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The collapse of unlisted mortgage companies: a regulatory dilemma

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Abstract

Purpose – Policy issues associated with the regulation of the unlisted debenture market have been highlighted in recent times with the collapse of a number of regionally based mortgage companies. The purpose of this paper is to analyse the decline and demise of the unlisted debenture market between 2007-2013 with particular reference to the effectiveness of the regulatory regime in stabilising the industry and protecting investors' interests.

Design/methodology/approach – A database was constructed which reflected the total population of unlisted mortgage companies in the financial sector. A snapshot approach was used to assess the extent to which these companies complied with regulatory provisions.

Findings – Findings suggest the regulatory process allowed these companies to continue operating despite not complying with the relevant Australian Securities and Investments Commission benchmarks. In the light of the current inquiry into the financial system, the research suggests that a re-evaluation of the regulatory approach is timely.

Research limitations/implications – This research is restricted to a study of one category of debenture issuers (issuers of mortgage finance). It is based on reports required by regulatory authorities. It does not provide an analysis of the motivations of investors in these companies.

Practical/implications – This research has implications for the implementation of regulatory change in respect to oversight of shadow banking activities. It suggested that a passive approach to regulation is not sufficient to ensure that the interests of investors are fully protected.

Originality/value – No prior research has systematically examined the unlisted mortgage and analysed the borrowing and lending activities of companies that have failed and those that have survived.

Keywords ASIC benchmarks, Debentures, Secured notes, Shadow banking, Unlisted mortgage companies

Paper type Research paper

Introduction

The collapse of the relatively large regionally based financial institution *Banksia Financial Group* in October 2012 has thrown the spotlight on the performance of the unlisted debenture market and highlighted significant deficiencies in the policy approach to the regulation of this type of financial institution. The failure of the Banksia group follows on from the demise of a number of parallel institutions in the wake of the Global Financial Crisis (GFC). The collapse of Fincorp, Australian Capital Reserve, Bridgecorp and Westpoint in 2007 impacted on around 20,000 investors who were owed in excess of $900m (Erskine, 2008a, 2008b). At the date of its collapse in October 2012, Banksia had approximately 23,000 accounts amounting to $660m.

In the light of the recent inquiry into the financial system (The Australian Government The Treasury, 2014), it is timely to consider the effectiveness of regulatory controls on non-prudentially regulated financial institutions. The history of the failure of unlisted mortgage companies illustrates the importance of this point of reference in the development of a "blueprint" for the financial system in the future. The shadow banking system has been under intense global scrutiny since the GFC. There has been a concerted effort by

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governments around the world to understand the causes of the GFC in an attempt to mitigate against such events in future (Avgouleas, 2009; Brown *et al.*, 2011; Eslake, 2009; Jain *et al.*, 2012; Lander, 2008; Shin, 2009). The role of the regulator in protecting not only the stability of financial markets but also the consumer in times of crises has been the subject of much debate (Hill, 2012, pp. 285-95).

There are two reasons why an investigation into the systemic problems of the unlisted mortgage market is important to policymakers. First, the growth of the "shadow banking" market has implications not only for legitimate banking institutions but also the broader financial sector[1]. The Interim Report into the Financial System in Australia has suggested that the shadow banking sector can be a source of systemic risk. In particular, the issue of "regulatory arbitrage" was identified, whereby the more risky types of lending are transferred from regulated to under-regulated financial institutions (Australian Government Treasury, 2014). An understanding of the implications of this type of behaviour is important for future policy development.

Second, the activities of unlisted mortgage companies in Australia have been largely focussed in regional areas. While the failure of a company like Banksia may have relatively little impact nationally, it has had substantial effects on the regions where it operated. Analysis of the failure of these institutions can provide insights for future policy applications aimed at promoting regional growth and development.

This study examines the performance of 28 major unlisted mortgage companies between 2007 to 2013. No prior research has systematically examined this sector of the market and analysed the borrowing and lending activities of companies that have collapsed. The paper has two aims. First to determine the extent to which these institutions met the guidelines/benchmarks established by the regulatory authority (the Australian Securities and Investments Commission [ASIC]). Second to assess the adequacy of the regulatory approach to this section of the financial services market.

The paper proceeds as follows. The next section discusses the market context in which unlisted mortgage companies have emerged. The regulatory requirements facing these companies, and the rationale for these requirements, are then examined. The study's research method is then outlined, followed by research findings, which centre on the collapse of this sector of the market and the compliance of the unlisted mortgage companies with applicable regulation. A discussion of the implications of the study's findings in respect to the adequacy of the regulatory approach and the actions of ASIC follows. A conclusion section completes the paper.

Market context

The issuing of debentures or the raising of funds through borrowing is a long-established business practice[2]. Finance companies have traditionally been major suppliers of debenture finance, particularly unlisted debentures (Pozsar *et al.*, 2010).

Whilst there are several categories of debenture issuers, it is the issuers of mortgage finance that are the focus of this study. These companies attract funds through the issue of debentures and secured notes to retail investors. Under the *Corporations Act 2001* (s 911A), these institutions are required to have an Australian Financial Services Licence. ASIC as the issuing body stipulates certain conduct and reporting requirements that all financial service providers must comply with.

