Provic Group response to financial systems enquiry 2014

1.Provic Group

Background

The Provic group consists of 6 like-minded companies in Victoria and New South Wales issuing debentures in the form of "Secured Notes". Funds raised are principally used to finance arm's length loans secured against real property up to a maximum of 70% LVR and to an average LVR of less than 50%. This level of lending is mandated by the operating manual for the Provic group which requires compliance to levels of capital equity, liquidity, lenders risk reserve (for doubtful debts).

While the Provic group companies promote to the public that they are **not a bank**, from a risk point of view they do compare favourably as identified in figures provided by APRA to questions on notice to Senate estimates.

Comparison Scorecard of operational risks between Banks and Provic member companies

		Banks (4Majors)	Provic Group
a.	**Capital**	4.8-5.9%	3.9- 9.9%

This is the financial institutions "hurt money" which provides a buffer in the event of financial difficulties, as well as providing incentives to operate prudently and responsibly. Provic member companies lending is all secured and they maintain a lower level of loan LVR across the portfolios increasing additional buffer before their equity is likely to be called upon.

b.	**Liquidity**	12.8-16.8%	20%+

Liquidity is an important measure of the short-term finance, health of an issuer or business. If there is insufficient cash or liquid assets, the financial institution might be unable to meet its obligations to run the business properly, to pay interest, to pay investors their money back at the end of their term, etc. Because our companies predominantly take fixed term investments as opposed to 'At Call' deposits, liquidity levels can be more accurately forecast, given fixed term investments are locked-in for specified periods and our high retention rates for roll-overs.

Provic group company liquid funds are generally invested in ADI's.

c.	**% Deposits 'At Call'**	56%	8%

The proportion of 'At Call' deposits is an indicator of the amount of funds investors can withdraw from a financial institution without notice (and the exposure to a run on their funds in times of economic uncertainty).

d. % Fixed term deposits 44% 92%

This is the flip-side to the At Call funds. The higher the level, the more accurately the financial institution can determine when the funds will be withdrawn and the necessary liquidity levels needed to accommodate it. The lower the proportion of fixed term deposits, the greater the risk for a run on investor funds.

e. % domestic deposits 53.7% 100%

Higher domestic deposits signify a greater level of insulation from external global macroeconomic issues.

f. % deposit loan funds secured against real property

75% 97%

Greatest comfort is offered by higher levels of security in real property.

g. % of lending on unsecured credit cards

1.8 – 3.1% 0%

This does not include unsecured lending in the form of personal loans and overdrafts.

h. % Loans where LVR <80% 67% 100%

With loans secured by mortgage of real estate, the higher the loan LVR the less equity owned by the borrower and the less security available for the lender. Only 67% of the bank's loans are less than 80% LVR compared to 100% for Provic company loans.

i. Requirement to disclose stress tests to the public.

No Yes

j. Government guarantee for retail investor deposits.

Yes No

* The figures for the banks were obtained from questions on notice to **APRA** at the February 2012 Senate estimates committee hearing.

Importance to Regional Australia

All of Provic group member companies operate in regional Victoria and New South Wales and they fill an important role in providing loans and investment opportunities for regional investors and businesses. Regional borrowers are often disadvantaged by restrictive centralised lending policies of the major institutions, and the Provic group companies provide for that special niche of borrowers. They also provide competitive investment interest rates for retail investors. These companies complement the system dominated by ADI's while providing competition in the financial market.

In 2008, 12 member companies collectively managed $1.2 billion, but since the global financial crisis a combination of circumstances and lack of desire to continue operating in an unpredictable market and regulatory climate has seen 6 companies withdraw from Provic group membership and the industry. Four of the member companies were taken over by banks or other institutions looking to expand their balance sheets. Two additional companies went into liquidation returning around $0.92 in the dollar to investors even after the forced sale of assets and having met extraordinary expenses associated with liquidation and payments to trustees, valuers and auditing firms.

While the retail investors have received most of their investment money from the 2 companies that went into liquidation. There is a strong belief among the group and investors that both of these companies were viable and profitable and that they fell victims to circumstances beyond their control in the form of faulty asset appraisals and should still be trading today. They were declared technically insolvent based on fire sale valuations and where assets such as investments in CDO's were valued on the basis of "mark to market" as opposed to "market to market "assessments.

The other 4 companies that surrendered their licences and assets to Bendigo bank and other institutions, did so because the risks of operating such companies were greatly exposing them to prospect of failure due to circumstances beyond their control.

