Chapter 3

Commercial property, the Australian economy and ABIP

Is ABIP needed?

3.1 A number of witnesses and submitters expressed concern about the broader macroeconomic ramifications if the commercial property sector were allowed to weaken significantly:

> …by not stepping in we could precipitate a broader problem, not in the property markets…but in the banking system itself. Remember that we still have a substantial proportion of bank loans underwritten by property. That is their collateral, so if we see a sufficient fall in property values then we start to have bank debt write-offs. They will lose equity and we will run into the sort of problem that we ran into in the late eighties and early nineties which caused a recession.[1]
>
> There is a clear risk that those foreign banks, in withdrawing their liquidity from the Australian system… could start a chain reaction of asset price discounting in Australia, which would impact on the broader Australia economy… It is an issue, not just for the commercial property sector but also for the general economy… because real estate is the collateral for the entire Australian banking system.[2]
>
> Without this legislation we may see a further reduction in confidence, a deeper economic downturn and a postponed economic recovery.[3]
>
> …withdrawal of finance from viable commercial property projects may have adverse effects on employment and investment in other sectors of the economy. [4]
>
> … all the anecdotes from all our members and from our own survey, which is part of the submission, indicate that finance is drying up… To see a precipitous fall in asset prices would be … disastrous for confidence… maintaining confidence is very critical in mitigating the depth of the recession.[5]

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1 Dr Frank Gelber, BIS Shrapnel, *Proof Committee Hansard*, 14 April 2009, p 19.

2 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, p 2.

3 Urban Taskforce Australia, *Submission 1*, p 1.

4 Treasury, *Submission 9*, p 12.

5 Mr Harnisch, Master Builders' Association, *Proof Committee Hansard*, 14 April 2009, pp 27-30.

> It is NAB's view that if the Banks and Government do not approach re-structuring pragmatically, particularly in syndicated situations, asset values could free fall, deepening the downturn and resulting in a flood of forced sales which will cause greater losses, business failures and increased unemployment.[6]

3.2 A contrary view was put by Mr Ergas:

> I do not believe that the evidence to date suggests that there is a looming crisis nor do I think that the evidence to date and historically suggests that even when there are cyclical downturns in commercial property prices that has contagion or spillover effects in the economy as a whole.[7]

3.3 The property and business services sector (contributing about 14 per cent in 2008) is an integral part of the growth of Australia's economy. The property and business services sector registered about 4.6 per cent annual growth since 1991 compared to 3.6 per cent growth of the economy during the same period.[8] Therefore the importance of the property and business sector to our overall economy should not be underestimated.

3.4 Urban Taskforce Australia, a group representing property developers and equity financiers, argued ABIP was crucial to Australia's economic recovery:

> The economy will pay a heavy price if this legislation is blocked. Without this legislation we may see a further reduction in confidence, a deeper economic downturn and a postponed economic recovery[9]

Access to Funding & Liquidity

3.5 ABIP is not designed to interfere with natural market outcomes to hold up prices, only to protect against undue and distorting over-corrections. As such, ABIP will act as a contingency measure which focuses on addressing liquidity gaps which arise from the withdrawal of funding from commercially viable assets and projects. That is, ABIP will fill the gap created by market failure where foreign banks withdraw and domestic banks are unable to increase their exposure to fill that gap because of their responsibility to maintain prudential standards placed on them by regulators.

3.6 Westpac have attributed the funding gap in the commercial property sector to:

- The high levels of leverage (high debt and low equity levels) which are characteristic of most major participants in the sector;
- The syndicated nature of most large debt facilities, and the participation in these syndicates of a number of foreign lenders;
- Major Australian financial institutions reaching industry concentration limits; and

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6 National Australia Bank, *Submission 11*, p 3.

7 Mr Henry Ergas, Concept Economics, *Proof Committee Hansard*, 14 April 2009, p 74.

8 Bills Digest, 17 March 2009, p 10.

9 Urban Taskforce Australia, *Submission 1*, p 1.

- A lack of liquidity in capital markets (particularly Commercial Mortgage Backed Securities) and other private sources of debt due to the effects of the global financial crisis.[10]

3.7 The National Australia Bank have described the situation like this:

> In the commercial property market, capital markets and private sources of funds have dried up, and Regional Banks have curtailed their growth ambitions due to large existing exposures and in some cases pending impairments. Refinancing risk is particularly elevated. This is compounded by the pressure on Foreign Banks to repatriate capital to domestic markets to shore up balance sheets eroded by losses from asset write-downs and write-offs. The four major Australian banks cannot solve the problem, due to industry concentration limits, and increasing capital requirements from credit quality downgrades.[11]

3.8 The Property Council of Australia has pointed out that where foreign banks refuse to refresh existing credit lines, many property owners and developers will be forced to unnecessarily liquidate commercially sound assets, increasing the risk of an artificial fire sale. The aggregate effect of this would be a delay of the cyclical recovery of property investment activity resulting in and caused by less new investment, slower economic growth and higher job losses.[12]

3.9 According to the National Australia Bank (NAB), over A$70bn of commercial property debt will require refinance in the next two years, of which A$50bn is syndicated debt. NAB's submissions quotes research that says that "an increasing number of foreign banks will… be less willing to refinance existing syndicate positions, placing pressure on corporates seeking funds" and that a recent Property Council of Australia member survey indicated that there is already evidence that some foreign banks are leaving our market.[13]

Commercial property prices

3.10 The Property Council warned that commercial property prices had fallen by 15-20 per cent in the past year and a further fall of around 15 per cent was in prospect.[14]

3.11 The establishment of ABIP is not intended to hold up property prices above their medium-term market equilibrium, but to prevent an overshooting. Treasury explained:

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10 Westpac, *Submission 14*, p 1.

