

The New World of dealing with banks

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A lot has been written about the subprime problems in the United States but not a lot understood. I will give you a short overview of how it happened and spend some time on what it means to you as a borrower of money in Australia.

The Subprime Meltdown

The subprime meltdown mainly resulted from the combination of loose lending by mortgage lenders and cleverly packaged, but poorly understood, investment products marketed to investors by investment banks. The combination has proved lethal.

Around 2004, the mortgage lenders came up with some innovative products to combat a slowing housing and mortgage market in the United States. They developed an Adjustable Rate Mortgage ("ARM"). ARMs allowed borrowers to borrow at a low rate of interest for the first two years, after which the rate increased.

These ARMs sounded much like the 'honeymoon rate' loans that we are used to in Australia but they had some fundamental differences.

In Australia, our lenders assessed the ability of the borrower to repay the loan not on the low honeymoon rate, but at the higher standard variable rate. Also, the gap between the honeymoon and the standard rate was about 1%. Normal credit assessment processes were followed, such as ensuring the borrower had stable employment, regular income and had assets (eg cash, investments, equity in own home).

In the United States, these ARM products were sold to borrowers that should never have had a loan. The following happened:

- At the end of the two year honeymoon period, the adjustable rate jumped up 5%. So a borrower with, say, a 6% loan jumped to 11% for the life of the loan;
- The mortgage lender only assessed the borrower's ability to repay the loan at the 6% honeymoon rate, not at the higher 11%;
- People who had never been able to secure a home loan before were now being aggressively marketed to by lenders, mortgage brokers and real estate agents;
- Many of these 'new' borrowers had temporary employment, irregular income and minimal assets. Commentators dubbed these borrowers NINJAs – No Income, No Job or Assets.

To do this lending, the mortgage lenders needed money to lend. This is where the investment bankers came in.

The investment bankers would buy thousands of these mortgages at a time from the mortgage lenders and then sell them to investors. The mortgage lenders would then start over again and find more borrowers and lend more money.

However, the investment bankers knew that they could not sell these risky subprime mortgages to the large investors like pension funds, hedge funds and insurance companies. So they performed some financial magic and repackaged these risky mortgages with other assets and convinced the investors that they were now no longer risky assets. You may have heard these called CDOs or Collateral Debt Obligations. The investors thought this was now a good investment.

So, the financial merry-go-round picked up pace.

The investors wanted more of these investments; the investment bankers bought more of the mortgages; the mortgage lenders found more borrowers. The investors were getting good returns and the investment bankers, mortgage lenders and mortgage brokers were all earning great fees and commissions. This caused a real estate and house building boom because all these 'new' borrowers had money to buy houses. Real estate values kept rising.

Everyone forgot that all these 'new' borrowers might not be able to afford their loans.

When the ARMs began resetting after two years (during 2006 & 2007) to the higher rates, there was an increase in mortgage defaults. We learnt that these borrowers really could not afford to pay their mortgage.

The financial merry-go-round came to a sudden stop.

Borrowers defaulted; investment banks couldn't pay the returns to the investors; investors sold out of their investments; the investment prices plummeted; the investment banks asked the mortgage lenders to buy back the defaulting loans; mortgage lenders couldn't buy them back and went bankrupt; the mortgage lenders foreclosed on the borrowers; real estate prices fell; building companies went broke; share markets lost value.

The result has been that a lot of people have lost a lot of money. But more importantly, financial institutions around the world have lost confidence in lending money to one another. This has now resulted in the liquidity crisis.

So what has happened in Australia?

Because investors and other financial institutions around the world have been spooked by the depth and speed of the subprime meltdown, they are only lending to good quality borrowers (like Australian Banks), but at much higher interest rates.

- **Credit Rationing**

Our banks have had to pass on these higher borrowing costs to us. You would have seen your business and property investment rates increase markedly in the past 6 months.

Also, many of the non-bank lenders that have grown in the past 15 years are now disappearing. They either cannot borrow money from investors at all (through securitisation) or the rate is too high to be competitive. We have seen players like Macquarie Bank and RAMS either leave the market or have to be sold.

Many large corporate entities also cannot raise money (through issuing bonds or other securities) overseas and are now returning to the Australian banks for their funds.

Accordingly, there is now a big demand on our banks for funding. They are having to prioritise and ration their lending. They are being increasingly choosy about the type of clients they want to lend to and are resetting interest margins higher according to risk.

- **Facility Reviews**

Already I am seeing existing business clients of banks undergoing 'facility reviews'. Many are being told that they have been assessed at a higher risk margin and that their interest rate has been increased. Others are being told that the bank requires more security or a lowering of borrowings within the next 90 days.

You need to be prepared for these reviews and argue your case strongly. You may need to seek alternative funding or change your current mix of funding. Make sure you are being well advised.

- **Covenants**

Another area that many business clients have neglected is lending covenants – these are things like your interest coverage ratio, debt ratio, net profit ratio etc that are found in your finance documents. These covenants are not given a lot of emphasis by clients at the time of securing finance facilities and have not been looked at closely by business bankers during the past few years.

These covenants have now become very important and banks are strictly enforcing them. If you breach a covenant it could be grounds for calling in all your facilities. Again, review them, stress test them with different business scenarios and get some good advice on them.

- **Relationship bankers**

Where have all the relationship bankers gone? We came through a period where banks were freely lending money and your nominated bank relationship manager smoothed the way to arrange generous terms and special arrangements if you were overdrawn or missed a covenant. Now no more.

The decisions on whether to increase a facility, accept a new customer or enforce a contractual condition with an existing customer are increasingly being made by the backroom credit assessors in Melbourne or Sydney head offices. The focus is on risk management and increasing bank margins. The 'relationship' part of the banking arrangement is very much secondary to this.

For clients with good cash flow and strong business or investment reasons to be borrowing money, there is still competition among the banks for your business. You just need to know how to present your business properly on paper and how to negotiate in this new credit environment.

- **Investors**

Many investors that purchased residential or commercial investment properties in the last 3 or 4 years took advantage of fixing the interest rate on all or part of their borrowings. Many of these fixed rates will be expiring this year. You will find that most banks will default the interest rate to the standard full variable rate. This may be some 2%-3% higher than the generous fixed rates you secured some years ago.

Just be aware that if you have significant personal borrowings, you may be able to negotiate a discounted rate lower than the standard variable rate your bank will default you to. You may find that you need to change to another lender to avail yourself of these discounted rates.

Summary

Remember that for strong business and individual borrowers there are still good opportunities to raise debt levels to take advantage of business and property acquisitions. Don't be afraid to restructure or renegotiate your finance. Prepare yourself for the negotiations with a banker and present your proposal in the best possible light.

If you are concerned about the competitiveness of your current finance facilities then have them reviewed by a finance professional.

Peter Sullivan.

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