The ASIC Chief Economist Alex Erskine in 2008 identified the main cause of the "*debenture company failures were attributed to property development companies involved mainly in residential property and where funds were raised from retail investors through the issue of debentures".*

Problems predominantly arose from property development as the underlying asset as illiquid security being influenced by cyclical trends where valuation problems arose and cash flows depend on sales to be made on development project completion. For many problem companies funds were raised for lending to related parties without appropriate controls or recourse. This cause of company collapse continued as a trend from 2008 and is consistent with most if not all debenture issuing company collapses to this date.

The more recent company collapses (such as Gippsland Secured Investments Ltd) however have been cynically attributed to a new systemic risk where company assets in the form of property held as security over loans are downgraded by fire sale valuations and where this becomes the benchmark for appointing a liquidator. In the case of Gippsland Secured Investments Ltd, many examples of undervaluing property have been cited including the following: 1 property valued at $820,000 was sold within 6 weeks of conducting the valuation for an amount of $1.3 million. Another significant loan for an amount of $4 million had security property fire sale valued at $5 million and this loan was refinanced out of GSI with a fair valuation of $10 million. Worrell's Solvency and Forensic Accountants have found that discrepancies in valuations of this magnitude are very common.

There also appears to be a conflict of interest between instructing audit companies, valuers and liquidators. In the case of Gippsland Secured Investments Ltd, the auditor firm appointed by the Trust Company to appraise the company assets for its viability was the same company appointed as liquidator. When all the assets of Gippsland Secured Investments have been sold under forced sale conditions, and all the auditing, liquidation, trustee and valuer fees have been paid (estimated $7 million), the investors in this company are likely to receive $.92 for every dollar invested. This is similar to the dividend paid by Southeast Secured Investments. Many of the loans from the company's loan book were sold to Deutsche bank at a discount of $.92 in the dollar.

2. <u>DEBENTURE ISSUING INDUSTRY – recent history</u>

During the last decade elements of the debenture issuing industry appear to have taken advantage of retail investors by offering misleading information as to the nature of the product they were investing in. These companies were heavily committed to risky developments and in most cases were using debentures to raise seed capital for related party development ventures. It would appear that most if not all of these companies have now left the industry but have left a poor image for the remaining companies that continue bona fides operations. Discredit was brought to well-run companies in an environment where ASICs was forced to create overreaching rules in an attempt to prevent misrepresentation. Media negativity has fuelled significant contagion impacts on remaining viable companies.

ASIC reacted by introducing Regulatory Guide 69 and 156, in order to better inform retail investors about the product and risks associated with investing in debentures. Unfortunately the retail investor does not understand that the catalyst to company failures is their significant commitment to development loans and mismanagement of loan arrears. This resulted from confusing retail investors with a confetti of related information without focusing on the real cause of company failures – developments and non-performing loans.

Oppressive and counterproductive advertising regulations requiring debenture issuing companies to:

a) state that they are not a bank;
b) state in their advertisements that " *investors risk losing some or all of their principal and interest";*
c) avoid using the following terms in advertisements:
'no fees'; 'deposit'; 'secured';' safe'; 'first ranking'; 'secure'; 'guaranteed'.

The statement that investors are at risk of losing **<u>all</u>** of their principal and interest is misleading in itself by definition of Secured Note where assets must exceed liabilities at all times.

These advertising requirements impacted significantly of the decline of investments in the Provic group companies reducing cash flow and imposing management stresses.

Australian Government guarantee by way of a “Financial Claims Scheme” extended to all ADI’s unlike the New Zealand Government, excluded debenture issuing companies. This scheme was introduced to divert the risk exposure of the major banks to a run on funds, where approximately 57% of their capital deposits base were ‘at call’ and where they only had 16% liquid funds to accommodate the run. The Provic group companies at call deposits account for less than 10% of deposits which they accommodate with an average of around 15% liquidity.

Concern was also directed to the banks where approximately 33% of their lending was on security with LVR’s exceeding 80%. The maximum LVR permitted by the Provic group is 70% and the average for the group was the less than 50% LVR.

The introduction of this scheme saw a significant withdrawal of funds from debenture issuing companies and being transferred to the sanctuary of guaranteed institutions which cause management stress on debenture issuers. This could have been avoided by expanding the safety net to include debenture issuers (excluding unsecured notes).

