks associated with:

(a) the liquidity prospects for the scheme;

(b) debt maturities and the interest rate and foreign exchange exposure associated with scheme borrowings;

(c) second-ranking mortgages;

(d) related party transactions;

(e) the availability of key information on valuations;

(f) high maximum and weighted average loan-to-valuation ratios and development and construction loans;

(g) the consistency of frequency of payments of distributions and a sensitivity analysis for forecasts; and

(h) the right of responsible entities to suspend withdrawal rights.

Liquidity

120 Under the proposed disclosure principle, responsible entities of pooled mortgage schemes should disclose the current and future prospects of liquidity of the scheme, as well as any significant risk factors that may affect the liquidity of the scheme. The responsible entity should also disclose the policy of the scheme on balancing the maturity of its assets with the maturity of its liabilities.

Scheme borrowing

121 Under the existing RG 45, the responsible entity should disclose the amount owing and the maturity profile in increments of not more than 12 months for each borrowing that will mature in five years or less. Under the proposed disclosure principle, there will be some modifications so that for borrowings due in less than two years, additional information is required (e.g. the undrawn credit facility and whether refinancing or sale of assets is likely during this period). For borrowings due between two and five years, the undrawn credit facility will also need to be disclosed. Generally, this means that more detailed information should be provided for borrowings that will mature in five years or less.

122 In addition, the responsible entity should disclose its interest rate and foreign exchange hedging policies, and whether the scheme's interest rate and foreign exchange exposure conforms with those policies.

Loan portfolio and diversification

123 Under the disclosure principle, responsible entities of pooled mortgage schemes should disclose the percentage of loans that are secured by second-ranking mortgages, the scheme's diversification policy and how the scheme's assets correlate with that policy.

Related party transactions

124 The information that should be provided for related party transactions reflects the guidance in RG 76. The disclosure principle describes in more detail the type of information that should be provided by responsible entities.

Valuation policy

125 The disclosure principle requires responsible entities to disclose where investors may access the scheme's valuation policy, the processes that the directors will adopt to form a view on the value of security property, the frequency of valuations and any material inconsistencies between current valuations and the scheme's valuation policy.

Lending principles: Loan-to-valuation ratios

126 Responsible entities should disclose the maximum and weighted average loan-to-valuation ratios for the scheme overall as at the date of reporting, and the criteria against which funds that are lent for property development are drawn down. For development properties, responsible entities should disclose by value the percentage of the scheme's assets that are development properties, the extent to which each development property is completed and the loan-to-cost ratio of each development loan as at the date of reporting.

Distribution practices

127 Responsible entities should disclose when they will pay distributions and the frequency of payment. In addition, responsible entities should include a table identifying up to five main factors that would have the most material impact on forecast distributions, the risk to distributions if there are changes to these factors and a sensitivity analysis based on changes to these factors. It should also explain how any excess return earned by the scheme will be applied.

Withdrawal arrangements

128 The information that should be provided on withdrawal arrangements has been expanded to address a responsible entity's ability to refuse or suspend withdrawal requests and the scheme's withdrawal policy. Additional information should be provided if the responsible entity makes representations to investors about their future ability to withdraw. Further, if there are statements regarding the scheme's historical ability to satisfy withdrawal requests, a responsible entity should ensure the statements clarify that investors should not conclude that there is a link between past and future withdrawals.

Other issues

129 There are other proposed amendments to RG 45 to provide additional guidance on:

(a) how responsible entities should set out their disclosure against the benchmarks under the 'if not, why not' approach; and

(b) the location and presentation of the RG 45 disclosures in the PDS or other disclosure document.

130 To complement the proposal to revise RG 45, we will also address investor education needs by updating the existing investor guide *Investing in mortgage funds?* to reflect the revisions to RG 45.

Impact analysis

Benefits

131 Option 1 is designed to benefit investors, responsible entities, the mortgage sector of the managed investment industry and the Government by:

(a) improving disclosure addressing the characteristics of the business models of unlisted mortgage schemes;

(b) enhancing the information available for investor analysis of the risks associated with mortgage schemes through improved disclosure;

(c) better aligning investor expectations about investments in unlisted mortgage schemes with the characteristics of those schemes influencing the ability of responsible entities to meet investor expectations; and

(d) increasing consistency of disclosure without being unreasonably burdensome on responsible entities.

