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ASIC

Australian Securities & Investments Commission

Statement on Fincorp

By Mr Tony D'Aloisio, Chairman
Australian Securities and Investments Commission to the Senate Standing Committee on Economics

Wednesday, 30 May 2007

The purpose of this statement is to provide an update to the Senate Standing Committee on Economics of ASIC's involvement with the Fincorp group of companies. The Fincorp group of companies is made up of 21 corporate entities. The group specialises in property development and property investments raising funds from the public to carry out these activities.

The key legal aspects of the structure are as follows:

- Fincorp Investments Ltd (Administrators Appointed) (Fincorp) raised moneys from the public through 'first ranking notes' and 'unsecured notes'. First ranking notes were notes issued by Fincorp secured over its assets by a floating charge. Unsecured notes were notes issued by Fincorp but not backed by any charge or other security.
- Fincorp lent the moneys it raised from the public to other companies in the group. Fincorp's main asset is 'loans receivables' from those companies. This asset is the asset subject to the floating charge which secures the first ranking notes. Those companies in turn used the borrowings from Fincorp to develop properties and make property investments. The floating charge did not extend over the assets of those companies.
- Companies in the group which were engaged in property development and investment also raised first mortgages against those properties (e.g. from banks) to a limit set by Fincorp. Those mortgages have priority over repayment of borrowings from those companies to Fincorp. In effect, those first mortgages rank ahead of the first ranking notes and the unsecured notes.

1. What's the current status of Fincorp?

Administrators (KordaMentha) were appointed on 23 March 2007.

On that date, amounts owed have been summarised by KordaMentha as follows:

- amounts owing to secured note holders $178m
- amounts owing to unsecured noteholder $23m

KordaMentha is in the process of selling the 10 properties owned by companies in the group with a view to:

- maximising value; and
- accelerating cash recoveries for all categories of investors.

KordaMentha have indicated that the second meeting of Fincorp creditors will be around 26 July 2007, and its report to creditors will be provided prior to 26 July 2007.

As at 2 April 2007 KordaMentha have estimated the following returns to investors (after repayment of the mortgages against the properties held by companies the group):

- first ranking notes — minimum 30 cents in the dollar
- unsecured notes— nil return likely.

KordaMentha will, as part of their report due around 26 July 2007, update these estimates.

There were 8,102 investors in Fincorp in first ranking notes and unsecured notes. The average investment per person in Fincorp was around $24,800 and the average age of those investors is 60. There were 151 people who invested more than $200,000 in Fincorp securities, and that group represents 23% (by value) and 2% by number of all Fincorp investors. Based on the number of investors in Fincorp securities, excluding the largest 151 investors, the average investment in Fincorp products was around $17,700*.

2. What is ASIC doing?

ASIC's current objectives are these:

a. to work with KordaMentha to maximise returns to noteholders.

b. once the KordaMentha report is available to assess potential actions for wrongdoing and third party claims for compensation. This may also extend to advertising associated with the raising of funds.

ASIC has now established a specific team headed by Jan Redfern (Executive Director – Enforcement) and made up of key people across directorates. That team has commenced investigations, including considering whether any freezing orders may be needed. For example, it is assessing with KordaMentha whether specific freezing orders are needed for a property owned by Macarthur Investments. The team is also assembling material to enable ASIC to assess the KordaMentha report and proceed with investigations for potential wrongdoing and in relation to third party claims for compensation and to pursue other investigations.

3. What went wrong with Fincorp?

The KordaMentha report due on or prior to 26 July 2007 will assist in understanding what went wrong. From the material available to us to date, difficulties with the group's business model emerged around August to November 2006. Those difficulties were around the value of the properties in the group and the management of the developments and investments. Put simply, it became apparent that:

- without raising further money the companies would run out of cash
- the valuation of the properties (some downwards) would not support further borrowings or issues of securities to the public.

Hence, the directors decided to place the whole group into voluntary administration.

We add, however, that further investigations and consideration of the KordaMentha report will be needed before confirming or otherwise what has just been outlined.

* The above has not covered Fincorp Financial Services Ltd (Administrators Appointed). It is the responsible entity for the Fincorp Enhanced Income Fund. This fund has assets of around $490,000 and with total units held of $541,000.

4. What did ASIC do?

The raising of money from the public by Fincorp was over a period of 4 years (2002 to 2006). ASIC's role was in 2 principal areas:

a. monitoring prospectuses and reviewing accounts in prospectuses lodged by Fincorp. (Note, ASIC does not approve prospectuses. It reviews them and its function is to ensure proper disclosure).

b. Alerting consumers through media release on the 'speculative debentures' or 'high yield' debentures and taking action in respect of misleading advertising.

