

choice

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Mr Rhys Bollen  
Regulatory Policy  
Australian Securities and Investments Commission  
GPO Box 9827  
SYDNEY NSW 2001

Email: [policy.submissions@asic.gov.au](mailto:policy.submissions@asic.gov.au)

Dear Mr Bollen

**UNLISTED, UNRATED DEBENTURES - ASIC CONSULTATION PAPER 89**

Thank you for the opportunity to comment on this issue. CHOICE commends ASIC for undertaking this review of the unlisted, unrated debentures sector, and we believe that ASIC's proposals will contribute to better consumer outcomes in the sector. We also have set out some additional proposals about better informing consumers or the relative risks of debentures compared to fixed interest products offered by prudentially regulated ADIs.

Please call me on 02 9577 3225 if you wish to discuss this submission.

Yours sincerely



**Peter Kell**  
Chief Executive

57 Carrington Road Marrickville NSW 2204

Phone 02 9577 3333 Fax 02 9577 3377 Email [ausconsumer@choice.com.au](mailto:ausconsumer@choice.com.au) [www.choice.com.au](http://www.choice.com.au)

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## **Unlisted, unrated Debentures - ASIC Consultation Paper 89**

### **CHOICE Submission October 2007**

CHOICE supports ASIC's increased scrutiny of the debentures market and supports the proposals put forward by ASIC in the consultation paper. Given the losses incurred by investors in this sector it is important that improvements to regulation are examined by the regulator.

CHOICE also values the research work that ASIC has undertaken to establish the range of products and issuers in the debentures market. This gives a very useful overview of this market, and has helped us better understand the range of products on offer.

In addition to the areas identified by ASIC, CHOICE believes that greater regulatory attention should be focused on the status of debentures within the broader spectrum of fixed interest 'deposit' products. This focus needs to be informed by consumer views on fixed interest investment products. In particular, a key regulatory objective should be to clearly inform consumers of the differences between investment deposit products issued by prudentially regulated ADIs (authorised deposit-taking institutions) and investment deposit products (debentures) issued by non-prudentially regulated firms.

CHOICE supports ASIC's three point plan over the next twelve months to tackle consumer problems in this sector. We also support the "if not, why not" basis of reporting for the sector.

### **Risks**

CHOICE agrees with the set of risks outlined by ASIC as a very useful description of the risks faced by consumers.

We suggest an additional element to the risk category of 'misleading advertising' (p12). The risk arising from misleading advertising for debentures goes beyond the creation of "unrealistic expectations" about the relative safety of these products. More specifically, the risk is that debentures are seen by many consumers as analogous to deposit products, especially term deposits, issued by prudentially regulated ADIs. This confusion is exacerbated by the lack of clarity in the regulation of deposit products in Australia.

### **Debentures, fixed interest deposit products, and consumer demand**

CHOICE believes that the regulation of debentures needs to start from the perspective of how consumers understand fixed interest 'deposit' products more generally, particularly term deposits. There is a substantial class of consumers who want a low

risk, simple investment vehicle for all or part of their savings. Often these are older, less experienced investors. These consumers generally wish to avoid the risks of the sharemarket, and instead focus on deposit-type products.

In this context, the key objective needs to be to offer consumers a very clear understanding of the differences across the fixed interest asset class. A major problem has been that these differences are not clear to many consumers, so that debentures are seen as a type of investment deposit product similar to a term deposit issued by a bank or other ADI. From a consumer perspective, it is easy to see why this confusion has arisen, as the “functionality” of the products is very similar:

- Like a term deposit, consumers invest a sum into a debenture for a fixed period.
- Like a term deposit there are regular fixed interest payments.
- Like term deposits, the capital amount can be redeemed at the end of the period or debentures can be rolled over by the consumer.

Furthermore, the advertising and marketing of unlisted, unrated debentures relentlessly focused on this apparent similarity to less risky fixed interest products. The similarity to ADI issued deposit products was consistently suggested either implicitly or even explicitly in the marketing by the issuers. In other words, the issuers clearly focused on the demand for low risk products from a class of risk-averse investors. Unfortunately, too many investors in this category have ended up losing money through debentures. And many of those consumers who have not lost money have arguably taken on more risk than they realise, often for a very modest additional return.

