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Commercial property lending not as bad as feared

What happened?

The Reserve Bank of Australia (RBA) last week released its half-yearly *Financial Stability Review* that aims to assess the current condition of the financial system and potential risks to financial stability. The review had a number of interesting insights into the current lending practices of Banks for commercial properties and the health of their lending portfolios to the sector.

Credit conditions

In relation to the general tightening of financial conditions, the Review notes that the commercial property sector has apparently been disproportionately affected:

> *Industry liaison suggests that banks have sought to restore credit standards somewhat, including by increasing their risk margins and strengthening non-price conditions such as collateral requirements and loan covenants, Indications are that this has been more pronounced for larger-value loan than for smaller business loans.* ***By industry, conditions have tightened appreciably for commercial property, reflecting the higher degree of uncertainty about asset quality and valuations.*** *(p32)*

Interestingly, the Review notes that foreign-owned banks had actually expanded their credit to domestic business borrowers over the past six months, albeit at a noticeably slower pace than has been witnessed over the past few years. Counterbalancing this slowing in foreign bank lending, the Review notes that '…credit extended by the five largest (domestic) banks has increased at a slightly faster pace than total business credit over the past six months'.

More specifically for commercial property, the Review notes:

> *The available evidence also suggests that, despite the tightening in conditions, banks have continued to lend to the commercial property sector. According to APRA data, banks' outstanding exposures to Australian commercial property increased by nearly $9 billion, or 5 per cent, over the December quarter. Information from the syndicated loan market also suggests that most property companies that had large refinancing requirements during 2008 were generally able to rollover their debt, albeit on less accommodating terms than in the recent past. (pp32-33)*

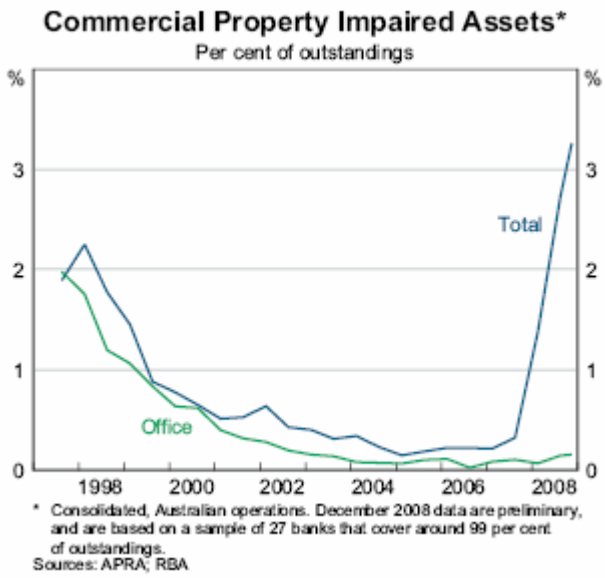
The Report later reinforces the point that most borrowers have still been able to refinance maturing debt as needed, noting that:

> *As an illustration, large borrowers in the commercial property sector – a sector that has reportedly found it particularly difficult to source funds – have had $5.3 billion of new syndicated loans approved since end-June 2008, more than offsetting the $3.4 billion of maturities over that period. (p59)*

Non-performing Loans

In relation to the volume of non-performing loans being carried by domestic banks, the Review states that the proportion of non-performing loans across all sectors has risen from 0.6% to 2.1% over the 12 months to December 2008. The increase is partly attributed to the slowing economy, '….but it is also due to a small number of exposures to highly geared companies with complicated financial structures and/or exposures to the commercial property sector'. More specifically on commercial property, the Review states:

In banks' commercial property portfolios, the impaired assets ratio stood at 3.3 per cent as at December 2008, compared to around 1½ per cent in early 2008 (Graph). This ratio is now higher than it has been for around a decade or so, but is much lower than the levels reached in the early 1990s. Much of the recent rise is accounted for by loans for retail property and, to a lesser extent, residential development, with only a small rise in the arrears rate on loans for office property. (p21)



Implications

While the terms of commercial property lending have become more onerous, there is no evidence to date to support the notion that companies in the property sector face a systemic problem in rolling over debt, or that foreign banks have pulled out of syndicated loan arrangements in anything but isolated instances. This indicates one of two things, either foreign banks are holding out until the Rudd Bank arrangements are in place before they repatriate capital back to their domestic market, or that there is more liquidity in the market for viable commercial property projects and investment than initially thought and there is actually little need for the Rudd Bank arrangements at all.

If the latter is true, it is possible that the Rudd Bank will, at the margin, make for an 'easy out' for foreign banks that might have otherwise maintained their commitment to the Australian market and the sector might well have been much better served leaving things to market forces to fund commercially viable ventures. After all, if there are good profits in funding a viable deal there will inevitably be other sources of funding that emerge to take up the slack (and it has not always been the case that Australian commercial property has been primarily funded by banks). Conversely, the existence of Rudd Bank as an alternative source of funding might reduce any bargaining power that offshore banks may have to hold syndicates to "ransom" on roll-over dates.

In relation to non-performing loans, the evidence suggests that the problem remains largely confined to the well publicised troubles of Centro Properties and several residential developers such as Raptis and City Pacific. This indicates that problems remain largely a reflection of the business models and debt structures of individual companies rather than more widespread problems emanating from the broader economic slowdown.

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