Many unlisted mortgage companies, especially those in regional areas, can trace their ancestry to solicitors' mortgage investment companies (SMICs). There is a long history of solicitors holding money and providing financial services to their clients (Middleton, 2003). Historically, these funds were held in trust and regulated by the Law Society in each state. Following a series of high-profile collapses in the 1990s, governments in various states took

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action to separate the finance functions of law firms from their core business. SMICs emerged as separate entities, although still with a close connection to their associated legal practice. They continued to grow their lending facilities primarily through the issue of debentures. They played an important role in the regional property development market, providing a source of funds for small local enterprises that found it difficult to raise funds in other money and capital markets, particularly from the traditional banking sector. Their connection to local solicitors allowed them to capitalise on the relationship that firms of regional solicitors had with their clients. Investors viewed them as trustworthy because of their standing in the local community. Research undertaken by ASIC (2008a) which profiled investor characteristics suggested that many investors do not seek formal advice but instead rely on their impressions of the security of the product when making investment decisions. The link between SMICs and well-respected members of the legal community in local areas fostered the impression that investing in unlisted debentures offered locally was safe and secure.

The success of SMICs encouraged the entrance of other funds providers in regional areas from the late 1990s. By 2007, just prior to the GFC, the debenture market was characterised by a small number of suppliers, predominantly operating in regional areas. Nearly half had evolved from solicitor mortgage funds and, for the most part, operated as public unlisted companies.

Regulation

Market failure provides the economic rationale for policy prescriptions that regulate financial institutions. The body of literature surrounding financial regulation reflects a lack of consensus on its impact. In this respect, there are two strands to the debate. The first revolves around the efficiency of the market, including broader issues of financial and economic stability. The second relates to welfare concerns and the implications of market failure for consumers. This reflects the two approaches to financial sector regulation taken in Australia. The first concerns the setting of prudential standards, which are designed to ensure the stability and soundness of the financial system is protected. The second is concerned with encouraging a market that promotes consumer welfare. This point has been made succinctly by Schwarcz (2012), who argues that regulators must grapple with the issue of how to optimally minimise systemic risk while preserving market efficiency.

Prudential controls have largely focussed on deposit-taking institutions, principally banks, buildings societies and credit unions. The comparative size of these institutions as a proportion of total financial sector assets, their impact on broader macroeconomic aggregates and their role in taking and investing the deposits of the public have meant that the setting of prudential controls has generally been deemed to be necessary. Registered finance companies, of which unlisted mortgage companies are a part, have not been subject to the same prudential regulation (APRA, 2013). The Reserve Bank of Australia has been of the view that, as these finance companies were not subject to runs or contagion, their collapse did not threaten the overall stability of the financial system and therefore did not require prudential control (Erskine, 2008a). Oversight of the unlisted debenture market was vested in the ASIC. The role of this regulator was to essentially monitor and review information disclosures and alert retail investors to the risks of debenture issues. The approach taken has relied on the principle of "freedom with disclosure" (ASIC, 2007a). The rationale behind this line of thinking was that markets are the key drivers of efficiency and as such intervention should be kept to a minimum (Australian Government Joint Parliamentary Committee, 2009, p. 7). In this respect, the emphasis was placed on conduct and disclosure regulation designed to ensure investors had appropriate information upon which to base investment decisions.

Regulation of the unlisted mortgage market attempts to achieve balance in respect to two key aims. On the one hand, regulation provides the mechanism for consumers to make

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informed decisions. On the other, it endeavours to moderate the impact of any intervention on the market and on businesses operating within it. The aim is to essentially enhance competition by making information more freely available and, in doing so, offset the negative effects of market imperfections on consumers.

Chapters 6D and 2L of the *Corporations Act* (2001, as amended) form the basis on which finance companies, such as unlisted mortgage companies, are regulated. Chapter 6D regulates the way in which funds can be raised. It stipulates that securities cannot be offered for sale until a disclosure document has been lodged with the ASIC. This document commonly takes the form of a prospectus, profile statement or other information statement. Chapter 2L establishes the requirement that a trust deed and trustee be appointed with oversight over the fund-raising activities of the company. The trustee has the power to call meetings of investors, provide information and make recommendations to investors. The role of the trustee is to act as an independent watchdog protecting investor interests and the security of their investment. In summary, regulation of unlisted mortgage companies is based primarily on:

- the provision of relevant and reliable information by institutions; and
- a trust deed and trustee to protect depositors/investors.

From 2002 it became evident that there were issues with this approach to the oversight of unlisted mortgage firms (ASIC, 2002). In July 2003, ASIC took action over 14 debenture prospectuses with significant disclosure deficiencies. These deficiencies included failure to comply with the requirement for a trust deed and trustee, lack of disclosure of bad debts and inadequate disclosure of lending policies, financial information and use of funds (ASIC, 2002). An ASIC inquiry in 2005 expressed serious concerns over high-yield debentures (ASIC, 2005). ASIC listed as significant problems, aggressive and misleading advertising, conflicts of interests over related party transactions, problems with property valuations and inadequate disclosures (ASIC, 2005). In 2007, a series of collapses of residential property development companies that had issued unlisted debentures further highlighted fatal flaws. In 2007, Australian Capital Reserve Ltd., Bridgecorp Finance Ltd. and Fincorp Investments Ltd. were all placed in receivership (Erskine, 2008a).

