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The Secretary
Financial System Inquiry
Treasury Building
Parkes Place
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By email

Sirs,

Unlisted, Unrated Debentures

This submission relates to the issue of unlisted, unrated debt instruments such as Unsecured Notes, Notes, Secured Notes, Debentures and Mortgage Debentures issued for use as capital for the provision of real property-secured mortgage products. For ease of reference we make no differentiation between them; hence any reference to 'debentures' and 'the debenture sector' relates generically to all unlisted, unrated debt issues.

The Problems

Debentures are one of Australia's oldest debt instruments having been used by the first Governor for public fund raising. They peaked in popularity in the post war period as issuances by traditional Finance Companies that found them an efficient way to raise funds directly from the public to fund lending products provided to the community; much in the same way as a Credit Union or Building Society. The debenture sector has been sullied in recent years by multiple failures. In our opinion the causes for the failures remain concerns in the sector today and include:

1. Improper funding models: use of debentures by development companies where the liquid nature of debenture is at odds with the illiquid nature of development assets;
2. Outdated reporting protocols: the debenture sector is legislated by the outdated and often patched Corporations Act (Cth) with complicated and inefficient oversight by equally outdated protocols under Trustees' Trust Deeds where Trustees rely on largely retrospective data (albeit for forward-looking cash-flows for liquidity);
3. An asymmetry of information: Issuers harbour information, they are able prepare performance data in preparation for reporting cycles and investors have no way of understanding current risk between these reporting cycles;
4. Half-pregnant regulatory benchmarks: ASIC's benchmarks are on the right track but not at the required destination. They can only be considered proper 'Benchmarks' when issuers and issuances can be judged competitively against them on a common, comparative platform.

A snapshot of the market as it stands today is as follows:

- Debentures and Notes are legislated under Section 2 of the Corporations Act (Cth); 1961 legislation that has been reinforced with regulatory patches so many time it is the legislative equivalent to Theseus' Ship';
- Issues are subject to the appointment of Trustees under the Corporations Act Sect 74 as a means to protect investors' interests and to hold charge over assets;
- Historically Trustees relied on regular retrospective reporting for all but forward-looking cash-flow estimates for liquidity';
- During the GFC (though not entirely caused by it) there were highly publicized failures of Unlisted Unrated Issuers including Westpoint, Bridgecorp, Fincorp and Australian Capital Reserve. In total 16 of 34 retail issuers would fail owing $1.5 billion to investors. Following this ASIC introduced RG 69 "Debentures and Notes Improving Disclosure for Retail Investors". This saw the introduction of 'benchmarks' for (1) Equity (capital Adequacy cover), (2) Liquidity, (3) Rollovers, (4) Debt Maturity ('(2) – (4)' collectively - cash-flow analysis), (5) Loan Portfolio, (6) Related Party Transactions, (7) Valuations and (8) Lending Principles. ASIC stopped short of setting absolute targets for these but introduced an 'if not – why not' approach to reporting;
- Most of the GFC failures were by entities predominantly involved in property development, a business wholly unsuitable to funding by fixed-term debt instruments because of the non-fungible nature of underlying security assets;
- Following the introduction of ASICs 'benchmarks' failures continued; the most prominent of these being those of Provident Group, Banksia and most recently GSI, though with these Trustee nervousness may have contributed to a hair-trigger approach to appointing Administrators when fundamentally the companies were, according to their benchmark reporting at least, capable of 'trading down' and returning investors' funds without the costly encumbrance of an Administrator';
- In 2013 ASIC distributed CP 199 seeking feedback to proposed changes to its 'if not – why not' benchmarks for Capital Adequacy and Liquidity, converting these to fixed targets to be achieved over time to targets for Capital Adequacy of 8% and Liquidity of 9%;
- Trustee nervousness continues and this is in danger of contributing to potential for investor losses which runs counter to the purpose of their appointment. The nature of the industry is such that any Administrator appointment causes immediate investor toxicity, not just for the issuers but for all issuers and by and large it can be avoided by an increase in issuer's Capital or conversion of debt to equity (Debentures to Preference Shares for example) and a process of managed debt settlement without the unnecessary intervention of expensive Administrators. The Trustees could, under their remit, oversee such processes.

The Opportunity

The Federal Government has an opportunity to bring immediate stability to the debenture sector with very little regulatory and legislative intervention and by so doing open up for considerable benefit the non-bank Mortgage-Backed Security Market.

