

**SUBMISSION BY  
STRATEGIC FINANCE LIMITED**

**TO**

**AUSTRALIAN SECURITIES AND INVESTMENT  
COMMISSION**

**ON**

**CONSULTATION PAPER 89  
UNLISTED, UNRATED DEBENTURES – IMPROVING  
DISCLOSURE FOR RETAIL INVESTMENTS**

**1 OCTOBER 2007**

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## INTRODUCTION

1. Strategic Finance Limited (“Strategic”) is one of New Zealand’s leading finance companies. Strategic is ultimately owned by Allco HIT Limited, an ASX listed company. Its core operation is property finance, but it also engages in non-property lending. Strategic is currently not an issuer in Australia. However as part of the proposed expansion of its business into Australia Strategic may look to issue debentures into that market in the future.
2. The New Zealand and Australian Governments have signed an agreement underpinning a requirement for the mutual regulation of security offerings between the two countries. The regime aims to allow issuers to offer securities in both Australia and New Zealand using the offer documents from their own jurisdiction when offering securities in the other jurisdiction. It is likely to come into force late 2007. However Strategic considers that the two Governments will over time align offer documents used in both countries. Consequently, consideration needs to be given to the implications of the proposed regulatory changes in both jurisdictions.
3. Strategic makes this submission in response to Consultation Paper 89 released by the Australian Securities and Investments Commission (“ASIC”) in August 2007 regarding unlisted, unrated debentures and improving disclosure for retail investors.
4. Strategic supports ASIC’s desired outcome to have disclosure that better informs investors about the business models and risks of unlisted, unrated debenture issuers.
5. Any changes that come out of this review have the potential to have a significant impact on the way issuers that offer securities operate their businesses. Strategic is well-placed to contribute to Consultation Paper 89 drawing on its extensive experience of the non-bank financial market in New Zealand. Strategic welcomes this opportunity to share its knowledge and experience to help formulate a regime that achieves ASIC’s objectives while preserving business efficiency and flexibility of the public fund-raising process and keeping compliance costs to a minimum.

## STRATEGIC FINANCE LIMITED

1. Strategic engages in property lending, non-property lending and corporate advisory services in both New Zealand and Australia. Further details on Strategic’s activities are available at their website <http://www.strategicfinance.co.nz>
2. Strategic has experienced strong growth since its inception in 1999. As at 30 June 2007, Strategic had total assets of \$696 million with a net profit of \$30 million for the year.

## EXECUTIVE SUMMARY

1. Strategic has provided answers to specific questions below that are specifically relevant to it and finance company issuers.

## IMPROVED DISCLOSURE

### *C1Q1*

*Are the categories of unlisted, unrated debentures that should be excluded from the proposals in this paper, and if so on what basis (e.g. issuers who raise funds for internal working capital purposes only)?*

Strategic agrees with ASIC's overall approach to unlisted, unrated debentures by implementing changes based on the four principles outlined in the paper. However, it appears in the paper that each issuer must obtain a credit rating for each of its products and if not it must disclose "why not". Strategic submits that if an issuer obtains a credit rating then it should be automatically excluded from the requirement of complying and reporting on the remaining seven benchmarks. The relevant credit rating agency will carry out a full indepth analysis of the issuer in order to designate a rating for the particular product.

A rating reduces the need for investors to try and understand more complex and voluminous financial information on issuers. Ratings would provide the most cost effective means of enabling consumers to distinguish between higher and lower risk issuers and thereby make better informed investment decisions.

## BENCHMARKS (GENERAL)

### *D1Q1*

*Have we identified the relevant benchmarks and ratios? What is missing and/or have we included anything that is not relevant?*

Strategic has provided comments on each individual benchmark as set out below. Strategic also believes that an issuer should be managed by people with a good track record, experience and with clearly demonstrated skills.

In addition to the benchmarks proposed by ASIC, Strategic submits that a fit and proper management benchmark is also introduced.

For example, the fit and proper benchmark could be based on the New Zealand Ministry of Economic Development ("MED") proposal for negative assurance criteria for registration of financial providers in New Zealand as follows:

"No controlling shareholder, director or senior manager of the issuer:

- is an undisclosed bankrupt; or
- is a person prohibited being a director of or in control of the management of a company under the Corporations Law; or
- has been convicted of a crime involving dishonesty or fraud within the preceding five years or has been convicted of a crime involving the laundering or financing of terrorism."

