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BIENNIAL CONVENTION 2011

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CALL FOR PAPERS

10 –13 APRIL 2011 • HILTON SYDNEY

Securitise This – SPV's post GFC

Jon Tindall

Key words: Securitisation, insurance, risk-transfer, re-insurance, ART, derivatives, SPV, special purpose vechile

Purpose of your paper: To detail the structure and pricing of modern securitisation transactions and to outline the state of the insurance securitisation market.

Synopsis: In this paper the insurance securitisation market is explored with particular reference to the development of the market in a local context. Initially this paper investigates the development of modern securitisation practises, having their roots in risk-transfer products developed by investment banks in the first half of the 20th Century. This development is then traced to its impacts on the insurance industry, which was an early adopter of these financial engineering techniques, particularly with respect to reinsurance transactions.

The pricing of these structures is detailed as well as an investigation of the critical risk management and taxation considerations that make these structures appealing from a risk transfer perspective. Applications to general insurance products are outlined including recent securitisation transaction involving Motor, Liability and Property classes of business.

The role of securitisation structures in the credit explosion that lead to the GFC is investigated and a framework is proposed that allows better transparency of these relatively complicated vehicles. The paper concludes with a series of practical examples that highlight the capability of securitisation structures and the paper proposes a range of products that are capable of transferring risk more efficiently than the current products offered by the insurance and re-insurance markets.

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APPROACHES TO SETTING CAPITAL FOR INVESTMENT GUARANTEES

John Nicholls, Duncan Rawlinson and Ismar Tuzovic

Key words: Investment Guarantee, Variable Annuity, Risk Management, Hedge, Capital

Purpose of your paper: We discuss the factors impacting the appropriate level of capital margins for guaranteed investment contracts and examine the effectiveness of “short-cut” approaches to determining capital levels.

Synopsis:

Investment guarantee products are becoming increasingly prevalent in the Australian market following their growing popularity in a number of overseas markets. Various approaches have been developed to address capital requirements for these guarantees, many of which could be described as “short cut” approaches. For those writing guaranteed business, or those considering entering the market, an understanding of capital dynamics is critical.

This paper examines:

- approaches to setting capital margins for the types of investment guarantees offered under modern variable annuity style products that have been proposed in various markets;
- a “theoretically correct” approach to calculating capital for such guarantees;
- the key factors influencing the level of capital; and
- the difficulties in calibrating short-cut approaches.

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A house or a home? Finding value in Australian residential property

Anthony Street

Key words: Residential property, Australia, valuation, bubble, total returns, gearing

Purpose of your paper:
Debate is currently raging on the state of the Australian residential property market. On one side are analysts arguing the market is anywhere from 30% to 50% overvalued while the other side argues current prices are justified by, amongst other things, supply shortages and population growth. This paper will attempt to disentangle and summarise the arguments on both sides, while pointing out the not insignificant vested interests that can get in the way of a truly objective view. It will also examine residential property as an investment asset class, the impact of negative gearing and potential returns going forward.

Synopsis:
The Australian residential property market is currently estimated at $3.5 trillion, almost 3 times the size of the Australian equity market and 3 times Australia's annual GDP. Residential property has a massive impact on the financial wellbeing of individuals and is a key driver of broader economic activity. It is therefore not surprising that over recent years it has been a major focus of Federal Government fiscal decisions and RBA monetary policy settings.

Many commentators both in Australia and overseas believe Australian residential prices are significantly overvalued. The median house price in Australia now exceeds $500,000, an annual price increase of over 9%pa over the last 13 years[1], the ratio of house prices to GDP per capita is reaching 10 times compared to a long run average of 6.5 times[2], and the house price to income ratio in Australia is over 7 times compared to 3 to 4 times globally.

What caused this dramatic price increase? Negative gearing, a strong economy with low unemployment and cheap debt. More recently the Federal and state Governments' first home-owner grants stalled the post GFC housing market decline and over the 12 months to June 2010 house prices rose over 18%[3].

On the "what bubble?" side of the argument, commentators point to the undersupply in the market caused by poor planning and a lengthy development approval process, population increases, and low interest rates, which have kept affordability in check. CBA has also recently cited the house price to household income ratio in Australia is in line with global equivalents particularly for coastal, capital cities where the majority of the Australian population resides.

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[1] Source: REIA
[2] Source: Morgan Stanley
[3] Source: ABS

A common theme on this side of the argument is that “it’s structural, not cyclical” changes causing the house price growth. While this type of argument is often a classic portend to the end of most bubbles, the paper will consider whether in this case it is justified.

