

## Edition 67, 20 June 2014

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### Dealing with the demise of Defined Benefit funds

#### **Kevin O'Sullivan**

With the demise of Defined Benefit (DB) arrangements, what have we gained and what have we lost? Can we retain or get back some of the good features of DB funds?

Under a DB scheme, members' benefits, not required contributions, are specified within the rules of the fund, typically using a formula approach. Under a Defined Contribution (DC) scheme, the level/s of contributions is/are specified in the fund's rules, with the eventual benefits being uncertain.

It would be foolhardy to think that DB funds could make a comeback in Australia after many years of employers closing DB funds to new members or to future accruals. These closures have been done for many reasons, including:

- employers wanting to reduce or eliminate their exposure to DB funding risks
- changes to accounting rules that led to undesirable balance sheet and/or P&L effects for employer sponsors
- individual member preferences for bank account style DC accounts
- superannuation legislation (such as the introduction of the Superannuation Guarantee) and related requirements (such as DB funding prudential standards) predominantly being based on DC arrangements, with DB arrangements often treated as an afterthought, and
- changes in the packaging arrangements of employees' remuneration.

Although there are very few open DB funds (UniSuper is the largest open DB fund in Australia), those open DB funds together with the DB funds that have been closed to new members will remain material in size for many years (DB assets currently exceed \$150 billion) and will need to be well managed for their members and employer sponsors.

## **Advantages and disadvantages of DB funds**

Most of the advantages of DB funds over DC funds result from the pooling of risks. The key advantages of DB funds include:

- greater ability of members to predict their future benefit
- member protection from the impact of poor investment experience (including protection from sequencing risk prior to retirement)
- benefits can be set based on retirement needs
- where pensions are provided, members can receive comfort from knowing their expected level of post-retirement income (protection from sequencing risk) and that their benefit will not be exhausted prior to their death (protection from longevity risk).

In the past, DB funds were often promoted as a tool for employers to attract and retain employees. Whilst the existence of a DB fund can differentiate an employer, their desire to do so via DB super has waned over the years.

Many of the disadvantages of DB funds reside with the employer sponsors, with those shortcomings including:

- volatile (and potentially large) funding requirements
- volatile (and potentially large) impact on the balance sheet and P&L of employers
- the treatment of DB arrangements being difficult in modern remuneration arrangements (for example, less flexibility and difficulty in placing a value on each member's DB accruals)
- the perception that benefit structures can be too complex.

From the perspective of individual members, DB arrangements can have additional shortcomings, such as the inability to reap the rewards of strong investment performance and perceived inequity in benefits between individuals.

Whilst the majority of legislation has been made without concern for DB funds and their members, much of it has benefited DB fund members as well as DC fund members. For example, the introduction of the Superannuation Guarantee (SG) in 1992 has led to almost universal coverage as well as improved vesting of members' superannuation benefits. Governance improvements have also benefited all super fund members. But the introduction of the SG and its focus on required contributions has also led to some less desirable outcomes. These predominantly stem from the resultant move from DB to DC arrangements under which members' benefits have greater exposure to market volatility and less certainty regarding retirement outcomes. There can also be a greater focus on lump sums and no obvious way to deal with longevity.

Prior to the SG's introduction, many employers were already providing good superannuation benefits, often well in excess of SG levels. Over the years, some of those employers have chosen to change such generous arrangements, for many reasons, but the DC focus of the SG legislation was often a contributing factor.

## **Which DB features could we introduce into non-DB arrangements?**

Given it is highly unlikely that we would go back to offering DB arrangements, I believe we would benefit from incorporating some of the features of DB funds into our predominantly DC environment.

Firstly, although the benefits of most DC members are determined as lump sum amounts, we should move to present members' benefits as income streams on benefit statements and websites. This should occur within lump sum DB funds as well. This has several benefits. Members can better appreciate whether or not their superannuation amounts are (or will be) adequate when they can compare an estimated post-retirement income with current income. Reporting lump sum amounts only can easily mislead people to believe that relatively modest lump sum savings are adequate when they are not. Also, the projection of future benefits as income streams can minimise member concern that arises with poor investment markets, putting into perspective, particularly for younger members, that market falls may not have a material impact on their ultimate benefit.

In a similar vein, stochastic modelling tools (like those typically used within the investment strategy modelling of DB funds) can be introduced. This would allow DC funds to provide their members with projections that enable them to better understand the range of potential benefit outcomes. Such tools could provide members of DC funds with more comprehensive information to assess the impact of possible investment strategies on their ultimate benefit rather than just relying on expected returns for each strategy.