In response to the failure of these companies, ASIC put forward a plan to improve disclosure protocols; they were spelt out in ASIC Regulatory Guide 69 (ASIC, 2012). Certain "benchmarks" were specified, these being based on four principles. First, the benchmarks were designed to assist investors in assessing the level of risk and the risk/return trade-off. Second, issuers of unlisted securities were required to disclose against the specific benchmarks on an "if not why not" basis and ensure advertising was consistent with these results. The third principle assumed that the parties involved with the issuers, such as trustees and auditors, would use this information in carrying out their duties. The fourth principle assumed that an appropriate education programme would be available to investors to assist them in understanding the relevance of these benchmarks in determining their decision to invest (ASIC, 2012). Table I summarises the disclosure requirements[3]. Benchmarks 1 to 4 apply to all issuers, 5 and 6 apply to those that on-lend money and 7 and 8 to property-related transactions (ASIC, 2009).

Unlisted mortgage companies are expected to provide information relating to the above benchmarks in any disclosure document and at least twice yearly in reports to the trustee. The approach taken is based on an "if not why not?" model, requiring debenture issuers to disclose whether they met each of the applicable benchmarks and, if not, to explain why not. ASIC's role is to monitor and review reported information and discuss issues arising with specific companies and trustees as and when required. There are no specific penalties attached to non-compliance

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Benchmark	Summary
Equity capital	Stipulates specific equity ratios and method of calculation. Must also include comparative ratio from previous year
Liquidity	Must disclose cash flow estimates for the next three months, and ensure that at all times, it has cash or cash equivalents sufficient to meet its projected cash needs over the next three months
Rollovers	An issuer should clearly disclose its approach to rollovers
Debt maturity	An issuer should disclose an analysis of the maturity profile of interest-bearing liabilities (including notes on issue) by term and value, and the interest rates applicable to its debts
Loan portfolio	An issuer who directly on-lends funds, or indirectly on-lend funds through a related party, should disclose the current nature of its (or the related party's) loan portfolio
Related party transactions	An issuer who on-lends funds should disclose its approach to related party transactions
Valuations	Stipulates the approach for valuing properties where property loans are made
Lending principles – loan-to-valuation ratios	Determines loan to valuation ratios where money is lent for property activities

Source: ASIC (2012)

Table I. Disclosure benchmarks

with the benchmarks. ASIC has two courses of action open to it to bring an issuer into line. It has the power to impose a stop order if a document does not comply with required disclosures. In addition, if it is considered that the trustee is not exercising their duty as required, ASIC can apply for a court order to protect the interests of investors (ASIC, 2007a).

The benchmark model was the key regulatory instrument in use at the time of the collapse of major regional mortgage investment companies such as Banksia.

Research method

This paper provides an analysis of the recent history of institutions comprising the unlisted mortgage market. The research methodology used involves an assessment of the major unlisted debenture issuers in Australia as at 2007, as identified in ASIC's *Consultation Paper 89* (ASIC, 2007a).

Thirty-six unlisted mortgage companies were identified as being in existence in 2007. These were listed in *Consultation Paper 89* as "unlisted, unrated debenture issuers" in the "mortgage financing" category (ASIC, 2007a). Eight companies were excluded from this data set for a variety of reasons. Three were listed companies or subsidiaries, two were either privately owned or privatised and three were very small concerns with no available trading information. Hence, 28 unlisted mortgage companies were identified for purposes of the study.

As noted in the previous section, the management of unlisted mortgage companies is vested in a trust deed administered by a trustee arrangement. As unlisted companies, the issue of securities is not undertaken on the stock exchange, but are instead made privately with the release of a prospectus available to potential investors. The unlisted mortgage companies are required to lodge all prospectuses, as well as quarterly reports to their trustees, with ASIC. The study's research method entailed hand-collecting the reports of the unlisted mortgage companies and constructing a database containing relevant details of their issuing, lending and operating activities. The years selected for the analysis were 2007, 2010 and 2013, which provide a snapshot across this period. The years 2007 and 2010 reflect the activities of entities prior to

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major periods of company failure, and also capture pre and post the GFC effects. The year 2013 is reflective of the current position of the market and the number of firms operating within it. This approach provides a picture of the market (for 2007, 2010 and 2013) as it underwent a period of substantial structural adjustment. The research method also provides a picture of compliance patterns with the relevant ASIC benchmarks, enabling conclusions to be drawn on the regulatory policy approach operating over the period.

Findings

As noted above, 28 unlisted mortgage companies were identified as existing in 2007 pursuant to the study's research method. These companies are listed in the Appendix.

Appendix shows that 19 of the 28 issuers in 2007 (67.9 per cent) were located in regional areas; the majority in regional Victoria, Queensland, New South Wales and South Australia. Thirteen of those 19 regional providers (68.4 per cent) can trace their ancestry to SMICs.

Of the 28 unlisted mortgage companies, only nine remained by 2013. This rapid reduction in numbers is indicative of the systemic problems within this sector of the industry. Further information on this reduction in numbers in the sector is provided in the following sub-section.