132 We consider that investors and the Government will benefit from the benchmarks and disclosure principles because they will improve disclosure on the characteristics of the business models of unlisted mortgage schemes and enhance the information available for investor analysis of the risks associated with them by:

(a) focusing investor attention through the benchmarks on the key characteristics of the business models of unlisted mortgage schemes that investors should be considering before investing, such as liquidity, scheme borrowings, loan portfolio diversification and security, related party transactions, loan-to-valuation ratios, distribution practices and withdrawal arrangements;

(b) requiring further disclosure about the liquidity prospects for the scheme, debt maturities, the interest rate and foreign exchange exposure associated with scheme borrowings, second-ranking mortgages, related party transactions, key information on valuations, maximum and weighted average loan-to-valuation ratios, development and construction loans, the consistency of frequency of payment of distributions, sensitivity analysis for forecasts and the right of responsible entities to suspend withdrawal rights;

(c) identifying the issues that we consider investors should consider before investing in unlisted mortgage schemes;

(d) posing the benchmarks in a way that creates an expectation for investors that an unlisted mortgage scheme would normally be expected to meet the benchmarks;

(e) requiring responsible entities to provide further explanation to investors on why the unlisted mortgage scheme has not met a benchmark; and

(f) requiring less resources to address investor complaints arising from investors not understanding these products, and the risks associated with them, or the product not performing in accordance with their expectations.

133 We believe that investors, responsible entities, the mortgage sector of the managed investment industry and the Government will benefit from investor expectations about investments in unlisted mortgage schemes being better aligned with the characteristics of those schemes. This will influence the ability of responsible entities to meet investor expectations by:

(a) encouraging responsible entities to prepare cash flows for 12 months which are updated at least every three months and reflect material changes, and are subject to directors' sign-off at least every three months, to promote better management of, and more accurate representations by responsible entities in relation to, scheme liquidity because:

(i) directors of responsible entities should have rigorously tested and satisfied themselves and their auditors that the scheme is capable of meeting its liabilities and other obligations over the next 12 months;

(ii) cash flow estimates signed off by directors are likely to have been prepared with care and diligence and be more accurate, providing management with a more effective decision-making tool;

(iii) for those responsible entities not currently preparing 12-month cash flow estimates, responsible entities will be better placed to detect cash shortfalls earlier, providing greater time to address those shortfalls; and

(iv) the extension of the period of the cash flow estimates from three months to 12 months should provide the responsible entity with sufficient notice to better address cash flow problems should they arise;

(b) encouraging responsible entities to adopt business models with characteristics and practices that are more sustainable and better reflect the assets of unlisted mortgage schemes, such as:

(i) the responsible entity preparing cash flow estimates that demonstrate the scheme's capacity to meet its cash needs, including anticipated withdrawals, for 12 months;

(ii) the responsible entity not borrowing on behalf of the scheme to fund payment of withdrawals or distributions; and

(iii) the responsible entity only marketing a scheme as liquid, and therefore creating at-call withdrawal expectations for investors if withdrawal requests will be paid within 90 days and:

(A) 80% of the scheme's assets is money in an account, available for withdrawal within 90 days or the responsible entity can reasonably be expected to realise the assets for market value within 10 business days; and

(B) for non-liquid schemes, the responsible entity making withdrawals available at least quarterly;

(c) discouraging responsible entities from adopting more risky lending practices, by requiring disclosure if:

(i) a scheme's assets are not diversified, any loan exceeds 5% or any loan is not secured by a first mortgage;

(ii) a responsible entity lends to related parties;

(iii) a scheme's valuation practices do not provide for independent valuations by professional valuers, on a rotational basis, in a manner that addresses any conflicts of interest before the issue or a renewal of a loan or where there is a risk that a decrease in the value of the secured property may have caused a material breach of a loan covenant; and

(iv) a scheme lends more than, for development, 70% on an 'as if complete' basis and in all other cases, 80% on an 'as is' basis; and

(d) the benchmarks and disclosure principles may encourage responsible entities to structure their products so that they can meet the benchmarks.

