Bramwell Brown Ltd

INVESTMENT ADVISERS – BROKERS

Director: Brett Dymond – AFA, BBS, GradDipBusStud (Personal Financial Planning)

Bramwell Brown Limited – Newsletter – March 2015

Harmoney – Peer to Peer Lending

In the search for higher returns, a number of clients have contacted me enquiring about the company "Harmoney." With shareholders Heartland Bank and Trade Me, Harmoney is a company operating an on-line platform for peer to peer lending, where borrowers and investors come together. Similar platforms operate in the US (Lending Club and Prosper) and the UK (Zopa and Ratesetter). It's a relatively straightforward concept where those looking to borrow money register their details, as do those looking to provide funds.

Borrowers apply for loans and are allocated a credit grade based on an assessment of their employment status, home ownership, income, and credit history. Applicants with past insolvencies or bankruptcies are not eligible to apply for a loan. Allocated loans are granted a credit grade between A1 and F5, with corresponding interest rates from 9.99% to 39.99%. The minimum loan amount is $1,000 and the maximum is $35,000, with loan terms either three years or five years. By default Harmoney loans are unsecured, although a borrower can increase the amount of money they are able to borrow by providing security in the form of a motor vehicle.

Registered investors are able to view the available loans on-line and can see what the funds are required for, the credit grade assigned to the loan, and some general information on the borrower. No personal details are disclosed. The minimum investment is $500 and you have the ability to spread your investment across as many loans as you like, as each loan is fractionalised into $25 "notes." Investors are charged a service fee of 1.25% of the principal and interest payments collected on each note.

With a maximum loan amount of $35,000 you will find the majority of these loans will be for debt consolidation, home improvements, holidays, and vehicle purchases. By their nature these loans are risky, although the fractionalisation allows investors to diversify their risk by funding many loans, rather than just one. If you would like to discuss this further don't hesitate to phone the office.

Don't forget – when risk turns to loss, most investors realise they weren't actually prepared to take the risk after all.

Fixed Interest

It seems forever since we last had a fixed interest offer worth discussing. I have spoken previously about the possibility of the banks issuing new securities that are designed to meet their obligations under the new Basel III regulatory standards. The ANZ Bank has just announced such an issue (see below). Here is a recap on the banking regulations from the May 2014 newsletter.

Open Bank Resolution, the Core Funding Ratio, and the revised Capital Adequacy Framework are measures that have come out of the Basel accords for regulation in the banking industry. Open Bank Resolution's prime objective is to ensure the continuation of the core banking functions of a distressed bank – to keep it "open." A bank may be placed into statutory management on the advice of the Minister of Finance following a recommendation from the Reserve Bank. Under OBR shareholders will be the first to bear any losses, followed by holders of subordinated debt. If there are any further losses these will be allocated to the bank's unsecured creditors which include its depositors. In that instance a proportion of depositors' funds would be frozen based on an estimate of the potential losses of the failed bank. Those frozen funds would be available to the statutory manager to apply against the bank's losses. The unfrozen portion of depositors' funds would be available immediately, and would be supported by a Government guarantee. The guarantee should discourage depositors from rushing to withdraw their funds, but there would be no restrictions on them doing so.

The Core Funding Ratio is a tool designed to prevent banks from relying on short-term overseas borrowing to fund its activities. The rules stipulate that banks must secure a percentage of their funding from equity (shareholders), retail deposits and wholesale sources such as bonds, with durations of at least one year. The core funding ratio was set at 65%, and has since risen to 75%.

Basel III is a global regulatory standard based around banks' capital adequacy, stress testing and liquidity risk. In a nut-shell the regulations place an expectation on banks to hold more equity capital on their balance sheets. This should strengthen our banking sector and lessen the risk of failure. The rules are designed to ensure there is a bigger pool of funds to absorb losses in the event of a bank failure. The very nature of banking means there is (or has been in the past) a low level of equity in relation to the size of the business. Depositors lend their money to the bank – the bank then on-lends that to borrowers. The assets and liabilities match but there's no equity to call on in the event of a loan default. This is fairly simplistic, but the point I'm making is that historically banks have not been able to absorb large losses. The global financial crisis saw governments bailing out banks to prevent a full-blown melt-down, and the subsequent regulations are designed to lessen the need for this to occur. Shareholders, bond-holders, and in some cases retail depositors will now be expected to carry some of the losses in the event of a bank failure. However, I don't think it will prevent governments from stepping in to shore up a bank in a worst case scenario.

