



FINANCIAL  
SERVICES  
INSTITUTE  
*of Australasia*

28 March 2013

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To whom it may concern,

**Response to Consultation Paper 199 - *Debentures: Reform to strengthen regulation***

Finsia represents 16,000 members from corporate finance & wholesale banking, financial markets, managed funds & superannuation, private wealth management and retail banking, and has a long history of contributing to higher standards of professionalism among industry participants.

Finsia appreciates the opportunity to respond to consultation paper 199 that outlines a number of proposals to strengthen the regulation of the debenture sector, including introducing minimum capital and liquidity requirements. Feedback has been provided under each relevant question below.

**B1Q1 Do you consider that our proposed definition of 'retail debenture issuing lenders' appropriately describes debenture issuers who offer products that have similar characteristics to deposits offered by ADIs (but are not ADIs) and are engaged in lending?**

Yes, Finsia believes the proposed definition is an accurate description. However, it could be clarified as to whether it is intended to apply to issuers who raise capital by issuing debentures under an 'excluded offer'. That is, those issuers who may raise capital predominantly through wholesale clients but may use the small scale offering exemption in section 708(1) of the Corporations Act, for example, to raise up to \$2 million from up to 20 retail clients in any 12 month period.

If not, the definition might be reworded to say (in part) as follows:

"We propose that mandatory capital and liquidity requirements should apply to an entity (issuer) that borrows or has borrowed money from retail clients through the issue of debentures under an offer that needs disclosure under Chapter 6D of the Corporations Act where those funds are ultimately used:"

**B1Q2 Do you think that our definition of 'retail debenture issuing lenders' is too wide or too narrow, and if so, why? Specifically, should limb (a) of our definition be narrowed to apply only to debenture issuers who provide finance or other advances of money to persons or entities outside the issuer's group for property-related lending, development or investment?**

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The definition is not too wide. There are finance companies that provide car loans and personal loans that issue debentures. So we would not suggest narrowing limb (a).

**B1Q3 Are there any other debenture issuers who should comply with the proposed capital and liquidity requirements but who would not come within our proposed definition?**

Finsia believes consideration should be given to applying the same financial requirements to entities that operate a similar business model to retail debenture issuers but which use a different legal structure i.e. mortgage unit trusts. We acknowledge that the size of that market is contracting and that ASIC has only recently implemented new financial requirements for responsible entities of registered managed investment schemes including trustees of mortgage trusts. However, for the sake of consistency, consideration should be given to applying the requirements across financial product issuers with different legal structures but similar business models.

**B1Q4 Are there any debenture issuers within the definition who should not be subject to our proposed capital and liquidity requirements? If so, please identify the type of issuers and why you do not think they should be subject to capital and liquidity requirements.**

Please refer to our response to B1Q1.

**B2Q1 Do you agree that retail debenture issuing lenders should be subject to minimum capital requirements?**

Finsia believes that in order to be consistent across the retail capital raising sector, debenture issuers should meet minimum capital requirements.

**B2Q2 If so, is the proposed capital requirement of 8% of risk-weighted assets high enough to reflect industry risk and the fact that debenture issuers will not be subject to prudential supervision?**

Yes, an 8% minimum capital requirement reflects a Basel I level and accounts for impairment.

**B2Q3 Do you agree with the proposal for calculating the capital ratio (i.e. capital base minus deductions divided by total risk-weighted assets)?**

Yes

**B2Q4 Do you agree with the proposed concept of 'capital base' and its inclusions?**

Yes

**B2Q5 Do you agree with the proposed concept of 'deductions', which reduce the capital base?**

Yes

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**B2Q6 Are there any other obligations that should apply to an issuer to ensure that the calculations (e.g. of the issuer's assets) are appropriate and accurate?**

Finsia believes that annual audits of the minimum capital requirements would provide a level of independent supervision. We currently have an audit of the net tangible asset (NTA) calculation for responsible entities and so we suggest this amount be also subject to audit.

**B2Q7 Should the fact that debenture holders may have a security interest over particular assets of the issuer be taken into account when imposing the proposed capital requirements and, if so, how?**

We do not believe this should affect the capital requirement because any charge is only likely to crystallize once the business has failed.

**B2Q8 What changes to the operations of issuers will occur if these capital requirements are implemented?**

We believe it will lead to a reduction in lending.