Government (ASIC) reactions and policies have been skewed to protecting retail investors without consideration for survival of debenture issuing companies. As such, as it has abandoned its obligations of the ASIC Act 2001, where its objectives are identified in Clause (2): *in performing its function and exercising its powers, ASIC must strive to:*

> *(a)* ***maintain, facilitate and improve the performance of the financial system and the entities within that system in the interests of commercial certainty, reducing business costs and the efficiency and development of the economy;*** *and*
> *(b) the competent and informed participation of investors and consumers in the financial system.*

Contagion impacts of failed or stressed companies on other viable entities continued as trustees like The Trust Company took measures to divest themselves of their role as trustee of companies like Gippsland Secured Investments Ltd. This company went into liquidation and after exhausting approximately $7 million in fees (liquidator, trustee, auditors, valuers, et cetera) it is now anticipated to return at least $0.92 in the dollar to investors. This is a result after forced sales of property and the sale of some of the loan book to Deutsche bank for amounts equating to as little as $0.92 in the dollar.

This company was viable and profitable and its assets approximated if not exceeded its liabilities (depending on which valuations used) at this point in time based on ‘mark to market’ sales and assessments.

Southern Finance was purchased by Bendigo bank group in circumstances where contagion impacts seriously affected liquidity due to *investor* withdrawals. This company should still be trading today but for experiencing a run on funds.

Southeast Secured Investments Ltd returning a dividend of $0.92 in the dollar after liquidation signals a similar story to that of Gippsland Secured Investments Ltd.

These three companies, GSI, SESI and Southern Finance (collectively managing $800 million) all operated under the trust deeds with the Trust Company and while investors did not stand to lose significant portions of their investments the Government and Authorities should have exercised their moral obligation to make adjustments within the system to ensure their survival as prosperous entities. This would have prevented a loss of funds by retail investors.

The challenge for the financial system’s enquiry is to identify the processes and checks and balances that can be put in place to prevent further unnecessary failures and loss of retail investor funds. These measures will effectively encourage the persistence, growth and further development of the debenture issuing industry as an alternative while increasing competition and development in regional Australia.

3. RECOMMENDATIONS.

That the Financial Systems Enquiry takes a stock of these experiences to implement **cost-effective** measures to contribute to the success of the debenture issuing industry for the purposes of positively contributing to the further development of regional Australia. We propose the following options to increase confidence in the development of the debenture issuing industry:

a) Introduce a Flat Rate(as opposed to risk weighted) Minimum Capital Requirement of 6% with capital to increase to 10% where greater than 20% of the deposit funds are secured against property developments.

This will enable companies that are not practising risky lending, have less than 10% related party lending and less than 20% of their deposit base in property developments to continue to grow while maintaining their 6% flat rate capital requirement. If companies breach the minimum capital requirements they will have 90 days to rectify the breach before any penalties are imposed.

b) Introduce minimum liquidity requirements of 12.5% of the deposit base.

Companies maintaining > 90% of their investment funds in fixed term investments can have a concessional minimum liquidity requirement of 10% of their deposit base, with a 12.5% recommended level to be maintained. If companies breach the minimum liquidity requirements they will have 90 days to rectify the breach before any penalties are imposed.

c) Remove the requirement from 'Secured Note Holders' for misleading advertising statements that *"investors risk losing some or all of their investment principal and interest"* and replace it with *"investors risk losing some of their investment principal and interest"*

By definition, a secured note can only be called such where the assets are deemed to exceed the liabilities of the company. In such circumstances it is impossible for investors to lose all of their investment principal and interest.

d) Appoint an independent arbiter to act as an external dispute resolution between the trustee/auditor and liquidator and the stressed company.

This will ensure that investor's interests and the company's best interest are acted upon in relation to assessment of the company assets and procedures.

e) Eliminate conflicts of interest, deny auditing companies the opportunity to be appointed as liquidators of stressed companies after their involvement in viability assessments.

No relationship and/or conflicts of interest should exist between valuers, auditors, liquidators and trustees involved in the assessment and winding up of stressed companies.

f) **Fire sale valuations should not be used as all property should be assessed on fair market price within a reasonable time frame depending on the level of exposure or LVR.**

Where the LVR is less than 70% it would be not unreasonable to provide 6 to 12 months for sales to occur.

This will give companies an opportunity to realise the true value of the assets within a reasonable timeframe.

It is unreasonable to expect companies to write off asset values at the bottom of an economic trough

g) **Assist the industry to develop a secondary market whereby the market can determine the values of debentures/securities/bonds.**

These recommendations can be implemented by way of the following options..

1. Amendments to the Corporations Act
2. Introduction of a regulatory guide
3. Adoption of a modified version of the New Zealand Model regulated by a government body.