MSC TRUSTEES

The House of Representatives Committee on Tax Revenue

DEVELOPMENT OF THE AUSTRALIAN RETAIL CORPORATE BOND MARKET

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28 May 2020

1. EXECUTIVE SUMMARY

Corporate bonds, debentures and notes are a perfectly legitimate way for corporate entities to raise capital.

Under regulation, retail bonds generally require appointment of an external, independent, licensed trustee to monitor the issuer's compliance with the Trust Deed and the related Corporation Act 2001 (the Act) obligations essentially acting as one voice for all investors and ensure their rights are protected.

One of the key issues limiting functional operation of the retail bond market in Australia is a lack of suitable trustees willing to provide services.

Trustees have left this market and/or are not willing to enter this market because of:

- a general lack of internal experience or technical understanding of retail notes, bonds and debentures;
- severely onerous regulatory conditions applicable to trustees in particular related to capital/NTA and insurance requirements;
- misunderstanding between issuers, trustees, regulators and the courts in respect of the role responsibility of the trustee and related interpretation of corporate act requirements specific to obligations of the trustee; and
- commercial reasons relating to non-viable inadequacy in risk/return parameters due to all of the above.

The resulting impact of a lack of availability trustees is a serious limitation for issuers seeking to raise capital in this format, often requiring restructuring of capital in less appropriate or more inefficient sources. This can have the effect of limiting investment options to retail investors to higher risk capital investment opportunities in the form of equity or less priority in the event of wind up, as well as missing out on an opportunity to benefit from other enhancements related to debt including security and oversight by independent parties such as trustees, auditors and sometimes even ASIC.

This submission has been drafted by MSC Trustees, one of the only active retail bond/note trustees in the Australian market. The submission focuses on a related impediment within the Corporations act creating challenges for trustees under current regulation, presenting an opportunity, if addressed, to certainly contribute to reactivation and development of the Australian retail bond market.

2. AUSTRALIAN RETAIL BOND MARKET

The Commonwealth Government has for some time pursued a broad agenda to foster a deep and liquid corporate bond market in Australia.

The Competitive and Sustainable Banking System Report of December 2011 said:

A vibrant corporate bond market is critical to putting competitive pressure on bank lending rates to business, and to harnessing our national superannuation savings so we can domestically fund more productive investment in our economy, via both the banking system and the corporate sector, reducing our reliance on offshore wholesale funding markets.

One of the expressed intentions of the Commonwealth Government Securities Retail Trading Bill introduced into Federal Parliament in mid-2012 was to increase retail investment in the bond market to 'over time, encourage companies to diversify their funding sources and offer opportunities for retail investor participation'.

In the current low yield environment, with bank deposits offering extremely low rates of interest, investors are increasingly forced to look to riskier investment to obtain a reasonable return. Corporate bonds can provide investors a balance between return and risk.

As Deloitte Access Economies said in The Corporate Bond Report 2018 at page 23:

Corporate bonds play an important role in a well-diversified portfolio, by offering a higher - but still stable - rate of return compared to other fixed income securities such as deposits and government bonds, albeit with a higher level of credit risk compared to these other investments (Stewart and Valtwies, 2015). In this context, corporate bonds can fill a niche between /ow-return and low-risk fixed income investments, and high-return but riskier shares, offering a mid-point in risk and return for investors seeking further diversification (ASIC, 2015). The relatively high yields of corporate bonds within the fixed income asset class is especially relevant in the current low yield environment, as discussed further in Section 5 of this report.

ASIC itself notes in Moneysmart that 'corporate bonds are generally less risky than shares issued by the same company'.

Deloitte also notes, at page 51, that corporate bonds provide relative certainty in funding and covenants until their maturity date, whereas banks may tighten loan covenants should risk appetites change. This allows companies to use the funds from bond issues to commit to long term strategies, without being concerned about potential changes in the amount and/or conditions of that funding.

Australian banks have traditionally limited exposure to corporate debt, particularly non-top 100 ASX - listed companies, unlisted companies and SME corporates. Corporate bonds, notes and debentures, therefore, also present as an attractive and valid alternative source of debt for all corporate entities from institutional level to smaller corporate.

3. AUSTRALIAN RETAIL BOND TRUSTEE APPETITE & COMPETITION

Offers of bonds to retail investors require a prospectus, and so be subject to Chapter 2L of the Act. Under regulation, such offers require the services of a trustee operating independently of the issuer, acting for and on behalf of bond holders.

Trustees are able to offer their services to the retail bond market under two separate authorisation streams:

1. Traditional trustee authority (**TTA**) providing general authorisation without transactional or independent appointment reference to ASIC (originally granted to the likes of Perpetual and Equity Trustees by acts or parliament more than 100 years ago); and
2. Appointment specific authority (**ASA**) under S283AC of the Act requiring individual appointment approval by ASIC and subject to highly onerous and uneconomic transaction specific capital and insurance conditions required of the trustee, set by internal ASIC policy, not regulation.