We have attached a table (see first table attached) which summarises ASIC's actions over the period 2002–2006 in relation to (a). I would like to take Committee through that table. The table is in the form of a timeline. Turning to the attached table you will note:

- There were 4 prospectuses to raise in total $201m over the 4 year period.
- With each prospectus, ASIC issued queries or stop orders (see blue boxes for details). These queries or stop orders were all satisfied (i.e. defects rectified).
- For the 4th prospectus, ASIC required an independent expert's report on the recoverability or impairment of loans from Fincorp to the group of companies. In other words, could Fincorp fully recover its loans (as I said earlier these loans were its main asset and subject to the floating charge for secured noteholders). This report was provided in May 2006 and confirmed 'no impairment' which, in effect, meant that the loans were (in the independent expert's opinion) recoverable by Fincorp in full. Indeed, the Fincorp audited accounts filed on 9 October 2006 for the year ending 30 June 2006 were not qualified in relation to 'no impairment'.

In relation to ASIC's actions on advertising (on (b) above) ASIC put out the following media releases. These were aimed at drawing risks to the attention of retail investors:

ASIC Media Releases

MR 02/404	ASIC action on prospectuses
MR 03/158	Fixed interest products – higher returns mean higher risk
MR 04-002	ASIC focuses on defective debenture prospectuses
MR 04-124	ASIC focuses on defective debenture prospectuses
MR 04-232	$1.8 billion at stake: warning to investors of high-yield debentures
MR 05-30	ASIC action protects vulnerable investors in high-yield debentures (and attached debenture campaign report)
MR 05-49	ASIC acts against high-yield debenture issuer
MR 05-272	ASIC requires Fincorp to correct its advertising
MR 05-290	Fincorp to offer millions in refunds to debenture trustees
MR 06-287	ASIC obtains consent orders from Bridgecorp Finance to protect the interests of noteholders
MR 06-290	Don't invest a cent in a fixed interest investment without using ASIC's 3-way test

5 What else should ASIC have done?

We are freshly assessing what else we could have done and, if necessary, to change our processes. For that purpose, with the objective of assisting us to improve, I am bringing in an external property and development expert and an expert valuer to advise us on changes we can make in the way we review prospectuses for these types of companies. Investment in these types of secured and unsecured notes carries risks because the debt securities:

- are unrated (e.g. no S&P rating of AAA etc or debt security).
- are unlisted (i.e. no secondary market which revalues them on an ongoing basis or provides an exit mechanism).
- moneys are on lent to companies which have little or no equity capital so there is no buffer if investments run into difficulties.
- late in the life of these projects, there is likely to be uncertainty on whether realizable prices are achievable for properties developed and whether they can support further borrowings from the public.

Hence, it is important for investors to understand how to analyse the underlying business model and strategies of these companies.

With the assistance of external experts, ASIC will assess what else (over and above what we do now) it can require to be put in prospectuses or otherwise made available to investors to assess underlying business models or strategies.

It is important, however, to make the point that even with those additional steps, risks for investors in these type of investments will not be removed. Corporate failures, in our system, cannot be eliminated. What ASIC will strive to do better is to put the inherent risks into the market so that investors and their advisers can make informed decisions.

6. What about similar debenture issues? How extensive is the problem?

ASIC is concerned that with this and other like problems such as Westpoint, retail investors have lost significant savings.

I would now like to take you to the second chart which is attached. Our assessment is that (see second chart attached) investments in debt securities (bank deposits, other deposits, debenture) by retail investors (household and small superfunds) totals around $523 billion. Debentures securities, the types of products Fincorp issued, account for about $34 billion of retail assets (6.5% of the debt securities market). The $34 billion is the total for both household and small superfunds.

The $34 billion debenture market can be further sub-divided into four groups being debentures that are:

- listed and rated ($4 billion)
- listed and unrated ($8 billion)
- unlisted and rated ($14 billion)
- unlisted and unrated ($8 billion).

The advantage of a reliable credit rating of a financial product is that an entity, skilled in credit analysis, monitors the financial health of the issuer and publicly advising the market of its opinion. When a financial product is listed, or traded in a secondary market, price discovery mechanisms and market forces ensure that:

- valuation of the security is adjusted on an ongoing basis; and
- provides liquidity so that investors are able to acquire and dispose of securities in an efficient manner.

The unlisted and unrated debenture market is the highest risk sector in the debt securities market as I have described it. It is about $8 billion and represents 1.5% of the total debt securities market of around $523m. Fincorp falls into this category.

ASIC has now made this sector a clear priority.

