The unlisted unrated debentures market

Following the collapse of several issuers of unlisted unrated debentures in early 2007, ASIC established benchmarks for disclosure and advertising, and an 'if not why not' approach for issuers of these debentures to retail investors. These measures are intended to help retail investors make informed decisions about unlisted unrated debentures while maintaining the essential framework of the market.

ALEX ERSKINE is Chief Economist, Australian Securities and Investments Commission (ASIC).[1]
Email: alex.erskine@asic.gov.au

THIS PAPER PROVIDES an economic analysis of recent developments in the unlisted unrated debentures market including changes to the regulatory framework and the recent vicissitudes of several issuers of debentures.[2]

The paper first briefly describes the characteristics of debentures and their historical role in Australian finance and then examines the regulatory environment and recent events which have prompted regulatory concern. It provides some statistics on developments in the market, an overview of ASIC's response to events and considers possible future trends in the market and regulation.

A debenture is essentially an undertaking given by a company to repay money lent to it by an investor and usually also includes a promise to pay interest on that loan.[3] Debentures are mostly issued to investors under a prospectus to fund a range of business activities (e.g. provision of finance and loans, property-related activities, investments, general operations).[4]

If a debenture is unrated it has not received a credit rating from an institution such as Standard & Poor's, Moody's or Fitch. If a debenture is unlisted it means that the issue is not listed on an exchange and there is no liquid secondary market to observe the value of the debentures or sell them to other investors. There may, however, be withdrawal/redemption facilities offered at the discretion of the issuer.

The typical investors in unlisted unrated debentures are retail investors, including the trustees of self-managed superannuation funds. Some are 'sophisticated investors', others are not. Other investors include businesses, partnerships or other trusts.

History

Debentures emerged as financial instruments in Australia in the 1840s. The earliest index reference to debentures in Australia, in S.J. Butlin's *Foundations of the Australian Monetary System 1788 – 1851*, is the £50,000 issue of 'immigration debentures authorised by the otherwise debt-abhorring NSW Governor Sir George Gipps in 1842'.[5]

After this introduction, government increasingly borrowed funds by issuing inscribed stock, while corporations used debentures. According to the 1965 Vernon Report, debentures (along with registered notes and deposits) had become a major form of financing for Australia's listed companies by the mid-1950s.[6]

The Campbell Committee in 1980 observed that 'the larger finance companies obtain their funds predominantly from the household sector by issuing debentures and unsecured notes'. Most common maturities seem to be out to five years with a large part of funds with maturities less than two years.[7]

Major reforms to the financial system in the 1980s had a significant impact on the industry. Gizycki and Lowe[8] recorded a decline in the number of finance companies from 191 in 1990 to 114 in 1999, and a decline in their share of total assets in the financial system from 7.6% to 4.3%, largely as a result of their loss of competitive advantage in the newly deregulated era. The recession in the early 1990s had also taken a toll.

Regulatory framework

a. Finance companies

Finance companies have never been subject to prudential regulation in Australia, although the *Financial Corporations Act 1974* contained provisions that could have enabled federal control.

In 1996, the Reserve Bank of Australia (RBA) urged the Wallis Committee to accept that finance companies were a different case from building societies, credit unions and merchant banks: 'They do not take deposits, but finance themselves through the issue of debentures under the prospectus disclosure provisions of the Corporations Law subject to the ASC [Australian Securities Commission]. Their liabilities are relatively long term, and they are not subject to runs or contagion. Several have failed over the past two decades without threatening system stability. The RBA sees no case to change their present regulatory regime'.[9]

The Government accepted the Wallis Committee recommendation to establish a separate prudential regulator for banks, insurance and *superannuation* – the Australian Prudential Regulation Authority (APRA) – but to leave the regulation of finance companies[10] and their products with what has become the Australian Securities and Investments Commission (ASIC).

