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The Unlisted Unrated Debentures Market

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Executive Summary

Debentures, including unlisted unrated debentures, have long had a place in retail investor portfolios in Australia, but comprise a small share of the total market for deposits and debt securities. One characteristic of the framework of the market for debentures in Australia is that issuers have not been prudentially supervised, and this continues. Following a number of failures in early 2007 amongst the issuers of unlisted unrated debentures, the Australian Securities & Investments Commission (ASIC) has established benchmarks for disclosure and advertising and an 'if not why not' approach for issuers of unlisted unrated debentures to retail investors. These measures are intended to assist retail investors to make informed decisions on unlisted unrated debentures while still leaving the essential framework of the market in place.

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Introduction

This paper tries to take a pragmatic economics-and-finance approach to developments in the unlisted unrated debentures market, rather than an overly-legalistic approach, but the legal and institutional framework applying to unlisted unrated debentures does strongly influence the topic.¹ Indeed, changes to the regulatory framework, together with the recent vicissitudes of several issuers of debentures, provide the structure and momentum for this paper.

A market not only requires a framework but also both some issuers and some investors. This paper accordingly looks at the main issuers of debentures before looking in detail at the retail investors who are the predominant buyers.

The legal proceedings that have followed the collapse of a number of issuers of unlisted unrated debentures are not the subject of this paper.

What is an unlisted unrated debenture?

In the modern era in Australia², 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 in relation to that loan.³ Debentures are different to deposits with an authorised deposit-taking institution (ADI, such as a bank, building society or credit union). They are also different from other investments such as shares in a company and units in a managed investment scheme.

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).

¹ The author, who admits to no legal training, has been interested to learn that 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".

² A debenture, like any financial instrument, is a creature of the law of the country in which it is issued. The focus of this paper is on debentures in Australia, not in the US, the UK, India or other countries that also provide for the issue of debentures.

³ Debentures cannot be issued by a proprietary company.

If a debenture is unrated it has not received a credit rating from an institution that provides a credit rating (for instance, from Standard & Poor's, Moody's or Fitch). A credit rating is an opinion about the likelihood of the issuer of the debentures experiencing an event of default (i.e. whether the company will be able to repay the money borrowed or interest due under the terms of the debenture).

If a debenture is unlisted it means that the issue is not listed on an exchange and that there is no liquid secondary market where a person can observe the value of the debentures or sell their debentures 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 not. However, some others are businesses, partnerships or other trusts. Debentures are offered to investors through prospectuses issued by a corporation.⁴

History

Debentures emerged as financial instruments in Australia in the 1840s. As such, they were not an early innovation in the history of finance or especially innovative.⁵ Instead the debentures introduced into Australia were derivative, imported from the UK, but no less useful despite that origin.

The earliest index reference to debentures in Australia in S.J. Butlin's "Foundations of the Australian Monetary System 1788 – 1851" is the borrowing of £50,000 by issue of "immigration debentures" authorised by the otherwise debt-abhorring NSW

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

⁵ Outlining the process of financial discovery, William N. Goetzmann and K. Geert Rouwenhorst list the 3 basic principles on which modern finance is based (see *The Origins of Value: The Financial Innovations that Created Modern Capital Markets*, Oxford 2005): (i) Intertemporal transfer of value through time: loan contracts were written in Mesopotamia more than 3,000 years ago; (ii) Ability to contract on future outcomes: the origin of contingent contracts was also in Mesopotamia; (iii) Negotiability of claims: fully negotiable paper bills (fiat money) emerged in China in the 11th century; futures contracts on agricultural products in Japan in the 17th century; active secondary markets in debt contracts in medieval times as capital markets emerged in many centres of Western Europe.

Governor Sir George Gipps in 1842, the middle of the 1841 – 1843 slump.⁶ This has been described as a “daring innovation”.⁷

Butlin goes on to describe the issue of “colonial debentures” totalling £23,000 in 1844⁸ and further special issues for the benefit of the Savings Banks of New South Wales and Port Phillip hotly debated and finally issued in 1848.

