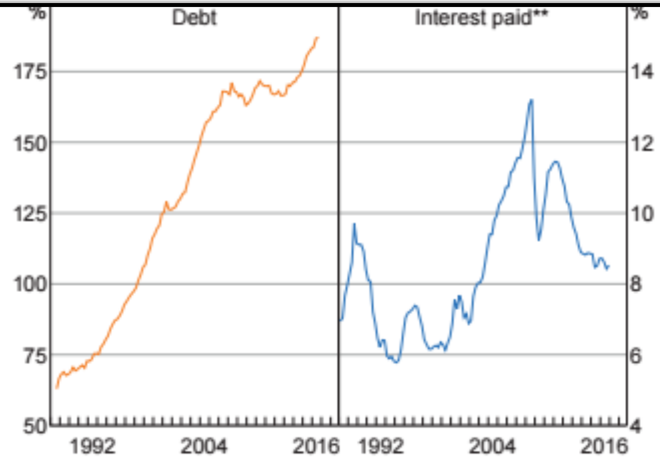
BORROWERS NEED TO BE AWARE & BEWARE

Personal, business and corporate borrowers would be wise to ensure they understand how the changes taking place in the economy generally and the banking sector in particular will impact on their borrowing arrangements. This newsletter highlights the main areas of concern, explains how the banks are responding and offers six tips to safeguard your borrowing arrangements.

HOUSEHOLD DEBT.

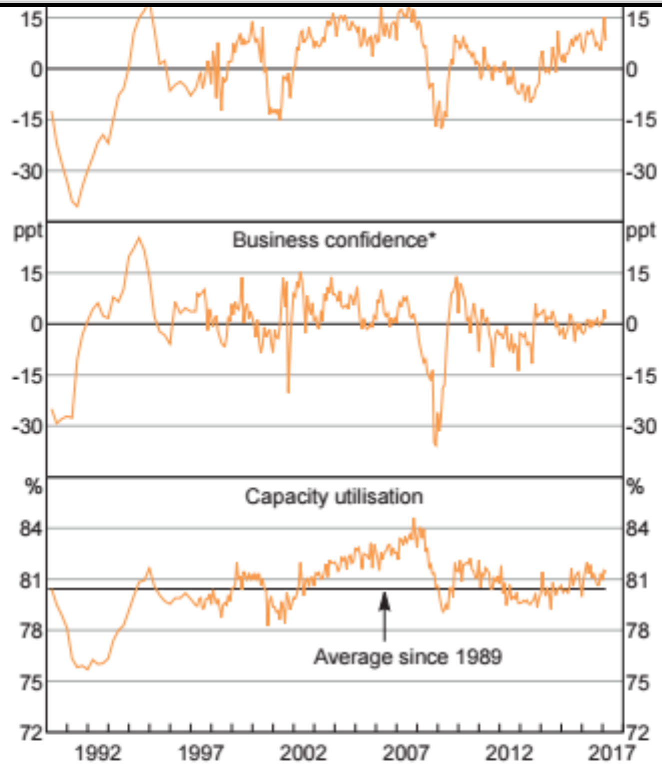
At more than 120% of GDP, Australia's household debt and household debt servicing ratios are the third highest in the world and are still rising. And slow growth in wages is making it harder for some households to service and pay down their debt. Over the past year the value of housing related debt increased by 6.5 per cent whilst household income grew by around 3 per cent. The table below starkly illustrates this point. A couple of interest rate rises and a fall in asset values will result in significant and wide spread financial stress.



The increasing gap between actual and sustainable debt is a global phenomena as revealed in a recent IMF report which concluded that countries with low interest rates and unemployment along with high house prices tend to have larger gaps. The IMF recommended policymakers pay attention to excessively low interest rates and inflated house prices to avoid imbalances that may utlimately pose risks to macroeconomic stability.