Subsequently, the *Financial Statistics (Collection of Data) Act 2001* repealed the *Financial Corporations Act 1974*. Corporations that were previously registered under the Financial Corporations Act – including finance companies – have since been known as registered financial corporations (RFCs). From 1 July 2002, the responsibility for the registration and categorisation of financial corporations was transferred from the RBA to APRA, but at no stage has APRA supervised, regulated or reported statistically on RFCs. APRA passes on the data collected for publication by the RBA and the ABS.

b. Debentures, including unlisted unrated debentures

The *Financial Services Reform Act 2001* (FSRA) came into force on 1 March 2002.[11] The FSRA replaced old Chapters 7 (Securities) and 8 (The Futures Industry) of the *Corporations Act 2001* with a new Chapter 7 (Financial Services and Markets). The key elements of the post-2002 regulatory structure are a uniform licencing scheme for financial services providers, licencing of financial product markets, and clearing and settlement facilities, and financial product disclosure.

An issuer does not need to have an Australian financial services licence (AFSL) to issue a debenture. However, a debenture can only be sold to the public by the holder of an AFSL. Thus an issuer without an AFSL needs to use an AFSL holder as an intermediary.

Property finance companies

A number of issuers of unlisted unrated debentures collapsed in 2007 in Australia – Fincorp Investments Limited (March/April 2007), Australian Capital Reserve Limited (May 2007) and Bridgecorp Finance Limited (July 2007). There were a number of common features of these failures: property development companies involved mainly in residential property development raised funds from retail investors through the issue of debentures – that is, the investor provided loan funds to the issuer who issued a debenture with a promise to pay a rate of interest (usually fixed) for a defined term and then repay the loan.[12] In total, around 20,000 investors in these companies were owed approximately $900 million.[13]

The main difficulties facing issuers is providing investors with the security of regular income and capital certainty. This is especially problematic when property (and particularly property development) is the underlying asset as the security is both illiquid and cyclical, valuation problems can arise and cash flows depend on sales at project completion.[14] Problems may also arise if the debenture issuer has allowed debenture holders an early withdrawal mechanism.

The main difficulties facing retail investors when considering investing in unlisted unrated debentures include inadequate information on, and understanding of, risk and return and underestimation of the benefits of diversification. The investors who invested in the unlisted unrated debentures that ran into problems tended to be older, sought income for retirement, wanted capital protection, were more easily influenced by advertising and tended not to enjoy investing. (See Appendix 1 for more details on the retail investors who invest in debentures.)

Size of the market

Virtually all debenture holders are retail investors (including self managed superannuation funds). ASIC analysis[15] in 2007 showed that:

- debentures issued to retail investors account for around 7% of the total retail market for deposits and debt securities of $523 billion, or some $34 billion; and

- of that $34 billion, some $8 billion (or 24%) is invested in unlisted, unrated debentures. Most recent failures have been in this unlisted, unrated category.

Investments in unlisted unrated debentures amount to an estimated 1.5% of total household holdings of deposits and debt securities. While only a small minority of retail investors hold debentures, some held a disproportionate share of their total investments in the unlisted unrated debentures of issuers that have run into trouble (see Appendix 1).

Table 1 provides ASIC estimates of the size of the debenture market in recent years.

TABLE 1: Size of the debenture market in Australia 2006–08

	June 2006	June 2007	December 2007	April 2008
Unlisted unrated debentures				
Amount on issue ($billion)	6.6	7.6	7.6	6.7
Number of issuers	84	89	86	
All debentures				
Amount on issue ($billion)	28.7	31.3	29.7	
Number of issuers	154	159	153	

Sources: ASIC Report 127; Consultation Paper 89.

Although amounts on issue increased between 30 June 2006 and 30 June 2007, more issuers reduced the amount on issue than increased it. This pulling back became more pronounced in the six months to 31 December 2007.

ASIC's approach

ASIC is not a prudential regulator. In business, companies are allowed to take risks and to fail. The problems arise from the debenture issuer's obligation to adequately inform and not mislead the intended retail investor base, so that investors have the material required to make an informed investment decision.