Elsewhere Butlin records that the troubles of the Bank of Queensland in the 1860s in financing the Brisbane Bridge were also finally settled by issue of government debentures in 1870, distributed among its English shareholders.⁹

After this introduction, Government borrowings were increasingly made as inscribed stock, and debentures became a form of borrowing by corporations. According to the Vernon Report 1965, by the mid-1950s debentures (along with registered notes and deposits) had become a major form of financing for Australia’s listed companies.¹⁰

Hutchinson and Lee report that in Australia “debentures were ... an established financial instrument by the 1920s and were used by many of the English registered companies listed on Australian exchanges, but few Australian registered companies aside from utility companies issued debentures prior to the 1950s”.¹¹

Looking back, the Wallis committee in 1997 reported that finance companies had accounted for 1.4 per cent of total financial sector assets in 1939 and 1.0 per cent in

⁶ S.J. Butlin “Foundations of the Australian Monetary System 1788 – 1851” Sydney 1953, Chapter 10 page 315 and 325.

⁷ In the Australian Dictionary of Biography Online Edition.

⁸ Issues of New Zealand government “Fitzroy debentures” also were made in 1844 and 1845, according to “The History of New Zealand Banking” <http://www.banknotes.ws/history.html>.

⁹ See S.J. Butlin “The Australian Monetary System 1851 – 1914”, published 1986 by Judith F. Butlin.

¹⁰ See New Capital Raisings by Australian Companies, 1948-49 to 1963-64 in Volume 2 of the “Report of the Committee of Economic Enquiry” Commonwealth of Australia May 1965.

¹¹ Diane Hutchinson and Philip Lee “The Equity Market and Industry Development: New Companies on the SSX, 1920-50” Paper presented at the Asia Pacific Economic and Business History Conference, Queensland University of Technology, 16th-18th February 2006. They conjecture that “this may be because most lacked the strong and steady cash flow necessary to convince lenders that they could service debentures, but it also likely reflected the absence of regulation governing trust deeds”. In addition they observe that “there was a paucity of institutions willing or able to organise and underwrite debenture issues in NSW at least until the late 1940s”.

1948, but this rose sharply to 7.4 per cent in 1960 and 9.0 per cent in 1970.¹² The growth in the 1950s reflected significant demand for hire purchase finance for household consumables. Demand for this less regulated form of finance had been met by specialist finance companies and, by 1959, by the private trading banks acquiring interest in finance companies.

The Campbell committee in 1980 more closely scrutinised the ways that households saved. It found that "households do not deploy their funds exclusively through financial intermediaries; they acquire some primary securities such as shares, mortgages, certain classes of debentures and government bonds".¹³ However, the committee noted two forces, one of saving through deposits in banks to obtain housing loans and the other of the institutionalisation of household saving, that were reducing household direct investment in other instruments such as ordinary and preference shares (and also – though this was left un-stated – debentures).

The Campbell committee 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."¹⁴

The situation facing finance companies changed after the major reforms to the financial system in the 1980s. Gizycki and Lowe¹⁵ 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.

¹² See Table 14.2 sourced to Lewis & Wallace (eds) 1985, p. 2, in the Final Report of the Financial System Inquiry (Wallis Report) Chapter 14: Stocktake: Historical Perspective March 1997.

¹³ The Interim Report of the Committee of Inquiry into the Australian Financial System 1980.

¹⁴ *Op cit.* Para 5.65

¹⁵ Marianne Gizycki and Phillip Lowe The Australian Financial System in the 1990s in Reserve Bank of Australia The Australian Economy in the 1990s Proceedings of a Conference 2000 (Table 2 page 192).

Regulatory framework

(a) Finance Companies

Finance companies *per se* have never been subject to prudential regulation in Australia.

The Financial Corporations Act 1974 contained provisions in Part IV which could have enabled federal control of a range of financial institutions other than banks, including finance companies and general financiers. These provisions for direct regulation of non-bank financial institutions (NBFIs) were not proclaimed, although the Act still required reporting of NBFI data to the Reserve Bank of Australia (RBA).¹⁶

In 1996, the RBA urged the Wallis committee to accept that, in contrast to building societies, credit unions and merchant banks, “finance companies are a different case. 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. 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.”¹⁷ The Wallis committee essentially accepted the view put by the Reserve Bank regarding the lack of need for prudential supervision of finance companies.¹⁸

¹⁶ See the Final Report of the Financial System Inquiry (Wallis Report) Chapter 14: Stocktake: Historical Perspective March 1997.

¹⁷ Reserve Bank of Australia "Submission to the Financial System Inquiry" 6 September 1996 published as Occasional Paper No. 14. At the time, the RBA was seeking to retain supervision of banks and would accept supervision responsibilities for building societies and credit unions, but was not seeking to supervise finance companies. 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, most do not engage in maturity transformation of any significant degree, only about 5 per cent of their liabilities are at call, so the threat of a “run” is not an issue, and contagion or a threat to financial stability is equally unlikely as many have failed in the past and the community accepts that finance companies “are further out on the risk/return frontier than the banks”.