For members of DC funds and members of lump sum DB funds that do not provide pensions or annuities on retirement, post-retirement solutions to assure individuals that their retirement savings will last for their lifetime need to be developed. Solutions would include a combination of advice and product. Financial advice can assist individuals to structure their arrangements appropriately. Product solutions will continue to develop as funds take advantage of many innovative ideas to protect members against outliving their savings. I hope that we will see the legislative change required to enable greater ability to cater for longevity risk.

In a DC fund, individual members bear all of the risk: market, longevity, sequencing, etc. In a DB fund, employer sponsors bear all or the majority of the risk. But is either arrangement optimal? I believe that we will one day see the introduction of arrangements under which pooling will be used to enable members to share the risks, like a DB fund, but without employer sponsors bearing so much of the risks. Like DB and DC funds, Defined Ambition arrangements (like Collective DC funds) have advantages and disadvantages but, over time, they may find a niche in Australia.

These enhancements can occur through a combination of targeted actions by super funds and legislative change. As they look to retain the significant amounts of money of baby boomers approaching retirement in coming years, funds see the need to better cater for members in retirement and post retirement solutions will grow. Funds also see the need to help members better consider the adequacy of their retirement savings and take appropriate actions.

Future legislative change, such as requiring all funds to show income equivalents on benefit statements and structuring tax and Age Pension rules to encourage or require members to take benefits in income form could also have a significant positive impact on our superannuation system.

I'm very optimistic that many of these enhancements will occur and that members and Australian society in general will benefit as a result.

*Kevin O'Sullivan is Chief Executive Officer of UniSuper Management Pty Ltd*

## **Diversification: past, present and future – part 1**

### **Harry Chemay**

Diversification. The word once appeared to suggest higher returns delivered with lower risk. Through the GFC however, diversification's fabled benefits appeared to vanish just when needed most, leaving many disillusioned. So what does diversification actually promise, and what can it realistically deliver? In this trilogy of articles we'll look at diversification through a retirement planning lens, from its earlier incarnations to its potential future applications.

#### **Diversification through the ages – from Shakespeare to Sharpe**

One of the earliest references to diversification appears in Shakespeare's '*The Merchant of Venice*'. The merchant, Antonio, when asked whether his melancholy might be due to worrying about his ships at sea, says...

*Believe me no. I thank my fortune for it –  
My ventures are not in one bottom trusted,  
Nor to one place, nor is my whole estate  
Upon the fortune of this present year.  
Therefore my merchandise makes me not sad.*

Antonio, in owning more than just one vessel, was applying the principles of diversification. He knew that while it was possible that one of his ships might be lost on any one voyage (denting his wealth a little), it was extremely unlikely that *all* his ships would be lost (in different seas and weather conditions) at the same time, leaving him destitute. Thus from the earliest days, diversification was recognised as a tool better suited to avoiding financial disaster than to maximising wealth. Another 350 odd years passed before diversification's investment benefits were quantified in a 1952 paper titled '*Portfolio Selection*' written by a Ph.D. candidate at the University of Chicago.

### **Enter the diversification engineers**

In writing his doctoral dissertation on the role of risk in investing, Harry Markowitz applied the concept of *variance*, a statistical measure of 'spread' around an average outcome. He used variance as a measure of risk, with a risky investment being one with a large range of possible outcomes around its expected return. Markowitz was thus the first person to put a number on investment risk, albeit a risk metric that primarily measures the volatility of returns. Today a close relative, *standard deviation*, is the most commonly used measure of risk in institutional asset management.

Markowitz demonstrated in mathematical terms how investment diversification works: you can have two individually risky assets (high standard deviations) and yet combine them to produce a less risky *portfolio* (his choice of words) provided the two assets do not move in identical fashion in response to the same stimulus. This co-movement is known as correlation, and the lower the better. Thus a portfolio consisting of just two shareholdings, one an ice cream maker and the other an overcoat maker, should result in a less risky outcome than holding either in isolation. The seasonal variations in temperature would benefit one if not the other.

William Sharpe wrote part of his doctoral dissertation under Markowitz and took his supervisor's ideas further in the early 1960s when he recognised that the single biggest influence on the direction of a company's share price was the direction of the share market as a whole. He also noted that investors were, by then, able to diversify their shareholdings relatively easily and at low cost. Sharpe surmised that the benefits of diversification were available to all, and as such investors should not expect to be compensated for risk that could be diversified away by holding a broadly-based share portfolio.

