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Australia's First Bank

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Committee Secretary

Senate Standing Committee on Economics

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Inquiry into the Australian Business Investment Partnership Bill 2009

Introduction

Westpac Banking Corporation (Westpac) appreciates the opportunity to provide comments in relation to the proposed Australian Business Investment Partnership (ABIP) Bill 2009 ('the Bill').

This submission outlines Westpac's perspective on the state of commercial property financing in Australia, and the potential risks that face that sector. In light of these circumstances, the appropriateness of ABIP as a public and private response to the identified issues is considered. Apart from some comments in respect of ABIP's management and governance, the submission does not comment on specific issues of the Bill's drafting.

The Australian commercial property sector

The majority of participants in the Australian commercial property sector do not have significant underlying problems (such as tenants facing solvency issues or large holdings of stressed, undeveloped or speculative real estate). Notwithstanding these relatively sound fundamentals, the sector is currently experiencing a funding and liquidity shortfall, with these pressures having the potential to increase in the near- to medium-term.

These funding and liquidity gaps have their origins in a number of areas:

- 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.

- 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.

The issue of 'foreign bank flight' has received significant attention. Whilst Westpac is not in a position to comment on the specific strategies or lending plans of other institutions, it is possible to make a number of observations on this point.

Firstly, decisions by foreign financial institutions to either withdraw entirely from Australia or to reduce their lending exposures to particular sectors may have no relation to the commercial attractiveness or risk levels of particular deals on offer. Rather, such decisions may be the result of macroeconomic or regulatory factors in the institution's home country, or bank-specific actions in relation to balance sheet or capital management. In the case of the Australian commercial property sector, such decisions – usually taken overseas - may result in these institutions declining to participate in fundamentally sound and profitable transactions.

Consequences of this situation

As noted above, this submission does not seek to comment on the business strategies of particular foreign banks, nor to predict the future for CMBS / capital markets. However, Westpac believes that the consequences of the identified liquidity gap not being met are potentially serious for the commercial property and finance sectors, and for the economy as a whole. These consequences include:

- Widespread deleveraging in the commercial property sector through forced asset sales.
- A consequential oversupply of property on the market, causing a precipitous decline in asset values, and placing further strain on debt covenants as loan-to-value ratios (LVR) rise.
- Pressure on bank capital requirements, suggesting further decreases in lending exposure to the sector.

Combined, these issues mean that commercial property sector participants are beginning to experience difficulty in accessing credit markets or in 'rolling over' existing loan facilities.

Property sector analysts have also identified that the current closure of CMBS markets and the potential for reduction in foreign bank lending contribute to a heightened perception of risk and loss of confidence in the market, which in turn is likely to make equity raisings more difficult.

Through a series of such interconnected events, a reinforcing downward spiral in the Australian commercial property sector is possible, leading to inevitable job losses, and further declines in the value of large superannuation fund holdings. The social as well as financial dislocation caused by such a spiral would be significant.

It is Westpac's view that these risks need to be addressed now, and pre-emptive contingency measures put in place to manage them should they eventuate. We consider that the alternative – waiting until problems become severe before developing a solution – runs the risk of exacerbating the situation and delaying recovery.

ABIP as a potential solution

Westpac's view is that Government intervention in private markets to support particular asset classes needs to be temporary, and targeted specifically at addressing aberrant market behaviour or extraordinary conditions. The current short selling restrictions are an example of this type of intervention.

In the case of the commercial property sector, Westpac believes that a mechanism to avoid the potential for an unjustified and unnecessary 'fire sale' of viable high-quality assets and consequent over-correction in asset prices (with the accompanying social impacts) is warranted. Specifically, such a mechanism needs to ensure sufficient liquidity in the market to prevent the collapse of otherwise viable property entities.

Accordingly, we have worked co-operatively with Government and other sector participants to develop the concept of ABIP. We believe that ABIP meets the conditions for intervention set out above:

- It addresses extraordinary market conditions (in this case, abnormally reduced levels of liquidity),
- It is a 'safety net' provision only, and will not be activated unless market failure requires.
- Further to this point, pricing and governance requirements will operate to ensure that ABIP will operate as a 'lender of last recourse' rather than as a competitive participant in the market.
- It is intended to be a temporary intervention only, and will be wound down as soon as market conditions permit.

A visible, targeted and specific contingency measure of this type may also have the effect of supporting confidence in the market; which of itself will assist companies facing a recapitalisation task. Conversely, the absence of such support will lead to continued uncertainty and ongoing difficulty for sector participants in accessing both debt and equity.

Governance, Mandate and Structure

The Bill provides for a shareholding structure which includes initial loan participation from the Commonwealth and the four major domestic banks (Westpac, ANZ, CBA and NAB). Westpac's view is that this is an appropriate structure, as having this level of capital invested will ensure appropriate focus and a prudent approach to commercial lending decisions by ABIP.

Westpac also notes that the Bill allows for flexibility to provide financing in other areas of commercial lending, subject to unanimous shareholder agreement. The Bank believes that incorporating this flexibility at the drafting stage may be appropriate, although at present our participation relates exclusively to the commercial property financing task described earlier. Our support for any expansion of ABIP's mandate would be conditional on the identification of similar market dislocation or failure in other segments of the economy, and subject to the same views on Government intervention in these areas.

In relation to ABIP's governance, most key actions will require unanimity, and the Shareholders Agreement includes a Commonwealth Government right of veto over all enforcement decisions. Westpac believes that such mechanisms will operate to ensure that ABIP's lending and pricing decisions are appropriate, and to ensure that no particular advantage accrues to any one participant.

Further to this point, ABIP's lending criteria will not allow participants to use the vehicle to reduce their own exposure to particular property deals, nor to refinance existing loans from the four major banks. Westpac considers this important to ensure that ABIP operates as intended – to address a particular failure that has resulted in a lack of liquidity from sources other than the major Australian banks.

Conclusion

Westpac believes that the Australian Business Investment Partnership Bill 2009 and the Australian Business Investment Partnership (Consequential Amendment) Bill 2009 represent an appropriate contingency measure to address existing and potential market dislocations in the commercial property sector caused by the global financial crisis. The intervention is intended to be for a short period of time, and to operate as a safety net rather than a first resort. The governance structures are appropriate for the sound management of risk. On these bases, Westpac supports the Bills and commends them to the Committee and to the Senate.

Yours Faithfully,

Andrew Buttsworth
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