This point provides some context for the collapse of companies issuing debentures. While such collapses are very unfortunate, they will occasionally occur in a market economy (although they should occur less often with more rigorous disclosure, better management and proper controls in place). However, the main reason that the set of recent collapses constitutes a regulatory failure is that too many of the consumers who had put their money into unlisted, unrated debentures believed they were akin to investing in deposit products offered by prudentially regulated banks, building societies or credit unions. This problem – consumer confusion - was surely avoidable. The issue therefore is not just that collapses have taken place, but that elderly, inexperienced investors, who were seeking low risk investments, put their money into products that they mistakenly believed were safe, secure and low risk.

Because of these issues, CHOICE believes that the most pressing information issue concerns the distinction between investment deposit products issued by prudentially regulated entities compared to non-prudentially regulated issuers. That is, there needs to be some clear disclosure about the nature of the issuer so that consumers who demand low risk investments do not put their money into unrated, unlisted debentures.

Many millions of dollars are spent each year on prudential regulation by both government, through APRA, and prudentially regulated entities. Yet the lack of consumer understanding about Australia’s system of prudential regulation means that many consumers do not understand the ways in which prudential regulation affects the risks associated with different fixed interest products. A deposit guarantee scheme would certainly improve this situation, but CHOICE appreciates that this issue is not

within ASIC's area of responsibility (see appendix to this submission). So consumers need a very clear signal that allows them to understand whether the fixed interest "deposit-type" product they are considering is offered by a prudentially regulated ADI or by a firm that is not prudentially regulated at all.

In effect, the issuers of unlisted, unrated debentures have been taking advantage of the regulatory confusion that can emerge at the boundaries between different regulators – in this case ASIC and APRA. It is therefore essential that ASIC works with APRA to develop simple, consumer focused information that allows consumers to understand the distinction between these different categories of deposit products. This should appear in both disclosure documents and advertising. This will then allow both consumers who want a lower risk ADI deposit product, and those who wish to pursue higher risk fixed interest investments, to make an informed choice. If a debenture was issued by a "bank related" entity (or other ADI related entity), then this could also be clearly set out, but it should be clear that this is not from an ADI.

One possible difference between term deposits and unlisted, unrated debentures is the interest rate. However, for many consumers there is little understanding of how a difference of a few percentage points (or less) can result in a major difference in the level of risk. This difficulty is exacerbated by at least five factors:

- The advertising for these products relentlessly promoted the concepts of safety, security etc. On the other hand banks and other ADIs have done little to distinguish their "investment deposit" products (term deposits) from debentures in marketing or promotion.
- As ASIC's consultation paper demonstrates, some debentures offer interest rates that are no different to those offered by ADIs via term deposits. There is no simple rule for interest rates and risk differentials with debentures.
- It is arguable that some debenture issuers should have offered consumers much higher interest rates to truly reflect and reward the level of risk involved. In other words, a difference of a percentage point or two substantially underpriced the risks, yet consumers had very limited means to accurately assess this risk.
- It is difficult for consumers to assess the difference in risk implied by a small difference in interest rate in a climate where returns on other asset classes, notably in the sharemarket, have been much higher for an extended period of time. Well known "blue chip" stocks have been generating very high returns.
- The nature of the risk in fixed interest products is different to that encountered in market-linked investments. It is arguably more difficult to explain, in that the risk can be characterised as binary – the investor gets a set interest payment and their capital returned, or the investment falls over<sup>1</sup>. CHOICE has yet to see a simple explanation of how consumers can easily determine whether a small difference in interest rate translates to higher risks.

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<sup>1</sup> Professor Ian McAuley made the observation about the "binary" nature of risk in debentures

These points mean that a focus on the product, rather than the nature of the issuer, will only be a partial solution to consumer needs.

