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Retirement spending: it's time to set the bar lower

Andrew Boal

The longevity of its citizens is one indicator of the prosperity of a society. Australia is well up there – the most recent published Australian life tables (released in December 2014) show that a 65 year old man today is expected (on average) to live to 84.2 years and a female to 87.0 years. This means we will have more retirees living for longer. But in terms of their financial health, the key question is: Will their savings run out before they do?

Life expectancy continues to increase

There's no doubt that Australian retirees will need to combine lower spending strategies and the right investment options to improve the chance that their income will last for an increasingly likely period of 25 years or more in retirement. Mortality rates for the over 65s have been improving steadily since the early 1970s and retirees are now expected to live 3 to 3.5 years longer. Using these improved life tables, there is more than a 70% chance that at least one of a retired couple will be alive at the age of 90.

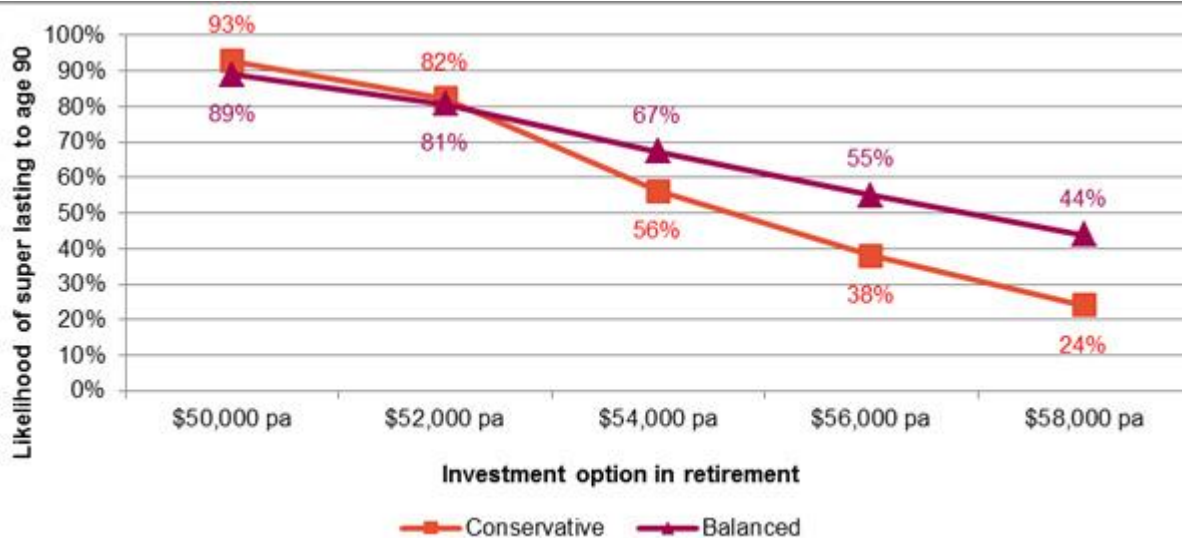
Using Towers Watson's Retirement Planner, we modelled a number of scenarios for a couple, both aged 65, retiring today with superannuation assets of \$500,000. A couple was chosen based on 2007 Census data that showed more than 70% of Australians enter retirement as part of a couple. When considering how you invest for financial success in retirement, there are several factors that come into play, including how much superannuation a saver has available at the start of retirement, their spending plans, the amount of any other savings they have, as well as their risk tolerance and preferences. An individual's spending strategy however, is one of the biggest factors that will determine whether or not they will achieve financial success.

The Retirement Planner showed the impact of different investment strategies for the couple who want to make their savings last 25 years to age 90, varying their exposure to growth assets from 0% (cash) to 30% (conservative) to 50% (moderate) to 70% (balanced) to 85% (growth) to 100% (high growth).

Investing in a balanced portfolio, the couple is expected to be able to spend \$57,705 a year (including Age Pension amounts available after applying means tests) up to age 90. After that, they would be expected to rely solely on the age pension. It is important to recognise that this is only the *expected* outcome. There is only a 48% chance that their superannuation will last until age 90. But if we looked at this from the spending perspective, we can see a different impact.

If the couple adopts a lower spending strategy (say, \$50,000 or \$52,000 a year), there is a much higher likelihood of success (more than 80%) for both the conservative and balanced options. Alternatively, if the couple spends at higher levels (such as \$54,000 to \$58,000 a year) then the investment option chosen has a more significant impact on the outcome. For example, under a balanced investment option, spending \$54,000 a year has a 67% likelihood of success, compared to 56% under a conservative investment option.