Based on our market experience, the following table lists the only trustees which have been operational in the last 8 years:

Trustee	Authority	Active?	Status
Perpetual Corporate Trust	TTA	Yes	Reluctant, limited to very large listed corporates only
Equity Trustees	TTA	No	Zero appetite
TrustCo	TTA	No	Company wholly acquired by Perpetual
AET / Sargon	ASA	Yes	Recently inactive due to takeover / shareholder buyout
Sandhurst Trustees	TTA	No	Book transferred to MSC Trustees, zero appetite
MSC Trustees	ASA	Yes	Broad appetite, regulatory conditions prohibitive

While the largest corporations can secure one of the TTA trustee companies to act as trustee for the bond holders, we understand that Perpetual is the only active such trustee company and has generally not undertaken that role for companies other than the very largest. More recently, we understand the Perpetual board has sought to limit further exposure to the bond, note and debenture market.

ASICs current internal policy with regards to ASA, that could support the issuance of retail corporate bonds is punitive, resulting in the provision of this service by existing and other trustee companies to be uneconomic.

Without the ability to appoint a trustee in accordance with the Act, mid-cap and smaller companies are therefore excluded from issuing bonds to fund their operations. ASIC's current policy is therefore a constraint on the development of a deeper corporate bond market in Australia.

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4. REGULATORY CONDITIONS

ASIC's policy to assess trustee ASA approval in accordance with s283GB of the Act has inhibited other corporates from applying for the role as trustee.

ASIC's current policy imposes the following financial conditions for ASA approval:

ASIC Financial Conditions on the Trustee
For unlisted debenture issuers (a) $250,000 in net current assets per trusteeship; and (b) professional indemnity insurance (PI Insurance) equivalent to: i) if the total value of debentures issued per trust is: (A) $5 million or less, the PI Insurance must be held at the total value of debentures issued; or (B) more than $5 million, the PI Insurance must be held for the greater of: (I) $5 million; or (II) 25% of the total value of debentures issued; ii) for multiple trusteeships, the applicant must maintain a level of PI Insurance that would allow it to claim on each separate trust; and iii) any PI Insurance to be held for the applicant's actions as debenture trustee must be in addition to any PI Insurance that the body corporate is required to hold under its AFS licence obligations.
For listed debenture issuers In order to be granted approval to act as trustee for listed debenture issuers a body corporate must: (a) only act as trustee for listed debenture issuers who do not, at the time the trustee is appointed, have a 'going concern' audit qualification or an emphasis of matter paragraph in their most recent financial report; and (b) possess: i) net tangible assets of at least $5 million; and ii) PI Insurance covering aggregate claims of a minimum of $100 million, in addition to any PI Insurance that the body corporate is required to hold under its AFS licence obligations.

We query if by setting significantly higher financial conditions for Ch 2L appointments, ASIC may unintentionally force Issuers out of the retail bond market (or by making it more difficult), by making such activities commercially undesirable for an Issuer due to unreasonably high trustee fees.

In addition, the approval process for an ASA submission has an unreasonable expectation that an issuer provides *"approval"* to an entity which has no existing regulatory authority to perform the role of trustee. The Trustee has no form of confirmation of authority subject to reasonable parameters or conditionality so as to provide certainty and comfort to incumbent trustee firms and issuers and indeed seek such *"approval"* or mandate from those individual issuers subject to final ASIC approval.

5. REGULATORY INTERPRETATION

The current financial conditions on the trustee are out of step with the requirements on the issuer itself and do not appear to consider the role of the trustee versus that of the issuer.

Ch 2L trustee's duties in section 283DA are summarised as the following:

i. to exercise reasonable diligence to ascertain whether the property of the issuer (and any guarantor) that is or should be available will be sufficient to repay the debenture debt when such debt becomes due;

ii. to exercise reasonable diligence to ascertain whether the issuer (and any guarantor) has committed a breach of the terms of the debentures, trust deed or Chapter 2L;

iii. to take reasonable steps to ensure the defaulting issuer (and any guarantor) remedies breaches that are materially prejudicial to noteholders;

iv. to notify ASIC of certain matters;

v. to provide information to noteholders in certain situations, and to comply with directions from noteholders; and

vi. to apply to the court in certain circumstances.

<u>NTA requirements</u>

In applying the financial conditions on the trustee, ASIC assumes a nexus between the trustees NTA is directly proportional to the size of the issuer and notes on issue. However this assumption is inconsistent with the inherent nature of the trustee's role, as outlined above, being that of a security trustee on behalf a group of noteholders. The trustee's duties to the Noteholders do not differentiate between the number of Noteholders or the number of Notes each Noteholder holds.