¹⁸ The Wallis committee set out its recommendation regarding the prudential supervision of finance companies in Chapter 8 on "Financial Safety".

In the event, the government accepted the Wallis committee recommendation to establish a separate prudential regulator for banks, insurance and superannuation, i.e., what has become the Australian Prudential Regulation Authority (APRA), but to leave the regulation of finance companies and their products with what has become the Australian Securities & 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 the 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 2002.¹⁹ The FSRA provides a uniform licensing scheme for all financial services providers, and also requires licenses for financial product markets and clearing and settlement systems. 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 licensing of financial services providers, licensing of financial product markets and clearing and settlement facilities and financial product disclosure.

The FSRA replaced product-dependent requirements with a uniform regulatory regime across a range of financial products. These include *inter alia* debentures.

An issuer does not need to have an Australian financial services license (AFSL) to issue a debenture. However, a debenture can only be sold to the public by the holder

¹⁹ *Alias* Corporate Law Economic Reform Program (CLERP) 6.

of an AFSL. Thus an issuer without an AFSL needs to use an AFSL holder as an intermediary.

The focus of recent regulatory attention

A number of failures of issuers of unlisted unrated debentures occurred 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: the failures were of property development companies involved mainly in residential property development and funds were raised from retail investors through issue of debentures (that is, the investor provided loan funds to the issuer and in return the issuer issued a debenture with a promise to pay a rate of interest (usually fixed) for a defined term and then repay the loan.²⁰ In total, around 20 000 investors in these companies were owed approximately \$900 million.²¹

The main difficulties facing issuers is keeping the apparent promises made to investors of the security of regular income and capital certainty. This is especially problematic when property (and especially property development) is the underlying asset, as the security is both illiquid and cyclical, valuation problems can arise and cash flows depend on sales to be made on project completion.²² Problems may also arise if the debenture issuer has allowed debenture holders an early withdrawal mechanism.

The main difficulties facing retail investors considering investing in unlisted unrated debentures at the time of the investment decision would seem to be misconceptions about the investment attraction of property, inadequate information on and understanding of risk and underestimation of the benefits of diversification. The

²⁰ Westpoint Group raised funds by way of promissory notes (rather than debentures) but operated in the way outlined above.

²¹ See RBA Financial Stability Review – September 2007 Developments in the Financial System Infrastructure

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

investors who unfortunately invested in the unlisted unrated debentures which ran into problems tended to be older, sought income for retirement, wanted capital protection, were more easily influenced by advertising and did not enjoy investing. Further detail on what ASIC has learned about the retail investors who invest in debentures is in Appendix 1.

The size of the market

ASIC has found it most useful to consider debentures in the context of household holdings of total deposits and debt securities (including Self Managed Superannuation Funds (SMSFs)), as virtually all debenture holders are retail investors.

Consultation Paper 89 recounted that ASIC presented at the Senate Economics Committee on 30 May 2007 a preliminary analysis of the market for deposits and debt securities in Australia.²³ The analysis showed that:

- (a) 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
- (b) 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.

From these estimates we can observe that all investments in unlisted unrated debentures amount to an estimated 0.3 per cent of total household holdings of deposits and debt securities. As the data in Appendix 1 suggests, only a small minority of retail investors hold debentures, but some have unfortunately held a disproportionate share of their total investments in unlisted unrated debentures of issuers that have run into trouble.

²³ See Appendix 1 of CP89 released 30 May 2007

In Report 127 in April 2008, as a result of new issues and exits, the amount of unlisted unrated debentures in household hands was found to have declined to \$6.7 billion.

The data in the Consultation Paper were estimates, as the balance date used for aggregating the figures from individual prospectuses was not consistent. Recounting on a more consistent basis, we find that total issuance on 30 June 2006 was an estimated \$6.6 billion (from 84 issuers), and that this total rose to an estimated \$7.6 billion (from 89 issuers) on 30 June 2007, an increase of 15.3 per cent. The data for 31 December 2007 for the issuers for which we have more recent data and relevant balance sheet dates show a fall of 0.9 per cent from what had been on issue at 30 June 2007, implying that the total issuance of unlisted unrated debentures may have subsided marginally, to still an estimated \$7.6 billion on rounding on 31 December 2007 (from 86 issuers).

