Angst looms for banks over exposures

Property observed

Robert Harley

At his annual results, Australia and New Zealand Banking Group's chief executive, Mike Smith, warned analysts about commercial property. "We recognise that within areas like property . . . given the instability in those markets at the moment, there are likely to be more concentrated losses," he said.

Commercial property was not a focus of the latest bank results. In passing mentions, St George acknowledged its $427 million exposure to Centro; Suncorp tried to justify the jump in its development book; and Westpac noted that "commercial property sentiment was weak" as market values were heading lower.

But the banks' commercial property exposures are an increasing focus of concern – within the banking industry, among investors, and by property borrowers themselves.

While impairment is low at the moment, that will change. As the economy deteriorates, and property markets slide, the capacity to service the loans, and the strength of the underlying valuations, will come under pressure.

And the actions of the bankers could make it worse. If they lose patience with distressed borrowers as they have with Allco; if they decline to refinance existing loans; or if they stop new property lending, they could precipitate an even more savage decline in values.

The head of Australian Equities at Perpetual, John Sevior, is already worried. "The banks have a substantial commercial property exposure," he said. "I would suggest that the carrrying value of that exposure in aggregate would be unrealistically high and any stuff they have leant on at silly values will be seriously under question."

Bill Moss, the man who founded Macquarie Bank's property and investment banking operation and who now chairs recovery practice PPB, says the commercial property problems will be "something the banks will be announcing in 12 months' time".

In a year's time the downturn – Moss is sure it will be a recession – will have bitten and property vacancies will be rising, building income will be dropping and values will be clearly falling.

"Of course the banks will have more problems then; a lot of small businesses, and big businesses, will collapse," he says.

JP Morgan banking analyst, Brian Johnson, also warned this week that the deterioration in the bank's asset quality had a way to go.

"In this environment not only do commercial property values come under pressure, but so do the cash flows servicing the interest cover over the duration of the loan."

The size of the banking sector's hold on property might surprise.

Australia's banks had an exposure of $120.9 billion to the nation's office towers, shopping centres, industrial facilities, hotels and residential land developments in September 2007 – the last date for which the Australian Prudential Regulation Authority has released statistics.

The foreign banks, several of which have been aggressive property lenders, had a further $29.5 billion.

The total exposure – $150 billion – is more than all the equity in the real estate investment trusts.

Worryingly, the exposure jumped 16 per cent between March and September last year, just as the commercial property boom was reaching its crescendo. Loan to value ratios struck in those six months would already be breached.

Of course, the finance problems for commercial property don't end with the banks.

The freeze on the mortgage trusts has closed a source of funding which has provided $20 billion to developers and small business shunned by the banks. And soon the first of the $80 billion in commercial mortgage backed securities taken out by the big end of town comes up for renegotiation.

But the banks have dominated commercial property lending in Australia. Many of the problems, and the solutions, will land on their board tables.

In the early 1990s, the collapse of commercial property almost brought down Westpac, and severely shook the ANZ.

This shakeout will be different – better in some ways, but worse in others.

The banks are generally less exposed to commercial property than in the past and the property fundamentals are better. But the absolute shortage of money is a crisis not faced before, certainly not since the mid-1970s.

In September 2007, the major banks exposure to property was just 5.5 per cent of total assets. The ANZ's $27 billion was 8 per cent of the total book. For the smaller domestic banks it was a significantly higher 10.5 per cent.

At the moment the proportion of declared non-performing loans is low.

In the ANZ's book, non-performing loans are negligible but the proportion of exposures "in high risk" had jumped from less than 2 per cent to near 6 per cent.

A key concern is the way the debt has ballooned in the past year. The Commonwealth Bank's exposure to property, $37.3 billion, jumped over 30 per cent in 12 months to June.

At Suncorp's full year results chief financial officer, Chris Skilton acknowledged a "heavy weighting to property" in its Business Bank. Development exposure jumped to $5.9 billion and property investment funding to $5.6 billion.

Skilton said the jump was primarily due to strong drawdowns on "prior contractual committed facilities" but stressed that the credit quality remained sound.

"We had to balance the issue of maintaining the value of our franchise which could have been severely damaged if we had not been prepared to support our existing customers who could still afford to service the increased cost of debt as well as provide appropriate security," he said.

At least one foreign bank has made a different call. It pulled the pin on a project already under construction in western Sydney and called in the receivers.

The key question is what the other banks will do as more loan covenants are breached and more interest repayments are not met. And whether the banks will inject funds into the market to allow transactions and set the new level of valuations.

"I have the sense they will nurture the loans through, but there will be some pain," says Michael Holm, the executive chairman of the largest commercial mortgage originator, Balmain Commercial.

Similarly Michael Rothner, the managing director of rival commercial mortgage originator, Ashe Morgan Winthrop says the banks are not being precipitous, and appointing administrators and receivers because they are worried about the flow on effects.

If the banks force sales, but don't lend to potential buyers, all they do is push down values and worsen their position.

"The biggest issue is cash flow and the interest rate cuts have helped," says Rothner.

"But they are nervous about empty or non-income producing property; they are worried about people capitalising their interest." he says.

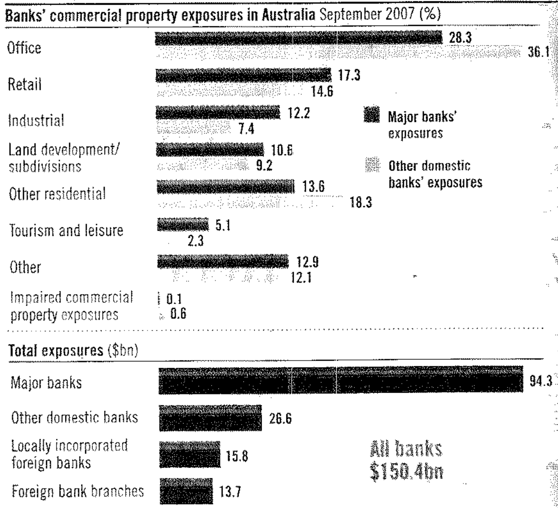
However there is an opposing view. Moss says the banks can only nurture borrowers for a certain period of time. Then they have to cut.

The credit crisis has already savaged the real estate investment trusts.

Billions of dollars in equity have been lost as the REITS have been forced to recapitalise to meet the new era of constrained finance.

Soon the bank's non-REIT borrowers will have to recapitalise as well. And that will mean pain for both banks and borrowers.

Feeling exposed



SOURCE: APRA

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