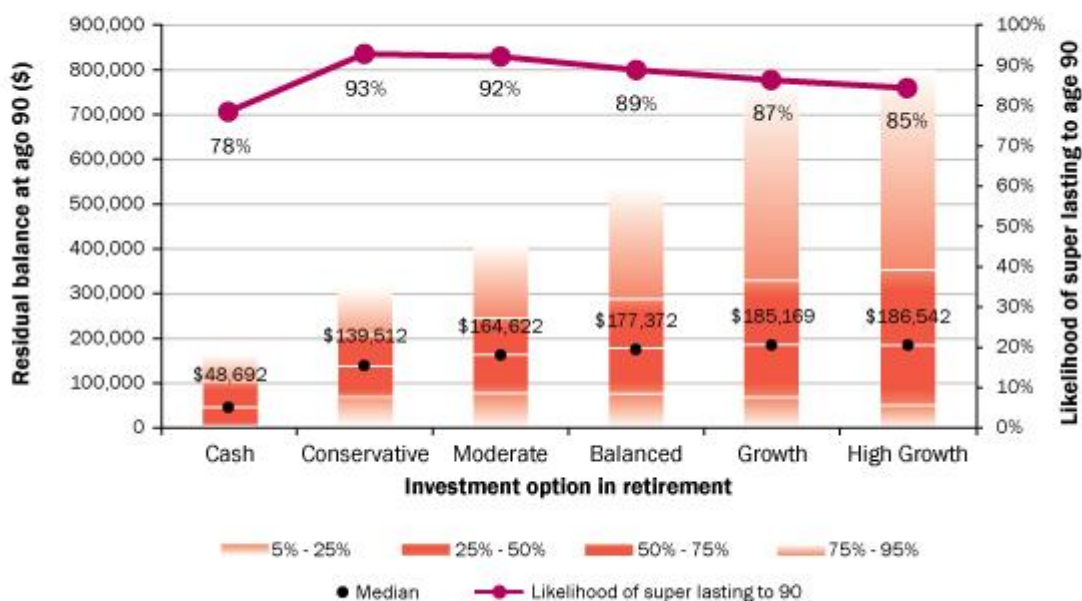
Impact of spending strategy and investment option on likelihood of super lasting to age 90



Source: Towers Watson analysis 2014

When combined with a lower spending strategy, there is little difference in the likelihood of savings lasting to age 90 for a conservative versus a balanced investment portfolio. But the residual balance left over at age 90 is likely to be much higher for a balanced investment portfolio. For the sample couple, staying invested in growth assets produces a better outcome than de-risking, either gradually via a lifecycle or target date fund or more suddenly.

\$50,000 pa spending strategy – residual balance and likelihood of super lasting to age 90



Source: Towers Watson analysis 2014

Retirees likely to have variable spending patterns

A number of academic research papers suggest that a retiree’s spending is likely to start reducing by around age 80. This is supported by recent ASFA research which produced a revised Retirement Standard for a 90 year old (the original ASFA Retirement Standard is based on a 70 year old), which shows that the ‘comfortable’ level of expenditures for a 90 year old is about 10% lower than for retirees aged 65-80.

This provides a good opportunity for a retiree in their 70s to purchase some form of guaranteed annuity or other longevity risk pooling vehicle. An adaptive spending strategy, where people adjust their spending based on recent performance, is also likely to further improve the likelihood of financial success in retirement.

When designing default retirement income solutions, superannuation funds first need to understand the demographics and expectations of the members they are targeting. The funds also need to help their members to understand more about their own expected retirement outcomes and the risks they face, by providing tools such as written retirement income estimates and online calculators. Only then will funds be able to guide their members more effectively into retirement income solutions that better suit their needs.

Andrew Boal is Managing Director for Towers Watson in Australia. This article is general information and readers should seek their own professional advice. A full copy of the paper: The path to retirement success: How important are your investment and spending strategies? can be found [here](#).

The terms they are a-changin'

Graham Hand

*Come gather 'round people
Wherever you roam
And admit that the waters
Around you have grown
And accept it that soon
You'll be drenched to the bone.
If your time to you
Is worth savin'
Then you better start swimmin'
Or you'll sink like a stone
For the times they are a-changin'.*

(From Bob Dylan's *The Times They Are A-Changin'*)

The cash rate is heading for 2%, and term deposit rates are next to fall, yet term deposits and cash accounts are the mainstay of most personal investment portfolios, including about 30% of the assets of SMSFs. Cuffelinks has previously written about alternatives to term deposits (['Where to now for term deposit investors?'](#)) and how some risks were not well understood (['Term deposit investors did not understand the risk'](#)). With cash rates heading down, and major changes to the terms and conditions of term deposits, investors need to rethink their rollover strategies. As Dylan says, "You better start swimmin' or you'll sink like a stone."