As the RBA's March 2008 *Financial Stability Review*[16] recounted, regarding the issuance of debentures to retail investors:

> ASIC's proposed changes were released for industry consultation in August 2007. This was followed in October 2007 by the release of the new requirements in 'Regulatory Guide 69 – Debentures – Improving Disclosure for Retail Investors'. Under the new arrangements, disclosure benchmarks have been set for, among other things, equity capital, liquidity, rollovers, credit ratings, loan portfolios, related-party transactions, valuations and lending principles. If issuers do not meet these benchmarks, they are required to explain why this is so. ASIC is now reviewing fundraising documents against this 'if not, why not' approach, with a view to issuing a public report in June 2008.
>
> Another element of ASIC's response relates to the advertising of debentures. In December 2007, ASIC released 'Regulatory Guide 156 – Debentures Advertising' which details several principles-based standards in relation to the advertising of debentures to apply if the debentures are offered to retail investors.
>
> In addition, any statements made in response to inquiries are subject to the same regulation regarding misleading and deceptive conduct as the advertisements.
>
> The guide also makes clear that ASIC expects publishers to have systems and controls to detect and refuse advertisements for debentures that do not comply with these advertising standards. While the primary responsibility for advertising material rests with the organisation placing the advertisement, the publisher or other media conduit may also have some responsibility for its content. Accordingly, ASIC has included guidance on the role of publishers and the media in promoting debenture products.
>
> Compliance with the new standards for advertising has been in effect since February 2008.

On 23 April 2008, ASIC announced its actions on disclosure and released several documents:[17]

- Media release: '08–82 ASIC acts to provide retail investors with better disclosure in unlisted unrated debentures'. This summarises what ASIC has done against its 'three–point plan' (including the Westpoint compensation claims);
- 'Report 126: Understanding investors in the unlisted unrated debenture market.' This outlines the findings of the investor research ASIC commissioned to better understand the profile and motivations of unlisted, unrated debenture investors;
- 'Report 127: Debentures – improving disclosure for retail investors.' This presents the findings of ASIC's review into disclosure made by each unlisted, unrated debenture issuer against the new disclosure regime; and
- 'Investing in debentures? Independent guide for investors reading a prospectus for unlisted debentures.' This is designed to help retail investors make investment decisions about unlisted, unrated debentures by providing further explanation of the new benchmarks.

Further difficulties for some issuers of unlisted unrated debentures have recently been reported in the media.

Concerns

ASIC has engaged the industry, investor groups and other experts in extensive consultations. Some interesting suggestions came from the self-appointed members of the Australia–New Zealand Shadow Financial Regulatory

Committee (ANZSFRC) in September 2007.[18] The ANZSFRC:

- emphasised that the prudential safety net should be limited and the boundary line should not be blurred;
- called on the Australian and New Zealand authorities to speedily finalise and implement their proposals regarding failure management arrangements, which would help to clearly delineate the safety net boundary;
- … recommended that proposals for new disclosure requirements should be 'road tested' with consumers as part of the required regulatory impact assessment;
- suggested that regulators review whether increasing (or retaining) the role of mandatory trustees for debenture or deposit-like securities was appropriate;
- argued that the authorities should promote the development of secondary markets for such securities as a complement to other measures which have been proposed for improving information (and exit mechanisms) for retail investors; and
- questioned whether the application of an 'if not why not' approach to disclosing whether benchmark financial indicators had been met, as proposed by ASIC, was effectively equivalent to compulsion, and called for more detailed consideration of the proposed benchmarks.

ASIC's approach has responded to many of the ANZSFRC concerns:

- the limited extent of the prudential safety net has been maintained: debenture issuers can still fail and investors lose money;
- disclosure requirements are being road-tested with consumers for effectiveness;
- while the role of mandatory trustees for debentures remains, issuers have the option of moving to alternative structures, including managed investment schemes where different arrangements apply;
- the development of secondary markets in unlisted debentures is a longer-term objective. ASIC's preference for exchange-traded rather than over-the-counter traded instruments for retail investors is well known; and
- the 'if not why not' approach has not made meeting the benchmarks compulsory – for instance, only half of the 82 issuers listed in ASIC's April 2008 report met the benchmark for equity capital and half opted to explain 'why not'.

