NARROW ROAD CAPITAL

Narrow Road Capital Submission to the Financial System Inquiry

Introduction

Narrow Road Capital is an Australian fund manager specialising in high yield and distressed Australian credit. It is therefore well placed to make a submission on many issues relating to credit and lending activities, and is happy to assist further if requested by the members of the Inquiry panel. This submission aims to provide unbiased commentary on selected areas of the Australian financial system. It aims to not only identify problems but to provide simple solutions that can be relatively easily implemented.

Two key themes are mentioned regularly throughout this submission. Firstly, retail investors generally do not understand complex financial products and as a result often make poor investment decisions. It is not the place of any government to remove all risk, but by providing simple and easily accessible information some retail investors will change their behaviour and reduce or avoid high risk investments. Secondly, by making financial services easier to understand, governments can substantially reduce the pressure they receive to bailout individuals and institutions that have incurred losses when undertaking risky activities.

Banks

The memories of the sudden arrival and severity of the global financial crisis seems to have been quickly forgotten by banks globally, including banks in Australia. The near failure of several decent sized banks and the need for a government guarantee highlighted just how fragile banks can be, even the largest and most well managed Australian banks. The need for a lower risk business model via higher levels of capital and more term funding was clearly shown to be necessary if banks are not going to be asking for further government assistance in future economic downturns.

The introduction of higher levels of capital as part of Basel III regulations is a positive outcome. However, the average level of subordinated capital in the four Australian major banks is still only 5.49% of total assets or 3.96% if measured on common equity (core tier 1) alone[1]. This equates to leverage of 18.2 times and 25.3 times respectively. The risk of this buffer being exhausted and senior creditors or taxpayers suffering losses remains realistic in a time of substantial and sustained distress.

Banks still remain very short in their funding profiles with nothing near matched funding of their long term loans. Again Basel III has helped, but without much more than a widely believed rumour in a time of stress, an Australia major bank could find itself turning to the RBA for liquidity assistance. The committed liquidity facility with the RBA is massively under-priced, and reflects an enormous subsidy by taxpayers of banks. The facility is a backstop funding facility that is only likely to be used if a bank is substantially stressed or distressed. The risk that this cheap source of funding could suffer capital losses appears to have been ignored when pricing levels were set.

Given the recent experience of fragility of banks, it is prudent and fair for APRA to insist on banks holding greater levels of capital. No doubt the major banks will argue that this will be expensive and will hinder lending and therefore economic growth. This argument is demolished by recent research[2] that has found the cost of taxpayers bailing out banks and the volatility added to economic cycles when banks fail or cease lending is far more costly than a small increase in the cost of lending throughout the economic cycle.

Noting the costs argument though, there are cheaper ways for banks to increase their capital levels and still provide more cushion to taxpayers and senior creditors. The cheapest way to increase capital levels is by increasing the amount of hybrid instruments (total tier 1) and subordinated debt (tier 2) capital. As illustrated in the table below, relative to total assets the four major banks on average have 3.96% in pure equity, 0.86% in hybrid capital and 0.67% in subordinated debt[1]. Lifting this to 4% pure equity, 2% hybrid capital and 2% subordinated debt would at current prices increase the average funding costs of a bank by 6.6 basis points from 3.263% to 3.329%. This estimate is conservative in that by holding more subordinated capital a bank may attract a higher credit rating, and thus decrease its cost of funding relative to its current position.

Capital Type	Current Market Cost of Capital	Average Major Bank Capital Level	Weighted Average Cost of Capital	Alternative Capital Level	Weighted Average Cost of Capital
Senior	2.90%	94.51%	2.741%	92.00%	2.668%
Subordinated	4.90%	0.67%	0.033%	2.00%	0.098%
Hybrid	6.15%	0.86%	0.053%	2.00%	0.123%
Equity	11.00%	3.96%	0.436%	4.00%	0.440%
Total	N/A	100.00%	3.263%	100.00%	3.329%

If fully passed on to borrowers, a 0.066% interest rate increase on a typical loan would be barely noticed. However, in a time of crisis the amount of capital available to absorb losses before senior creditors or taxpayers are impacted has been increased by 45.7%. This would make banks far less likely to ever need assistance with solvency issues. However liquidity issues will still remain, particularly as Australian banks have a strong dependence on wholesale and overseas funding. Taking into account the government guarantee of retail deposits, the massively under-priced RBA backstop facility and the recent history of substantial loan losses at some banks, Australian banks are not bullet proof and the proposed increase in capital levels would be a very prudent and fair standard for APRA to implement.