Although not authorised deposit-taking institutions (ADIs), a large proportion of unlisted mortgage companies accepted "deposits" (at call debentures). In this respect, they were treading a fine line. The *Banking Act 1959* stipulates the basis by which the business of baking is undertaken. Specifically, only ADIs are able to accept deposits and make loans. Retail finance corporations are exempt from authorisation, as they do not take deposits. However, they do provide "at call" facilities that allow investors to add and withdraw from an investment account. In 2007, 62 per cent of the unlisted mortgage companies examined provided at call facilities. This rose to 75 per cent in 2010, falling slightly to 73 per cent in 2013. This practice created an impression among depositors that these companies were similar to banks and, as such, subject to the same types of prudential controls that governed ADIs. Thus, when these companies failed, investors not only lost longer-term funds invested but also lost any savings kept in at call accounts.

The collapse of the unlisted debenture market

Cracks in the structure of the unlisted debenture market began to appear in the aftermath of the GFC. As noted above, only 9 of the 28 unlisted mortgage companies remained solvent by 2013. Hence, 19 companies (67.9 per cent) disappeared over the course of this seven-year period, 2007 to 2013.

Table II presents, for each year 2007 to 2013, the pattern of demise of the 19 unlisted mortgage companies. Appendix also provides a list of the nine surviving companies (as at the end of 2013) and further details on the 19 companies that disappeared over this period.

The figures in Table II reveal that the major reason for the disappearance of the 19 mortgage companies was due to placement into receivership. Thirteen of the 19 (68.4 per cent, or slightly over two-thirds) disappeared in this way, with one further company being voluntarily wound up. For the other five companies, three ceased operating as mortgage companies with the sale of their loan book and two were taken over[4].

Table II indicates that two main periods of failure occurred. The first in the wake of the GFC, and the second between 2012 and 2013. An estimated $557.42m of investor funds was lost with liquidation. Returns to depositors ranged from 3.7¢ in the dollar to 90¢ in the dollar.

The amount of debentures and secured notes on issue by the unlisted mortgage companies is shown in Table III. The distinction is made between continuing and discontinuing entities, across the survey years 2007, 2010 and 2013. The table indicates both

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the large amounts that had been invested in the secured notes and the sizeable decline in these amounts over the period examined as a number of the companies failed. The total amount of secured notes on issue amounted to $2,960m in 2007. Of this total amount, $482m of notes had been issued by continuing entities (i.e. entities that continued after the end of 2013), and $2,478m by entities that had ceased issuing notes by the end of 2013. It is clear that companies that failed had a history of lending greater amounts. In 2007, continuing entities issued an average of $60m worth of secured notes, while for those that failed, the average was $130m.

For 2010, the total amount of notes on issue by the entities examined had declined to $1,825m. The notes issued by continuing entities increased to $526m, a 9.2 per cent increase over 2007. In contrast, and as some of the entities operating in 2007 discontinued their operations, the notes on issue in 2010 fell to $1,299m, a 47.6 per cent decline from 2007. For 2013, the total amount of notes on issue by the entities that continued after 2013 declined to $591m. In summary, and to highlight the magnitude of the entities that discontinued their operations by the end of 2013, the total amount of secured notes on issue by the entities examined in this paper declined from $2,960m in 2007 to $591m in 2013, a decrease of 80 per cent. A further point of note is the extent of lending by firms that subsequently went into receivership. Thirteen of the 19 firms that failed had gone into receivership by 2013. These firms issued an average of $126m of secured notes in 2007, more than double that of continuing firms.

Figure 1 summarises the lending patterns of unlisted mortgage companies. There is a definite shift in the make-up of loan portfolios between 2007 and 2013. In 2007, lending for property development constituted 30 per cent of all loans. This proportion was higher

Table II. The demise of unlisted mortgage companies

	Reason for unlisted mortgage company demise				
Year	Receivership	Voluntary wind-up	Loan book sold	Takeover	Total
2007	0	0	0	1	1
2008	7	0	0	0	7
2009	1	0	0	1	2
2010	0	0	0	0	0
2011	1	0	0	0	1
2012	3	0	2	0	5
2013	1	1	1	0	3
Total	13	1	3	2	19

Table III. Debentures and secured notes on issue

Entity status	2007 $m	2010 $m	2013 $m
Continuing entities	482.02	526.25	590.95
Discontinuing entities			
Receivership	1,640.70	861.20	—
Voluntary wind-up	15.80	12.10	—
Loan book sold	441.70	425.40	—
Taken over by another issuer	379.80	—	—
Total discontinuing entities	2,478.00	1,298.70	—
Total	2,960.02	1,824.95	590.95

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amongst firms that went into receivership in the following year (38 per cent). Of the other categories, residential lending represented 29 per cent, rural 23 per cent and commercial 13 per cent in 2007.

In the following period, 2010, there was a dramatic decline in lending for property development, which fell to 12 per cent of total loans. The focus shifted to residential lending (40 per cent) and increases occurred in both rural (27 per cent) and commercial lending (16 per cent). This trend continued in 2013, with residential lending now the main type of lending, comprising 42 per cent, and lending for property development falling to 11 per cent. However, despite the shift away from more speculative property development lending, unlisted mortgage companies continued to fail. Table IV compares particulars of loan management between those companies that survived and those that didn't, indicating some fundamental differences between the two.