Imagine if you will a mature Debt Market with a dedicated Exchange where companies under an AFSL, with an authorized Prospectus or Information memorandum (IM) raise debt capital (and possibly equity in the form of preferred stock) directly from investors, both retail and wholesale, for use in the provision of real property mortgage products. In this market the activities of listed companies are reported 'live' with a dynamic Rating so that investors can accurately compare them to a common Benchmark (based on ASIC benchmarks) to better understand the risk they represent. This is a complete RMBS and CMBS Market that would serve as an efficient securitization platform where similar profile assets are bundled for onward sale but where the bundled asset retained their absolute connection to the underlying loans including borrowers and their security assets – unlike the sub-prime CDO that precipitated the GFC.

Such a Market could also introduce single mortgage bond issuances similar to the Danish market. These types of product dampen the boom-bust property cycle because the debt asset's tradable value is tied directly to the underlying security asset.

This Market would compete efficiently with the banks, improve options for borrowers and open up Australia's debt market to match its equity options. It would provide considerable fixed-income investment opportunities to the World's fourth most liquid investment market. And it could happen by the effective use of debentures and with one easy regulatory step that is already 9/10ths ready to go following completion of CP 199.

Affecting Rapid Change

There are only two actions required to reinvigorate the debenture sector. They are relatively simple. The first action is required by the Trustees to improve their capacity to provide active oversight (which will diminish Trustee risk immediately). The other action is by ASIC, as Regulator. These are:

1. Trustees should collaborate to amend Trust Deeds, through negotiation with Issuers, to collate data via a single dynamic portal (see 'How we can help' below). This information would fulfil reporting on ASIC's benchmarks, with the addition of others necessary to give a live, dynamic view of risk against common, and comparable benchmarks. This would immediately improve the debenture sector by:
    a. Reducing Trustee risk;
    b. Removing information asymmetries and allowing market forces to prevail as investors discover how to evaluate Issuers on a rate for risk basis, This would immediate trigger a migration of capital to lower risk opportunities where coupon rates are equal resulting in an adjustment by Issuers by (i) reducing their risk profile of (ii) increasing the offered Coupon to match the risk they represent;
    c. Prepare the market for ratings.

2. ASIC should implement proposed actions under CP 199. Below we discuss what they should and shouldn't do and why.

What the Government / ASIC should do - and why

It should:

1. Leave debentures under ASIC's domain rather than moving them to the control of APRA because it almost has conditions right for an efficient market to emerge. In fact, if the Trustees take action to better collate appropriate data and make this available to the investing public in the form of directly comparable benchmarks, a form of self regulation will occur, with investors seeking rate for risk they can fully understand and with Issuers forced by potential capital flight to ensure that their Coupon provides the appropriate return for the risk they represent.
2. Introduce fixed Capital requirements of 8% and Liquidity requirements of 9% for unlisted unrated debenture issuers and allow the currently planned 4 year term for them to achieve this.
3. Introduce a ratings-based Capital and Liquidity target for Issuers that obtain an independent rating. This will allow a more flexible approach to Capital and Liquidity befitting their rating, which may be increased or decreased depending on the risk profile of the Issue. ASIC's benchmarks have to date been Issuer-centric but this mentality restricts Issuers homogeneous issuances with common risk profiles by Prospectus or IM. Investors have diverse appetites for risk for which these could be catered.

   A simplified example: a company could make two classes of Issues; (a) for capital offering a Coupon of (say) 5% per annum to be used for a maximum LVR of 50% and a maximum loan term of 90 days, to attract bridging finance borrowers and (b) for capital paying a Coupon 10% per annum to be used to take over distressed loans in default under contracts which allow for a higher return during the process of work-out or forced sale. These are just hypothetical examples but they show how inappropriate fixed Capital and Liquidity ratios are. For scenario (a) Capital coverage of 8% and Liquidity of 9% might be considered excessive but for scenario (2) they might be too low. to determine these factors however requires more than just an NPV of Coupon Rate over term to maturity. There are many more variables which require consideration to set these at the correct levels. We argue this variable approach to Capital and Liquidity should only apply to rated Issuers where these considerations are possible and we offer a stronger rating-ready data pooling below in 'How We Can Help'.