There has certainly been a change in the market over the course of the 18 months under review. Between 30 June 2006 and 30 June 2007, we find that 22 issuers had increased their issues by 10 per cent or more and 24 had decreased their issues by 10 per cent or more. Between 30 June 2007 and 31 December 2007, of the issuers with recent data, only 10 had increased their issues by 10 per cent or more whereas 18 had reduced their issues by 10 per cent or more.

A similar profile is found if we expand the market to all debentures on issue (including listed and unlisted and rated and unrated issues). The total for all debentures on 30 June 2006 is an estimated \$28.7 billion (from 154 issuers), which rose by 9.1 per cent to an estimated \$31.3 billion (from 159 issuers) by 30 June 2007.²⁴ The total for all debentures is estimated to have then declined to an estimate of \$29.7 billion (from 153 issuers) by 31 December 2007, a fall of 5.1 per cent from the 30 June 2007 estimate.

Throughout the 18 months under review, the issuers of listed and/or rated debentures (i.e. excluding unlisted unrated debentures) performed very similarly to the issuers of

²⁴ These estimated totals differ from those in CP89 and Report 127, as a result of different coverage and reclassification of some liabilities as debentures and vice versa.

all debentures. Between 230 June 2006 and 30 June 2007, only 5 issuers of listed and/or rated debentures increased their issue by 10 per cent or more, whereas 29 reduced their issue by 10 per cent or more. This pulling back became more pronounced in the 6 months to 31 December 2007: only one of the issuers of listed and/or rated debentures increased their issues by 10 per cent or more, but 16 reduced their issues by 10 per cent or more (7 by 20 per cent or more).

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 latest Financial Stability Review²⁵ recounted, regarding "Issuance of Debentures to Retail Investors":

Following the collapse of several property development companies in recent years, ASIC has taken a number of steps to improve disclosure requirements applying to unlisted and unrated debentures. This follows concerns that retail investors in these debentures did not always fully understand the risks that they were taking. In mid 2007, it is estimated that unlisted and unrated debentures accounted for approximately \$8 billion of the \$34 billion in debentures held by retail investors and self-managed superannuation funds.

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, related-party transactions and credit ratings.²⁶ If issuers do not meet these benchmarks, they

²⁵ RBA Financial Stability Review – March 2008 Developments in the Financial System Infrastructure

²⁶ The benchmarks proposed in ASIC Consultation Paper 89 "Unlisted, unrated debentures – improving disclosure for retail investors" August 2007 were in summary:

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. The standards, which apply only if the debentures are offered to retail investors, require that advertisements:

- (a) include a prominent statement to the effect that investors risk losing some or all of their principal investment;
- (b) only quote an interest rate if it is accompanied by prominent disclosure of either the current credit rating for the debenture and what that means, or where to find this information, or, where the debenture does not have a rating, explain the implications of the debenture not having a rating;
- (c) state that the debenture is not a bank deposit and avoid the use of terms such as 'secure', 'secured', and 'guaranteed', as these statements may convey a misleading impression as to the risk profile of the debenture;

-
1. Equity capital: Issuers should have a minimum of 20 per cent equity where funds are lent, directly or indirectly, to property developers, or 8 per cent in other cases.
 2. Liquidity: Issuers should estimate their cash needs for the next three months and have cash on-hand to meet these needs.
 3. Rollovers: Issuers should disclose their approach to rollovers of debentures, including automatic rollovers.
 4. Issuers should have their debentures rated for credit risk by a recognised agency, and have that rating disclosed in the prospectus and in advertising.
 5. Loan portfolio: Issuers should disclose details of loans they have extended, or expect to extend over the coming year.
 6. Related party transactions: Issuers should disclose how many loans they have made to related parties, or expect to make to related parties over the next 12 months, and what assessment and approval process they follow for such loans.
 7. Valuations: Valuations should be fully disclosed. Development property assets should be valued on a cost, 'as is' and 'as if complete' basis, with all three disclosed.
 8. Lending principles – Loan-to-Value ratios: Issuers lending money for property development should be required to maintain a maximum 70 per cent loan-to-valuation ratio, based on a valuation that assumes the development is completed, and 80 per cent on the basis of the latest market valuation.

ASIC also proposed that advertising for these products should not use words such as 'secure' and 'safe', and should disclose prominently that there is a risk that investors may lose some, or all, of their capital. It is envisaged that trustees, advisers, valuers and auditors would use these benchmarks to fulfil their responsibilities.

- (d) not state, or imply, that the investment is suitable for a particular class of investor; and
- (e) be consistent with the corresponding disclosures in the prospectus.

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.