APRA

There are two primary reasons banks fail, firstly and most commonly losses incurred on widespread bad loans and secondly losses incurred by rogue traders. Australia has seen a number of banks, often subsidiaries or offices of overseas based banks go through substantial periods of stress in the last five years where failure would have occurred without parental or external support. A number of the second tier banks have also recorded annual losses on their lending activities in recent years. These losses were almost always caused by bad lending within the corporate and institutional departments; that is loans of $10 million and above. It is therefore in this area that APRA should devote additional resources if it is to have the best chance of avoiding future bank failures.

Best practice for regulating large ticket lending activities is arguably the US Office of the Comptroller of the Currency (OCC). Through the Shared National Credits (SNC) program, the OCC inspectors annually review large loans that are shared or syndicated into multiple banks. The regulator grades the loans, and in doing so forces the banks to hold additional levels of capital against loans where substantial weakness or high probability of loss is identified.

This program helps protect the banking system in two ways. Firstly, by regularly inspecting loan books the regulator is able to identify problem loans and institutions with high concentrations of such loans. By identifying the issues early, the regulator can force banks to hold greater levels of capital and raise such capital at time when the capital markets easily accommodate new capital raisings. Secondly, regulators gain a much greater sense of where the credit cycle is at, and can therefore more accurately determine what the countercyclical capital buffers should be. One example of the usefulness of this process is recent regulatory actions where US banks have been ordered not to hold loans where the leverage exceeds six times EBITDA; that is the loans most likely to default if a downturn occurs.

From the position of the author, who has in the past discussed directly with APRA employees specific problem loans, the Australian regulator does not yet have the staff of the level of experience of the OCC. APRA would either need to build up such a team, or outsource the analysis to a private sector provider such as a rating agency or other credit specialists to be able to run a similar program of credit reviews. This could be a shared process, with the external provider grading the loans, and APRA providing the capital level decisions and implementation with banks.

Securitisation

Securitisation is an ideal way to fund many types of credit provision, as it matches long term funding with long term loans. By doing so, the liquidity risks and credit risks that plague governments when they backstop banks in a time of liquidity and solvency crisis, are transferred to the private sector. Governments should therefore encourage securitisation by both banks and non-banks wherever possible, if at least for no other reason than to lessen the cost on future generations if bailouts of banks are required.

The securitisation market in Australia has recovered well since the global financial crisis. This has been assisted by the fact that there have been only very small losses to investors relative to overseas markets, with Fitch estimating losses from 2000-2011 at 0.01% of principal in Australian and New Zealand[3]. Local and overseas demand for AAA rated notes is strong and would support a substantial expansion from 2013 volumes of $31 billion. The key pinch point for increasing the total amount of issuance is finding buyers for BBB, BB and B rated tranches. This is a turnaround from the position of 2009-2012 when the AOFM assisted the market by buying AAA rated tranches.

The dominance of the four major banks in the provision of residential mortgages, and their lower equity requirements under Basel III, means that non-major banks and non-bank lenders are at a substantial disadvantage. If the government wanted to encourage further competition for residential mortgages but with only a limited investment then targeting the BBB, BB and B rated tranches would be an ideal way to do so. By focussing on these tranches in prime (conforming) non-LMI residential mortgages a $1 billion investment would support $40-60 billion of total issuance. Supporting of this size would make a meaningful difference to the current competitive position of major bank dominance. The investment would also have an expected return of bank bills + 5-7%.

If the Australian Government was to pursue a strategy of investing in the mezzanine tranches of securitisation it should do so using the skills, experience and contacts of the Future Fund. The Future Fund has developed a detailed knowledge of both securitisation and esoteric credit managers, and would be ideally placed to assist the Australian Government with finding the appropriate manager or managers to invest in securitisation.