A team has been set up (headed by Jennifer O'Donnell, Executive Director – Compliance) with both internal and externally sourced experience and expertise. It will report directly to me and it has been given the task of implementing a 3 point plan:

1. For existing debenture and other issuers involved in the retail investor sector:
    a. Assess with trustees, and external property experts underlying business models and stress test objectives and valuations to identify changes in risk profile since a prospectus was issued and, as necessary, report to investors.
    b. With trustees, assess debt/equity ratios and loan value ratios to see what changes may be possible.
    c. With external rating agencies, assess the potential to rate existing issues.
2. For proposed new debenture and other similar issues.
    a. With trustees, and expert property experts assess what additional protection can be added on the way business models work (and risks outlined for investors).
    b. With advertisers, assess what specific 'warnings' should go into retail advertisements and retail advertorials.
    c. Through our review process for prospectuses filed, examine ways to more clearly bring out underlying risks.
    d. With rating agencies, assess prospects for ratings.
    e. With issuers, assess what level of equity (from the promoters or principals) is desirable and how the level of their capital at risk is communicated to the market.
3. For both existing and new issues, develop a series of investor education programs aimed at the retail sector on:
    a. Diversifying risk through allocation of investment by asset classes.
    b. Risk/reward premiums and how they work when assessing an investment.
    c. How to examine underlying business models for unrated and unlisted debt securities.

We would like over the next 12 months or so to implement and assess the results of the above action plan before considering other options.

7. How does what is proposed fit in wider picture of the retail investor sector?

I identified earlier in my opening remarks, the priority ASIC has placed the retail sector (households and small superfunds) which has total stock of around $2.1 trillion. What I have just outlined covers debt securities (made up of some $523m). ASIC will also assess the issue and risks in other sectors of retail investment (and pursue initiatives of the type which I outlined in my opening remarks).

I hope this gives the Committee an indication of ASIC's priorities for this area.