More recent developments

On 23 April 2008, ASIC announced its actions on disclosure and released several documents:²⁷

- 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;

²⁷ Published at www.asic.gov.au/uud

- 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 assist retail investors in making investment decisions about unlisted, unrated debentures by providing further explanation of the new benchmarks.

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

Concerns raised

There have been extensive consultations, in which ASIC engaged the industry, investor groups and other experts. Some interesting suggestions came from the self-appointed members of the Australia-New Zealand Shadow Financial Regulatory Committee (ANZSFRC) in September 2007.²⁸ As summarised in its statement, the ANZSFRC:

- Emphasises that the prudential safety net should be limited in extent. This means that regulatory proposals such as those being considered to protect investors in financial products need to take care not to blur the boundary line of the safety net.
- Repeats its December 2006 call to 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.
- Recommends that proposals for new disclosure requirements should be “road tested” with consumers as part of the required regulatory impact assessment.

²⁸ ANZSFRC Statement No 3, 25 September 2007, "Responding to Failures in Retail Investment Markets". Memo: one co-chair of ANZSFRC is Professor Kevin Davis, Professor of Finance at the University of Melbourne and Director of the Melbourne Centre for Financial Studies.

- Suggests that regulators review whether increasing (or retaining) the role of mandatory trustees for debenture or deposit-like securities is appropriate, given the availability of alternative, possibly superior, approaches to fulfilling their current investor protection role.
- Argues 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.
- Questions whether the application of an “if not why not” approach to disclosing whether benchmark financial indicators have been met, as proposed by the Australian Securities and Investments Commission (ASIC), is effectively equivalent to compulsion, and calls for more detailed consideration of the benchmarks proposed.

This was a useful contribution to the consultation process. The approach taken can be seen to have recognised and responded to many of the views put by the ANZSFRC:

- The limited extent of the prudential safety net has been maintained: debenture issuers still can fail and investors lose money – and some regrettably will.
- Disclosure requirements are being road-tested with consumers for effectiveness.
- While the role of mandatory trustees for debentures remains, issuers have an 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 enthusiasm for exchange-traded rather than over-the-counter traded instruments for retail investors is well known.
- Finally, the “if not why not” approach demonstrably 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" – although ASIC would obviously be happy if more issuers did meet or exceed the benchmarks.

Without doubt not all in the industry are happy with the approach taken, involving the eight benchmarks and the 'if not why not' and advertising guidelines, while some consumer advocates may also be frustrated by the outcome.²⁹

The actions taken need also to be tested against some broader regulatory objectives. For instance, one important test is whether the measures serve to counterbalance the financial and economic cycle or accentuate it.³⁰ 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 that tend to arise from provision of a safety net.³¹
- And by relying on enhanced disclosure and slightly tougher benchmarks, the measures encourage and help consumers to be interested and better informed in assessing the risks that they are taking on in their investments.

If disclosures are sound and consumers pay heed, the outcome should be counter-cyclical (at least, compared to a situation of no additional disclosure) unless – perversely – retail investors consider that a problem disclosed is therefore not a problem.³²

²⁹ See, for instance, an article by Anthony Klan "Hewson slams ASIC over debenture firms" The Australian 17 April 2008.

³⁰ Question posed by The Economist in its Special Report on International Banking – "Cycle clips: Regulators need to counterbalance the cycle, not accentuate it", 15 May 2008.

³¹ With failure still permitted, ASIC's actions certainly fall far short of the "occasional heavy-handedness" approvingly referred to by The Economist for regulating activities within the prudential safety net. A former regulator told The Economist "what you have to do every so often is pick a performance measure of some kind, line the banks up and shoot the dog. The rest will quickly cower at the other end of the row". See The Economist *Op Cit*.

³² More basic concerns arise if the disclosures are not understood or even read.

Looking forward

Despite some industry and consumer criticism, there are signs that the market is continuing. For instance, a most recent item in the national media³³ 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 so that they can make an informed investment choice.

There are likely also to be implications for other product classes. ASIC Regulatory Guide 69 indicated in October 2007 that "over coming months, we [ASIC] will also be considering whether a similar approach is appropriate for any other sectors, including some managed investment schemes". [RG 69.23]

The potential problems seen with unlisted unrated debentures in terms of the ill-informed allure to consumers and the difficulty for issuers keeping their apparent promises can also be seen in other property-related products, including mortgage trusts and property funds. So the consideration of applying similar requirements and guidelines to these areas is a logical next step.