Sharpe introduced the dichotomy of diversifiable (company-specific) idiosyncratic risk and non-diversifiable systematic (market) risk. He felt that investors in competitive share markets should only expect above-market returns from any systematic risk they choose to hold in excess of market risk. In short, in the absence of superior and enduring investment insight, to beat the market you have to accept more risk than the market.

Together Markowitz and Sharpe provided a theoretical foundation for diversification. These efforts saw both awarded (along with Merton Miller) the 1990 Nobel Prize in Economic Sciences "for their pioneering work in the theory of financial economics". At heart however Markowitz and Sharpe were merely expressing mathematically the practical wisdom in two age-old sayings: "Don't put all your eggs in one basket" and "Nothing ventured, nothing gained". The aim of all prudent investing is to find the right balance between these two adages.

### **Asset classes – Diversification grows up**

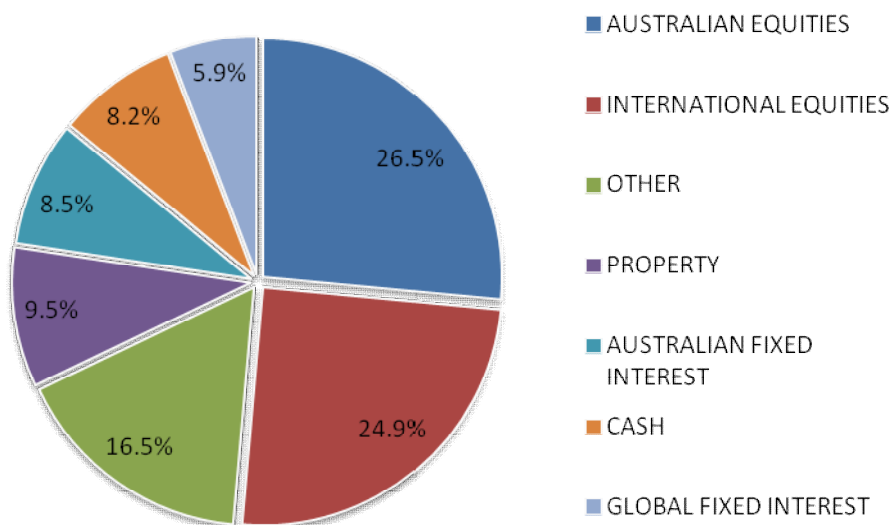
Markowitz and Sharpe were concerned primarily with risk and return from a share market perspective. Investors tend to hold their wealth in assets other than just shares. Prudent investors will allocate wealth across a number of asset classes, each with its own risk/return characteristics. At the highest level these asset classes are cash, fixed interest (debt), shares (equity) and property.

The diversification principles underlying portfolio construction have changed little in the past 50-odd years. The process starts with an investment policy which states the overarching investment objective(s)

and the acceptable risk/return trade-offs. Asset classes are named as are their policy weights. Taken together these form the portfolio's 'Strategic Asset Allocation' (SAA). Each asset class will have a benchmark against which performance is monitored. Finally an allowable limit might be set for intentionally deviating from the SAA to take advantage of perceived shorter-term valuation anomalies (often termed tactical or dynamic asset allocation).

How does all the above translate into the real world? As the SAA 'pie chart' that has become a ubiquitous part of investing today. Below is the current asset allocation of the average default superannuation fund option, offered by Australian super funds, as compiled by global consulting firm Mercer:

## Asset Allocation (Ave. Default Option)



Source: Financial Services Council, *Asset Allocation of Pension Funds Around the World* (February 2014)

As the chart indicates, some 51.4% is allocated to equities, both domestic and international. Together with property, the total allocation to 'growth' assets sum to almost 61%. Part of the 16.5% in 'Other' might also have growth-like characteristics, such as allocations to private equity, hedge funds and certain types of infrastructure.

By investing across various asset classes, superannuation funds seek to apply Markowitz and Sharpe's principals of diversification. Pie charts tell us how *capital* is allocated. They tell us little, however, about how *risk* is allocated. In the next article we turn our attention to the risks embedded in diversified portfolios such as the one above.