Table IV shows that the average size of the loan book of failed companies is much larger than companies that have survived beyond 2013. This is mirrored in their lower equity to debt ratios. In 2007, the average value of loans made by failed companies was more than double that of surviving companies. Days to maturity tended to be lower for continuing companies, indicating that they were lending over shorter periods. More significantly, the number of loans in arrears was considerably higher with failed companies. This is reflected in the higher loan to valuation ratios (LVRs) within this group, indicating that they were lending more per loan.

Compliance with ASIC benchmarks

The activities of unlisted mortgage companies indicate the high levels of risk-taking amongst entities that later ran into trouble. The following section considers the extent to which these companies complied with the eight ASIC benchmarks listed in Regulatory Guide 69 (ASIC, 2012).

Table V indicates that, although compliance has improved over time (partly as a result of various entities discontinuing their operations over the period), there were significant areas of concern, particularly in the areas of equity and valuations. Benchmark 1 requires issuers to have a minimum equity ratio (total equity/total liabilities + total equity) of 8 per cent (except for notes raised to support property development, where the required equity ratio is 20 per cent). In this case, even continuing issuers have failed consistently. Only three of the nine continuing issuers met this target in 2013. A further three had ratios of only 3 per cent,

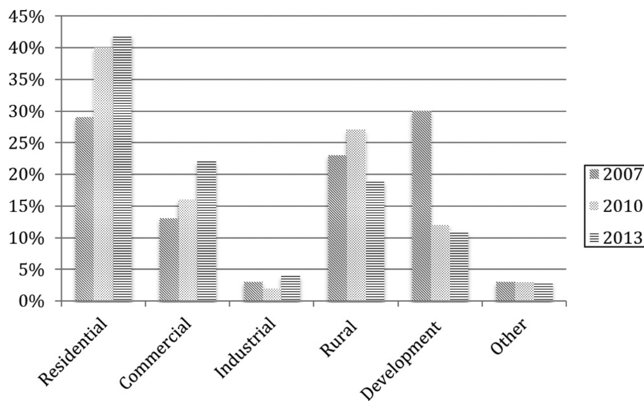

Figure 1.
The loan exposure of all issuers

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Year	Average total loan $m	Average loan size $m	Average term to maturity days	No. of loans in arrears	Average LVR (%)	Average equity ratio (%)
2007						
Continuing entities	58.25	0.9	343	33	47	7.4
Discontinuing entitiesa*	137.41	1.4	142	109	64	4.7
2010						
Continuing entities	59.85	0.8	316	72	45	9.3
Discontinuing entities	182.98	0.6	122	191	67	5.9
2013						
Continuing entities	53.36	0.7	462	76	47	9.4
Discontinuing entities	322.40	0.45	na	160	na	na

Note: [a]Data for discontinuing entities are based on loans still outstanding that year

Table IV. Summary of loan trends

less than half that required by the benchmark. The reason given for not meeting the designated equity level was that the firms involved already held significantly more assets than required by their trust deed.

Only 1of the 19 discontinued issuers complied with the equity benchmark (Benchmark 1) in 2007. The average equity ratio of these firms was 4.7 per cent, although some were reported as low as 1 per cent. Inadequate equity ratios become an issue when investments encounter problems. Apart from the raising of more capital, there are few alternative funds available to support loan defaults in the short term. ASIC (2012) also identifies two other issues associated with low levels of equity. First, the interests of issuers and note holders are

Benchmark	Proportion of companies complying 2007 (%)	2010 (%)	2013 (%)
Continuing entities:			
1. Equity	25	25	38
2. Liquidity	63	100	100
3. Rollovers	100	100	100
4. Maturity/credit rating	0	100	100
5. Loan portfolio	50	100	100
6. Related parties	50	100	100
7. Valuations	13	38	50
8. Loan to valuation ratio	88	88	100
Discontinued entities:			
1. Equity	6	22	—
2. Liquidity	78	100	—
3. Rollovers	94	100	—
4. Maturity/credit rating	0	89	—
5. Loan portfolio	78	89	—
6. Related parties	94	100	—
7. Valuations	6	22	—
8. Loan to valuation ratio	67	44	—

Note: [a]See Table I for details of benchmarks

Table V. Summary of ASIC benchmark compliance in the unlisted debenture market*

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not well aligned and agency problems are more likely to occur. Second, there is less incentive to pursue management practices that would protect the interests of investors.

The liquidity benchmark (Benchmark 2) requires issuers to be able to meet project cash flow requirements for the following three months. Although this benchmark was not met by either continuing or discontinued issuers in 2007, it was met in the following periods.

The rollover benchmark (Benchmark 3) requires companies to disclose their rollover process and how investors were informed of any changes that were required to be disclosed. There were very high levels of compliance over the study period for this benchmark.

Benchmark 4 (maturity/credit ratings) was designed to measure the credit risk associated with loans made. Initially it was intended that credit risk would be measured through an external credit rating agency. Unlisted mortgage companies objected to this on a number of grounds. They argued that the cost was not warranted, that the approach used by external agencies was not relevant to this particular market sector and that the "prudent" lending practices of these companies reduced credit risk (ASIC, 2008b). No companies used an external rating agency in 2007, and therefore, they did not pass this benchmark. This benchmark was later replaced by a measure of debt maturity. This new benchmark required issuers to provide an analysis of the maturity profile of interest-bearing liabilities, including interest rates. The rationale for this measure was to provide investors with an understanding of how the business was funded and the nature of its debt obligations (ASIC, 2012). High levels of compliance with this benchmark are evident. However, the move from an external to an internal risk assessment may not have served investors as well as anticipated, given the number of failures post 2007.