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

³³ Alexandra Cain “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 2008

Finally, it is important to be clear that this is not a move to prudential regulation and all that entails. The approach taken by ASIC is entirely in line with the longstanding principles of disclosure-based regulation of companies and securities markets in place over many years 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.³⁴ Only 11% of investors reported owning an ‘other direct investment’, of which less than 40% owned a debenture.

Figure 1: Investment products owned by investors³⁵

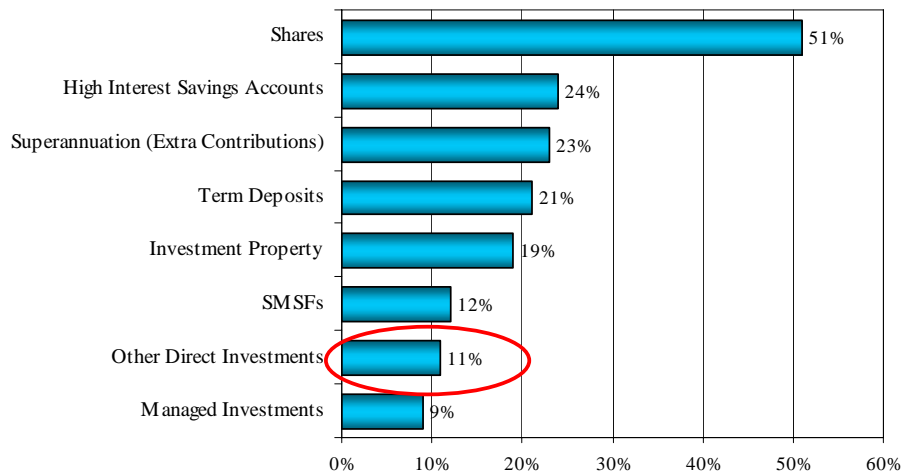
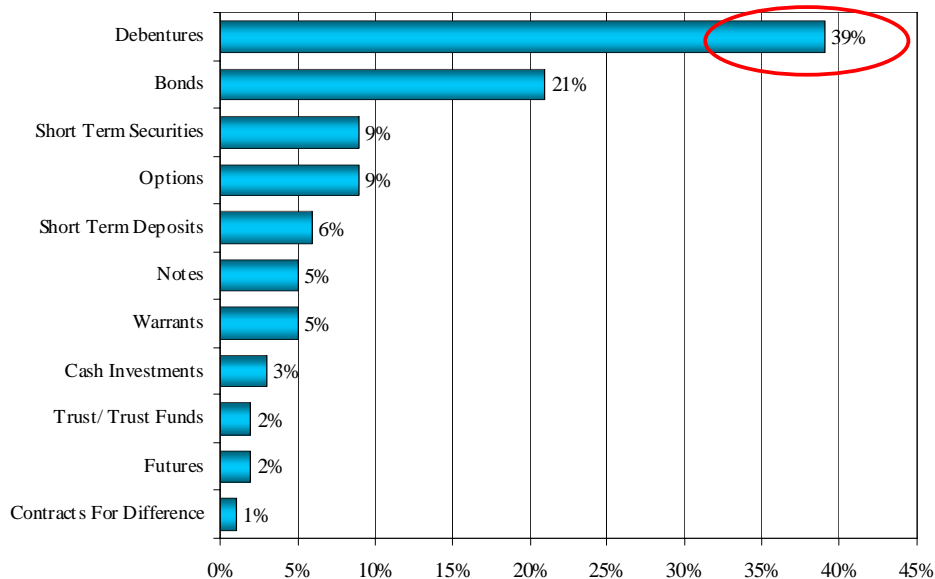


Figure 2: Types of other direct investments owned by investors³⁶



34 *Australian investors: at a glance* is available from the ASIC website.

35 Base: Total investors, n=1217. Includes multiple investment product holdings.

36 Base: Other direct investors, n=98. Includes only respondents recruited to talk about other direct investments. The information in this chart is based on a question that only applied to respondents specifically recruited to talk about their other direct investment (Q3HH. What type of other direct

In 2007/08 brandmanagement conducted research for ASIC about people who had invested in unlisted, unrated debentures (UUDs).³⁷ 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)³⁸
- a ‘control’ sample of general investors (General investors).³⁹

Two key ‘types’ of investors emerged in this research, referred to as Type 1 investors and Type 2 investors. 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. A summary of the key characteristics of Type 1 and Type 2 investors is presented below.