In summary, the first step in the regulation of this sector should be to very clearly convey to consumers, especially those seeking a simple, low risk investment, that debentures are significantly different to ADI investment deposit products. This difference is important despite the apparent similarities between these products. The major reason for this difference is because of the regulatory regime under which the issuer operates. This would help to ensure that consumers who were after a very low risk deposit product more appropriately focused on the offerings from ADIs. For this class of consumer it is unnecessary to understand the more detailed issues around benchmarks for liquidity, credit rating etc.

This objective could be partly met by the sensible restrictions on advertising and marketing proposed by ASIC. But it also requires a clear and unambiguous method for communicating to consumers the particular risks associated with the issuer (ADI vs non-ADI) which is not apparent in the market at present. Perhaps this could involve a restriction on the use of the term "deposit" to describe products other than those offered by APRA regulated ADIs.

The market should work in such a way that those consumers who are after low risk deposit products understand that debentures are by and large out of their range of choices. This would then leave a class of consumers who were interested in a fixed interest product that offered higher returns than a term deposit. It is this class of consumers that would clearly benefit from the proposed benchmarks suggested by ASIC.

## **Benchmarks**

CHOICE supports the development and implementation of benchmarks as proposed by ASIC.

### ***Credit Ratings***

CHOICE supports the requirement of issuers to have their products rated. However, we do note some limitations to credit rating.

Consumers do not necessarily have a good understanding of credit ratings. One reason is that rating agencies do not use consistent terminology in their ratings. In particular, rating agencies do not always use straightforward consumer-focused language, and instead may use more complicated probability measures or technical language. In CHOICE's experience (from a wide range of consumer markets) the existence of multiple, inconsistent "ratings" or "quality marks" may actually increase consumer confusion and cynicism. It would be more beneficial if there were common terms and a consistent approach used in ratings for the retail debenture market.

A second drawback is the possibility that issuers will use other assurances rather than rating agencies. Would these satisfy the 'if not why not' criterion? For example, Westpoint had been audited by KPMG, a firm known to most consumers. Bridgecorp had been awarded a "gold medal" by Cannex/Money Magazine. If these were

satisfactory it may further confuse consumers, so it would be preferable for a rating to be a formal requirement.

There is then the issue of which agencies may undertake rating, and CHOICE notes at least one agency had rated Westpoint and Bridgecorp – in the case of Bridgecorp suggesting that it was “of reasonably good quality” not long before its collapse. We are pleased that ASIC has identified a limited range of credible agencies, and that these agencies will assist in the application of the Equity Capital benchmark.

Overall these issues are not an argument against ratings, but we agree with ASIC that they play one role but need to be supplemented by other benchmarks.

### ***Equity Capital and Liquidity benchmarks***

CHOICE supports the equity capital and liquidity benchmarks proposed by ASIC.

### ***Valuations***

On the issue of valuations, CHOICE particularly supports the requirements D9 (d) and (e). Conflict of interest is a key issue with valuers, and we agree with ASIC that investor confidence will be improved if there is a stronger degree of independence.

### ***Rollovers***

Research from behavioural economics highlights the dominating influence of default options for consumers. Therefore, on the issue of rollovers CHOICE would prefer that debenture issuers do not have automatic rollovers as their default option. Consumers should be able to clearly and easily choose the option of automatic rollover, but this should not be the default for all investors. Automatic rollover should be “opt in” rather than “opt out”.

## **Disclosure**

CHOICE supports the proposals for disclosure outlined by ASIC.

As discussed above, in addition to ASIC’s proposals, CHOICE believes a clear message that allows consumers to understand that debentures are not like deposit products offered directly by ADIs is a critical feature of upfront disclosure. Again, this needs to convey the different risks associated with the issuer.

## **Advertising**

CHOICE strongly supports the proposals to improve advertising. ASIC has previously issued advertising guidance to the financial services industry. For example, ASIC provided guidance on the use of past performance for investment funds, and this has largely been successful in limiting the use of inappropriate past returns in marketing. This guidance discussed issues such as the appropriate use of “fine print”, which is well recognised as inadequate to convey key information to consumers.

In particular, CHOICE supports the proposal that advertisements for these products should not use terms that imply secured or guaranteed (etc) as set out in F3(a). We

also support the proposal that would require promoters to avoid implying that these investments are particularly suitable for a particular class of investors.