Benchmark 5 (loan portfolio) requires companies that directly or indirectly on-lend funds to disclose the nature of their loan portfolio. This disclosure should include the number and types of loans, their value, maturity profile, interest rates charged and the nature of security required. This benchmark was designed to highlight any risks associated with the loan portfolio if it was skewed in a particular direction. Disclosure of this benchmark has improved over time. However, this did not mean that loan structures were sound. Table IV illustrates the high level of arrears and debt to equity ratios, particularly in companies that subsequently failed.

Lending to related parties was also a practice common with many unlisted mortgage companies. This type of activity created extra risk, as the relationship between the two parties had the potential to compromise the effectiveness with which such loans were managed (ASIC, 2012). Benchmark 6 requires the issuers to declare related party transactions and provide details of such loans and the approval process followed in this respect. Table V indicates that, initially, continuing issuers had a low level of compliance (50 per cent). However, in both cases, compliance did improve over time and all issuers have complied since 2010.

As property is a key component of the loan portfolios of unlisted mortgage companies, the valuation benchmark (Benchmark 7) is of particular significance. Valuations affect key ratios such as equity and LVRs. Accuracy is important in the determination of the company's financial position and the viability of particular investments. Benchmark 7 established several protocols to be used in the valuation of property and development property. First, residential and commercial property should be valued at current market value, while development property is estimated assuming certain improvements are complete. Second, development properties should be revalued at least every 12 months. Third, there should be a clear policy on how valuations are obtained, valuers should be licensed and approved by the trustees and no single valuer should value more than one-third of total valuations (ASIC, 2012). Table V indicates that

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compliance with this benchmark was poor. Only 6 per cent of discontinued companies complied in 2007 (13 per cent for continuing). Even in 2013, only half the issuers complied.

Benchmark 8 (loan to valuation ratio, or LVR) establishes the lending principles for property and development property investment. It stipulates in the case of loans for property, that not more than 80 per cent of the valuation should be lent. This ratio is 70 per cent for development property, with a further condition that funds should be released in stages only based on the progress of the project. The higher the LVR, indicating a more aggressive the approach to lending, the greater the risk that changes in market conditions will impact on the security of the loan (ASIC, 2012). Discontinued issuers did not perform well in complying with this ratio, particularly in 2010, when only 44 per cent of issuers complied. The average LVR for continuing issuers ranged from 47 per cent in 2007 to 49 per cent in 2013. The average for discontinued companies was 64 per cent in 2007 and 67 per cent in 2010. In general, continuing issuers had lower LVRs than companies that failed over this period.

Discussion

Was the regulatory approach adequate?

The approach to regulation and the attitudes of regulatory authorities highlighted two key issues, which impacted on the adequacy of the policy approach. In the first instance, regulatory reforms emerging in the wake of the Wallis Inquiry took a "big picture" approach. The problem with this methodology was that its broad coverage meant that the quasi-banking activities of the small, regionally based unlisted mortgage companies went largely unnoticed. Unlisted mortgage companies offered a range of banking-like facilities to investors, including at call accounts.

The impression created was that these entities were alternatives to banks. This was often reinforced by their position in their regional area. Speaking of the collapse of Banksia, one investor stated:

> People invested locally in Banksia because it was investing back into the community [. . .]. It wasn't a matter of greed; it's a matter of country people looking after country people (Long and Cronau, 2013).

Those mortgage companies that had previous links to solicitors and legal practices, in particular, had built up a level of trust within the local community. This relationship is summed up by the word of one investor who had "banked" with Banksia and its predecessors since the 1960s: "We treated it like a bank. You could just go in and withdraw your money[. . .]" (Drummond, 2012).

The quasi-banking activities of unlisted mortgage companies undermined one of the key rationales for not regulating them in the same way as for ADIs. It was assumed that failure of one such company would not lead to contagion and threaten financial stability (Wallis *et al.*, 1997, p. 352). While this held true at the national level, it was not the case at the regional level (ASIC, 2013). Contagion did become an issue and it did impact on regional economic activity. For example, the failure of Banksia led to the freezing of funds, and the eventual sale of the loan book, of Southern Finance, a competitor which had its offices in the same city as one of Banksia's branches (Frost, 2013). Hence, regional economic effects were magnified.

The approach taken by regulatory authorities such as ASIC was based on the notion of ensuring that accurate information was provided to investors to make informed decisions about the nature of their investment portfolio. This premise incorrectly

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assumed a level of financial literacy amongst the investing population that would allow them to make this type of decision. Research by ASIC in 2008 indicated that a high level of financial literacy was not necessarily the case. A survey of investors in the unlisted mortgage market undertaken by ASIC indicated that many investors did not have a complete understanding of the market they were investing in (ASIC, 2008c). Some did not realise they were investing in a debenture or what the product was. The level of misunderstanding indicates that many were confused about what they were investing in, often mistaking it for a term deposit with a high level of security (ASIC, 2008c, pp. 24-6).