The power of 'retail inertia'

Back in the good old days, before political correctness, banks used to describe the willingness of customers to accept almost whatever was offered to them on term deposit rollovers as 'retail inertia'. Banks could have a term deposit special at 5% and rollover similar deposits at 4% and the majority of customers accepted the lower rate. Retail inertia is still used by the banks today, even if it's not called that. Check what it says on a typical term deposit rollover letter:

"If you have a special rate, that rate will generally apply for a single term. Standard term deposit rates may apply for subsequent terms."

Which is bankspeak for: "You'll receive a lower standard rate unless you ask for a special one."

Why do banks offer special bonus rates for the first four months on some at-call deposits? At the end of the four months, customers fall to the 'standard' rate, and most don't leave. A 0.3% bonus for 4 months is only equal to 0.1% per annum, an immaterial cost for gathering genuine retail deposits. It's the same with credit cards and the 'six months interest free' for switching banks. They hope customers can't be bothered changing again.

There is no incentive for banks to offer their best rates on rollovers. Consider some simple maths to show the true cost of paying up for the less sticky deposits. Assume \$100 million of 12 month term deposits mature next week. \$90 million of it will rollover if the rate offered is 3% and \$10 million of it demands a higher rate, say 3.5%.

Question: If the bank wants to keep the entire \$100 million, what is the effective rate (cost to the bank) on the extra \$10 million?

Answer: The bank pays 3.5% on the full \$100 million (\$3.5 million) including an extra 0.5% on the \$90 million (\$4.5 million) which was not necessary. Effective cost \$8 million or 8%. Ouch!

Bank response: Raise the \$10 million from new investors at a 'blackboard special' rate of 3.75% and rollover the \$90 million at 3%. Cost of \$10 million is \$3.75 million, saving \$4.25 million. That's the money-earning power of retail inertia. Retail banking is a great business.

Don't ignore the bank letter

The rollover letter is not like the gas or electricity bill where the customer must accept the cost:

1. Critically review the rollover rate. Most depositors tick 'rollover for the same term on maturity' when they open a term deposit, and if no action is taken, whatever rate is offered by the bank will be locked in. Most banks give a one week grace period if the rollover date is missed. When some term deposit offers now start with a '2', the letters can no longer be ignored.
2. Phone your bank and ask for a higher rate. First, go to a comparison web site like ratecity.com.au or mozo.com.au, and arm yourself with the highest rate. They're all government guaranteed for amounts up to \$250,000. Even if the bank is not prepared to match the offer from a small credit union, it will probably offer more than in the rollover letter.
3. Watch other changes in terms and conditions. Changing liquidity regulations as part of Basel III mean banks will be far stricter allowing access to term deposits. In the past, banks permitted early access, often with no interest rate penalty (if term deposit access was obtained just after an interest payment, banks would not pay less than face value). Bank regulators realised this was unsatisfactory, as banks report the maturity profile of their deposits assuming none were repaid early. Now, all the banks are writing to customers saying funds cannot be accessed (even with a penalty) inside a 31 day notice period.
4. Consider another term, although accepting higher rates for longer terms carries risks. Last month, I had a maturing five year investment originally placed with Westpac in January 2010. The previous rate was a handsome 8%, and even at the time, it proved extremely popular with Westpac raising \$2 billion in a couple of weeks. Westpac's current five year rate is 3.9% and income has halved. It's one thing accepting 3.9% (a real return of 2%) for a short-term, but too much market risk for insufficient reward over five years.
5. Don't leave the paperwork until the last minute. Although banks usually nominate a grace period to negotiate a rollover, some require attendance at a branch to verify a variation. In today's online and mobile world of banking, it can be frustrating finding a branch just to sign a form. Also, the interest rate paid during the grace period is nominal, 0.5% to 1%, so act early.
6. Consider an alternative. Looking at mozo.com.au for terms of 1 to 3 months, most rates are less than 3%. Where term deposits once offered decent rates at negligible credit risk, now they are giving little more than capital security. It's worth considering alternatives such as corporate bonds, bond funds or listed securities. For some guidance, [Australia Ratings](#) has assigned risk ratings to 65 ASX-listed securities, and all investment platforms have a range of bond funds.

Whenever you see the words 'Automatic Renewal' on a term deposit rollover, there's a strong chance you can do better. Listen to Bob, who says at the end of the second verse: "For the loser now will be later to win. For the times they are a-changin'".

Graham Hand has worked in banking and wealth management for 35 years and is Editor of Cuffelinks. This article is general information and readers should seek their own professional advice.

Tax paid by your SMSF can be returned to your dependants

Monica Rule

How would you like the tax paid by your SMSF to be returned to your dependants upon your death? An anti-detriment payment can make it possible.

Why is a refund possible?

Prior to 30 June 1988, superannuation funds paid no tax on deductible contributions. Benefits payable (in respect of the membership period after 30 June 1983) were taxed at 30%. A lump sum death benefit paid to a dependant was paid tax free.