Strategic also believes that there should be quarterly attestation to the Trustee confirming that the offer documents are without material misstatement, accurate, relevant and can be relied upon as reflecting the true statement of position of the issuer.

## BENCHMARK 1 – CREDIT RATINGS

### D2Q1

*Will traditional credit ratings be sufficient? Do they sufficiently highlight to investors the risk of the principal investment not being repaid? Please give reasons.*

Strategic submits that traditional credit ratings are sufficient to highlight the risk of the principal investment not being repaid. Ratings provide a relatively simple metric summarising in one measure the risk of an issuer defaulting on its financial obligations.

The Reserve Bank of New Zealand<sup>1</sup> has taken the view that ratings would strengthen market disciplines on issuers and reduce the need for a more intrusive form of regulation and supervision both in terms of a reduced need for prudential restrictions on issuers and less detailed financial public disclosure requirements. In turn this would reduce the regulatory cost for issuers relative to the situation where there are no required ratings.

It appears that currently the public have a limited understanding of credit ratings. However public education initiatives can promote public understanding through explanatory information, public education initiatives and by encouraging financial news media to highlight the importance of ratings (either of each product or in respect of the issuer).

### D2Q2

*Are there providers other than recognised credit rating agencies that could provide a sufficiently robust and objective credit rating for the purpose of this proposal? Please give reasons.*

Strategic considers that recognised credit rating agencies approved by the New Zealand Reserve Bank should also be recognised as appropriate rating agencies in Australia. This is consistent with the proposed legislation on trans-tasman mutual recognition of offer documents.

### D2Q4

*Where the debentures are unrated, will the statement and proposal D2(f) and the advertising statement in proposal F2(b) be sufficient to assist investors? If not, what else should be done (e.g. should ASIC require a prominent warning that unrated debenture products pose a “high risk” for consumer)?*

Strategic submits that there should be some form of notification in advertisements that a product is potentially higher risk if not rated rather than being a rated product. Advertisements should note if a product is rated and if so what rating it has in a way that can be readily understood by non-expert investors. However if a product is unrated it does not necessarily mean that the product is a high risk product. Advertisements should be labelled as “high risk” if any of the benchmarks proposed by ASIC are not reached.

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<sup>1</sup> Source is 'Questions and Answers on prudential requirements of Non-Bank Deposit Takers' from Reserve Bank website <http://www.rbnz.govt.nz>

## BENCHMARK 2 – EQUITY CAPITAL

### D3Q1

*Is the suggested equity ratio for property development activity appropriate? Please give reasons. and*

### D3Q3

*Is there a better measure of whether the issuer is appropriately capitalised? Please give details.*

Strategic notes that ASIC has imposed high benchmark thresholds on property development financiers on the basis that risks are most significant where funds are on-lent for the development of property assets.

Reasons as stipulated by ASIC include that there is often no cashflow to meet obligations until after a development has been completed and can be sold. Also, if further loan investments are needed to complete the development project the overall viability of the venture may be doubtful because income costs for the payment will increase.

The majority (if not all) of development finance is done on the basis of interest and fees capitalising into the loan. The statement that “there is often no cashflow to meet obligations until after a development is complete .....” is correct.

This does not mean that the development itself is not viable or does not provide adequate security for monies advanced.

The issue really arises when the issuer (financier) does not have the access to funds to complete the project and trigger the process of settlement / asset realisation.

In most instances the issuer’s advance is required to be made first and consequently this is unlikely to result in the project not completing due to lack of funding.

When this is not the case, the issuer must carry sufficient liquidity, financial resource. This issue is covered elsewhere in the discussion paper, but for those that conduct this type of lending activity carrying appropriate levels of liquidity or access to capital is inherent in their business model.

Strategic does not carry the view that this type of lending is “riskier” than other types of asset classes used as security and ascertains that if basic property finance principles are followed then this type of lending could be quite the opposite.

Strategic has formal credit policies and procedures in place that also counter ASIC’s concerns as follows:

In our experience Strategic:

1. Prior to any funding, knowledge of the total debt/borrowings and equity required to complete the project must be known as with how this debt/equity is to be provided.
2. Prior to any funding, a minimum number of fully committed unconditional qualifying presales with adequate deposits paid is required;
3. There must be a timetable in place for the construction phase which is independently certified by the financier’s quantity surveyor;
4. Where possible a maximum fixed price construction contract with an appropriately qualified construction firm.

