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Committee Secretary
Senate Standing Committee on Economics
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Australia

Inquiry into the Australian Business Investment Partnership Bill 2009 and the Australian Business Investment Partnership (Consequential Amendment) Bill 2009

National Australia Bank appreciates the opportunity to make the following submission to the Senate Standing Committee on Economics Inquiry into the Australian Business Investment Partnership.

1. INTRODUCTION

Prevailing economic conditions and outlook indicate that credit conditions are likely to continue to deteriorate, placing further pressure on corporate Australia. This is already evident in both the equity and credit markets.

Managing bank portfolio exposures in deteriorating economic conditions will present challenges for individual banks as they deal with customers in financial distress.

NAB believes there is merit in developing a specific solution for dealing with these unique and challenging circumstances to ensure that individual Bank responses do not compound the problems and, to the extent practical, that the overall interests of banks, customers and the economy are better aligned in managing through extraordinary times. NAB believes that the Australian Business Investment Partnership (ABIP) will help achieve this outcome.

2. BACKGROUND

Review of similar periods of economic uncertainty indicates that in markets where Banks are seeking to quickly reduce their exposures, or exit the market, precipitous realisation of security can occur. Such realisation results in crystallisation of losses at security values, which are close to the bottom of the market, and further deterioration in asset values.

A number of sectors have already fallen out of favour with both lenders and investors. There has been a significant reduction in capital flows into the market, and the subsequent de-leveraging process is creating more sellers than buyers.

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.

Capital values of commercial property and business assets are falling, and this trend is likely to continue in the short and possibly medium term. The extent of falls in value will vary depending on asset class/quality, credit conditions and individual sellers' situations. Deep discounts are being applied in forced sale circumstances.

The commercial property industry is a large employer, and commercial property is used extensively by businesses in general as security against which they borrow money to support much of the activity in the broader economy. Hence the impact of how commercial property is dealt with is far broader than just within its discrete market segment.

3. INDUSTRY WIDE STATUS

All of the Australian Banks have material exposures to the Australian commercial property market. In December 2008, banks held over A\$190bn of commercial property exposure, with an estimated 14% held by foreign banks. It is estimated that over A\$70bn of commercial property debt will require refinance in the next two years, of which A\$50bn is syndicated debt.

A number of the Foreign Banks have significant exposures, either directly or via purchased positions in syndicates. Merrill Lynch estimates that over the last three years, Foreign Banks have taken on more than 60% of domestic Australian syndicated debt¹.

Banks have traditionally drawn comfort from the fact that their major exposures are well secured by underlying assets and cash-flows. Recent weakening of economic conditions and investor demand for equity capital has seen a destabilisation of markets and rapid fall in asset values. This combined with a desire by some Banks to reduce large exposures or exit connections, is putting more pressure on an already tight credit market.

The aforementioned Merrill Lynch research also highlights that: "an increasing number of foreign banks will look to collapse troubled syndicates and/or will be less willing to refinance existing syndicate positions, placing pressure on corporates seeking funds." A recent Property Council of Australia member survey indicated that there is already evidence that some foreign banks are leaving our market.

4. NAB'S POSITION

In the non-property sector, some financial institutions may consider reducing exposures from sectors leveraged to the economic cycle such as retail, transport, mining, manufacturing, child-care, recreational and accommodation. The most vulnerable sectors will be those impacted by dependency on discretionary incomes. However, NAB believes the sector requiring immediate attention is commercial property.

At this point in time, the decline in property values is not anticipated to be as severe as the early 1990s, when high levels of speculative property development resulted in

¹ Australian Banks-Retail: Pressure on Corporate Lending, Merrill Lynch 13 November 2008



over supply, precipitating a significant downturn in economic activity. There are currently low vacancy rates across a number of asset classes, and limited new supply; at least partially as a result of lenders already acting responsibly and limiting approvals.

Consequently, a widespread reduction in corporate profitability moderated by limited tenant defaults, will allow clients to continue to service debt even if Loan to Value Ratios (LVR) are breached. This should reduce the number of forced sales, which accelerate falls in values.

As revised asset and business valuations are coming to hand, reflecting latest sales and market direction, an increasing number of borrowers are experiencing pressure and possibly breaching covenants.

In many cases the expectation is that debt restructuring will be possible, without significant additional risk, should Banks choose to support this approach and explore options such as equity injection, credit enhancement via recourse and/or reallocation of surplus cash flows to de-leverage businesses.

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.

Returning to a stable orderly market will require an uplift in equity investor sentiment underpinned by a stabilisation of asset values. This will require the Banks to return to more fundamental approaches of risk assessment and increased dependence on underlying business performance rather than implied asset values.

5. IDENTIFIABLE RISKS

- Failure to act in a consistent and sensible way could lead to a compounding effect of the market disruptions.
- Increased losses will be incurred by Banks and customers if security realisations force down values further.
- If some Banks act in a manner inconsistent with others, it will force all Banks to react.
- Prolonged or deeper than expected downturn could result in the need for longer term support from Banks.
- Inability of borrowers to access equity to moderate leveraged positions restricts the available options to remedy current problems.
- Problems in the commercial property sector can spread and cause issues elsewhere.
- Commercial property is a popular asset class for Australian investors, including superannuation funds and "mum and dad" retail investors through listed and unlisted trusts. A major collapse in the commercial property markets will not only impact on investor confidence, but also on the income and cashflow of many of these investors.

6. WHY CREATE ABIP?

The economic outlook for the economy whilst negative in the short term, is more positive over the medium term, and will improve more quickly if Banks take a more considered view on their exposures, and do not give in to the inevitable pressures to sell assets quickly, thus crystallising losses. ABIP provides a mechanism to assist that this does not occur.

ABIP is a temporary contingency vehicle with a defined life span which will ensure that, if required, Australia's financial system has the capability to deal with commercial property assets even whilst the current difficult economic conditions prevail. While the level of utilisation of ABIP's capacities is difficult to predict, it may be minimal and ideally, would be zero. Once market conditions normalise it will wind down.

Most ABIP Board decisions are unanimous, and thus ensure that there is no particular advantage to any of the shareholders. ABIP cannot refinance debt held by its shareholders, thus ensuring it is a vehicle for provision of support funding and not to refinance the major banks. The Government retains a right of veto on every transaction and decision via its Chairmanship of ABIP's board. The banks have shown their commitment via provision of equity and loan funding to ABIP.

ABIP will have clearly defined lending criteria which will be at least consistent with the lending criteria of the four major banks, will adopt conservative provisioning for bad and doubtful debts and will charge commercial rates for its loans. It does not have to write any loan and will be prohibited from writing loans where the deal does not have full shareholder support.

7. CONCLUSION

A solution for the liquidity / funding issues emerging in the commercial property industry as a result of the global economic crisis is needed promptly.

NAB believes that decisive action is required to promote investor confidence and to demonstrate that the government and the major banks are prepared and willing to work together to manage and remove liquidity issues for otherwise viable Australian property companies, should the need arise as a result of an inability to obtain refinancing from traditional sources. Managing these exposures has the flow on advantage of stabilising a number of areas within the economy and reducing unemployment and other negative impacts.

NAB supports establishment of the Australian Business Investment Partnership.