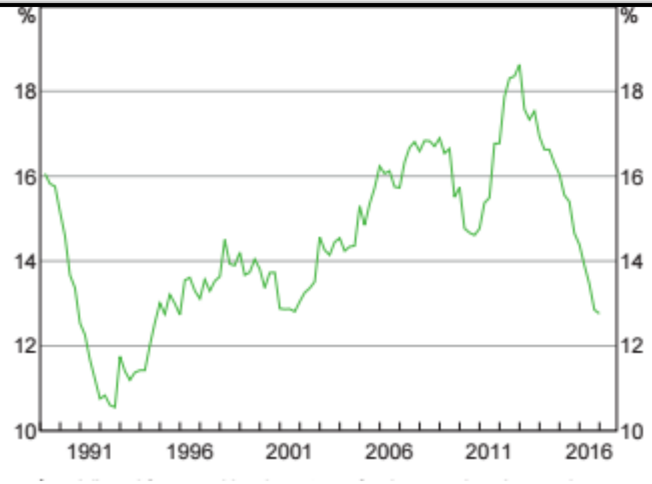
CONFIDENCE.

Confidence levels amongst business owners and consumers are concerning. The ANZ Consumer Confidence has just hit the lowest level since October 2015. The NAB Monthly Business Survey reveals concerns including the persistent weakness in retail conditions and the longer-term growth picture particularly as the contribution from LNG exports, temporarily higher commodity prices and the residential construction boom fade. Even though business conditions have picked up in the last couple of years, business confidence remains flat.



* Net balance; deviation from average since 1989
Sources: NAB; RBA

BUSINESS INVESTMENT.
Lack of confidence plays out in decisions by business owners to invest. For the past five years, business investment as a percentage of GDP has fallen significantly. Under-investment erodes our global competitiveness and impacts on unemployment levels.



FAILURE TO PAY THE PIPER.

Australian borrowers, both business and personal, have become hooked on interest only loans. In the last two decades borrowers have chased maximum leverage based on the prospect of future capital growth. But asset prices don't always increase and wages and profits don't always rise. The capacity of borrowers to service and repay debt is going to be tested.

In the housing loan market close to 40 per cent of owner occupied housing loans are interest only and for investment housing loans this number is more than 60 per cent. Equivalent data for business borrowing is not as readily available but interest only property loans remain common, often at LVRs as high as 70 per cent.

Under new APRA limits, banks will now limit the flow of interest-only mortgages to less than 30 per cent of new residential mortgage lending (currently 40 per cent). Within this, banks must place strict internal limits on the volumes of interest-only lending at LVRs more than 80 per cent and “ensure there is strong

Imposing restrictions on new interest only loans is one thing but what many are overlooking is ***what happens when existing interest only loans mature?*** According to Research by Digital Finance Analytics, around 83 per cent of existing personal interest only borrowers expect to roll their loan to another interest only term and to keep doing so. They are in for a rude shock! When interest only loans mature many borrowers are going to be hit with a double whammy of the introduction of principal repayments plus higher interest rates. This will be even more pronounced for investment home loans. Further, there will be other borrowers who will find their bank will simply seek repayment in full. This is as relevant to business as it is to consumer borrowers.

LACK OF POLITICAL LEADERSHIP.

We are being assured by the Government that it has things under control. “All of the warnings that the Reserve Bank and APRA have made about rising levels of debt are well made,” said the PM last week. “That’s their job, the system is working. They’re making changes and adjustments to the prudential rules that will take some of the heat out of the market, just at the right time” he said. But what is the Government doing?

Polls suggest the public’s confidence in the Government’s ability to manage the economy is waning but the Opposition’s credentials appear to be no better and meanwhile, the Senate crossbenchers continue to compromise the policies the Government took to the election. Our deficit is $36 billion and Commonwealth spending is currently set to remain at above 25% of GDP over the next four years. We have both a spending and a revenue problem. We need to tackle both, with targeted spending restraint on the one hand and comprehensive tax

The Treasurer's recent dismissal of changes to negative gearing combined with his nonsensical proposition that younger people should be allowed to access their superannuation to enable them to buy a home reflects a disturbing lack of economic and political nouse. The Turnbull Government looks destined to lose the next federal election provided the opposition does not implode in the meantime.