134 We consider that investors, responsible entities, the unlisted mortgage sector of the managed investment industry and the Government will benefit from the benchmarks and disclosure principles because:

(a) investors will have improved disclosure to assist them to better understand the characteristics of the business models of unlisted mortgage schemes;

(b) investors will have more focused disclosure to assist them to more easily identify and assess the risks associated with unlisted mortgage schemes;

(c) there will be enhanced disclosure to encourage better alignment between the expectations of investors regarding withdrawal rights and the capacity of responsible entities to meet those expectations because responsible entities will be required to disclose, in relation to schemes that they want to market as liquid, if the responsible entity has longer than 90 days to pay withdrawals or if 80% of their assets are not in cash, fixed term deposits of less than 90 days, or other assets which the responsible entity expects to be able to realise within 10 business days;

(d) additional disclosure will assist investors to identify those schemes that adopt unsustainable borrowing and distribution practices or have high concentration risk and to more easily compare the business models and risks of different schemes in the sector; and

(e) the benchmark for valuations requiring responsible entities to disclose if their valuation policy is not consistent with the benchmark will provide investors with disclosure designed to assist investors to better assess the reliability and currency of the valuations of the scheme's security properties, the value of the scheme's loan assets and the extent to which they may be impaired.

135 We consider that additional guidance for responsible entities regarding how to disclose against the benchmarks will benefit investors, responsible entities and the Government because:

(a) ASIC will have provided additional guidance to responsible entities regarding our expectations concerning disclosure;

(b) disclosure against the benchmark should reflect ASIC's further guidance resulting in more consistent disclosure to investors; and

(c) ASIC will require less resources to supervise compliance with the regulatory guide if our intentions are more clear.

Costs

136 Responsible entities and investors may incur costs as a consequence of the revisions to RG 45.

137 ASIC considers the costs that may be incurred by responsible entities and investors are:

(a) In relation to restructuring, there are unknown costs for responsible entities that choose to modify their business models, change the features of their schemes, review the borrowing arrangements and amend constitutional provisions to meet the benchmarks. Industry were given an opportunity to, but did not, provide overall estimates of these costs. Costs such as legal and financing may be incurred to restructure schemes' operations. As compliance with the benchmarks is not mandatory, it is uncertain what the total costs to industry might be. The cost will vary from scheme to scheme depending on such factors as the scheme's current disclosure, complexity of the scheme's existing arrangements, the scheme's total funds and financial position, the availability of scheme assets to pay down debt and the number of members. Schemes are more likely to restructure to meet the benchmarks where the responsible entity considers that they will be able to attract new investors to the mortgage scheme. Schemes are unlikely to restructure, for example, where the responsible entity determines that current disclosure substantially addresses the updated disclosure requirements or it is in the best interest of investors to wind up the scheme, rather than restructure. An example of when a responsible entity may choose to wind down, rather than restructure, is where the scheme cannot meet the benchmark for liquidity, but the majority of investors seek liquidity.

(b) In relation to mortgage schemes that choose to restructure to meet the benchmarks, resulting in schemes currently technically liquid no longer offering at-call withdrawal, investors will not incur any cost if they remain in the scheme but may incur an unknown opportunity cost of no longer having access to at-call withdrawals in those schemes. Investors may also incur minor administrative costs associated with switching

products, such as the time to complete withdrawal applications and applications for new units for alternative products. An investor's capacity to withdraw will depend on the availability of cash in the scheme to meet the withdrawal request.

(c) In relation to schemes that choose not to restructure to meet the benchmarks, responsible entities may incur an opportunity cost of lost fees if investors choose to exit from these schemes and the responsible entity determines to wind down the scheme because it is no longer in demand. A responsible entity would typically be entitled to a base fee of 1–2% of funds under management. For example, if a responsible entity with $100 million in funds under management in one scheme wound up that scheme, they would lose between $1 million and $2 million in fees. Restructuring and winding down is already occurring in the mortgage sector as responsible entities acknowledge that there is a reduced appetite for these schemes in the market as a consequence of their freezing after the global financial crisis. Investor money withdrawn from unlisted mortgage schemes is most likely to be alternatively invested in bank deposits or listed securities.

(d) In relation to any schemes for which the responsible entity determines to restructure to meet the benchmarks or wind down, investors may incur minor costs associated with restructuring or winding down schemes, including costs associated with liquefying, recovering or selling assets such as legal, accounting and brokering costs. The cost will vary depending on the structure and assets of the scheme depending on such factors as the complexity of the scheme's existing arrangements, the scheme's total funds and financial position, and the number of members. These costs could be as low as a few thousand or as high as a million dollars, depending on the circumstances.