What the Government / ASIC should not do - and why not

1. It should not move debentures to the auspices of APRA because :-
   - there would be a considerable period of unnecessary disruption and investor uncertainty;

- the debenture sector was always intended to be free from heavy regulation and this was why there was always a provision for prudential oversight by the Trustees;
- there have been failures, but it is not government's job to ensure they do not occur, this would be tantamount to a hollow guarantee. Its job is to make the market transparent so investors understand rate for risk. Then investors are free to take the risks they seek in full knowledge that there might be failures. ASICs embarrassment has been due to the fact that failures have occurred in a market with no transparency and where there was an erroneous expectation that the Trustees were ensuring against it. A misconception promoted by ASICs actions during and since these failures. When ASIC started down the track of improving transparency (with its benchmarks) it sadly became misguided and changed its approach to making all the risks similar (with fixed risk profiles for Capital and Liquidity). This is not the role of the Regulator;
- if the Government truly wants a sector of the market to be freer from regulatory encumbrance then it needs to be sure that market efficiencies exist within it. This was surely ASIC's original (and still unrealized) purpose for its benchmarks;
- to move debentures to APRA will surely require a complete (and unnecessary) revision of the prudential oversight process otherwise the debenture sector will become the most heavily regulated sector in the market with Trustees and APRA providing a duplicated oversight; this is regulatory lunacy;
- given there is nothing fundamentally wrong, except for the non-existence of market forces due to a lack of information symmetry, why go to the trouble of moving the entire regulatory responsibility to an alternate prudential body whose tendency will be to regulate further?;
- it is counterintuitive to ask the bank's regulator to preside over the future of a potentially competitive sector for RMBS and CMBS; and
- lastly, if under APRA debenture issuers were subject to heavy regulation and bank-like conditions for Capital Adequacy and Liquidity, but with a continuation of their current loan-to-value (LVR) restrictions under the Corporations Act (Max. 70% LVR for debenture issuer and 80% for banks without LMI) there will be a strong argument for the Government Deposit Guarantee to be extended to debenture issuers. Considering that debenture issuers do not have unsecured lending products but the banks do, with all else being equal, this would be a reasonable expectation.

2. The Regulator should not continue its insistences that Issuers make declarations in marketing and materials that "investors may lose all or some of their investment" under RG 156. This is an absurdity particularly if it introduces fixed Capital and Liquidity ratios for unrated entities and rating determined rates of Capital and Liquidity for rated entities because it makes a mockery of this process, and of the Trustee's involvement. Despite previous and devastating failures there is no evidence that investors can lose all their investment without an illegal act which itself allows for punitive measures. Further, with the introduction of the proposed changes above requiring debenture holders

subject to bank-like risk protections this declaration seems simply a misrepresentation orchestrated to disadvantages debenture issuers.

How we can help

We operate a risk management platform – Capital Management Exchange ‘CapMX’. It was built in collaboration of two of the Big Four Banks prior to the GFC to assist them with dynamic risk appreciation when providing debt to non-bank Finance Companies involved in providing real property-secured mortgage products. Via CapMX originators gain access to debt and manage loan assessments and post loan management. Senior debt providers use CapMX to set the conditions by which subordinated originators can gain access to their funds, including an inexhaustible array of credit and risk profiles. It provides them complete transparency over loans and loan portfolios. Credit and risk determinants can be pre-set including Capital Adequacy (the ratio between the funds contributed by the subordinated borrower when accessing senior debt), provisioning rules, anti-concentration rules and default management conditions. CapMX is capable of providing a dynamic overview of any loan portfolio on its Platform, including aged receivables, asset-coverage, and full risk reports direct to investors via web access - daily. By so doing it provides stakeholders the strongest possible understanding of risk versus reward.

A number of debenture issues are already familiar with the CapMX Platform as they use it as senior debt providers when accessing specific short-term risks as part of their overall mortgage portfolio appetites.

CapMX can easily meet the needs of Trustees to assess debenture issuers in relation to ASIC’s 8 benchmarks. It does not need current issuers to write or manage loans on its platform, Rather, the Platform can harvest relevant data directly from issuers disparate accounting, debenture issuing and accounting software and display it in an orderly manner by which Trustees and potentially investors can compare them against common benchmarks. As discussed above, this would allow Trustees to manage risk dynamically, and allow investors to use direct comparison for natural market forces to begin to prevail where currently they do not.

This would provide immediate comfort to Trustees and investors and it would remove the asymmetry of information that currently exists.