Table 1: Key characteristics of investor types

	• Typical Type 1 investor (53.7% of total investors)	• Typical Type 2 investor (46.3% of total investors)
Key investment characteristics	<ul style="list-style-type: none"> Attracted by perceived security, rate of interest/return and capital <i>protection</i> Seeking income for retirement Attracted to/influenced by product advertising, seeing frequency as a proxy for quality Less likely to seek advice about investment decision (from either formal/informal networks) Less likely to enjoy or spend time investing generally More likely to be ACR/Fincorp investor (86.7%) than Active UUD investor (43.7%) or General investor (34.8%) 	<ul style="list-style-type: none"> Attracted by perceived security, rate of interest/return and capital <i>growth</i> Seeking long-term saving Noticed but less influenced by product advertising More likely to have and use informal and formal advice networks More likely to enjoy and spend time investing generally More likely to be General investor (65.2%) or Active UUD investor (56.3%) than ACR/Fincorp investor (13.3%)
Key demographic characteristics	<ul style="list-style-type: none"> Mean age of 64 More likely to be female (39.6%)⁴⁰ More likely to be divorced (11.6%) or widowed (10.4%) Over-represented among those educated at high school level or below More likely to be retired and receiving some form of government support 	<ul style="list-style-type: none"> Mean age of 41 Less likely to be female (35.4%) Less likely to be divorced (3.0%) or widowed (0.4%) Over-represented among those with post-graduate qualifications Less likely to be retired and receiving some form of government support

investments do you have?). It does not include information about people recruited to talk about other investment products, who also owned another direct investment.

³⁷ *Understanding investors in the unlisted, unrated debenture (UUD) market* is available from the ASIC website.

³⁸ The quantitative sample of Active UUD investors covered 355 separate investments by 280 individuals across 27 different debenture issuers.

³⁹ Depending on the stage of research, this involved either those with general fixed interest investments or those with any type of investment (e.g. shares, investment property) and over \$50,000 to invest.

⁴⁰ ACR investors were particularly likely to be female (61.8% of ACR investors were female).

Figure 3 compares the investment features valued by ACR/Fincorp, Active UUD and General investors respectively.

Figure 3: Important investment features

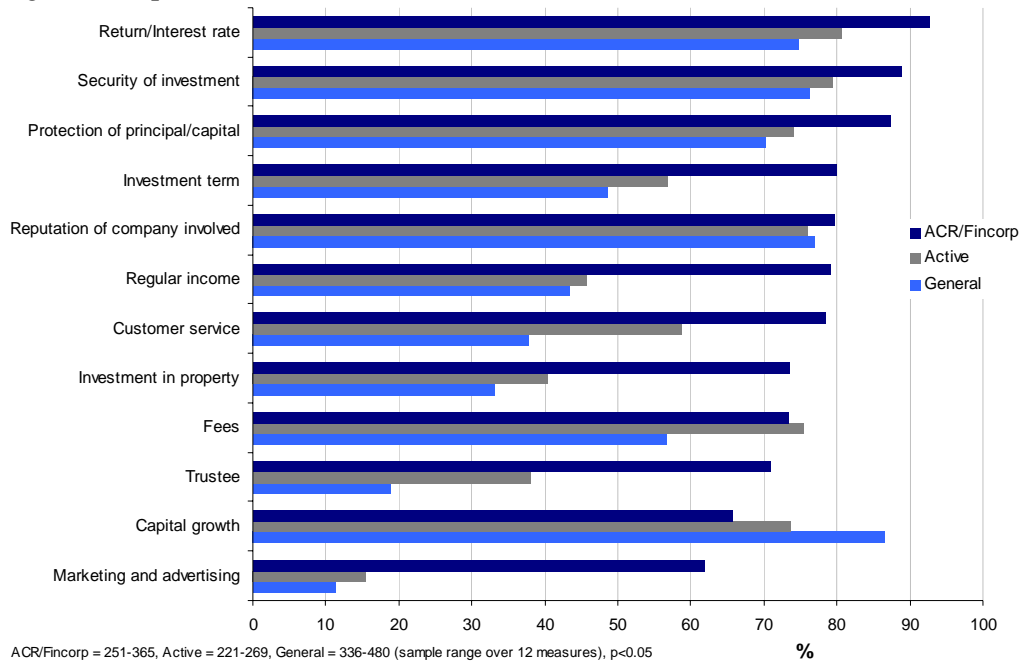
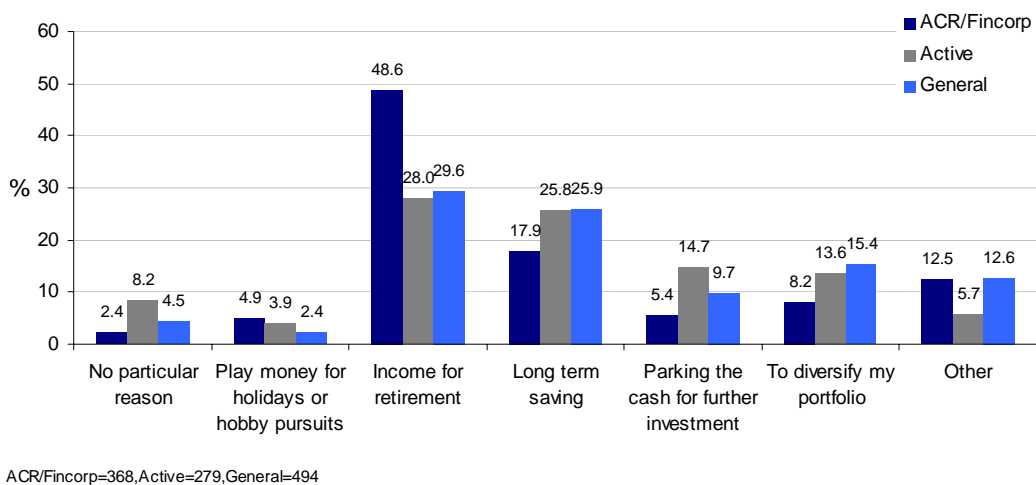