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## [Australia's default, part 1: A primer on government debt, default and inflation](#)

**Ashley Owen**

In writing about debt and bond markets in the post-GFC sovereign debt crisis, I have often referred to Australia's default. For example, I have compared it to recent defaults and debt restructures by countries like Greece in recent years. These references and comparisons have drawn much feedback from readers in Australia who have expressed surprise, shock and disbelief that Australia has defaulted on its government debts. This three-part series of articles tells the story of Australia's big default.

Many countries, including the US and Australia, have defaulted on their debts at one time or another – i.e. they have failed to pay interest and/or principal on government bills, notes and bonds when due. In the case of the US, the three 'defaults' on US Treasury Bills by the US government in 1979 were temporary and quickly rectified. [See [US Government shut-down – been there, done that](#), Cuffelinks, September 2013]

Australia's 1931 default was a 'big one' – a full scale Greece-like permanent restructure of Australia's entire stock of domestic debt owed to bond and note holders.

### **Domestic versus foreign debt**

Governments of countries can borrow from their own citizens and/or they can borrow from foreigners if the pool of domestic savings of its citizens is not sufficient to fund their government deficits. Money borrowed by governments from their own citizens is generally payable in the local domestic currency.

On the other hand, governments of countries with relatively weak currencies or relatively unstable or immature political environments often need to raise debt denominated in a foreign, stronger, (or 'sovereign') currency – like the US dollar, pound Sterling or now the Euro - in order to attract foreign investors to lend them money. Foreign investors will often demand repayment in a 'hard' currency because the domestic currency can easily be devalued or debased by the government.

For example, would you lend your hard earned Australian dollars to Argentina's government to be repaid in Argentine Pesos? Not likely. You would probably insist on repayment in a 'hard' currency like US dollars. (The Argentine Peso has fallen by 35% in the past year alone, so you would have lost 35% of your money had you lent your money in Pesos).

Government borrowing in a foreign 'hard currency' is usually termed 'sovereign debt' because borrowing in gold has been regarded as the ultimate 'hard currency' for loans for more than two thousand years. Even the mighty US of A had to resort to borrowing in foreign, harder currencies during its 1978-1979 government debt crisis. [See [US Government has previously defaulted, it's not risk-free](#), Cuffelinks, October 2013]

### **Defaulting on government debt**

Governments usually don't default outright on, or restructure, their domestic debt (debt issued in their own currency and owned by their own citizens) because they generally don't need to. If the Australian government suddenly decided to pay only 97 cents in the dollar on the money it owed on interest and principal obligations that were due for payment in 2015, then 94 cents in the dollar on money due in 2016, and 91 cents on money due in 2017, and so on, there would be riots in the streets and the government would probably be thrown out for renegeing on its obligations to repay money it owed when due.

A more subtle and surreptitious way of achieving a similar outcome (ie repaying less than the government owes) is for the government to create domestic inflation and/or unilaterally declare a new arbitrary value of its paper money and then repay the debts with the new devalued paper. This practice has also been going on for more than two thousand years. One of the earliest recorded examples of this was by Dionysius, ruler of Syracuse (405 – 367 BC) in Sicily during the wars between the Corinthians,

Athenians and Carthaginians for control of Syracuse. [See [Catapults and coin tricks: what Ben Bernanke learned from the Greeks](#), Cuffelinks, January 2013]

### **Creating inflation to avoid paying full value**

Governments have been creating inflation and printing money to pay off their debts with debased currency of lower real value ever since then, and they continue to do so today. Creating inflation by printing paper money is currently the flavour of the month with the major central banks of the world, with the US Federal Reserve, Bank of England, Swiss National Bank and the Bank of Japan leading the global charge.

All governments deliberately set out, as a matter of formal government policy, to create inflation to deliberately destroy the value of their own currencies, so that money they are legally obliged to pay in the future has less value than it does today. (Inflation has other side-effects that are seen by governments as being positive: it assists exporters, and it also creates an incentive for consumers to spend money rather than save it, as spending is seen perversely as more productive than saving, at least in the short term).

### **Australia leads the pack**

Australia's formal inflation target of 2% to 3% per year is the highest official inflation target in the world. It is a formal government policy to deliberately destroy the value of the wealth held by its own citizens by 2% to 3% each year!

This is why Australia has a fundamentally weak currency (relative to 'hard' currencies), and it is why Australia has the highest inflation rate and the highest interest rates in the developed world.