**B2Q9 Will issuers have any practical difficulties in meeting and maintaining our minimum capital requirements? Please estimate the likely cost.**

Finsia believes well managed issuers are highly likely to be already able to reach this level of capitalisation. A difficulty may arise with the cost of implementing a system to calculate RWAs, and monitoring this ratio.

**B3Q1 Do you agree that ASIC should be given this power? Why or why not?**

Yes. Not all issuer's business models will have the same risk setting and so providing ASIC with the flexibility to lower or raise the amount is prudent.

**B3Q2 If there is a discretionary power, what kind of circumstances should be considered in deciding whether to raise or lower the capital requirement?**

The nature of the lending being undertaken and whether the loans are being made on arm's length terms to unrelated borrowers.

**B4Q1 Do you have any comments on our general approach to risk weighting assets?**

We agree with your general approach as it aligns risk for investor and capital contribution requirement.

**B4Q4 Is there any common asset category that we have not identified? If so, what would be the appropriate risk weighting for that asset?**

Asset Finance secured by autos or 'yellow goods'. The appropriate risk weighting would be 100%.

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**B4Q5 Are there any other obligations (e.g. audit or other review requirements) that should apply to an issuer to ensure that the calculations (e.g. of the issuer's assets) are appropriate and accurate?**

Please refer to our response to B2Q6.

**B4Q6 What changes to the operations of issuers will occur if these capital requirements are implemented? Are there practical difficulties for issuers in maintaining the minimum capital requirement?**

Please refer to our response to B2Q9.

**B4Q7 Some of our risk weightings are conservative, given the absence of prudential supervision in the debenture sector. Do you agree with this approach?**

Given the history of retail losses in recent years, Finsia agrees with this approach.

**B4Q8 Do you consider that the risk weighting for assets that relate to property development activities is high enough? If not, how high should it be?**

The risk weighting has been set at three times the weight of residential mortgages which Finsia agrees is high enough.

**B5Q1 Do you agree with the general concept that retail debenture issuing lenders should maintain a minimum holding of 9% of their liabilities in high-quality liquid assets at all times?**

Yes

**B5Q2 Do you agree with the definitions of 'liabilities', 'capital base', 'deductions' and 'high-quality liquid assets'?**

Yes

**B5Q3 What changes to the operations of issuers will occur if these liquidity requirements are implemented?**

Finsia believes the proposed liquidity requirements will result in a reduction to issuers lending books. We are not in a position to quantify this reduction.

**B6Q1 Are our proposed monitoring requirements appropriate? If not, what other monitoring do you suggest?**

Yes, Finsia believes the proposed monitoring requirements are appropriate.

**B6Q3 Do you agree that the obligation for the issuer to carry on and conduct its business in a fair and efficient manner is sufficient to ensure that issuers are required to monitor the capital and liquidity requirements? If not, what specific obligations should be imposed on issuers for monitoring these requirements?**

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Yes

**B6Q4 Should there be more explicit rules around valuations of assets applicable to retail debenture issuing lenders?**

Finsia does not believe this is necessary. Generally accepted accounting principles should apply.

**B7Q1 Do you agree that trustees should have responsibility for supervising debenture issuers' compliance with the minimum capital and liquidity requirements?**

No, Finsia believes this should be the regulator's role so the risk of commercial conflicts is mitigated. It can also depend on the structure - an issuer who has a related party as Trustee should not be authorised to rely on that Trustee.

**B7Q3 Do you agree that issuers should not be able to raise further funds if they do not comply with the capital and liquidity requirements? Is the correct time to test this at the time that the funds are accepted, or another time? Why?**

Yes, Finsia agrees that issuers should not be able to raise further funds if they do not comply with the capital and liquidity requirements and the correct time to test this is at the time that the funds are accepted.

**B7Q4 Should a breach of capital and/or liquidity requirements automatically trigger an event of default power by the trustee, an automatic winding up of the company, court action by the trustee or ASIC, or some other action? If so, should any proposed trigger event be legislated or left as a matter for the trustee?**

Finsia believes that it should trigger the requirement to report the breach to ASIC where it is significant and the issuer should have a time period to correct the deficiency except where the deficiency is more than minor.

**B7Q5 To what extent should directors be held liable for a breach of capital or liquidity requirements?**

There are sufficient existing mechanisms under the law to prosecute directors for corporate failures. We do not consider additional liability provisions should be imposed.