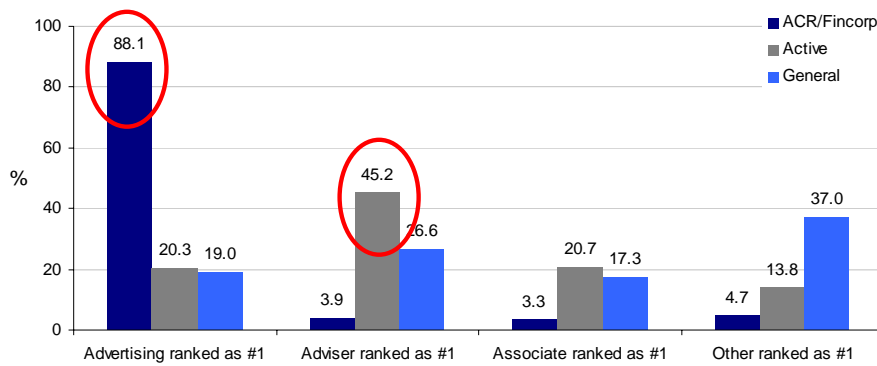
Figure 4 compares the main reason for investing for ACR/Fincorp, Active UUD and General investors respectively.

Figure 4: Main reason for investing



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

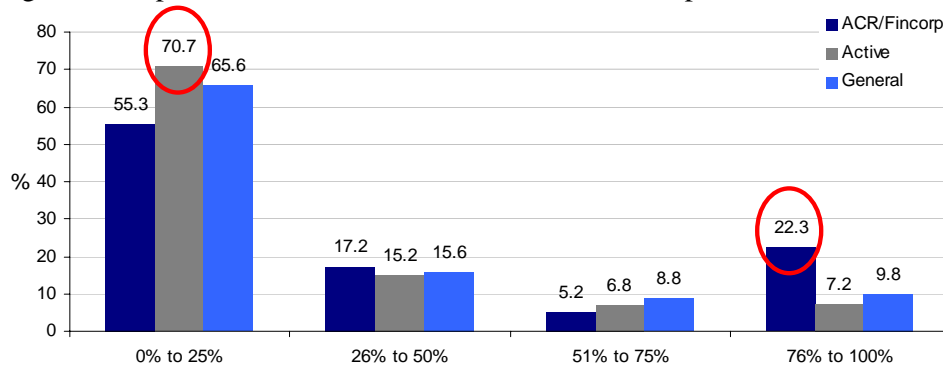
Figure 5: Most influential factor (#1) in investment decision⁴¹



ACR/Fincorp=362, Active=261, General=473

Finally, Active UUD investors appeared to be more likely to practice diversification than ACR/Fincorp investors. As Figure 4 shows, 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.

Figure 6: Proportion of total investments invested in one place⁴²



ACR/Fincorp=367, Active=263, General=480

41 'Other' included a wide range of influences on investment decisions (e.g. bank manager, own research, internet and direct mail).

42 For ACR/Fincorp and Active UUD investors this investment refers to their UUD investment and for General investors this refers to their largest investment.