Listed Bonds and Hybrids/Preference Shares

From the perspective of retail investors, particularly self-managed superannuation funds, the listed bond market is their ideal access point to direct investing in fixed income and credit securities. It is transparent, liquid, has low transaction costs and allows for investors to get exposure to investments in Australian companies with a lower risk than equities. Australian retail investors are increasing moving away from managed funds for credit and fixed income, with the liquidity issues, a comparative lack of transparency and fee levels reasons for this change. The demand side from retail investors is unquestionable for the right brand names, with 8 issues totalling $7.73 billion in 2013 and 20 issues totalling $14.09 billion in 2012.

Consecutive federal governments have sought to encourage the growth of listed bond market through simplified prospectuses, reduced disclosure obligations and by adding government bonds to the list of tradeable securities. These measures have been somewhat unsuccessful with issuance in 2013 dominated by banks and insurance companies with only one corporate issue. Supply is being held back by several factors which the Federal Government is able to address. These are:

- Providing regulatory and legislative assistance to reduce minimal parcel sizes to $100 units on unlisted corporate bonds – similar to what has occurred for government bonds to encourage more corporate bonds to trade in both listed and unlisted formats
- Making credit ratings available for retail investors by eliminating the onerous restrictions on rating agencies
- A mandated one page, simple review covering a product description, relative risk level and key risks in each PDS prepared by either ASIC or a private sector firm appointed by ASIC

Together these steps will increase the number of available issues, the liquidity and the knowledge base of the listed bond market. Retail and institutional investors will be better off trading medium and long term bonds in a listed format, as the cost of trading will fall dramatically compared to the current broker model for unlisted bonds. The clearer pricing and settlement mechanics of listed securities are other benefits for institutional buyers.

The one page review is necessary as most retail buyers are unable to distinguish the different risks between debt securities and preference share securities. From the author's experience, many financial advisors are also not able to understand the differences and are providing incorrect information to their clients on preference shares. ASIC has issued warnings on preference shares, noting that these are not guaranteed investments and can suffer substantial losses. Whilst this is to be commended, a higher level of information dissemination via an easy to read one page review as part of each prospectus would be a better method of communicating the risks.

Corporate Bonds and Syndicated Loans

It is commonly accepted that Australia has a relatively narrow and underdeveloped bond market compared to other countries, particularly the US. The predominant forms of debt funding for major corporations in Australia are syndicated loans and offshore issued bonds, with Australian listed and unlisted bonds a distant third. For institutional buyers of debt, such as insurance funds and superannuation funds, the syndicated loan market is a better format for taking credit risk. The common covenants and security packages embedded in syndicated loans makes them far less risky than the typical bond of the same credit rating. The Inquiry should therefore encourage development of the syndicated loan market for non-bank institutions and the listed bond market for retail investors.

The syndicated loan market is gradually gaining acceptance amongst institutional debt buyers. Many superannuation funds already have a level of exposure to syndicated loans, albeit through managers that are primarily focussed on US loans. The natural next step is to add Australian syndicated loans, with a handful of Australian fund managers actively marketing funds or mandates focussed on primarily Australian syndicated loans. The primary thing stopping further development is the lack of understanding on the part of the institutional investors of the relative advantages of Australian syndicated loans compared to bonds and their overseas equivalents. Market forces (i.e. fund managers providing this education to potential clients and asset consultants) should gradually correct the situation.

Debenture Issuance

The list of failed Australian debenture issuers is long with a regular stream of insolvencies over the last five years. The current regulatory regime is insufficient, with ASIC attempting to treat these vehicles in a similar way as general investment funds when they are in fact a leveraged, credit providing vehicle with many of the same risk issues as banks. It is arguable that APRA is best placed to review the underlying credit standards of debenture issuers, but

ASIC is best placed to cover the marketing and prospectus obligations. Debentures issuers are therefore sitting in between two regulators, neither of which seems to want to take responsibility for covering this high risk area.