**B7Q6 Do you think there should be any other consequences if the capital and liquidity requirements are not met? If so, please specify what consequences would be desirable.**

A 'stop issuance' should be sufficient in first instance.

**B8Q1 Are there any other reforms that should be introduced to strengthen the financial position of retail debenture issuing lenders?**

A brief quarterly financial update of assets, liabilities, capital, liquidity and arrears would be worthwhile. This could be lodged with ASIC and on the issuer's website.

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**B8Q4 What impact do you think the proposed standards would have on the structure of the retail debenture issuing lender sector and the number of entities in this sector?**

The sector is reducing the number of issuers, and Finsia believes that will likely continue.

**B9Q1 Do you consider the proposed transitional arrangements are appropriate? If not, what transitional arrangements would be adequate?**

Yes

**C1Q1 Will trustees have any practical issues with formally forming an opinion on the issuer's financial position, performance and viability?**

For this type of prudential supervision, Finsia anticipates that trustees will have to recruit staff with experience in the business being conducted by the issuer. If this were to occur, then this movement towards prudential supervision will increase costs to the issuer and reduce competition in the market as trustees withdraw. Increased costs may then also force issuers out of the market, reducing competition and liquidity in the debt market.

**C1Q2 We are proposing that trustees should perform this assessment at least quarterly, and more often if the issuer's financial position requires more frequent monitoring. Is this frequency appropriate? If not, what frequency would be appropriate?**

The professional investors in the securitization market often receive monthly data. We would propose that quarterly is sufficient, unless some breach has occurred (refer B7Q6) then monthly monitoring for a period would be appropriate.

**C1Q3 Should trustees' reporting obligations be explicitly set out in legislation, or would you consider guidance to be more appropriate, and why.**

Yes, Finsia believes the trustee's role needs to be clear.

**C1Q4 Do you consider that trustees should communicate their opinion to ASIC, the issuer and the issuer's auditor?**

If trustees are to become quasi-prudential regulators, then they should report to ASIC.

**C1Q5 We are not proposing that trustees should communicate their opinion on the issuer's financial position, performance and viability to debenture holders. Do you agree with this approach?**

As the trustee is appointed for the debenture holders, investors should be the primary recipients of this opinion.

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**C1Q6 Are trustees' current obligations sufficient to ensure that they are obliged to take appropriate action if the information they receive indicates concerns with the issuer's financial position, performance and viability?**

The substantive obligations sit within the trust deed rather than the law. Finsia believes the content requirements for trust deeds in s.283AB are insufficient.

**C2Q1 Do you consider that trustees will benefit from some specific indication in the law, or through guidance, about what is involved in assessing the issuer's financial position, performance and viability (proposal C1)?**

Yes

**C2Q2 Do you agree with proposal C2 (i.e. our indication of what the trustee's duty to assess the issuer's financial position, performance and viability would involve)? If not, what do you consider that regularly assessing an issuer's financial position, performance and viability would involve?**

Yes

**C3Q1 Do you consider that requiring trustees to exercise reasonable diligence to ensure that material information in the issuer's prospectus is correct and current will help retail investors make informed investment decisions?**

Yes, Finsia believes it will. We expect that trustees would then also be concurrently liable with issuers for the content of the prospectus and would force most trustees out of the market were it to be introduced.

**C3Q2 Will the proposed obligation be onerous for trustees? Please estimate the likely cost.**

Yes. We would expect that most trustees would exit the market.

**C3Q3 Should the legislation provide that trustees have a defence to liability if the material information is not correct and current? If so, should it be modelled on Ch 6D defences of reasonable diligence and reasonable reliance?**

As trustees are being asked to perform the same functions as the company in terms of due diligence, then they should have the same defences. In any event, Finsia believes this is likely to be a moot point because we cannot foresee that any trustee would accept this commercial risk – that is, to be responsible for some other entity's disclosure document.

**C3Q4 Will trustees have sufficient powers and access to information to carry out this role (taking into account our other proposals at C5–C7)?**

They would need to be able to access the company's books, records and staff leading up to the issue of a disclosure document.

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**C4Q1 Do you agree that the law should require trustees to monitor whether the issuer has adequate resources to meet their obligations to debenture holders?**

Finsia believes It is enough that they monitor ongoing compliance with the capital and liquidity requirements.