(e) In relation to disclosure and advertising, responsible entities may incur minor costs in updating PDSs, advertising and ongoing disclosure to address the benchmarks and disclosure principles in these disclosure documents. For example, if a Senior Associate in a large law firm spent one week to amend the disclosure documents, an estimated cost would be $24,000 (40 hours × $600 per hour). The transition period will mitigate some of these costs—for example, advertising will not need to be immediately changed and is not ordinarily booked far in advance.

(f) In relation to cash flow estimates, responsible entities of pooled mortgage schemes may incur unknown costs associated with:

(i) responsible entities extending the cash flow estimates from three months to 12 months. This will involve responsible entities extending their current analysis and projection of revenues, expenses and cash needs over the longer period. The requirement to extend cash flow estimates to 12 months is not expected to add significant costs for responsible entities. Some respondents

indicated that such estimates were already being produced for internal management purposes; and

(ii) the period for the cash flow estimates being extended from three months to 12 months.

(g) In relation to valuations, responsible entities may incur minor costs to procure additional valuations where there is a decrease in the value of security property. The need for these valuations depends on various factors, including whether a decrease in value may cause a material breach of loan covenant. Some respondents indicated that the costs of additional valuations will be borne either by borrowers or members of the fund in the form of lower distributions, but did not provide figures on the expected costs.

(h) ASIC may also incur costs associated with monitoring compliance with the revised requirements, estimated as the equivalent of a quarter of a full-time equivalent (estimated to cost between $25,000 and $30,000).

Summary of analysis

138 We consider the benefits to investors, responsible entities, the mortgage sector of the managed investment industry and the Government include:

(a) improved disclosure to investors regarding the characteristics of the business models of unlisted mortgage schemes;

(b) providing more focused disclosure to investors to assist them to analyse the risks associated with mortgage schemes,

(c) enhancing disclosure to encourage better alignment between investor expectations about investments in unlisted mortgage schemes and the characteristics of those schemes; and

(d) influencing the ability of responsible entities to meet investor expectations and increasing consistency of disclosure without being unreasonably burdensome on responsible entities.

139 These benefits outweigh the potential costs to responsible entities in restructuring, in loss of fees for any schemes that are wound down, in updating disclosure and advertising, in preparing and having cash flow estimates for 12 months and in preparing more frequent valuations and any potential costs to investors resulting from responsible entities passing on their additional costs to investors or in investors losing the at-call opportunity to withdraw from schemes which are currently technically liquid but which would not meet the benchmark. In the absence of information from industry to the contrary, we do not anticipate that the recommended option will result in significant additional costs for responsible entities or investors.

Option 2: Maintain the existing benchmarks in RG 45 in their present form (status quo)

140 Under this option, the existing RG 45 and investor guide would remain unchanged.

Impact analysis

Benefits

141 In the short term, this option avoids new direct costs on responsible entities or investors, because existing disclosures do not need to be updated (other than as required under the existing RG 45). To the extent that responsible entities have not satisfied the existing benchmark disclosure requirements under RG 45, ASIC could take action on a case-by-case basis against responsible entities.

Costs

142 We consider that providing guidance on the existing benchmark disclosures is an incomplete answer to the issues identified during our disclosure review and the different environment in which the sector now operates. The cost of continuing with the existing benchmarks include:

(a) insufficient information being available to investors about the characteristics of the business models of unlisted mortgage schemes;

(b) incomplete identification and analysis of the risks associated with unlisted mortgage schemes;

(c) continued misalignment of investor expectations about investments in unlisted mortgage schemes with the characteristics of those schemes influencing the ability of responsible entities to meet investor expectations;

(d) reduced investor appetite for investing in the unlisted mortgage sector of the managed investment industry resulting in investors seeking to withdraw their investments and there being a loss of alternative sources of finance for certain borrowers, such as developers; and

(e) increased cost to Government in addressing continued investor complaints, increased applications for relief from the provisions of the Corporations Act, parliamentary inquiries concerning these unlisted mortgage schemes. For example, since mortgage schemes were frozen in 2008, ASIC has, in relation to frozen funds, dealt with approximately 180 applications for relief at an estimated cost of $200,000 and 350 complaints at an estimated cost of $110,000. ASIC has also spent significant amounts of time responding to parliamentary inquiries liaising with, and supervising, industry participants, communicating

with the media and keeping investors updated by way of our website and information releases to the public.

143 In addition, we may incur costs associated with taking action on a case-by-case basis to enforce compliance with RG 45.