In July 1988, the government introduced a 15% contribution tax and reduced the 30% tax payable on benefits to 15%. This meant a lump sum death benefit payable to a dependant, was no longer entirely tax free because a 15% contribution tax had already been applied.

The new tax arrangement benefited members who lived long enough to enjoy the lower tax at the benefit phase but it did not compensate beneficiaries of members who died during the accumulation phase. The deceased member's beneficiaries were detrimentally affected.

To compensate deceased members' beneficiaries, the anti-detriment payment was introduced to restore the deceased's death benefit to what it would have been if the 15% contribution tax had not been introduced.

The law allows dependants (i.e. spouse, former spouse, and children) of the deceased member to receive an increased death benefit, via an additional lump sum payment from their SMSF, and provides a 'refund' of the contribution tax paid through a tax deduction to the SMSF.

How is it calculated?

The tax deduction available to the SMSF is the anti-detriment payment amount grossed up to reflect the 15% contribution tax. This is so the reduction in tax payable by the SMSF is equivalent to the anti-detriment amount. The 15% contribution tax refund is not paid as a cash refund by the Tax Office; instead it provides a tax deduction claimable by the SMSF. For example, if an SMSF makes an anti-detriment payment of \$200,000, it will be entitled to a tax deduction of \$1,333,333 (i.e. \$200,000 divided by 15%).

The SMSF can claim a tax deduction, which reduces its assessable income and potentially provides a tax saving equivalent to the anti-detriment amount. If the tax deduction cannot be fully used in the year the anti-detriment payment occurs, it can be carried forward to future years.

Example: Tony made concessional contributions totalling \$1,000,000 to his SMSF during his membership. His SMSF paid \$150,000 in contributions tax (i.e. \$1,000,000 x 15% tax). Tony's wife, Pam, would in theory be short by \$150,000 plus the earnings that would have accrued over Tony's membership period.

To reverse the effect of the contribution tax paid, an anti-detriment amount is calculated. If we assume that total earnings over the membership years amounts to be \$200,000, then the anti-detriment amount payable would be \$350,000 (i.e. \$150,000 contribution tax paid + \$200,000 potential earnings).

If the SMSF paid a lump sum death benefit to Pam that includes an additional \$350,000 anti-detriment amount, then the SMSF can claim a tax deduction of \$2,333,333 (i.e. \$350,000 divided by 15% contribution tax).

The tax deduction can be used to reduce the tax payable by the SMSF in the current financial year or it can be carried forward to future financial years.

Most SMSFs are unable to make an anti-detriment payment, as the law states it cannot be made from the deceased member's superannuation account. It is normally made from reserves maintained by an SMSF. SMSFs must have sufficient cash to pay the anti-detriment amount to the beneficiary.

Most SMSF accounting records do not track the contribution's tax paid on individual members' superannuation accounts and therefore a formula method is used to calculate the payment, based on the taxable component and service period of the deceased member. A common formula is $[(0.15 \times P) / (R - 0.15 \times P) \times C]$ where:

R is the total number of days in the eligible service period post 30 June 1983 up to the date of payment.

P is the number of days in component R that occur after 30 June 1988 up to the date of payment.

C is the taxable component of the lump sum death benefit excluding any insurance proceeds for which tax deductions on premiums have been claimed.

Example: Tony passes away on 15 June 2012 at the age of 60. His superannuation account balance is \$1,750,000 consisting of a \$1,000,000 taxable component + \$250,000 tax free component + \$500,000 insurance proceeds. Tony's SMSF membership commenced on 1 July 1985. Tony's lump sum death benefit is paid to his wife, Pam, on 1 July 2012.

Using the formula method the anti-detriment payment is calculated as follows:

R = 1 July 1985 (i.e. number of days post 30/6/1983) to 1 July 2012 = 9863 days

P = 1 July 1988 (i.e. number of days in R post 30/6/1988) to 1 July 2012 = 8767 days

C = \$1,000,000 (i.e. taxable component of the lump sum death benefit)

$(0.15 \times 8767 \text{ days}) / (9863 - 0.15 \times 8767) \times \$1,000,000 = \$153,843.90$ anti-detriment amount

Pam will receive a lump sum death benefit of \$ 1,903,843 (\$1,750,000 + \$153,843 anti-detriment amount) tax free and Tony's SMSF will be entitled to claim a tax deduction of \$1,025,626 (\$153,843.90 divided by 15%).

But there's always a twist with superannuation

Before you get too excited, let me give you a word of caution. It is the ATO's view that any amount credited from a reserve, counts as concessional contributions (currently capped at \$35,000 for those 49 years old or older as at 30 June 2014) of the deceased member unless the amount is less than 5% of the member's account balance, before the reserve amount is allocated. Therefore, if the anti-detriment amount paid is counted against the concessional contributions cap then the tax outcome will depend on the deceased member's circumstances.