11 NAB, *Submission 11*, pp 1&2.

12 Property Council of Australia, *Submission 6* p 4.

13 NAB, *Submission 11*, p 2.

14 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, p 11. A similar estimate of the recent fall in property prices was given by Dr Frank Gelber, BIS Shrapnel, *Proof Committee Hansard*, 14 April 2009, p 18.

> Withdrawal of finance from viable commercial property assets may force businesses to sell assets in a distressed sale, which could lead to a more rapid and disorderly fall in prices than would otherwise occur, resulting in prices falling below their underlying values.[15]

3.12 The Property Council of Australia noted:

> We do not believe that ABIP will prop up prices. From the very first announcement by the government, it was clear that, to the extent that there would be any rollover finance extended to an individual project, it would be on its revalued price, and all decisions had to be unanimous. The banks are not noted for lending money on the basis of projects which are overvalued. [16]

3.13 Vision, an industry participant, argue that ABIP is needed to smoothly transition the commercial property sector through the liquidity problems they are currently facing. Furthermore they argue that without responsible intervention an inflated boom market will return once the global financial crisis is over.

> The risk that is run in this sector is that no intervention now takes place and the industry shrinks as a result of lending practices. The flow on effect is that a boom market will be created once lending is relaxed and pent up demand is released. Under this irresponsible approach we will go back to the very boom and bust economies that economic policy is trying to smooth out. Shortages in land and availability of housing will create inflationary pressure that could be avoided by a sensible transitionary approach.[17]

Employment

3.14 The global economic downturn is already being reflected in the Australian labour market. Employment has stalled and the unemployment rate has risen from its low of 3.9 per cent in February 2008 to 5.4 per cent in April 2009.

3.15 Employment in the construction industry peaked at 995,000 in August 2008 and had contracted to 980,000 by February 2009. The Property Council has suggested that another 75,000 jobs may be lost if nothing is done.[18]

3.16 The Property Council suggested that around a fifth of these jobs might be saved with the stabilising influence of ABIP, but to prevent all of the job losses would require an injection of over $12 billion directly into the construction sector.[19] They

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15 Treasury, *Submission 9*, p 12.

16 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, p 9.

17 Vision, *Submission 4*, p 2.

18 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, pp 9&10, citing forecasts by Econtech and the Construction Forecasting Council, which take into account the stimulus package.

19 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, pp 2&3.

gave as a specific example, the Vision Tower project in Brisbane, where the withdrawal of a foreign bank halted the project and a result 600 employees were laid off or redeployed.[20] As the labour and property markets deteriorate, opportunities to redeploy workers will dry up.

3.17 Asked about whether the reduction in activity and employment might be a reflection of reduced demand in the economy rather than being related to cuts in the availability of finance, the Property Council replied it was 'overwhelmingly' due to lending restrictions:

> The vacancy rates in the Australian office sector are at historic lows. They are around 4.8 per cent at the moment. The average rate over the last 30 or 40 years is around 10 per cent…There is no oversupply in the resale sector. There is no evidence of an oversupply in the industrial sector. So we do not think there has been a big choking off of demand in the last six months. [21]

3.18 Similarly, the Master Builders Association believes that at least 100,000 direct jobs are at risk over the next 12 to 18 months.[22] While not offering a quantitative estimate, the Urban Development Institute of Australia reported:

> The lack of available credit for new projects is having a significant impact on employment in the development sector. Instead of creating jobs, developers are shedding staff because capital is just not available to invest in new projects.[23]

3.19 In his press release announcing the scheme, the Prime Minister said:

> Many of the 150,000 workers employed in the commercial property sector are tradespeople, such as plumbers, electricians and carpenters. Without action, a combination of weak demand and tight credit conditions could see up to 50,000 people in this sector lose their jobs… with flow-on effects to jobs in other parts of the economy.[24]

3.20 The employment estimate was produced by Treasury, who explained to the committee how it was calculated:

> Based on the cyclical behaviour of activity and employment in the commercial property sector in previous severe economic downturns of the 1980s and 1990s, without action, a combination of weak demand and tight credit market conditions could see economic activity in the commercial

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20 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, p 9. For further information on the impact on the Vision Tower project, see The Hon Wayne Swan MP, *House of Representatives Hansard*, 18 March 2009, p 2098 and Louise Dodson and Robert Harley, 'It's all a bit rich', *Australian Financial Review*, 21-22 March 2009.

21 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, p 13. Similarly, Dr Frank Gleber from BIS Shrapnel said ' a lot of projects are not proceeding for lack of funding'; *Proof Committee Hansard*, 14 April 2009, p 20.