ASIC's *Regulatory Guide 69* (ASIC, 2007b, 2008d, 2010, 2012) expressed guiding principles for the improved disclosures introduced. With the high level of entity failures in the sector, these principles have not proved to have been effective. Principle 1 states that "Benchmarks can help retail investors assess the risk and risk-reward prospects of debentures/notes" (ASIC, 2008d, p. 4; 2012, p. 5). But it appears that investors did not understand the nature of the risk implicit in the sector. Principle 3 states that "(t)hose parties involved with issuers (e.g. trustees, auditors and valuers) should use the benchmarks and the 'if not, why not' explanations in carrying out their responsibilities" (ASIC, 2008d, p. 5; 2012, p. 5). However, the expected protection arising from these parties being included in the regulatory process approach has not prevented business failures in the sector. Principle 4 states that "additional education will assist investors and potential investors in the unlisted debentures/note sector to understand the use of the benchmarks" (ASIC, 2008d, p. 5; 2012, p. 5). The nature of this "additional education", and who should be responsible for providing this education, was never specified and remains unclear.

In particular, our analysis reveals the low level of compliance with the equity (capital adequacy) benchmark. Without an adequate capital base, entities do not have a sufficient safety margin to withstand economic downturns. This proved to be the case with the majority of the entities examined. Regulatory Guide 69 required companies to report their equity (capital adequacy) against a series of benchmarks. The problem which emerged with this approach was that it was a reporting requirement only, not a compliance requirement. As long as the company reported against the benchmark, it fulfilled its regulatory obligations. Hence, if an entity disclosed that it did not comply with the equity benchmark, there was no consequence for that entity, given that the disclosure had been provided.

Similarly, the valuation benchmark had a low level of compliance, especially in the earlier periods examined in this study (2007 and 2010). This benchmark stipulates the approach for valuing properties where property loans have been made. But again, entities were only required to disclose whether or not they had adopted the particular valuation approach. They were not specifically required to follow the specified approaches. In fact, many unlisted mortgage companies did not follow the stipulated valuation approach, which was especially inappropriate with the decline in property values after the GFC. Most of the non-compliant entities failed to meet this benchmark because they used municipal valuations, rather than independent registered valuers. It is worth noting that the valuation benchmark does not include guidelines for how often properties, other than developments, should be revalued; merely that some type of valuation policy should be in place.

In hindsight, given the assumptions upon which the regulatory approach was built and the way in which unlisted mortgage companies evolved to take on quasi-banking activities, it could be concluded that the regulatory approach was inadequate. This conclusion is reinforced by an analysis of the compliance issues, which emerged. As noted earlier, oversight of the unlisted debenture market was vested in ASIC rather than Australian Prudential

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Regulation Authority (APRA), stemming from the assumption that prudential controls were not necessary. However, the subsequent demise of so many of these entities now makes this assumption questionable.

Actions of ASIC

It is clear, with the benefit of hindsight, that ASIC was limited in its intervention options in respect to the unlisted mortgage market over the period 2007 to 2013. Despite the high level of non-compliance with many of the key *Regulatory Guide 69* benchmarks and the sequential collapse of companies within this sector of the market, ASIC did not have the regulatory capacity to actively intervene. ASIC was constrained in its ability to take action because it could only do so after a breach, or suspected breach, had occurred, and then only on a case-by-case basis (Australian Government Treasury, 2014 p. 207). This quandary highlights the tension between the duality of regulatory objectives. The central aims of regulation were to encourage market efficiency and protect consumer interests (including market stability) (Australian Government Joint Parliamentary Committee, 2009) (PJC, 2009, p. 7). However, to encourage efficient market, intervention was kept to a minimum, focussing largely on disclosure obligations. This approach meant that when market failure occurred, there was little regulatory structure in place to address the problems arising.

Following on from the second round of unlisted mortgage company failures from 2012, ASIC, in consultation with APRA, is now working towards the introduction of tighter prudential controls aimed at ensuring the financial stability of these mortgage companies. Among the proposals currently being considered is that of mandatory capital and liquidity requirements. It is proposed that companies that issue debentures to retail investors maintain a minimum capital ratio of 8 per cent of their risk-weighted assets and have a minimum of 9 per cent of their liabilities in high-quality liquid assets (ASIC, 2013). For its part, APRA is developing protocols that will make it clearer to the public the difference between deposits held by ADIs and those held by debenture issuers (ASIC, 2013). Whilst the consultation phase for these proposals has finished, there is still not (as at the time of writing) any definitive outcome in terms of policy reform and implementation. Given the extent of company failure within the sector identified by this study, it could be argued this is a case of too little too late, especially for the investors who have lost their savings.

Conclusion

Unlisted mortgage companies emerged to fill a gap in a market not well serviced by the banking sector. They were largely regionally based, many having evolved from solicitors' mortgage investment funds. They traded on the trust relationship developed in the local community, their pedigree being enhanced by their associations with local solicitors. Light regulatory oversight allowed these institutions to develop as "shadow banks", many offering banking services such as at call investments.