Monica Rule is an SMSF specialist and author of The Self Managed Super Handbook – Superannuation Law for SMSFs in plain English. See www.monicarule.com.au. This article is general information and readers should seek their own professional advice.

Can small be beautiful in super?

Jack Gray

A prevailing superannuation belief is that benefits of scale are so substantial and longer-term returns from small funds so relatively poor that small funds will surely fade and die. Fortunately we don't live in such a Darwinian world, and some actually thrive: examples include small family offices and small hedge funds.

Economies and diseconomies of scale

Scale benefits likely do accrue in process-driven areas such as administration and custody, in insurance where risk-pooling reduces premia, and in passive management, an option few funds use effectively. Yet even in administration scale benefits have limits. At some size (\$100 billion?) decreasing returns to scale will push net marginal efficiency gains to zero ... and beyond. Potentially more damaging are legacy issues. Mergers leave funds exposed to rival and non-communicating people and software that materially undermine scale benefits.

On the investment side the evidence is mixed. For instance, SuperRatings' surveys of diversified funds reveals a strong negative correlation between (rankings of) size and performance over five and seven years. Contrariwise, studies of very large US, Canadian and Dutch DB funds (KPA 2006) show that after controlling for risk a ten-fold increase in funds under management (FUM) results in a 20 basis point reduction in unit costs. Based on similar data, Bauer (2011) concludes that "larger funds realise economies of scale *only in their relatively minor investments* in ... private equity and real estate, while thus experiencing liquidity-related diseconomies of scale in equity and fixed income." This appears to be in conflict with an EDHEC study of 7,500 private investments over 40 years which concludes that small portfolio investments outperform large (EDHEC 2011). However, for the large funds studied by Bauer most scale benefits in private equity and real estate likely derive from their direct internal management.

In some areas size has a known negative effect on performance. Depending on the strategy, diseconomies of scale in *active* listed equities can occur relatively quickly, probably around \$6 billion for a 'standard' broad-based Australian equities strategy, and perhaps as low as \$500 million for some specialised concentrated long-short strategies. As manager's FUM grow, driven by an all too common identification of size with power and influence and encouraged by asset-based fees, performance tends to fall as a result of greater market impact and of managers protecting their reputation and business by both increasing the number of holdings and decreasing risk. Charts 1 and 2, sourced from Mercer, BARRA and Russell, speak to those effects on global equity manager performance as measured by the two (dependent) variables - FUM and number of investment professionals.

CHART 1

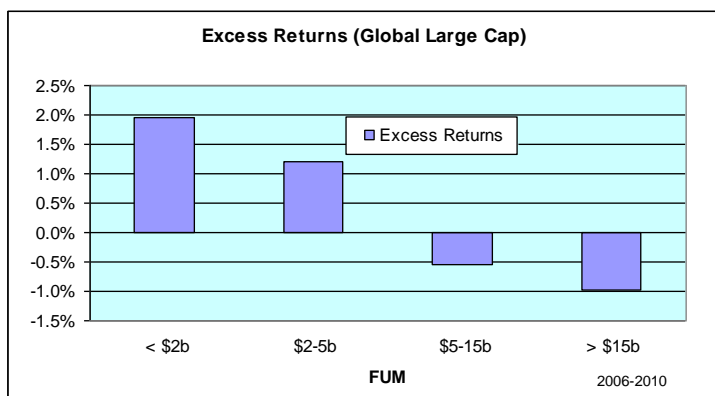
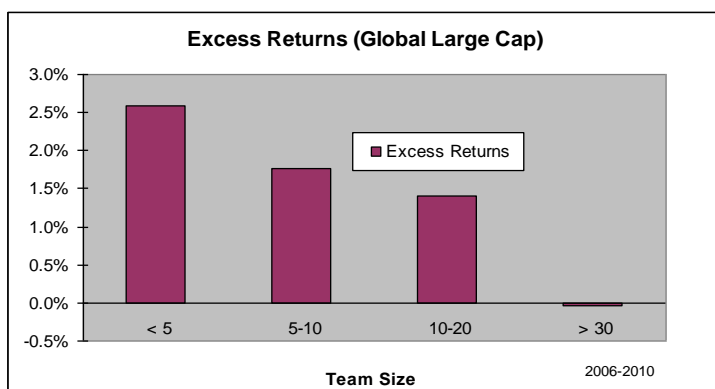


CHART 2



Many hedge funds recognise the damage size can inflict on their strategies and so choose to remain small which allows them to focus on being the best rather than the biggest.