The ASIC imposed "if not, why not" regulations provide a level of transparency. However, recent history has proven that disclosure of very high risk activities does not stop retail investors investing, as they are almost always unable to understand the technical terms within long documents. The issue here is the same as with listed preference shares, there is no obvious source of truth or simple explanations of the risks for a complex investment product.

The solution proposed is the similar as for listed bonds, with either ASIC or a private sector firm engaged by ASIC to undertake annual reviews and provide clear opinions on the relative risk levels. Ideally this would be via standardised two to three page reports on each debenture issuer, with the reports a compulsory part of any offer document. ASIC could show a table of equivalent risk metrics (e.g. capitals levels and arrears levels) of all debenture issuers on its website, thus allowing retail investors to compare debenture issuers and choose lower risk options.

Retail Insurance

It can seem as if every year at least one bushfire, cyclone, hail storm or flood strikes a major capital or regional city in Australian. The inevitable media coverage focuses on "poor Mr and Mrs Jones" who have lost everything and who either don't have any insurance coverage or who have failed to take out adequate coverage. At the retail level Australia remains under-insured[4], with state and federal governments often encouraging this situation to continue. Handouts for victims of natural disasters foster moral hazard situations, with those who have prepared by either having adequate insurance or by avoiding living in high risk areas subsidising the reckless who fail to take such steps.

Whilst the continuation of such government behaviour is in part political, there are several steps that governments can take to simplify retail insurance such that a greater take up rate will occur. These include:

- Compulsory one page disclosures that state in plain English what events are covered and not covered, for what amounts, for how long and for what cost
- Simplified and consistent risk categories across all insurers particularly in defining what is a storm and what is a flood
- Clear warnings on websites, sales calls and on the one pages disclosures of basic areas not covered (e.g. storm, flood or fire) and what the additional cost of an "all risks" policy would be
- Development of private or public sector aggregation websites to allow consumers to compare prices across different providers (the NSW Motor Accident Authority green slip website is a good example)
- Compulsory provision of two "all risk" quotes with any residential rental or sale contract to allow potential purchasers or renters to see the cost of cover and understand whether the area is expected to be particularly prone to any particular risks (e.g. the property is at major risk of flooding)
- A compulsory industry standard for efficient claims processing including payments of a "restart" portion out of a larger claim (e.g. $5,000) within 48 hours to allow affected individuals to obtain alternative accommodation and to purchase necessities that may have been lost
- Annual warnings in advance of the high risk summer period that consumers should check their insurance and that those who fail to prepare will not be able eligible for government assistance in the event of a disaster

By making risk and price information more available, markets forces will over time divert resources away from high risk areas and towards lower risk areas. If consumers are given adequate information and warning, governments should no longer feel any obligation to bailout reckless individuals who suffer loss, whether that is a result of the individual's failure to insure or choice to live in a high risk area. The cost of implementing the above changes is quite low compared to the annual bailout costs worn by governments. The changes will require industry consultation, but in many cases it is simply about providing the information in new and more transparent ways.

Agricultural Insurance

In a very similar vein to retail insurance, farmers regularly appear in the media arguing for bailouts when drought or flood has affected their businesses. Like the problems with retail insurance, past government bailouts have created a moral hazard situation with all tax payers (including those farmers who have adequately prepared) expected to fund further bailouts for reckless farmers. This treatment is largely unique amongst small businesses, few if any other industries receive such substantial hardship assistance on such a consistent basis.

There have been many high quality papers written on the issue of different insurance mechanisms available for farmers. This paper will not seek to cover those areas again but encourages the Inquiry to review at least the "Options for Insuring Australian Agriculture" paper on the Department of Agriculture, Fisheries and Forests website.

The lack of take-up in farm insurance mechanisms is function of the somewhat two tiered nature of farming in Australia. On one hand, the majority of farmers carry little or no debt and are able to remain solvent through times of adverse weather conditions. These farmers are unlikely to purchase insurance and would rather self-insure by maintaining adequate reserves set aside in good years.