The Reserve Bank capital adequacy framework talks about the various levels of capital, including share capital (ordinary shares), additional Tier 1 capital, and Tier 2 capital. The regulations dictate how much capital as a percentage of their assets a bank must hold in each category. Ordinary shares and additional Tier 1 capital carry the most risk, with Tier 2 capital ranking ahead, but still subordinated to depositors and general creditors of the bank. Additional Tier 1 capital carries greater risk, and a non-viability trigger event would result in heavy losses. The implications of a bank failure should be well explained in investment statements, and I would advise all investors to read and understand those implications. The chance of a bank failure is, however, low in my opinion.

I think there is potential for these unsecured bonds to offer a better return for the risk involved. The rates will be higher than those offered on term deposits to compensate for the extra risk in case of a bank failure. The important thing is that investors are fully aware of the potential for loss in the case of a bank non-viability trigger event – in the case of Tier 1 securities that loss will be significant – it will not be too different from being a shareholder in the company. In the case of a Tier 2 security the loss may be less, however not insignificant. What investors need to ask is "is the return adequate for the extra risk I'm expected to take?" Considering the strength of our banking system through one of the worst financial crises in some time I think these securities will have a place in a diversified portfolio.

ANZ Bank Capital Notes

ANZ Bank has announced that it is making an offer of up to $250 million of capital notes to the public, with the ability to accept unlimited oversubscriptions. These notes are additional Tier 1 capital for ANZ <u>and are required to absorb losses in certain circumstances</u>. Investors should be absolutely clear that these are complex securities that carry more risk than term deposits or secured bonds, and are more like shares in that respect. The notes are perpetual, although ANZ has the option to repay them or convert them to shares in May 2020. If not repaid previously the notes must be converted (provided conversion conditions are met) to shares in May 2022.

The interest rate payable on the notes will be a combination of the 5 year swap rate plus the margin. The indicative margin range is 3.50% to 3.60% per annum. If the interest rate was set today it would be between 7.17% and 7.27%. If the notes are not repaid or converted to shares in 2020 the interest rate will change to a floating rate, which is reset every three months. It will be a combination of the three month bank bill rate plus the margin. The notes have a BBB- credit rating from Standard & Poors and will pay interest quarterly in May, August, November and February. The offer opens on March 6th and closes on March 27th.

PLEASE CONTACT THE OFFICE AS SOON AS POSSIBLE TO SECURE AN ALLOCATION

Bank Term Deposit Rules

Keeping with the bank regulation theme, term deposit holders may have received letters from their bank informing them of new rules around their term deposits. These rules relate to the breaking of a term deposit and are part of the new regulations designed to strengthen the banking system. In the past banks would allow you to break a term deposit, with a corresponding reduction in the interest earned. Now banks will need 31 days notice if you wish to break a term deposit, unless you can prove financial hardship.

A recent financial literacy survey showed fifty two percent of respondents thought our banks were Government guaranteed. This is not the case. A guarantee was put in place during the Global Financial Crisis in 2008; however this was removed in 2011. Our banks are very sound; however investors should be under no illusion that they are lending their money to the bank as an unsecured creditor.

Interest Rates

Unfortunately interest rates continue to fall. Here are some of the non-bank rates on offer:

Term (Quarterly interest)	Heartland	Rabobank	UDC
On Call	4.50%	3.25%	3.45%
1 year	4.50%	4.37%	4.40%
2 years	4.65%	4.57%	4.40%
3 years	4.90%	4.76%	4.40%
4 years	5.10%	4.86%	4.40%
5 years	5.15%	4.96%	4.45%

Anti-Money Laundering & Countering Financing of Terrorism (AML/CFT)

The new AML/CFT laws have been in place for a number of years now. Clients will be aware of the increased requirement to provide updated identification. Financial advisers have an obligation to have their risk assessment and AML programme independently audited every two years. Every reporting entity must have their first audit completed by the end of June this year. There will be an inevitable rush to have this completed at the last minute so I ensured I was early, and engaged Compliance Plus to conduct our audit in November. I'm pleased to say that, on the whole, I am complying with the legislation. There are one or two areas, mainly around trusts, where I have to gather further information from clients. As we meet I will explain that to you.

DISCLOSURE STATEMENT AVAILABLE ON REQUEST AND FREE OF CHARGE