### **Japan – no way out but inflation**

Japan has the biggest pile of government debt in the world (relative to its national output). Creating inflation to destroy the real value of the yen is the only way out of its current debt situation. There is no other way of paying it off – with Japan's declining population, declining workforce, declining tax-payer base, and increasing welfare burden as its population ages rapidly. 95% of Japan's government debt is owed to its own citizens so it can just print more yen to pay it off. The main stated goal of the 'Abenomics' policies in Japan is to create inflation – i.e. to destroy the real value of the yen – in order to assist exporters, to encourage spending, and to repay debts in debased yen.

### **Australia's debt pile leading up to the default**

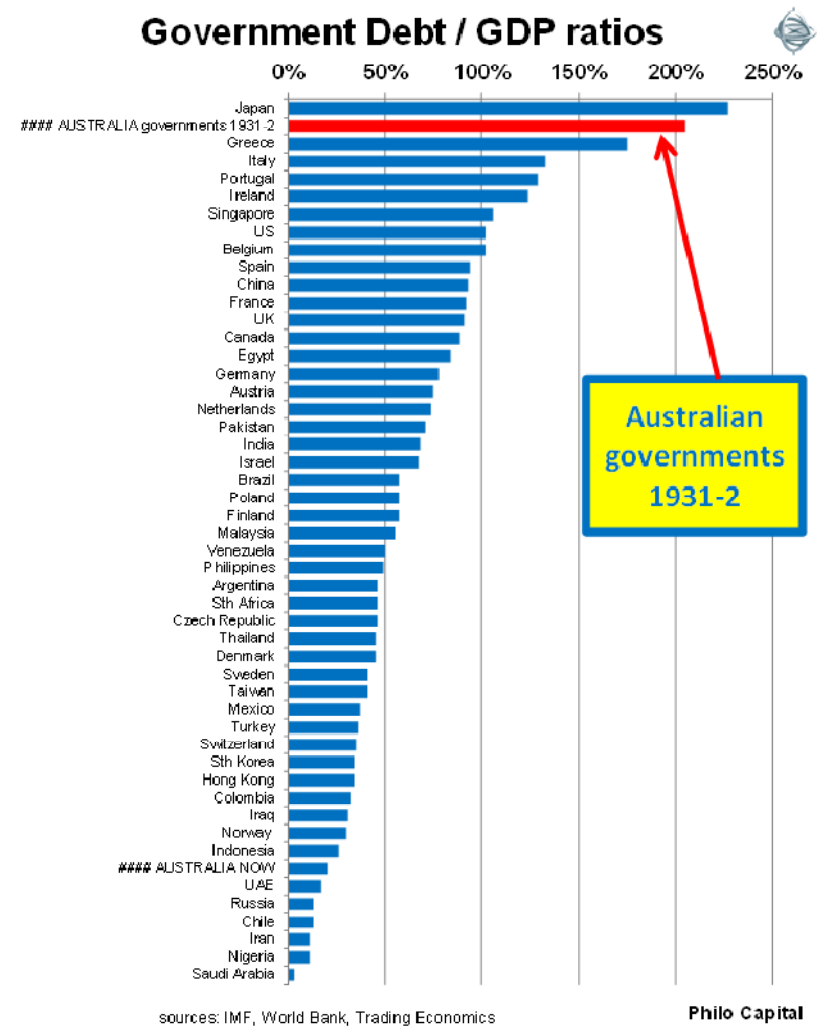
Australia has always been a country with a relatively young population with a relatively small savings base of its own, and so it has always had to rely on 'imported savings' in the form of foreign debt and foreign equity for capital to fund its development.

By 1932 Australia's government debt to GDP ratio reached 205% - on par with Japan today. However, unlike Japan, 55% of Australia's government debt was foreign debt. This was borrowed mainly from UK banks, repayable in London in Pounds Sterling, and traded on the London Stock Exchange. The rest was borrowed from Australian citizens and Australian institutions like insurance companies, and traded on the local stock exchanges – mainly Melbourne and Sydney.

Only 30% of the total government debt was Commonwealth government debt. The Commonwealth government only started to borrow money in a big way in the First World War but, under pressure from London bankers who had turned off the taps to the States in 1929, the Commonwealth government assumed responsibility for State debts. NSW was the most profligate state and had a disproportionately large share of debt, mostly to fund infrastructure projects like the rail and road networks.

The following chart shows Australia's government debt level in 1931-1932 as a per cent of national output (GDP) compared with the debt ratios of the top 50 countries today.