The second group of farmers is over-burdened by debt as well as often being inefficient and sub-scale. These farmers remain viable in good years, but the onset of material adverse conditions sees them unable to continue their businesses without government assistance. This group is unlikely to be able to afford some form of insurance, as their interest payments and lifestyle costs use up almost all of their income in the good years.

The underlying issue for this second group, estimated to be 10-30% of farmers, is excessive debt. The relative level of farm debt has accelerated dramatically over the last 10 years[5]. The example of eastern state farmers in recent times is illustrative of the true issue, even after good levels of rainfall since droughts broke in 2007[6], some farmers were still not prepared for an inevitable period of low rainfall starting in the second half of 2012. If governments feel the need to provide bailouts, any schemes should be a simple payment for exiting the industry, rather than any form of ongoing assistance. The failure to treat the underlying issue shows through in the continual flow of industry assistance requests whether these are for direct handouts, income support payments, favourable tax treatment, barriers to imports, special treatment from banks when farmers cannot pay their debts or interest rate subsidies.

Notwithstanding that crop insurance mechanisms have historically had a very low take-up, the government may choose to intervene to ensure a nationwide system of insurance is available. In doing this, a government would be comfortably able to adopt a "no more bailouts" policy, letting farmers know that those who self-insure need to have adequate reserves. Taking account of the likely low take-up rate which would discourage commercial insurers from widely offering an insurance product, the government could offer an annual payment to one or two insurers in return for their commitment to offer a widely available product. Rather than subsidising the cost of insurance to farmers, this would cover the fixed costs (such as expert actuarial and weather staff) that an insurer would need to incur to be able to offer such a product.

Financial Advice

The debate over FOFA changes has been overly complex when it should be quite simple. Financial advisors and financial planners should have a simple "all commissions rebated to the client" policy. Advice provided and action taken should always be in the best interest of the client, with the client's interests always put before the interests of the advisor and their employer. The client should therefore directly and explicitly pay for the advice.

Anyone selling financial products or services who cannot meet these criteria is a sales person, and should be required to disclose their interests at the beginning of the discussion. This could be a simple as *"I am a salesperson not a financial advisor which means that I may earn commissions by selling products and services to you. The products and services I am selling may not be in your best interests and you may want to seek independent financial advice before agreeing to purchase."*

Self-Managed Superannuation Funds (SMSFs)

As SMSFs are not required to seek expert investment advice, some additional restrictions should be implemented to better protect retail investors. The potential to suffer near complete capital losses on what could be their primary source of income in retirement will have a substantial impact on government provided age pensions, and justifies additional intervention. The introduction of gearing for residential property has resulted in some SMSFs putting virtually 100% of their capital into highly leveraged residential property. This is a very risky strategy, from both the leverage involved and the lack of diversification. To curb excessive risk taking, two simple rules are proposed.

Leverage, which must be non-recourse to other assets in the SMSF, should be limited to 50% of the value of the asset. (This would cover equities as well). Secondly, no more than 50% of the total assets should be held in any one individual asset. Implemented together these rules will the lower the probability of very large losses, which particularly if occurring near or after retirement are nearly impossible to recover from.

The debate over whether art is an allowable investment class has frequently missed one key point. Round trip sales costs on artworks and collectibles typically exceed 25% of the invested amount. Taking into account the capital lost just to invest, it becomes very difficult to argue that art and collectibles are a legitimate asset class with positive long term return prospects. The lack of any ongoing cashflows, unless the item is rented out for display, also reduces the chance of any meaningful return to the investor. To deal with this issue, any asset class that is likely to have round trip buying and selling costs in excess of 10% of the asset value should be disqualified from SMSFs.

End of Submission

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Appendices

Written by Jonathan Rochford for Narrow Road Capital on March 29, 2014. Comments, criticisms and requests for further information are welcomed and can be sent to info@narrowroadcapital.com

References

1 Calculated from data taken from the most recent annual report for each of ANZ, CBA, NAB and Westpac

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5 http://www.benrees.com.au/docs/Rural%20Australia%20v%20Orthodox%20Economics.pdf

6 http://www.bom.gov.au/climate/current/annual/aus/archive/index.shtml

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