PIMCO and Blackrock's success hints at fixed income not suffering from diseconomies to the same extent. That perception may be due to the recent 15 year bull run and because global fixed income markets are huge compared to equity markets and most managers use derivatives extensively, instruments that suffer less from diseconomies.

There is evidence that smaller direct property and private equity managers outperform larger ones, which may be a result of access to smaller deals left by larger managers, greater flexibility in deal structures and pricing, and small size being a proxy for youth and vigour.

The mixed evidence suggests a healthy default hypothesis: Actually *capturing* economies of scale in institutional investing requires substantial organisational, investment and commercial acumen. Mere merging is unlikely to suffice.

Large can innovate and small can thrive by specialising

Prevailing dogma holds that small (and often young) organisations are hungry, flexible and innovative while large (and often old) ones are comfortable, inflexible and sclerotic due to the drag of empires, silos, egos, agents and staff alienation. Yet very large companies *can* be flexible and nimble (think Apple, Cisco) and even GM and the Soviet bureaucracy had pockets of hunger and innovation (think the Soviet space programme.) *Forbes* produces an annual survey of the most innovative large companies, an impressive list we hear little about. But even if the dogma is largely valid it's not clear that hunger, flexibility and innovation are critical for super funds. And even organisations lacking those attributes and lacking scale can survive in our non-Darwinian market. One common source of survival is *affinity*, leveraging the value we ascribe to the comfort of being with 'our own', something CBUS and AvSuper claim to exploit although the power of default award funds likely explains most of the 'affinity'.

But the dominant way small organisations *thrive* (think biotech) is through specialisation, often via single product lines, and a consequent sharp focus. Yet aside from the colour of their brochures super funds of all sizes are essentially indistinguishable in their offerings. In that uniform world, a world driven by peer risk and the fear of being different, specialisation is neither evident nor desirable, so focus is lost through a haze of complexity induced by offering everything to everyone.

Below are some inchoate ideas on how a small (\$4-10 billion?) superannuation fund ('SmallSuper') might break from that uniform commoditisation and *thrive* through a degree of specialisation.

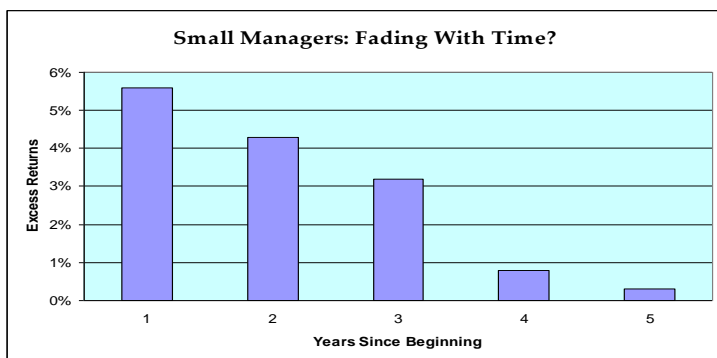
A new strategy for SmallSuper

The strategy is to identify and capture investment opportunities left on the table by large funds - a *family office* or old-style *investment banking* approach that will require substantial organisational courage, investment talent, commercial acumen, skilful governance and the courage to not do everything.

The most evident sources of opportunities are capacity-constrained strategies, particularly but not exclusively in active listed equities niche strategies. Examples include US microcap, catastrophe bonds, local residential property, South American power generation and other investments deemed too small for consultants' businesses and that large funds ignore because of the immaterial impact on total returns. For instance, a microcap manager with \$400 million capacity represents a 0.5% allocation for AusSuper even if it took all capacity, but approximately 10% for SmallSuper at which size it would have a material impact on return and risk. In the unlikely event that AusSuper or any consulting firm even knows about the strategy or the manager they will likely dismiss it, leaving the opportunity to SmallSuper.

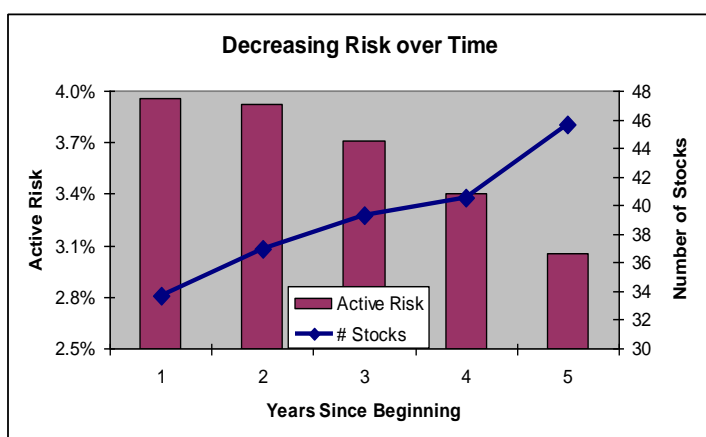
To have a significant impact on performance initially perhaps 30-50% of SmallSuper would be thoughtfully structured around similar opportunities across a variety of asset classes and strategies, allocations that would expand with experience and confidence. A major component of the expected performance boost is likely to come in the managers' early years, as seen in Chart 3. Charts 3 and 4 are sourced from Russell studies on global equities.