The collapse of these companies has highlighted serious shortcomings in the regulation of these entities. It has called into question the validity of the policy approach to these types of non-bank financial institutions. The approach taken to overseeing the activities of these firms was to develop a series of benchmarks that entities were required to report on. This was purely a reporting requirement, and no penalty was imposed for not reaching these benchmarks. Analysis of the lending patterns of these firms reveals high levels of risk-taking. This was manifest in low levels of equity to debt, a tendency to lend large amounts on a single mortgage and high numbers of loans in arrears. Non-compliance with critical benchmarks, such as equity and valuation measures in particular, should have provided an alert to the systemic nature of the problems within the industry.

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The failure of unlisted mortgage companies also represented a failure of policy. The principles upon which the benchmark approach was developed did not accurately reflect the market situation. Underlying the policy was the assumption that investors had the ability to assess the quality of the investment choice and make informed decisions. This notion was flawed because it did not take into account the nature of the relationship between the investor and the mortgage company. The shadow banking activities of many unlisted mortgage companies, together with their position in the regional economy, contributed to a misunderstanding of the nature of their business activities. Investors could not clearly distinguish between the activities of the unlisted mortgage companies and banks. They did not, as a result, have a full appreciation of the risks involved. Furthermore, the reporting requirements were not designed to protect against company failure. Even though they indicated systemic problems with lending activities, this information was not acted upon by the responsible parties. The assumption that auditors and trustees could or would act to restrain excessive risk-taking was flawed.

In the wake of the second round of company collapses, the move by ASIC to introduce tighter prudential controls is a step in the right direction. However, it will only be successful if compliance is mandatory. This will represent a move away from the conventional policy approach to regulating these types of entities. The shift from passive to active regulation has repercussions for the broader regulatory debate. In the light of recommendations of the recent Financial Services Inquiry, it may be a timely discussion to have. This report has suggested that ASIC be given greater proactive powers to intervene where there is the risk of "significant consumer detriment". This power would only be used in a "last resort" (Australian Government Treasury, 2014). A question for broader debate is will this approach go far enough to ensuring the goals of financial services regulation are achievable? The experience of the unlisted mortgage sector suggests such targeted intervention, whilst improving the regulatory process, may not go far enough.

Notes

1. See also Schwartz and Carr (2013). Adrian and Ashcraft (2012) provide a more detailed definition.
2. Debentures are short-term securities, which involve a contract to lend funds for a specified period, usually at a fixed rate of interest. Secured notes are very similar. The key distinction between the two is that debentures are secured by tangible property and notes by a first ranking security over the property (MoneySmart, 2014).
3. Specific benchmarks have altered slightly since their introduction. Table 1 reflects the latest benchmarks in use. Credit ratings was one benchmark deleted from the original model and replaced by debt maturity disclosure.
4. The proportion of mortgage companies being placed in receivership over the period is slightly understated. The mortgage company taken over in 2009 was Statewide Secured Investments, taken over by Banksia. But Banksia itself was placed in receivership in 2013: McGrath (2012).

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Appendix

Issuer name	Evolved from solicitors	Established	Head office location	Accepts at call deposits
Continuing				
Anglesey Secured Investments Ltd	No	2004	Forbes, NSW	No
Balanced Securities Ltd	Yes	1998	Melbourne	No
Central Victorian Investments Ltd	Yes	1993	Regional Victoria	Yes
W&D Finance Ltd	Yes	1966	Ballarat	Yes
Hargraves Secured Investments Ltd	Yes	1999	Yarrawonga, VIC	Yes
Progressive Mortgage Company Ltd	No	2000	Sydney	Yes
Sewells Finance Ltd	Yes	1995	Colac, South West VIC	Yes
Vicstate Savings & Loans Ltd	No	1968	Ballarat	Yes
Win Securities Ltd	Yes	1990	Wangaratta VIC	Yes
Discontinued				
Receivership				
Australian Secured Investments Ltd	No	2004	Queensland	No
Banksia Securities Ltd	Yes	1968	Regional Victoria	Yes
Cymbis Finance Australia Ltd	No	2004	Brisbane	No
Donovan Oates Hannaford Mortgage Corp Ltd	Yes	1999	Port Macquarie	Yes
G R Finance Ltd	No	2000	Melbourne	No
Gippsland Secured Investments Ltd	Yes	1970	Gippsland, VIC	Yes
Grenfell Securities Ltd	No	2000	Sydney	No
Hastings Capital Ltd	No	2002	Sydney	48 h
LKM Capital Ltd	No	1999	Coffs Harbour	No
Momentum Mortgages Ltd	No	2003	Port Macquarie	24 h
Provident Capital Ltd	No	2000	Sydney	No
South Eastern Secured Investments Ltd	Yes	1995	Gippsland, VIC	Yes
Wickham Securities Ltd	No	2004	Brisbane	No
Voluntary wind-up				
Eurofinance Capital Ltd	No	2002	Sydney	No
Loan book sold				
H.D. & C. Securities Ltd	Yes	2000	Benalla, VIC	Yes
Southern Finance Ltd	Yes	1990	South West Vic	Yes
Victorian Securities Corporation Ltd	?	1960	Ballarat	Yes
Taken over by another issuer				
Statewide Secured Investments Ltd	Yes	1966	Gippsland, VIC	Yes
Webster Investments Ltd	Yes	1965	Ballarat	Yes

Table AI. Unlisted, unrated mortgage companies: 2007-2013

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