Summary of analysis

144 In summary, we consider the costs significantly outweigh the benefits of this option.

C Consultation

145 In October 2010, we published Consultation Paper 141 *Mortgage schemes: Strengthening the disclosure benchmarks* (CP 141), which set out our proposed revisions to the eight benchmarks in RG 45. We also proposed to clarify our expectations in regards to compliance by feeder funds with RG 45 and, more generally, how the benchmark disclosures should be made in accordance with the 'if not, why not' approach.

146 We invited submissions on our proposed revisions to the benchmarks. The formal consultation period ended on 26 November 2010. We received eight written submissions from stakeholders, including responsible entities of mortgage schemes, an industry association, a consumer agency, a rating agency and legal representatives of mortgage scheme operators. After reviewing the written submissions, we met with the main industry association (the Financial Services Council), two responsible entities and a law firm representing over 10 separate responsible entities. Most of the submissions were generally supportive of the proposed revisions. Our report *Response to submissions on CP 141 Mortgage schemes: Strengthening the disclosure benchmarks* (REP 285) provides detailed information about the responses to CP 141 and outlines our responses to the feedback.

147 The main issues raised by respondents related to:

(a) whether the benchmarks should be updated;

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

(c) whether the introduction of a 70% loan-to-valuation ratio threshold for property development loans was inconsistent with industry norms and that an 'as is' basis for valuation would not be appropriate and would be costly for development property;

(d) the inconsistency between the definition of a 'liquid' scheme in the Corporations Act and the proposed Benchmark 8 concerning withdrawals; and

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

148 Our response to the issues raised include:

(a) We consider that there is a reasonable case for updating the benchmarks and disclosure requirements to improve disclosure to investors about the characteristics of the business models of unlisted mortgage schemes, to provide more focused disclosure to enable enhanced investor identification and analysis of the risks associated with unlisted

mortgage schemes, better align investor expectations about investments in unlisted mortgage schemes with the characteristics of those schemes influencing the ability of responsible entities to meet investor expectations and increase consistency of disclosure. One industry association queried whether the benchmarks should be updated, or if the issue is about compliance with the 'if not, why not' approach. We consider the revised RG 45 provides further clarity around ASIC's expectations regarding disclosure through the benchmarks and disclosure principles to address and clarify the business model and risks associated with mortgage schemes, and also provides further clarity concerning how ASIC's expectations might be addressed through compliance with the 'if not, why not' approach.

(b) In relation to Benchmark 1, 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. We have clarified that cash flow estimates do not need to be disclosed, but do need to be signed off by directors. We maintain that cash flow estimates are an important risk management tool that should be robustly reviewed by directors.

(c) In relation to Benchmark 2, we have clarified, as requested, the term 'borrowings' by limiting it to current borrowings and current intentions to borrow on behalf of the scheme.

(d) In relation to Benchmark 3, we have adopted suggestions to reduce the threshold relating to the concentration risk from 10% to 5% of the scheme assets.

(e) In relation to Benchmark 4, we have adopted a suggestion for the benchmark to cover loans to the scheme's investment manager. For consistency with RG 76, we have also clarified the details of the related party transactions that should be disclosed. We received one submission querying whether the disclosures of details of related party transactions might be in breach of commercial confidentiality. We note, however, the current RG 45 already provides for disclosure of these details and no changes are proposed under the revised RG 45.

(f) In relation to Benchmark 5, we have amended the benchmark on valuation policy in response to concerns that 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 a loan covenant.

(g) In relation to Benchmark 6, 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. Some concern has been expressed that the benchmarks and additional disclosure did not sufficiently distinguish the risk associated with development and construction loans from other loans. To address this, we have included in relation to property development and construction loans:

(i) the requirement to disclose the percentage of scheme assets in development and construction loans;

(ii) the requirement to disclose, in relation to each loan, the percentage the loan and/or the amount drawn down on the loan represents against the cost of the secured asset (e.g. the cost of the land plus the cost of construction); and

(iii) guidance for mortgage schemes with development and construction loans exceeding a threshold (e.g. 20%) that they should identify the scheme as a development and/or construction mortgage scheme in the name of the scheme.

(h) In relation to Benchmark 7, we have clarified that the responsible entity will not pay current distributions from scheme borrowings. This benchmark previously required disclosure as to the source of distributions.

(i) In relation to Benchmark 8, the time period for the realisation of assets remains at 10 business days 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.

(j) In relation to feeder funds, we have provided further guidance to responsible entities on how they can meet the benchmark and apply the disclosure principles.