Undoubtedly, not all in the industry are happy with the approach involving the eight benchmarks and the 'if not why not' and advertising guidelines, while some consumer advocates may also be frustrated by the outcome.

The actions also need to be tested against some broader regulatory objectives. For instance, one important test is whether the measures counterbalance the financial and economic cycle or accentuate it. There are two main considerations:

- by not extending the prudential safety net and still permitting failure, the measures should avoid the moral hazard and other incentive problems that exacerbate the pro-cyclical tendencies of finance; and
- by relying on enhanced disclosure and slightly tougher benchmarks, the measures encourage and help consumers to be interested and better informed about the risks in their investments.

If disclosures are sound and consumers pay heed, the outcome should be countercyclical (at least, compared to a situation with no additional disclosure) unless – perversely – retail investors consider that a problem disclosed is therefore not a problem.[19]

Looking forward

Despite some industry and consumer criticism, there are signs that the market is continuing. For instance, a recent item in the national media[20] suggests that 'despite a few prominent failures of unlisted products, debentures are back …. debentures remain a useful income-generating tool. They are also a way of diversifying an investment portfolio'.

The need for ASIC's enhanced disclosure requirements is likely to persist. Would-be investors in unlisted unrated debentures will always need adequate information to make informed investment choices.

There are also likely to be implications for other product classes. ASIC Superseded Regulatory Guide 69 indicated in October 2007 that 'over coming months, we will also be considering whether a similar approach is appropriate for any other sectors, including some managed investment schemes'.[21]

The potential problems with unlisted unrated debentures, in terms of unlisted illiquid products invested in illiquid assets, can also occur in other property-related products, including mortgage trusts and property funds. So applying similar requirements and guidelines to these areas is a logical next step.[22]

In addition, retail investors are increasingly able to invest in more complex products such as alternative investments, which are less familiar, less readily understandable and more volatile and where the risks are relatively hard for the investor to see and for the issuer to manage. As a result, it seems reasonable to suppose that the approach taken with unlisted unrated debentures may be extended to retail offerings of alternative investments more generally.

Finally, it is important to be clear that the changes introduced by ASIC are not a move to prudential regulation and all that would properly entail. The approach taken by ASIC is in line with the longstanding principles of disclosure-based regulation of companies and securities markets and the changes are a sensible evolution informed by the legitimate needs of retail investors. Substantial challenges still lie ahead for investor education and investor financial literacy to take advantage of the improved disclosure.

Appendix 1

What ASIC has learned about the retail investors who invest in debentures

According to research conducted by Roy Morgan Research for ASIC in 2006–07 few Australian investors own debentures.[23] Only 11% of investors reported owning an 'other direct investment' (i.e. other than shares, savings and term deposits, super, investment property or managed investments), of which less than 40% owned a debenture.

In 2007–08 brandmanagement conducted research for ASIC about people who had invested in unlisted, unrated debentures (UUDs).[24] This research compared three groups of investors in order to understand who invested and why:

- people who had invested in ACR and/or Fincorp (ACR/Fincorp investors);
- people who had investments in UUDs at the time of the research (active UUD investors); and
- a 'control' sample of general investors (general investors).

Two key 'types' of investors emerged in this research, referred to as Type 1 investors and Type 2 investors. Type 1 investors were *inter alia*: more likely to be attracted by capital protection than growth; seeking income for retirement; more influenced by product advertising; less likely to seek advice; older; retired; more likely to be divorced or widowed; and less well-educated.

ACR/Fincorp investors (86.7%) were much more likely to be Type 1 investors than the other investor groups (active UUD: 43.7%, general: 34.8%). General (65.2%) and active UUD (56.3%) investors were more likely to be Type 2 investors.

Among the investment features valued by ACR/Fincorp, relative to active UUD and general investors, marketing and advertising, the property-related nature of the investment, customer service, and regular income stand out as key differences.

The main differences in their reasons for investing was a much greater emphasis on 'income for retirement' by ACR/Fincorp investors, and greater emphasis on long-term savings and portfolio diversification by the other groups.

