

# The FOS Approach to Fixed Interest Investments

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We have created a series of FOS Approach documents, such as this one, to help consumers and financial services providers better understand how we reach decisions about key issues.

These documents explain the way we approach some common issues and dispute types that we see at FOS. However, it is important to understand that each dispute that comes to us is unique, so this information is a guide only. No determination (decision) can be seen as a precedent for future cases, and no FOS Approach document can cover everything you might want to know about key issues.

# 1 At a glance

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## 1.1 Scope

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A 'fixed interest' investment is one that pays a regular rate of interest for a specified term with the expectation that the principal will be repaid at the end of the term (maturity date). Traditionally such investments are considered safe, secure investments, but this is not always the case.

The interest rate can be set (fixed), or it can change over the term of the investment (variable).

Fixed interest investments are usually issued by corporations, government and semi-government bodies and financial institutions, such as banks, to raise funds.

This document provides information on FOS's approach to disputes about these investments.

## 1.2 Summary

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Generally disputes are lodged with FOS about whether a particular fixed interest investment was appropriate for the investor or that an advisor did not disclose the risks of the investment.

In considering such disputes FOS needs to understand:

- what the investor was actually invested in
- the rate of return promised
- who issued the investment.

Once this assessment has been made, FOS can then determine whether the investment was appropriate for the Applicant's circumstances and whether the advisor adequately disclosed the risks of the investment, particularly the risks of capital loss.

## 2 In detail

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### 2.1 What is a fixed interest investment?

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The term fixed interest investment is used to describe any investment that pay interest. It includes:

- term deposits
- bonds
- unlisted debentures, secured and unsecured notes
- unlisted mortgage schemes
- mezzanine investments

### 2.2 Who are fixed interest investments generally considered suitable for?

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Fixed interest investments are normally suitable if you want:

- to park your money for a short period of time
- to hold money that you do not want to lose
- to reduce overall risk in a portfolio.

Not all investments paying interest will suit all the purposes listed above. Just because an investment is a fixed interest investment does not mean that you will get all the capital you invested back or that you are guaranteed to receive interest payments. You need to understand the nature of the investment and the risks associated with the investment.

### 2.3 What will FOS look at when assessing fixed interest investments?

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#### Level of risk

Just because an investment promises that it will pay interest, does not mean that it is safe. Investments vary from the very safe such as a savings account with a major bank, to the very risky, such as unlisted unsecured notes.

You need to examine the product carefully, not simply rely on the name used to describe the product. For instance, simply because a product is called a 'secured note' doesn't mean it is safe. The product is not a bank deposit, its not Government guaranteed, and there is a risk you could lose some or all of your money.

The reference to 'secured' simply means that the issuer has provided some form of security to the trustee of the note issue.

#### The nature of the investment

FOS will always look at the nature of the fixed interest investment to assess the risk of the investment.

If the fixed interest investment is a managed fund, FOS will always look at the underlying asset allocation of the fund. Sometimes managed funds marketed as 'fixed interest' have a proportion of the investments invested in shares or property or other more 'risky' investments.

The below table provides an indication of the risks of various fixed interest investments:

Less risky		Most risky		
Australian Government Bond	Term Deposit	Corporate Bond	Debenture	Shares Property

### Who issued the investment?

The risk of the investment depends on the entity issuing the investment.

If the issuing entity was regulated by Australian Prudential Regulated Authority (APRA) it will be safer because they have capital requirements specified by Government. This includes banks, building societies, credit unions, life insurance companies and superannuation funds. A list of [APRA regulated institutions](http://www.apra.gov.au/adi/pages/adilist.aspx) can be found at <http://www.apra.gov.au/adi/pages/adilist.aspx>

An investment issued by a private company can be more risky. Sometimes the company may have initially tried to borrow funds from a bank, but been refused because the bank viewed lending the company money as too risky. It then offers investors a corporate bond or the like.

### What is the rate of return promised?

Normally the higher the rate of return, the higher the risk. Any such assessment would normally be made by reference to the cash rate at the relevant time. So if the cash rate is 2.5%, and a fixed interest investment is paying 8.5%, the investment would normally involve risks to capital for the issuer to achieve such a high rate of return.

### Once FOS assesses the nature of the investment it can then consider whether the investment was appropriate for the investor

The above considerations help FOS in establishing the risk of the investment. FOS then looks at whether the risks were appropriate for the investor and adequately disclosed. This is dependent on the facts of the individual case. Just because a riskier fixed interest investment was recommended, does not necessarily mean it was inappropriate. Risk disclosure by the advisor is also critical.

## 3 Context

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### 3.1 Case study

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FOS considered a dispute about advice to invest in a particular managed fund which was marketed as a fixed interest product.

The fund had the following features which made it different from a straightforward fixed interest product:

- whilst it provided regular payments to investors, the rate of this return was variable
- the fund manager was investing in Australian and International Equities, as well as having exposure to the US sub-prime market, and could invest in below investment grade assets
- the fund was neither income nor capital guaranteed
- the fund had a high gearing ability, as high as 300%, and
- the fund was governed by Cayman Islands regulations rather than Australian regulations.

The Panel said that the FSP's recommended asset allocation was made on a generic basis without any real understanding of the product, the product manager's discretions or the influence of those discretions on the possible outcome of the performance of the product.

The product was classified as a defensive asset when a review of its underlying investments would have shown:

- it was not a defensive asset
- the adviser failed to exercise any degree of care with respect to monitoring or understanding the effects of the internal gearing of this product, especially as it related to its overall risk and performance, and
- the fund had a mandate which, if exercised, would make it inappropriate for the investor. It may only have been appropriate for an investor under the most favourable conditions, for example, low/no gearing and holding only investment grade assets or the like.

## 3.2 References

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### Definitions

Term	Definition
Debenture	A medium to long-term investment issued by a company. You are lending money to the company. In return you will receive a regular and fixed interest amount for the term of the investment. The invested funds (principal) are repaid at the end of the term (maturity).
Cash Rate	The interest rate which financial institutions pay to borrow or charge to lend funds in the money market on an overnight basis.

### Useful links

Document type	Title / Link
ASIC approaches	<a href="http://www.moneysmart.gov.au">MoneySmart</a> ( <a href="http://www.moneysmart.gov.au">http://www.moneysmart.gov.au</a> )  Investing in <a href="#">unlisted debentures and unsecured notes?</a> (October 2010) <a href="http://bit.ly/296AQMC">http://bit.ly/296AQMC</a>  <a href="#">Investor alert: Fixed interest products</a> - higher returns mean higher risks <a href="http://bit.ly/28ZPjY3">http://bit.ly/28ZPjY3</a>
List of <a href="#">APRA regulated institutions</a>	<a href="http://www.apra.gov.au/adi/pages/adilist.aspx">http://www.apra.gov.au/adi/pages/adilist.aspx</a>