149 Other than in relation to related party transactions, as noted above, respondents did not express any concerns, on the grounds of commercial confidentiality, that the revised benchmarks would affect their ability or willingness to disclose the required information. We also note that, as with the current RG 45, if responsible entities fail to meet one or more of the revised benchmarks, this does not necessarily mean that a particular scheme is a bad investment, but it would mean that investors are provided with information as to why the scheme cannot meet the benchmark.

D Conclusion and recommended option

150 ASIC recommends Option 1 because it addresses the identified problems and achieves our objectives. On the basis of the evidence provided, ASIC concludes that the benefits are likely to outweigh the costs, but such a conclusion is tentative given the difficulty in obtaining objective quantitative evidence.

151 ASIC considers Option 1 achieves ASIC's objectives because it:

(a) will ensure that investors have better disclosure on the business model and operation of unlisted mortgage schemes by setting benchmarks that focus on the characteristics that are critical for investors to be aware of and assess;

(b) will ensure that investors have access to information to provide a clearer appreciation 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) identifies the key risks for disclosure to investors by enhancing the issues upon which disclosure is required in the disclosure principles;

(d) aligns investors' expectations about their investment in schemes with the ability of responsible entities to meet those expectations by requiring responsible entities to disclose against the benchmarks and apply the disclosure principles that illuminate the main features of unlisted mortgage schemes;

(e) sets benchmarks and disclosure principles that are framed as clearly and simply as possible, with all benchmarks being located together and all disclosure principles being separately located from the benchmarks, to encourage consistency of information being provided by responsible entities so that it is easier for investors to compare investments; and

(f) provides further guidance to responsible entities to ensure our expectations are clear regarding how to disclose against the benchmarks and apply the disclosure principles.

152 ASIC concludes that the benefit to investors, responsible entities, the mortgage sector of the managed investment industry and the Government flowing from improving disclosure to investors about the characteristics of the business models of unlisted mortgage schemes, enhancing the information available to make it easier for investors to identify and analyse the risks associated with mortgage schemes, better aligning investor expectations about investments in unlisted mortgage schemes with the characteristics of those schemes influencing the ability of responsible entities to meet investor expectations and increasing consistency of disclosure outweigh the potential costs to responsible entities in restructuring, in loss of

fees for any schemes that are wound down, in updating disclosure and advertising, in preparing and having cash flow estimates for 12 months and in preparing more frequent valuations, and any potential costs to investors resulting from responsible entities passing on their additional costs to investors or from investors losing the at-call opportunity to withdraw from schemes which are currently technically liquid but which would not meet the revised benchmark.

153 On this basis, ASIC recommends Option 1.

E Implementation and review

Implementation

154 Our recommendations in Section D would be implemented by updating RG 45 and revising our investor guide to reflect the proposals. The revised RG 45 and investor guide are expected to be published around early May 2012.

155 The unlisted mortgage scheme sector has participated actively in consultations on CP 141 and has been aware that it will be necessary to revise its disclosures under the proposed changes.

156 Existing fundraising documents that are still in use should include the updated disclosure against the revised benchmarks and the information outlined in the disclosure principles, or provide the disclosure from 1 January 2013.

157 Fundraising documents for new mortgage schemes should provide the revised benchmark and disclosure principle information from 1 January 2013.

Review

158 We will review a selection of fundraising documents and updated investor disclosure from 1 January 2013 (as they become publicly available) over a period of six months. This review will check that the benchmark information has been adequately disclosed to investors on an ‘if not, why not’ basis and that the responsible entity has included the disclosure principle information.

159 Over this period, we will also:

(a) work with responsible entities to ensure that the benchmarks, disclosure principles and our disclosure expectations are understood;

(b) discuss with responsible entities any concerns we have with their disclosure and, where necessary, seek additional disclosure from them (e.g. about the practical impact of not disclosing against a particular benchmark or applying the disclosure principles, and the associated risks for investors); and

(c) conduct surveillance visits, as needed, to reinforce our expectations.

160 We can use stop order powers if we consider that a PDS does not comply with the content requirements. We will continue to monitor fundraising documents on an ongoing basis as part of our business-as-usual activities.

ASIC guidance

161 Our proposed policy will be implemented by publishing the following documents:

(a) a revised regulatory guide RG 45;

(b) an updated investor guide; and

(c) a report on submissions received in response to CP 141 (see REP 285).