While product advertising was a key decision driver for ACR/Fincorp investors, active UUD investors were more influenced by advisers and other associates.

Finally, active UUD investors appeared to be more likely to practice diversification than ACR/Fincorp investors. ACR/Fincorp investors were the most likely investor group to have invested more than 75% of their total investments in their UUD investment. Active UUD investors were the most likely group to have invested 25% or less of their total investments in their UUD investment.

Notes

1 The author wishes to thank his colleagues, and especially Richard Harrison and Clare Marlin, for helpful comments and assistance. The views in this paper are those of the author and are not necessarily shared by the Australian Securities and Investments Commission.

2 Several provisions of the Corporations Act in Chapter 2L define what is or is not a debenture, including a section (283BH(3)) headed 'When debentures can be called debentures'.

3 Debentures cannot be issued by a proprietary company.

4 By contrast, investments offered by Managed Investment Schemes (MIS) are issued under a Product Disclosure Statement (PDS).

5 S.J. Butlin 1953, *Foundations of the Australian Monetary System 1788–1851*, chapter 10, p. 315 and p. 325.

6 See Commonwealth of Australia 1965, 'New Capital Raisings by Australian Companies 1948–49 to 1963–64' in vol. 2 of the *Report of the Committee of Economic Enquiry*, May.

7 The Interim Report of the Committee of Inquiry into the Australian Financial System 1980, para 5.65.

8 Marianne Gizycki and Phillip Lowe 2000, 'The Australian Financial System in the 1990s', Reserve Bank of Australia, *Proceedings of a Conference*, table 2, p. 192.

9 Reserve Bank of Australia 1996, 'Submission to the Financial System Inquiry', 6 September, published as Occasional Paper no. 14. The body of the RBA submission argues (in chapter 14, para. 156) that few (only 20 out of 100) borrow from retail markets under the disclosure provisions of the Corporations Law and subject to the surveillance of the ASC, and the community accepts that finance companies 'are further out on the risk/return frontier than the banks'.

10 The Wallis Committee set out its recommendation regarding the prudential supervision of finance companies in chapter 8 on 'Financial Safety'.

11 *Alias* Corporate Law Economic Reform Program (CLERP) 6.

12 Westpoint Group raised funds by way of promissory notes (rather than debentures) but operated in the way outlined above.

13 See 'Developments in the Financial System Infrastructure' 2007, *RBA Financial Stability Review*, Sept.

14 These are not new problems and they are often not resolved quickly or favourably for investors. See, for instance, Leonie Wood 2007, 'Land sales bring Cambridge Credit saga to a close', *The Sydney Morning Herald*, 22 September – Cambridge Credit Corporation Limited collapsed in September 1974, with 19,500 debenture holders having invested $90 million.

15 See Appendix 1 of CP89 released 30 May 2007.

16 See 'Developments in the Financial System Infrastructure' 2008, *RBA Financial Stability Review*, March.

17 Published at www.asic.gov.au/uud

18 ANZSFRC Statement no. 3 2007, 'Responding to Failures in Retail Investment Markets', 25 September.

19 More basic concerns arise if the disclosures are not understood or even read.

20 Alexandra Cain 2008, 'Steady investment tortoise starts to outshine flashier hares rocky economic times have resurrected the debenture', *Australian Financial Review Special Report on Alternative Investments*, 15 May.

21 See [RG 69.23]. Regulatory Guide 69 was reissued in August 2008.

22 ASIC has since issued guidance for these areas in Regulatory Guide 45 *Mortgage schemes—improving disclosure for retail investors* and Regulatory Guide 46 *Unlisted property schemes—improving disclosure for retail investors* (both September 2008).

23 *Australian investors: at a glance* is available from the ASIC website, http://www.fido.gov.au/asic/pdflib.nsf/LookupByFileName/rep_121_Australian_investors_at_a_glance.pdf/$file/rep_121_Australian_investors_at_a_glance.pdf

24 'Understanding investors in the unlisted, unrated debenture (UUD) market' is available from the ASIC website.