Looking ahead:
From a simple investment perspective, residential valuations should be a function of future potential income plus an estimate of capital growth in the land and building. Gross rental yields are currently estimated to be in the 4-5% range, and therefore net income yields taking into account agent fees, repairs and maintenance, rates and other bills, would be lucky to exceed 2%. If gearing is used, with mortgage rates around 7%, it is clearly a cash-flow negative investment. Investors in residential property justify this low yield on the basis of capital appreciation. Over the past 20 years this strategy has worked in most cases given the strong run in residential prices. However, going forward unless historical price growth can continue, buying residential property will not stack up as a rationale investment decision. The paper will examine total returns that might be expected under various future macro and microeconomic scenarios.

The Australian residential market is no doubt significantly different to the US and therefore it is unlikely Australia will experience the same dramatic fall in house prices. However, inevitably some adjustment over the medium to long term must occur to narrow the gap between current prices and fundamental fair value.

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PANEL DISCUSSION - Beyond the benchmark: Perspectives on adding value to the investment process

Greg Liddell, Alistair Barker, Michael O'Neill and Geoff Warren

Key words: Panel, Investment Management, Portfolio Construction, Objectives, Active, Passive, Default, Index.

Purpose of your paper: The panel discussion will address the myths: (i) that the market cap weighted index is a natural default, and (ii) that beating the index through skill is the only way that active management can add value.

Synopsis:

Facilitator:

- ***Greg Liddell, Russell Investments:*** Greg is the Director of Consulting and Advisory Services for Russell Investments.

Panel members:

- **Alistair Barker, Australia Super:** Alistair is an investment manager responsible for direct investments across the infrastructure, property, private equity and loan asset classes.
- **Michael O'Neill, Investors Mutual:** Michael is an equities manager specialising in Insurance, Information Technology and Media sectors, covering large and small cap companies. Michael sits on the Council of the IAAust.
- **Dr Geoff Warren, School of Finance ANU:** Geoff is a Senior Lecturer with a research focus in asset pricing, valuations, portfolio construction and funds management. Geoff has previously worked as Director of Capital Markets Research at Russell Investments; Head of Research and Investment Strategy at JP Morgan Australia / Ord Minnett Securities and as an Equity Portfolio Manager/Analyst with AMP Investments.

Panel discussion points:

1. Is an index the natural default?

This topic is designed to address the myth that market cap investing is always the best default position:

- Is a replicable index available?
- Is the index efficiently constructed?
- Does the index accord with investor objectives and liabilities?
- Accommodating alternatives including property and infrastructure.

2. Skill aside, how else might an active approach add value to the investment process?

We avoid the controversial issue of whether active management can beat the index, and ask what other factors might cause an investor to choose an active approach:

- Is the market suited to active approaches? We discuss investor sophistication, access to assets, and suitability of the index in different markets.
- Can good managers be identified and accessed at low cost?
- Under what circumstances do active approaches better accord with investor objectives? We consider examples including tailored fixed income mandates to meet liability driven investment strategies, turnover restrictions and active tax management.

3. What type of investors should be indexed, and who should be looking for some alternative?

We avoid the tired debate of active versus passive, and conclude that it all depends on the circumstances.

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Unlocking the Equity in Your Home: Just how Risky is it?

Shauna Ferris

Key words: Double Gearing, Margin Loans, Disclosure, Storm Financial

Purpose of your paper: In recent years we have seen thousands of Australians suffering financial devastation as a result of double-geared investments (e.g. via Storm Financial). From time to time, customers are advised to "unlock the equity in their homes", by mortgaging their homes; investing in unit trusts; borrowing even more via margin loans; and investing the proceeds in the same unit trust. The financial advisors who recommend these products sometimes assure the customers that this package is "safe". When the customers subsequently suffer large losses, the financial institutions may face both reputational damage and financial damage (in the form of compensation payments). The purpose of this paper is to assess the riskiness of such packages to both the customer (financial risk) and the companies which market such products (operational risk).

Synopsis:

The testimony of Storm Financial customers to the Ripoll enquiry has revealed many flaws in our regulatory system. Mis-selling of double geared investment packages have caused financial ruin for many customers. Although these products can be suitable for some investors, they were often marketed to people who could ill-afford to lose any money, and who did not understand the risks they were taking. Many of them claimed that their financial advisors assured them that their money would be safe, and encouraged them to gear up to the maximum permissible limit.

This is by no means the first time that mis-selling of double geared investment packages has caused serious problems. We will examine a similar case from the 1990s, where a double gearded investment packages was marketed by a life insurer. This led to compensation payments of more than $15 million from the insurer to the customers, along with quite damaging publicity. We will adopt an ERM perspective on mis-selling, i.e.

- Product Design
- Customer Suitability
- Promotional Material and Illustrations
- Sales Force Selection, Training, and Remuneration
- Monitoring Compliance with Legislation
- Enforcement of Compliance
- Delivery of Promised Services
- Responding to Complaints

Many customers assert that the advisors did not disclose the risks underlying this investment strategy, we will build a model for assessing the risks and presenting this information to the customer.