5. A full project feasibility needs to be produced which also includes all financier's costs, contingencies, etc and this is also independently certified by a quantity surveyor. This demonstrates the profitability of the project;
6. The project is managed by a project management team and the team includes a representative of the financier;
7. A valuation is carried prior to the loan being drawn down to ascertain the "as is" value and the residual value of the land following completion of the development;
8. The level of funding will reflect the pre sales level, fixed price construction contract, adequate project management, an acceptable feasibility and the residual value of the project; and
9. During the construction phase the loan is drawn down on a cost to complete basis as independently certified by the financier's quantity surveyor.

Therefore, a property developer following the basic property development procedures above should not encounter cashflow difficulties and the uncertainties that ASIC has identified are eliminated.

Strategic submits that the latest property finance company failures in both Australia and New Zealand are due to errant behaviour rather than finance companies financing property developments. No amount of legislation can deal with fraud and errant behaviour.

Currently in New Zealand no finance company could meet the 20% equity threshold test. This is significantly higher than the ratio required for a trading bank. There are finance companies in New Zealand that hold investment grade ratings from the major rating agencies which do not meet the 20% equity threshold.

Strategic favours the New Zealand MED approach to licensing and regulating New Zealand deposit takers which includes a minimum capital requirement of \$2,000,000 and a minimum capital ratio as determined by the trustee for each issuer. That ratio must be measured on the basis set out in regulation by the prudential regulator which at this stage appears to be based on a simplified form of the Basel 2. This means that the trustee determines the capital ratio requirements for a company relative to the size and nature of the issuers business. This then could form the percentage required for benchmark disclosure and reporting. In any event Strategic submits that 10% equity is reasonable across the board for all issuers. The 2007 KPMG financial institutions performance survey noted that the New Zealand non-bank financial services industry average is 9.7%.

### **BENCHMARK 3 – LIQUIDITY**

#### *D4Q1*

*Is holding cash or cash equivalents equal to an estimate of 3 months' cash needs appropriate? Please give reasons.*

Strategic submits that liquidity needs to reflect the maturity profile of the debenture book rather than on the basis of cashflow. Cashflows continually change in finance businesses, are very difficult to accurately calculate and can easily be manipulated to suit a particular event, e.g. in order to satisfy a benchmark.

On this basis Strategic submits rather than a benchmark of a 3 month cashflow requirement that each issuer has a minimum of 10% of total assets at any one time.

The 2007 KPMG Financial Institutions Performance Survey indicated that in New Zealand 7.5% liquidity is good practice.

#### *D4Q2*

*How should cash or "cash equivalent" be defined for the purposes of this requirement? What (if any) liquid assets should be included?*

Strategic seeks to clarify that cash or cash equivalents include cash and/or committed undrawn bank lines.

## **BENCHMARK 4 – LENDING PRINCIPLES LOAN TO VALUE RATIOS**

#### *D5Q1*

*Is the suggested loan to valuation ratio for property development lending appropriate? Please give reasons.*

The benchmark as currently proposed raises various practical application questions as follows:

- Is the 70% assessed at the time the loan is drawn or does the 70% apply during the term of the loan; and if so what are the consequences of the LVR falling below 70% during this time?
- Is 70% the aggregate of the lending exposure to one borrower group and the aggregate of all securities held for that borrower group or is the 70% ascertained on each individual loan?
- If the loan is a property development loan but has a combination of land and other security, would the loan to valuation ratio be 70% or 80%?

Refer below for Strategic's alternative benchmark proposal for investors to assess the quality of loans in determining the financial position and performance of the issuer.

#### *D5Q3*

*Is there a better measure of whether the issuer is following appropriate lending practices? Please give reasons.*

If a product is not rated then a distinction should be made between secured and unsecured lending.

If the lending is secured, Strategic submits that a better benchmark measure is to report on security classes as a total percent of the financier's portfolio and the disclosure of the weighted average loan to value ratio for each class of asset. The benchmarks should therefore be disclosed as information. This needs to be backed up by ASIC instigating greater education initiatives to promote financial literacy amongst investors so they can find out how to analyse this information. This in turn will lead to more meaningful investor disclosure.

Strategic submits that this will give information for investors to properly analyse the position of a finance company whilst at the same time giving a finance company flexibility in the way it operates its business.