HOW ARE THE BANKS RESPONDING?

The banks are faced with a difficult balancing act. They have had to raise substantial volumes of capital and further raisings seem inevitable. Meanwhile, shareholders dividend expectations and the market's relentless focus on short term earnings remain. Banks continue to reduce staffing numbers whilst spending $ millions trying to convince the community that they really do believe in the primacy of the customer.

Anna Bligh, the recently appointed CEO of the Australian Bankers Association, pulled no punches when she said "the public has lost confidence that the banks have got the balance between shareholders and customers right." And she astutely observed "the thing that will ultimately shift the dial on this is real action by the banking industry." Like the boy with the wheelbarrow, Anna Bligh has the job in front of her but at least she openly acknowledges that it is deeds not words that will lead to change.

Banks are making sure their balance sheets remain strong by raising more capital and tightening credit standards.

Borrwowers are finding it's harder and takes longer to get approvals from banks. Credit standards are tighter and loan conditions are more stringent.

rates. They are looking for stronger debt servicing coverage and the term of loans are being more tightly aligned to assured income streams.

In practical terms this means property investment LVRs have tightened (50 per cent is the new 60 per cent) and sub 50 per cent LVRs are not necessarily seen as conservative. Other property lending covenants such as Interest Cover and Weighted Average Lease Expiries are tighter and for development deals equity, pre-sales, loan to cost ratios have tightened.

Banks are increasing the price of credit – IF you can get it.
Application fees are higher and banks are asking for mandate fees to prevent the borrowers from shopping around and to ensure they don't do a lot of work for nothing.

Margins have increased particularly with line fees or facility fees which are charged on the approved limit rather than what is actually drawn down.

Banks are becoming more insistent that borrowers lock in some or all of the interest rates making it clear that they are concerned that rising interest rates could create liquidity challenges for the borrower. A cynical view might be that this is another way in which the bank can generate fee income.

These are all symptoms of a sellers market. The first concern of any borrower should be “can we get the funds we need?” Once this question has been answered in the affirmative, factors like price and terms can then be considered. Price is an issue for all borrowers but if you can’t get a bank to lend, price is a non-issue.

Compliance and risk management guide banker behaviour more then ever before.

Banks are very selective about who they lend to. They are looking after their best existing customers but new to bank customers face substantial obstacles not the least being time in switching to another bank.

SIX TIPS TO SAFEGUARD YOUR BORROWING ARRANGEMENTS.

1. **Stay close to your bank** and make sure you know where you stand. Perhaps seek a longer-term commitment, you might pay a bit more for a two or three-year term but it could be worth it.

2. **Don't look to push the boundaries** on bank financing. Ensure your forecasts are based on conservative LVRs and other parameters. If a deal relies on high leverage to be viable, its unlikely to find support. Remember, you need the bank more than the bank needs you.

3. **Create headroom in facilities and covenants.** Pay down debt whenever possible and try to negotiate maximum headroom in your covenants to limit the chances of a breach. This could be worth a lot more than a couple of basis points on a lending margin.

4. **Think about fixing your interest rate.** While there is the prospect that rates could still fall further, in the overall scheme of things rates remain at historic low levels.

necessarily a viable Plan B. If your current bank is not willing to support you, what makes you think a new bank will? Perhaps talk to a non-bank lender who may charge you more but can offer quicker decision making and certainty of funding.

6. P**erform.** If you do what you tell your bank you will do as per your budgets, business plan and the terms and conditions of your loan agreement you should be fine. But if anything changes, don't ignore it, proactively and openly communicate a viable plan to address any issues.

Interested in your comments or feedback.

Wishing all readers a safe and peaceful Easter & Passover.