**C4Q2 Should the law or guidance specify what adequate resources are required for different businesses, or is this better assessed by the trustee on a case-by-case basis?**

Yes

**C4Q3 Should the debenture issuer be required to demonstrate to the trustee on a regular basis that its management, including directors, has sufficient experience and skills to manage the issuer's business?**

No, we don't believe this is necessary.

**C4Q4 Should the law or guidance prescribe the types of experience, skills and qualifications held by the issuer's key personnel (e.g. directors)?**

No, we don't believe this is necessary.

**C4Q5 Do any additional obligations need to be imposed on the issuer to have adequate resources, or is the obligation in s283BB(a) sufficient?**

No, it is insufficient. Further guidance is required.

**C5Q1 What limitations, if any, should there be on the type of information that the trustee can request? Please estimate the likely cost for issuers.**

If the trustee is to be obligated to do the things proposed in the consultation paper, then it should have full access of information.

**C5Q2 Do you agree that the debenture issuer should provide information to the trustee within a reasonable period of time?**

Yes

**C5Q3 It has been suggested that trustees should have a role in the appointment of the issuer's auditor. Do you agree? For example, should the trustee have the power to veto new appointments? If so, should this power only apply in the case of retail debenture issuing lenders?**

If the proposals in the consultation paper are adopted, then the role of the auditor will be almost redundant. Given the trustee is going to be accountable for the operation of the business, then it would seem fair for it to have a role in the appointment of the auditor.

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**C6Q1 Do you agree with the application of the proposals?**

Yes, Finsia believes the application of proposals is reasonable.

**C7Q1 Do you agree that the proposed amendments to the trustee's role and powers should have a transition period of 12 months? If not, what transition period do you recommend and why?**

We believe the proposed amendments to the trustee's role and powers should have a transition period of 12 months minimum.

**D1Q1 Do you agree that the auditor should be required to directly report to and communicate with the trustee? Will this help trustees to better exercise their powers and perform their duties?**

Yes

**D1Q2 Will this proposal better focus the auditor's attention on the role the auditor plays in relation to the debenture holders?**

Yes

**D1Q5 Do you think that auditors should have any positive obligations to make inquiries or produce reports, other than those currently required under the Corporations Act or proposed above?**

No, we believe the current auditing requirements are appropriate.

**D2Q1 Do you agree that this requirement should apply to the debenture sector generally, or should it only apply to retail debenture issuing lenders?**

We believe that it should only apply to retail issuers only.

**D3Q1 Do you agree that a transition period of 12 months after the next end of financial year will be sufficient? If not, what transition period would be appropriate?**

Finsia believes these are fundamental changes to the nature of the industry and recommend a transition period of 24 months.

**E1Q1 Do you agree that retail investors need a prospectus before deciding whether or not to leave their funds invested or make a further investment with a retail debenture issuing lender? If not, would a reduced form of disclosure be appropriate?**

We believe a short form disclosure should be sufficient. The investor will already know about the issuer and the type of security. Any further disclosure should simply be about the loan book and the company's financial health.

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**E1Q2 We are proposing that only retail debenture issuing lenders should be required to give a prospectus to existing retail investors. Do you consider this proposal should apply to all debenture issuers?**

No

**E1Q3 Will this requirement be onerous for debenture issuers? If so, please estimate the likely cost.**

If the issuers are continuously raising capital, then they will have a prospectus on issue at all times. The costs, therefore, should be minimal.

**E1Q4 Should investors have to take some action to roll over their debenture investments (rather than rollovers happening automatically if they do not take action)?**

Yes, Finsia believes it should be appropriate that investors be asked to re-confirm their investment for the next term.

**E1Q5 Regulatory Guide 198 Unlisted disclosing entities: Continuous disclosure obligations (RG 198) recommends and facilitates unlisted debenture issuers putting their continuous disclosure notices on their website (as a matter of good practice). Should this be a legal requirement for retail debenture issuing lenders? Should this obligation apply more broadly to all debenture issuers?**

No, Finsia believes the current requirements/guidelines are sufficient.

**E2Q1 Do you agree with this 12-month transition period for the proposed amendment to s708(14)? If not, what transition period do you recommend and why?**

Yes, Finsia believes the 12-month transition period is appropriate.

Finsia is grateful for this opportunity to respond and is willing to be involved in any further consultations on these matters. If you have any further questions please contact Samuel Bell, Senior Policy Advisor on (02) 9275 7953 or email [s.bell@finsia.com](mailto:s.bell@finsia.com).

Yours sincerely,



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