## **BENCHMARK 5 – LOAN PORTFOLIO DIVERSIFICATION AND SECURITY**

*D7Q2*

*Are there more effective ways of the issuer disclosing the level of diversification of their loan portfolio? Please give details.*

Strategic agrees with ASIC's recommendation that there should be transparent disclosure of loan portfolio diversification. However, it would be very difficult to produce an accurate twelve month forecast if the issuer is a property development financier. The forecast may or may not reflect the actual outcome. Potentially this could create the need for updated forecasts and re-disclosure on a monthly basis. This does not give the investor any certainty when making an investment decision if the forecast is likely to be updated every month after the investment has been made.

Strategic considers this benchmark could be accurately reported quarterly on a retrospective basis. The trustee and investor will then be in a better position to monitor any significant changes in the financial position and performance of the issuer over time.

## **BENCHMARK 6 – VALUATIONS**

*D9Q1*

*Have we identified the issues relevant to valuations? What is missing? Have we included anything that is not relevant?*

Strategic submits that as a financier it takes a conservative approach to valuation. Generally lenders are not looking for aggressive valuations so would select valuers accordingly. Do trustees have the requisite expertise to assess the quality of valuers on a panel? Selection of valuers should be left to the issuer using its internal governance procedures to ascertain the best quality valuers for that issuer. ASIC has proposed that issuers should establish a panel of valuers and ensure that no one valuer conducts more than a third of issuer's valuation work. Strategic seeks to clarify whether ASIC is referring to one third of individual valuers within organisations or one third of valuations are to be undertaken by each valuation firm. In New Zealand there is a smaller pool of major valuation firms and therefore it may be difficult for New Zealand issuers to comply with this requirement.

*D9Q5*

*Should the full valuation reports be made available to investors? Please give reasons.*

Strategic is of the view that it is little benefit for investors to have access to full copies of the valuation reports as that is only one aspect of the loan appraisal process. Looking at the valuation in isolation is meaningless. Investors would need access to the full loan files which is not practical. In addition, valuations are commercially sensitive and could jeopardise business opportunities if disclosed to the wrong parties.

The financial position of a finance company is reflected in its financials. Valuations are not relevant to the issuers financial position, rather valuations are specific to assets. A finance company's main asset is its loan book. Undertaking valuations of assets used as security is only part of the security process and cannot be aggregated to ascertain the financial position of a finance company issuer.

In any event the valuation can only be relied upon by the person for whom the valuation is addressed.

## **BENCHMARK 7 – RELATED PARTY TRANSACTIONS**

### *D10Q1*

*Have we identified the issues relevant for related party transactions? What is missing? Have we included anything that is not relevant?*

Strategic confirms the view of ASIC in respect of the related party benchmark and further considers that any valuations undertaken by an issuer in respect of related party transactions need to be very robust and independently verified if required by the trustee.

### *D10Q2*

*Are there more effective ways of dealing with related party transactions? Please give details.*

Trust deeds should set a limit on the related party lending that is set in relation to the issuer's capital. Also directors of the issuer should certify the Trustee that the terms of the related party transaction are arms length.

## **BENCHMARK 8 – ROLLOVERS**

### *D11Q1*

*Should issuers be required to give investor and up-to-date prospectus before their investments are due to rollover, to assist them in their decision-making?*

Strategic supports ASIC's requirement to give investors the most recent prospectus before their investments are due to rollover to assist them in their decision making.

### *D11Q2*

*Should the default be that the principal is repaid unless the investor expressly decides to rollover?*

Strategic submits that the default should be that if an investor cannot be located that the principal plus any accrued interest thereon is rolled over however that investor can require redemption within 6 months of that rollover without penalty.

## **ADVERTISING**

### *QF3Q1*

*Have we identified the relevant issues on advertising? What is missing? Have we included anything that is not relevant?*

Strategic submits that if an issuer has an unrated product that the advertisement should contain a statement advising that the product carries a potential higher risk than an equivalent rated product. However it may be more appropriate to tie warnings into the benchmarks rather than to credit ratings. Unrated debentures may not necessarily pose a higher risk for investors.

## **CONCLUSION**

Strategic supports ASIC's initiatives. However in some areas there needs to be some modifications to ensure that practically compliance is achievable. It is Strategic's view that investors need to be given plain English information that is easy for them to digest to assist with their investment decisions. We attach a recent Strategic investor bulletin in which we are trying to achieve this objective.