CHART 3



Well-documented evidence shows how in the beginning managers do outperform net of fees, but with growth not only does outperformance decline but the fraction of outperformance clients receive declines even more. With no legacy to lose young funds tend to take more risk and consequently perform better. With age and growth they tend to pull in risk to preserve their business, as seen in Chart 4, an effect likely to hold in all investment areas.

CHART 4



A further opportunity for SmallSuper lies in selective local unlisted investments. A [paper by Josh Lerner \(2013\)](#) shows how funds *can* generate strong returns by capitalising on local knowledge of local projects. SmallSuper should be able to act more quickly on many smaller or local projects provided it can effectively hedge the dangerous and ubiquitous *domestic-bias risk* of believing that mere propinquity creates informational and commercial advantage.

Challenges for SmallSuper

Capitalising on this strategy will require the early identification of future winners and a consequent high tolerance for *immediacy risk*, the risk of entering an untested strategy and manager. It will require the skills, temperament and strength to fire managers before comfort sets in and a consequent low tolerance for the *endowment bias*. SmallSuper could eventually extend its strategy by selectively incubating, seeding and taking equity stakes in new managers, an approach that contains another set of risks.

Doubtless SmallSuper’s risk profile will change and new levels of skills and understanding will be needed, along with different resources, incentives and a likely increase in costs. Critically it will require a different and more appropriate governance structure along the lines of the early US endowments. Initially those changes and charges can be partly offset by an intelligent structuring of the remaining 50-70% of the fund as a totally passive diversified fund or outsourced to a manager capable of acting as a *genuine* strategic partner (as compared to a tactical commodity) particularly as a source of new opportunities that provide economies of *scope*.

SmallSuper’s fund will be exposed to the business risk of being quite different to the mass of look-alike competitors. It can be re-positioned as the innovative higher growth fund exposed to genuinely *different*

risks, a super fund that's resisting the imperative to become a marketing and distribution machine at the expense of investing.

Conclusion

There are opportunities for smaller superannuation funds to distinguish themselves. To do so will require a creative restructuring of the fund designed to capitalise on being small, and the courage to remain simple, focused and different from the herd.

Dr Jack Gray is a Director of Brookvine, an independent advisor, and the Paul Woolley Centre for Capital Market Dysfunctionalities, University of Technology, Sydney. He was voted one of the Top 10 most influential academics in the world for institutional investing. Jack would like to thank Steve Hall (CEO, Brookvine) and Alison Tarditi (CIO, Commonwealth Superannuation Corporation) for criticisms and improvements. A somewhat expanded version is available at http://www.brookvine.com.au/58/Recent-Presentations-Papers/download/243/Can-Small-be-Beautiful_0115.pdf

A beginner's guide to peer to peer lending

Jonathan Rochford

What is peer to peer lending?

Peer to peer lending (P2P) is an alternative to traditional bank intermediated lending. Potential borrowers and lenders are brought together on a website, in much the same way that Amazon brings together buyers and sellers of general merchandise. What is unique about P2P lending is that borrowers and lenders are often both individuals, instead of a traditional business to consumer loan.

P2P lending has gained prominence in recent months following the billion dollar IPO of Lending Club in the US. In Australia, Society One has attracted the country's second largest bank Westpac, as well as business moguls James Packer and Lachlan Murdoch as equity investors. Lending Club and Society One both specialise in personal loans, but the Australian website Balmain Private specialises in commercial property lending on a P2P basis. Ratesetter from the UK also set up in Australia a few months ago, while Lend2Fund is preparing to launch soon.

How does it work?

Potential borrowers submit an application form to the website platform, much the same as any other loan application. The platform's systems and staff then verify the critical information (borrower identity, credit history and employment), assess the risk of the loan, set the interest rate and put the application up on the website. Potential lenders review the available applications and select the borrowers they want to fund, in part or full. Once the loan amount is fully funded the website then passes the money from the lender/s to the borrower, minus an upfront fee.

Once the loan is made, the platform is responsible for the servicing of the loan, which encompasses processing repayments and chasing up missed payments. If the borrower defaults the platform handles the debt collection aspects but the lender bears any loss.

Why does it exist?

P2P lending is growing rapidly as it fills a number of gaps in credit markets. Firstly, P2P lending is primarily unsecured personal loans, which banks struggle to make at a competitive interest rate. These loans are typically for smaller amounts with a relatively high work load to establish and maintain. Banks generally prefer to offer potential borrowers credit cards as these deliver banks higher interest rates, a perpetual loan period and ongoing transaction revenue. As with many online orientated businesses, P2P

lending has a lower cost of operation than bricks and mortar retail and thus it can offer lower interest rates than banks, which attracts potential borrowers.