## Government Debt / GDP ratios



We can see from this chart that Australia's government debt at the height of the 1930s crisis was worse than any other country today except Japan, and much worse than Greece, Ireland, Argentina and Venezuela. In contrast, Australia's government debt levels today are near the bottom of the chart.

### Crippling interest burden

The interest burden on total government debts consumed a massive 40% of all government revenues in the 1920s and 1930s (compared to just 4% today). The problem was that total tax revenues were only 16% of GDP (23% today), and this left a massive hole in government finances. With Australia excluded from foreign debt markets from 1929 onward, and the pool of domestic savings hit by the depression, there was no other way out of the crisis but to default on interest payments and maturing principal repayments. The commercial banks and the Commonwealth Bank, which was the government's wholly owned banker and central bank, all refused to lend it more money. Something had to give.

In Part 2 of this story we look at how this happened, which bond holders were rescued, and which were forced to take a 'haircut' on their interest and principal repayments.

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## Quality over quantity: a lesson of value

### **Andrew Macken**

There are, broadly speaking, two kinds of stock market investors in this world: those who believe they can beat the market and those who don't. The latter group of investors tends to buy index-style funds that hold shares in nearly every company in proportion to their index weight to ensure delivery of the market return, net of fees, with little deviation.

But what about the former group of investors? One philosophy which has demonstrated sustainable outperformance of the market over long periods of time is that of 'value investing'. Under this philosophy, the investor will hold shares in fewer companies which are of relatively higher quality and purchased at relatively lower valuations.

While many subscribe to these ideas, putting them into practice is not a trivial task. One area that many investors grapple with is articulating precisely what constitutes a 'high quality' business. One way to think about the quality of a business is to answer the following question: how easy would it be for a competitor to recreate the business? If the answer is 'very easy' – as would be the case for, say, a corner store, then the quality of the business is low. On the other hand, if the answer is 'very difficult, time consuming or costly' – as is the case for, say, Facebook, then the quality of the business is high.

When thinking about how to answer this question, one can think of three key sources of quality. A business can be qualitatively evaluated for these elements with a check-list type approach. The three sources of quality are: economies of scale, customer captivity and government protection, such as licenses or patents.

Economies of scale relate to the dynamic of bigger businesses exhibiting a cost advantage over smaller businesses. When fixed costs can be spread across a larger quantity of goods and services, average unit costs are lower. Furthermore, bigger businesses can exhibit stronger bargaining power over suppliers and drive more favourable terms than smaller businesses. We are seeing this dynamic all too clearly in the Australian supermarkets space.

Customer captivity relates to the ease with which customers can switch to a competitor. A business that has a large degree of customer captivity is often more successful in pushing through higher prices. There are various forms of customer captivity. These include integrated systems between the business and its customers, as is the case for Visa and Mastercard, as well as customer loyalty programs that effectively increase the cost for customers to switch.

Finally, when a business has privileged access to resources or a patent, this represents an advantage that cannot easily be recreated by competitors. For instance, one of the reasons why BHP is such a world-class business is because it has government-protected rights to mine the natural resources of Australia and other nations. Without these rights, the company's quality would be severely impaired. Patents on new technology create a similar degree of quality to the extent they are protected by the government.

Value investors will aim to hold portfolios of shares in companies that exhibit many of the elements described above. As long as the investor does not overpay for these businesses initially, they can be reasonably assured of market outperformance over long periods of time. These principles of value investing are worth keeping in mind for both individual investors as well as those looking to evaluate the investment managers of externally-managed funds.

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## Taking the heat out of home lending

### Jonathan Rochford

The APRA Draft [Prudential Practice Guide 223 Residential Mortgage Lending](#) released last month is long on motherhood statements but short on specifics. This is somewhat understandable in an environment where the banks are lobbying aggressively for as few risk restrictions as possible on their businesses when overall credit growth has been sluggish. However, the lessons learnt by other countries during the financial crisis are being ignored by many in Australia, with the predominant view being that since Australia escaped largely unscathed in the last decade it is immune from credit problems in the years to come.

A number of key measures indicate that Australian house prices are at elevated levels, with Australian cities routinely coming near the bottom of global affordability rankings. The combination of low unemployment and very low interest rates means that the pool of potential buyers has increased over the last two years. At the same time as economic factors have favoured borrowers, banks have eased their lending criteria with APRA publicly noting its concerns. Together these changes have allowed potential borrowers to qualify with smaller deposits and/or lower income levels, or to borrow more than they previously would have been able to. Should unemployment or interest rates increase materially, or if tax changes reduce the availability of negative gearing or increase land taxes, a reversion of house prices is eminently possible. There is clearly an increased heat level in the Australian home lending market.