We would propose to consult to issuers as well as connect directly and securely to their systems to harvest data so that we could assess them on the following basis:

- Capital Adequacy (Equity Ratio)
- Cash-Flow Management
    - Liquidity
    - Rollovers
    - Debt Maturity
    - Asset Maturity
- Loan Portfolio Management Data
    - LVR
    - General Lending Conditions on a per asset type and location

- Granulated and portfolio data on a per asset and location basis
    - Number of loans, location, asset type, LMI Category
    - Applicant credit history, industry sector
    - Rates of interest
    - Maturity cycles
    - Aged receivables
    - Capital Adequacy Coverage
    - Performance $ / % / days(aged receivables, default loans, loans in recovery)
- Liquidity Cycles
- Provisioning Processes
    - General commitment to
    - Process of Management of
    - Suggested Amount deemed appropriate considering Loan Portfolio Management Data
- Related Party Transactions
    - General commitment to
    - Process of Management of
- Valuations
    - General commitment to
    - Process of Management of
- Regulatory Reporting
    - ASIC / Trustee / Austrac (AML CTF)
        - Systems
        - People
        - Processes
        - History
- Dispute Resolution
    - General Commitment to
    - Process of Management of
    - History
        - VCAT, CTTT, COSL, FOS etc by
            - Number
            - $ Volume
            - Date
            - Nature
            - Resolution / Outcome
- Monitoring of and commentary on Balance Sheet
    - Potential ' hidden risks' such as moving potential losses to 'non-current assets'
    - Non-provisioning of aged receivables carried as non-current assets
    - Non- cash items
    - Any anomalous items
- Systems:
    - Loan / Risk Management
    - Debt Issuance
    - Accounting
    - HR
    - Regulatory Compliance

- HR
    - Key Persons Risks
    - Staff Retention /Experience
    - Management Structure
    - Operating Tools

CapMX would also make this data available to licensed ratings agencies for them to offer competitive ratings services.

Once Issuers can be compared against a common set of benchmarks natural market forces will see capital migrate to rates for risk it desires. Thereafter efficiencies in risk pricing would begin to occur.

The cost of establishing this dynamic, common comparison platform would be negligible as it would be offset by efficiencies of cost with the capacity to standardize reports for auditors and to provide standard compliance reports to ASIC. And it would set the ground work for the creation of an active market where rated issuers are listed and where debentures are openly traded.

Conclusion

Debentures are a flexible and simple instrument for capital raising that have been allowed to be abused by outdated regulation and methods of oversight. ASIC is 9/10ths of the way to creating conditions for the emergence of a vibrant and investor-transparent market. The vision here is to see it evolve into a fully-fledged Debenture Exchange via which retail and wholesale investors could gain access to viable non-bank RMBS and CMBS risk and where real market depth can emerge. We believe this is achievable within a 30-month timeframe.

Moving debentures to APRA is the regulatory equivalent of a leaf-blower, making the issue someone else's problem when (to stretch the analogy) it has removed 90% of the leaves from the trees.

If we shore up the supply of valuable performance data to the Trustees and if the Trustees share this on a common open-market platform for direct comparison, market forces will emerge. If ASIC then introduces fixed Capital and Liquidity targets and rating-related adjustment allowances for these for rated Issuers and Issues within four years, it will set the stage for the emergence of an Exchange and a viable, trustable market and a voluminous alternative source of mortgage funding to the banks – and a viable market for the banks to issue, or acquire assets for Covered Bonds.

We would welcome an opportunity to discuss this further. As The Right Honorable Joe Hockey is our Local Member, we particularly recommend a meeting with him or Mathias Cormann to discuss this at the earliest opportunity.

Yours faithfully,

Andrew Way

About The Author

The Author has worked in banking and finance for 30 years, specializing in risk management. Originally from the UK, he has worked extensively in Asian emerging markets while living in Hong Kong from 1987 to 1993 and Singapore from 1993 to 1999 before moving to Australia where he was CEO International Ratings for Ernst & Young. He has worked in the private sector and as a Consultant and Advisor to Governments and Non-Governmental Organizations. He participated as an Expert Group Adviser to the United Nations for Regulatory Reform in emerging markets and was the founder of its Asia Infrastructure Development Alliance (AIDA) a tripartite Alliance which, for the first time in UN history, brought together Industry leaders with their ministerial and NGO counterparts to discuss ways to better prepare markets for regulatory change to facilitate increased opportunities for Public Private Partnerships (PPPs). He was the Publisher of the Australia Stocktake of Infrastructure Investment Opportunities in 1998 under the Economist in cooperation with the Office of the Prime Minister. He has considerable experience of the debenture sector and has been a regular contributor to the consultative process. He continues to consult to Debenture Issuers on matters related to risk mitigation, regulatory reform and funding diversification.