Secondly, P2P lending currently offers high prospective returns to investors. In a world of ultra-low interest rates, gross returns of 6-25% are very attractive relative to bank deposit rates. For reasons explained later, these rates are likely to fall in the future but whilst competition is minimal and funding is somewhat restricted the higher expected rates of return will draw in potential lenders.

How new is P2P lending?

P2P lending in its current form dates back to 2005, but its roots can be seen right across capital markets. Non-bank lenders have brought together borrowers and capital providers for thousands of years. Stock exchanges have been fragmenting the ownership of companies into marketable parcels for hundreds of years. Corporate bonds have fragmented the debt of corporations for decades. Amazon has used the internet to bring together buyers and sellers of goods, with Amazon providing the platform for the products and the support necessary to facilitate the sales. In a sense P2P lending isn't new at all, it just uses modern technology to change the way some loans are made.

Is P2P lending risky?

Like all lending activities, P2P has the potential to range from very good to very bad. Subprime lending in the US showed that if done badly, supposedly 'safe as houses' residential lending can have default rates that exceed 50%. In contrast, many lenders to prime quality borrowers averaged default rates less than 1% per annum.

The first key test for P2P lending will come during the next economic downturn. Many P2P borrowers are living paycheque to paycheque (if they had savings it is unlikely they would need a loan) and don't have material assets to sell. As unemployment rises, it is likely that default rates on P2P loans will also increase. There is limited data available predating the financial crisis but what is available for Lending Club shows that negative returns were recorded in 2007 and 2008.

How will P2P lending evolve?

P2P lending suits particular niches within the credit markets, but it doesn't offer the prospect of completely removing banks from the picture. Loans that are relatively small, that don't involve overdraft or revolving facilities, or that are considered higher risk are most suited to a P2P platform. Shorter term (three years or less) unsecured loans to individuals and businesses are therefore the ideal targets. Secured business lending that goes just beyond the credit criteria that banks will allow is also fertile ground. Debtor finance, which uses unpaid invoices as security, is another attractive area for P2P lending.

As P2P platforms grow it is likely that individuals will be largely replaced by institutions as the lenders, as P2P platforms turn to cheaper institutional capital for their funding. This development would mirror the way that non-bank lenders in residential mortgages, commercial mortgages and auto loans obtain their funding through bank warehouses and securitisation markets. Moody's has recently rated a pool of P2P loans, with the lack of credit ratings previously a key hurdle to attracting more institutional capital. Banks and finance companies will ultimately set up competitor brands or buy out P2P platforms completely, with Goldman Sachs currently in discussions with the Aztec Money platform. What banks currently lack is the technology and entrepreneurship to start competing websites, but as the platforms are proven to be profitable they will attract funding and takeover offers from banks.

How should potential lenders analyse the risk?

In analysing the risk of any credit investment, the 5 C's of credit are a good starting point. These are:

Character: assessing willingness to pay

Cashflow: assessing ability to repay

Capital: assessing the equity contribution of the borrower

Collateral: minimising the loss if the borrower defaults

Covenants: restrictions to stop the risk level increasing

Where the typically unsecured personal loans of P2P lending differ from most other forms of lending is that capital, collateral and covenants are largely non-existent. Borrowers haven't saved much (no capital) and own few or no material assets that could be sold if they fail to repay their loan (no collateral). Being personal loans there aren't going to be any material covenants. This leaves character and cashflow as the main items to assess.

Character will be best shown by the borrower's credit history. Potential borrowers with a history of repaying their loans, credit cards and utilities on time and in full are the lowest risk. Borrowers with no history, or with a history of missing their obligations are higher risk. Cashflow assessment is a comparison of the borrower's income relative to their expenses. If the borrower has a good employment history and an income that easily covers their rent and other general expenses as well as debt repayments then the risk will be low. If the borrower has irregular income or a scattered work history then the probability of default will be much higher. If the borrower doesn't have a meaningful excess of expected income after meeting expected expenses then the probability of default will also be elevated.

Conclusion

P2P lending is an interesting and potentially profitable addition to the credit investment universe. The use of new technology allows credit to be made available to more potential borrowers at lower interest rates. The place of individuals as the main lenders is likely to fade over time, with their replacements being banks and securitisation markets who can offer a lower cost of capital. As with all new markets, new entrants are springing up, with banks and finance companies likely to start competitor brands or buy existing platforms. When analysing potential loans, lenders should focus on the character and cashflow of the potential borrowers and remember that the higher interest rates paid by higher risk borrowers doesn't automatically translate to higher net returns.

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