<u>Insurance requirement</u>

The PI insurance requirements being either $100m (where the trustee holds $5m NTA) or 25% of the notes on issue (uncapped) goes beyond the insurance requirements of the issuers themselves. The insurance requirements are set over and above the insurance requirements already imposed on the trustee via its AFSL conditions.

There does not appear to be additional insurance requirements applied to corporations when issuing notes, bonds or debentures. We are not aware of specific legislation that dictates the level of insurance required to be held by the issuers, however there are some regulatory guidelines (RG 126) prescribed by ASIC. In accordance with the guidance, the issuers are required to undertake a self-assessment of their insurance requirements to determine the adequacy of insurance required applying a minimum of $2m. In addition, relief can be applied where there is practical unavailability of insurance. This relief does not appear to be available under the financial conditions applied to trustee.

If a bond, note or debenture issuer fails, investors will not have automatic rights to claim against the professional indemnity insurance of the trustee. A trustee (and its insurer) will be liable only if the trustee has failed in its duty to the debenture holders. If a debenture issuer fails for purely commercial reasons, with neither the issuer or the trustee being at fault, the insurance held by the trustee will be of no comfort to the investors.

The current uncapped level of insurance imposed by ASIC's ASA policy assumes the systemic risk position that a failure by one issuer resulting in a potential claim would impact all issuers at once; ignores that issuers holding an AFSL have their own insurance; and that a breach by a trustee of its duties will be a contributory factor only to a loss by investors, not the primary cause of the loss; and places the trustee in virtually the position of a partial underwriter to each issuer.

Indeed, high level of insurance as required under current ASIC policy would increase costs of the trusteeship, which would likely be passed on to the corporate bond issuer and indirectly down to the investors, thereby disadvantaging investors for no practical benefit. In a worse-case scenario, issuers who are unable to recover such costs may result in those issuers being unable to continue in business.

6. INSURANCE MARKET

Over recent years, the insurance market has become increasingly difficult and both local and overseas Insurance companies means they are taking remedial action on their financial services portfolios. Two clear strategies have emerged:

1. **Exit market:** Many Insurers have exited the market for D&O and PI Insurance for Australian financial services companies. For example, over the past 18 months the following Lloyds Syndicates have withdrawn from the Australian market: Channel; Hamilton; Chaucer; Brit; Canopius; Barbican and Apsen. These Syndicates represent a significant proportion of Lloyds capacity that previously supported D&O and PI Insurance for Australian companies.

The frequency and severity of claims including class actions in Australia against financial services companies has generated losses to the insurance industry vastly in excess of the annualised premium pool and had an adverse impact on the profitability and therefore the sustainability of insurance for such risks in Australia.

2. **Remedial action:** Insurers are also taking remedial action on their portfolio to bring it back to profitability. This is in form of:

    a. Price increases, with price increases reported of anywhere up to 400% on some risks;
    b. Limit reduction. Insurers are generally only offering reduced policy limits;
    c. Deductible increases;
    d. Coverage restrictions. Some clients are offered cover under restricted coverage basis.

The recent COVID-19 event has resulted in further deterioration of the insurance market and overall market conditions are the worst they have been for at least 20 years. There has been a significant reduction in capacity both from Australian insurers and Lloyds of London where Australian PI insurance remains one of the least profitable sectors globally. Major Lloyds underwriters of Australian businesses including Neon, Vibe, Pioneer Syndicate 1980 and Acappella Syndicate 2014 have withdrawn from the market and gone into run-off.

The uncertainty created in global financial markets by the COVID-19 event has led to many insurers declining to write new risks or significantly increasing premiums and reducing cover and capacity. There is no appetite in the Australian market, trustee businesses now rely totally on the Lloyds market for our insurance this has greatly impacted the ability to obtain insurance. Insurance at certain levels has become practically unavailable.

7. RISK / RETURN CONSIDERATIONS

Neither issuers nor the trustee guarantees the performance of corporate bonds, notes or debentures. And obviously no investment is risk free.

Bond performance is largely dictated by operational performance of the issuer itself, and investors need to navigate commercial risks associated with financial position of the individual issuers during the period of their investment.

Risks for investors associated with the trustee appointment, relate to credentials/capability of the trustee and their ability to meet statutory obligations.

In setting regulatory policy as it applies to bonds, notes and debentures, ASIC appear to have taken the following general approach:

- applied policy in an overly simple, one size fits all method, only differentiating between listed and unlisted issuers;
- potentially overly influenced by historical retail investor losses in particular by a number of debenture issuers thereby insisting on onerous conditions, particularly applied to unlisted issuers and trustees acting under ASA approvals; and
- applying disproportionate responsibility for performance of bonds, notes and debentures on the trustee.