As a guide to what action APRA and banks should be taking now, specific limits are proposed below on key loan characteristics. Potential borrowers should also note these recommendations, as banks may seek to maximise the amount they lend rather than suggesting a lower amount that may be in the customer's best interests.

#### **Loan to value ratios (LVRs)**

LVRs measure how much debt and equity a borrower has in a property. Australian and international default studies have found a very high correlation between high LVR loans (those with low equity) and high default rates. Low levels of equity leave little or no room for periods of greatly reduced income levels such as unemployment or maternity leave. LVRs for bank loans should therefore be capped at 90%, with borrowers required to raise at least 10% of the purchase price as well as covering the cost of stamp duty and lenders mortgage insurance.

#### **Second lien (or second mortgage) loans**

Default studies in the United States have shown that loans with second liens default at a much higher rate than loans without. Whilst having multiple layers of debt secured against residential property is rare in Australia, if the maximum LVR is reduced the demand for second lien debt may increase. Australian banks should be limited to offering first lien loans, with no allowance for second liens on properties securing bank loans.

#### **Affordability tests**

For many years, common industry practice has been to test the ability of borrowers to meet their repayments assuming interest rates rise by 2% from current levels. With home loan rates now at record lows, banks should increase this test to 3%. This increased stress test implies a movement in the RBA cash rate from the current level of 2.50% to 5.50%, which would be approximately in line with the average of the cash rate over the last 20 years. Banks that use a standardised measure such as the Henderson Poverty Index for living expenses should also be required to have a buffer of at least 10% in their servicing calculations. Many potential borrowers are unlikely to live on such a meagre existence, particularly higher income earners who are disproportionately represented in new lending. Affordability tests should also be based on amortisation of the loan over no more than 25 years.

#### **Interest only loans**

Interest only loans are most common with investors, with owner occupiers typically making principal and interest repayments. The lack of amortisation increases the risk of these loans, particularly if interest

rates should rise materially without a similar increase in rental yields. To counter this risk, interest only loans should be limited to 80% LVR and for a maximum of five years.

### **Loan tenor**

Long dated loans mean that borrowers make very little headway in reducing their principal in their first few years. They can also be an indicator that borrowers are stretching to make the minimum repayments. Banks should be allowed to offer loan tenors to a maximum of 25 years, with interest only loans limited to five years followed by a 20 year amortisation period.

### **Lenders mortgage insurance (LMI)**

The international experience with LMI is chequered, with poor outcomes in the United States during the global financial crisis and in the United Kingdom in the 1990's. However, many banks in Australia see the risk of loss on insured loans as minimal. The international experience indicates that during a time when claims are most likely to be made and the insurance is most vital, (when a substantial and sustained increase in unemployment is accompanied by falling house prices) LMI providers may not be able to meet all claims in a timely fashion. To take into account this risk, banks should not be able to treat high LVR insured loans the same as low LVR uninsured loans.

### **Capital weights**

The introduction of Basel III capital weights has seen the major Australian banks holding lower levels of capital against home loans at a time when house prices are arguably most elevated. A tiered system should be introduced that recognises the lower risk attached to low LVR loans and that also provides some credit to insurance from well capitalised LMI providers. Uninsured loans at or below 70% LVR and insured loans at or below 80% LVR could continue to receive the highly discounted risk weighting allowed by Basel III. Uninsured loans of 70-80% and insured loans of 80-85% should be subject to a 50% risk weighting. All other loans should be subject to a full risk weighting. It is acknowledged that such a change would likely result in tiered interest rates to borrowers. This would be a positive development with lower risk borrowers rewarded with a lower interest rate.

### **Conclusion**

In the provision of credit, bad outcomes are not evenly spread with marginal borrowers being a disproportionately large source of impairments and losses. The combination of the current economic environment and easing of lending criteria has brought substantial heat to the Australian home lending market with a greater number of marginal borrowers obtaining finance from banks. The elevated risk posed by these borrowers is added to the systemic risks of Australian banks with their highly leveraged business models and strong dependence on overseas funding. By introducing specific measures aimed at limiting high risk home lending now, APRA would be able to substantially lower the risk profile of Australian banks in advance of a potential reversion in house prices.

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