22 Mr Harnisch, Master Builders' Association, *Proof Committee Hansard*, 14 April 2009, p 30.

23 Urban Development Institute of Australia, *Submission 13*, p 2.

24 Prime Minister, *Media Release*, 24 January 2009.

property sector decline by around one third with consequent job losses of up to 50,000.[25]

3.21 Mr Henry Ergas has challenged the claim that the proposal will protect these jobs:

…changes in the value of existing assets in no way directly alter employment prospects. Indeed, were rents to fall, business costs would be reduced and that might improve conditions across a wide range of sectors. True, the development projects that would otherwise not occur may create some jobs. But why would those jobs be any more valuable than the jobs that could be created by using the $2 billion for other purposes, including cutting economically distorting taxes?

The Government claims to be acting on behalf of the 150,000 people employed in the commercial property sector, many of whom are tradespeople such as plumbers, electricians and carpenters. But what of the hundreds of thousands of shop assistants, cleaners, delivery drivers whose jobs will now not be "supported" by lower commercial property prices flowing through to lower retail rental costs?[26]

3.22 However, the Property Council rejects Mr Ergas' assumption that rents would decline in line with falls in property prices:

Rents are determined in terms of the supply of space and the demand for space, in our view. We do not believe that there is a nexus between the value of the asset and the amount that is charged for the renting of the space in that asset.[27]

Superannuation

3.23 More than a third of the equity in the commercial property sector is held by superannuation funds, representing about 10 per cent of aggregate funds in superannuation overall. A decline in the value of such assets would have substantial implications for the millions of Australians who have invested in superannuation funds with an interest in the sector.

3.24 An 'artificial' collapse of commercial property values (caused by the market failure discussed above) would flow through to the wealth held by over 10 million Australians in their superannuation. This will affect retirees who will have lower income, putting greater pressure on the social welfare safety net. It could also lead to those looking forward to retirement to try to save more by cutting back spending, further dampening activity.

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25 Treasury, *Submission 9*, p 13 .

26 Concept Economics, *Submission 10*, p. 13.

27 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, p 11.

Residential property prices

3.25 There has been some commentary about the impact of the economic downturn on the residential property sector and whether ABIP will address any of these concerns. For example, Dr Ian Harper, one of Australia's best known academic economists, said:

> …the difficulty is if commercial property developers find themselves in a position where they can't refinance existing loans. So this is whether it's for new developments or existing developments. They have no alternative but to sell down those assets, those properties. And if that produces a general downward pressure on land prices, that's where the cross-infection into house prices and house-land packages can start.[28]

3.26 Mr Verwer of the Property Council noted the increasing involvement of large developers (such as Mirvac, LendLease and Stockland) in building residential property complexes in the last 10 years and highlighted that the focus of ABIP is not to address risk in the broader residential property sector. Mr Verwer went on to say that, although these developers represent a small and pivotal part of the sector, broad scale domestic housing prices will be unaffected by the proposal.[29]

3.27 ABIP will only cross the boundary into the residential sector in cases where broader scale institutional investors seek loans from ABIP who have also moved into the residential sector and borrowed money from banks in order to take the risks to develop those master-planned communities and suburban developments. As this involvement is relatively small, ABIP will not have any material impact on residential housing prices.

Will ABIP be an effective response?

3.28 The majority of submissions and evidence provided to the inquiry argued that ABIP was a necessary and effective contingency measure to support the commercial property sector in the event of a withdrawal of foreign investment.

3.29 The Property Council are enthusiastic supporters of ABIP, believing it to be an appropriate response that deals with a strategic risk by quantifying it and managing it.[30] Their Chief Executive Officer said that his international colleagues believe ABIP

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28 ABC, *The World Today*, 28 January 2009, available at http://www.abc.net.au/worldtoday/content/2008/s2476285.htm

29 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, p 10.

30 Mr Peter Verwer, CEO, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, pp 7-8.

is a far better policy than the schemes being considered by any other country with a similar focus. He commented:

> …the ABIP proposal will encourage Australian property investors to rotate back into domestic investment as soon as economic fundamentals correct themselves...What ABIP is doing is specifically identifying the implications of the withdrawal of a large chunk of strategic credit to Australia and the way in which that would artificially discount well-performing assets—well performing assets are the only assets that are addressed by ABIP—and the implications for the broader community. It is focused; it is elegant…[31]

3.30 The Master Builders Association also saw ABIP as providing some useful certainty for industry, commenting that:

> …confidence, in the end, is what is going to drive the Australian economy back into recovery.[32]

Committee view

3.31 The committee accepts there is a real danger of excessive cutbacks in foreign bank lending leading to unnecessary job losses and disruptive overshooting of commercial property prices. The creation of ABIP provides an effective tool to address this problem if it materialises.

31 Mr Peter Verwer, Property Council of Australia, *Proof Committee Hansard*, 14 April 2009, pp 2 and 8.

32 Mr Wilhelm Harnisch, Chief Executive, Master Builders' Association, *Proof Committee Hansard*, 14 April 2009, pp 30-31.