We consider ASIC could contemplate placing more emphasis and consideration to other relevant factors in setting policy such as the following potential risk mitigants:

- the nature of the issue, e.g. bond, note or debenture;
- financial standing and operating track record of the issuer;
- commercial investment enhancements such as security and corporate guarantees; and
- credentials, capability and track record of the trustee.

Further, in setting transaction specific capital and insurance obligations on the trustee acting under ASA approval, we believe the policy is unduly onerous because:

- it assumes the unlikely risk scenario of multiple simultaneous claims or systemic failure of the trustee across all appointments;
- the requirements place disproportionate responsibility to the trustees in comparison to requirements placed on the issuers themselves or the commercial risk taken by investors;

- the requirements vastly increase the costs of providing trustee services and an uneconomic situation because the trustee is unable to achieve economies of scale over a number of appointments;
- trustee services become too expensive and impact net returns to investors;
- the trustees inability to commercialise their service are not incentivised to remain in the market; and
- bond issuers and retail investors suffer because this this investment class becomes unattractive due to costs, returns non-commensurate with risk and inability to source trustees.

We believe failures in the debenture market are over influencing ASIC policy because investments in bonds, notes and debentures have largely been successful. Even in recent legal action in the debenture market, investors have recouped the majority of their investment from the assets of the issuer.

According to publicly available information, the investors in the following recent debenture failures have received to date:

Banksia	80-85¢ in the dollar
Gippsland Secured Investments	89¢ in the dollar
Southeast Secured Investments	92¢ in the dollar

The worst failures in the Australian debenture market have been by Westpoint Corporation Limited, Fincorp Group and Australia Capital Reserve Limited. Each of which were companies that raised funds to lend to related property development entities, this risks of which are hardly relevant to the majority of other corporate bond, note or debenture issues.

We note that in the case of Fincorp Limited, which collapsed owing investors some $200 million, a class action against the trustee was settled for $29 million, or less than 15% of the total indebtedness at the time of the collapse. Australian Capital Reserve collapsed reportedly collapsed owing $300 million. The class action brought on behalf of 4,000 investors against the trustee was settled for $25 million, or just over 8% of the total indebtedness.

We understand that settlements were commercial decisions for the trustees in each of these matters that may have taken into account many factors, including resources and reputation impact of defending such actions over long periods in the courts. Settlements do not necessarily represent any admittance of guilt by the trustee firms nor success achieve of the class actions, and circumstances of historic collapses are always dependent on a large range of factors which are can be unique to a particular issuer. Therefore, financial outcomes of such settlements do not provide a certain guide to potential liability for trustee companies more broadly.

In summary:

a. The principal value or performance of retail bond investments are not guaranteed, by the issuer and certainly not the trustee;

b. The trustee is neither the promoter, underwriter nor guarantor of any return or repayment;

c. Trustees must accept all regulatory responsibilities of a bond trustee, which would include appropriate due diligence prior to accepting a trustee role for any issuer and then on an ongoing basis as is required by the law and under the trust deed;

d. In addition to requirements on the trustee, regulations are designed to provide some protection to bond holders in respect of portfolio transparency (for example, benchmark disclosure and quarterly statutory reporting);

e. It is extremely unlikely that the issues (such as those experienced in other debenture issuer collapses) could or would be simultaneous and uniform in magnitude across an entire portfolio of multiple corporate bond, note or debenture issuers;

f. In addition and separate to insurance requirements, regulations already ensure financial backing of the trustee in the event of a breach of its duties, which although dictated per issuer, provide for stronger financial resourcing for a trustee that performs the role for multiple issuers, and this equity backing provides a significant and material incentive for the trustee to perform its duties in accordance with the law at all times;

g. The MIS regime does not require an insurance level contemplated by ASIC for corporate bond trustees and we would argue that the associated risks are not entirely different;

h. A responsible entity of a mortgage fund is not required to have the level of insurance cover which covers the value of the entire portfolio of assets of the fund in circumstances where a responsible entity is responsible for its direct decisions relating to the assets of the fund and representation made to investors as compared to an independent trustee that has a limited oversight responsibility under the law.

8. CONCLUSION

We believe there is a demonstrable and clear link between the current dysfunction and lack of activity in the Australian retail bond market and the limited availability of suitable trustees.

And further, there is also a clear link between the limited appetite of trustees to service the Australian retail bond market and the onerous regulatory hurdles applicable to trustees, rendering them unable to provide their services economically.

It is our conclusion that potential rationalisation of regulatory conditions applicable to trustees presents a genuine opportunity reactivate and develop the Australian retail bond market.

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