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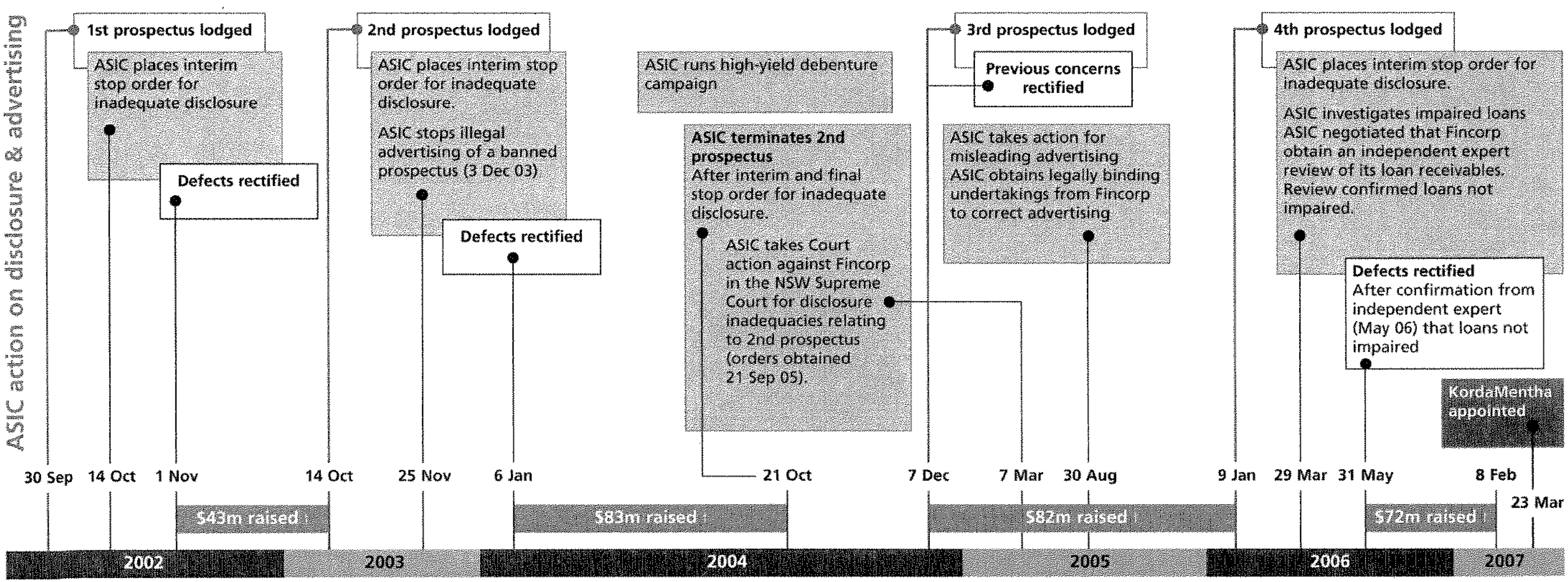
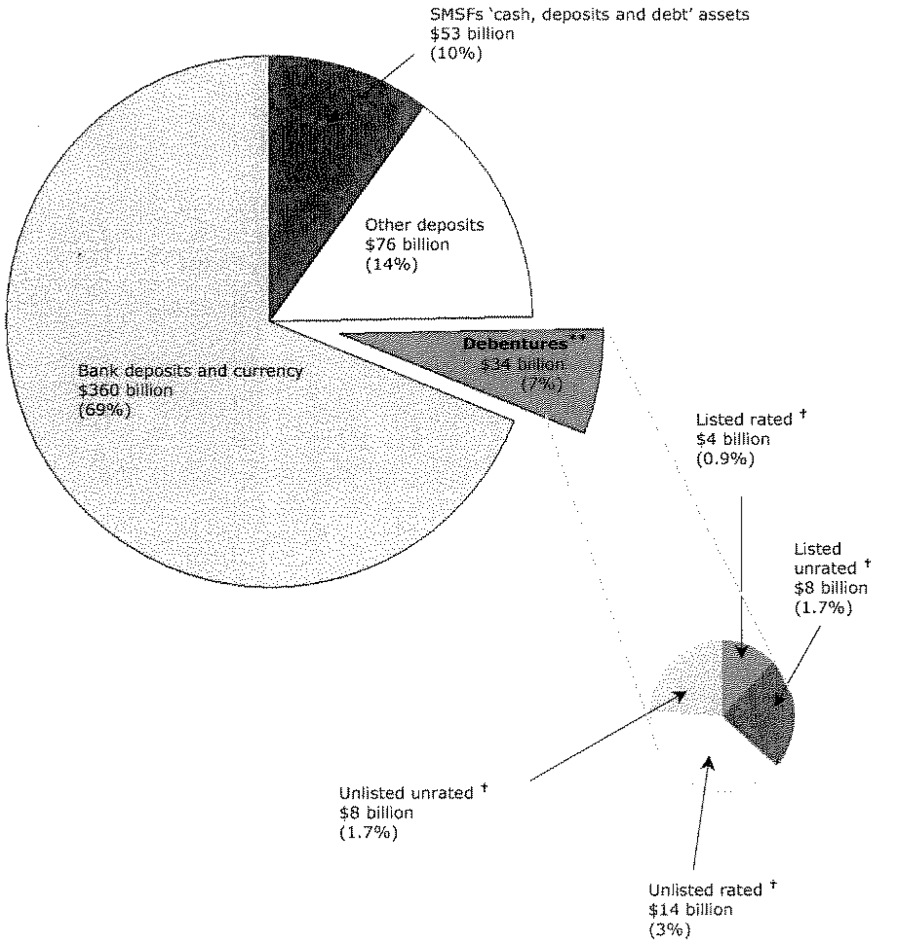
Fincorp Investments Limited (Administrators Appointed) 2002–2007 (Source: ASIC)



† Approximate funds raised derived from quarterly trustee reports. Periods of funds raised are indicative only and it is possible that funds were legitimately raised outside these times.

Deposits and Debt Securities Held by Retail Investors* - December 2006

Total deposits and debt securities:
$523 billion
(100%)



Notes

* This graph does not include direct retail investments into managed investment schemes.

** The figure for debentures reflects total amount outstanding. As such, it includes holdings by individuals, SMSFs and non-retail investors (though non-retail holdings are likely to be small). Because of this, the figure for "SMSFs 'cash, deposits and debt' assets" could be overstated to the extent that it may include debenture investments already accounted for in the "debentures" category.

† There are 135 issuers of debentures with total assets of $95 billion and total debentures on issue of $34 billion. The average debt-to-equity ratio is 2.4. The average debt-to-tangible equity ratio is 5.1. Of these issuers, 10 are **listed and rated** (total assets $29.3 billion and total debentures on issue $4.3 billion); 38 are **listed but unrated** (total assets of $25.2 billion and debentures on issue totalling $8.4 billion); 4 are **unlisted but rated** issuers (total assets of $22.4 billion and total debentures on issue $13.6 billion); and 83 are **unlisted and unrated** (total assets $17.8 billion and debentures on issue $8.0 billion). ASIC has generated these figures by analysing the most recent financial accounts of all debenture issuers in Australia. We note that the Trustee Corporations Association of Australia has estimated that its members manage over $40 billion in retail debentures.

Sources: ABS; APRA; ASIC.