This latter proposal may require some guidelines from ASIC about the visual images that are used in promoting these investments, especially if used extensively in marketing campaigns. For example, Fincorp used full page advertisements backgrounded by photographs of an older couple walking along the beach during a long and aggressive marketing campaign – these visual messages are very powerful in influencing consumers.

Finally, consistent with our concerns about the risks associated with different issuers of deposit type products, we would strongly support a requirement that debenture advertising provided some simple “mark” or statement about whether the issuer was prudentially regulated or not.

## **Investor Education**

CHOICE supports the research and education initiatives proposed by ASIC.

CHOICE supports the proposal to explore funding options with industry participants for investor education. However, we note that there is a strong desire on the part of consumers to receive financial and investor education from independent sources. It would therefore be important to have any industry-funded education arranged and administered in such a way that it was clearly independent of any provider. Consumers will value education more highly if it comes from sources without a conflict of interest in selling a product or advice.

In addition to the areas outlined by ASIC in section H (paras 102, 103), CHOICE also believes there is an important role for a more focused education initiative to ensure that investors understand the differences in fixed interest deposit-type products offered by ADIs and those deposit-type products issued by non-prudentially regulated firms.

In other countries with deposit guarantee schemes, such as Canada, this education objective is built around the public explanation of the guarantee scheme (eg what falls inside the scheme, what falls outside). In the absence of such a scheme in Australia, at a minimum it would be important for consumers to understand the different risks associated with prudentially regulated and non-prudentially regulated issuers.

## **Regulatory and Financial Impact**

The impact of major collapses has both direct effects through consumer losses, and also significant ongoing impacts should consumers have to rely on family or governments to support them. This is particularly acute when older investors have been disproportionately affected by such collapses. This situation is particularly problematic when many consumers entered into these products without being able to understand the level of risk. In this case the losses are not a normal part of investing, but are due to market and regulatory failure. It also means that there are consumers at

present who have money in products with a higher level of risk than they understand or wish to have.

On the issue of competition, if the regulatory system around investment deposit products could be substantially clarified for consumers this would help to ensure that competition around fixed interest products with different risks occurred on a "level playing field". It is very clear that the issuers of unrated, unlisted debentures have been taking advantage of consumer confusion about the level of safety associated with their products. In effect, issuers of unlisted, unrated debentures have been "free riding" on the safety of the prudential regulatory system, despite not having to incur the costs involved in participating in this system. Consumers have been the losers from this free riding behaviour, and it has clearly reduced the efficiency of the market as a result. It has also reduced the cost-effectiveness of prudential regulation in the ADI sector. A clearer disclosure regime could help address this problem.

Too much of the marketing of unlisted unrated debentures has portrayed such products as if they are competing on the same level as term deposits offered by banks or other ADIs. In this way consumers see these products as more competitive because they may offer a higher return, but in reality the risk levels are substantially higher. In other words, a system that allowed retail consumers to properly understand the difference between difference classes of fixed interest investments would facilitate competition within these classes, rather than perpetuating the current muddled environment where "competition" involves apples and oranges.

In our submission to the government's review of deposit guarantee schemes, CHOICE noted that the absence of such regulation should not be seen as "costless".

## **Appendix - Deposit Guarantee Scheme**

The absence of a deposit guarantee scheme in Australia makes it more difficult for consumers to clearly distinguish between low risk (prudentially regulated) and higher risk deposit products. This is of course a policy matter outside of ASIC's responsibility, and quite appropriately has not been dealt with in the ASIC consultation paper. However, the recent collapses highlight the problems that face consumers in the absence of such a scheme. ASIC's role in informing consumers about different risk levels would be assisted by a sensible deposit guarantee scheme<sup>2</sup>.

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<sup>2</sup> The Government issued a discussion paper on deposit guarantee schemes, as part of a wider study of financial system guarantees, in May 2004. This was one of the responses to the HIH Royal Commission. No such scheme has been introduced. Australia is one of the only developed countries without such a scheme.