mikephippsfinance

Be Careful What You Wish For

Thank god for the Australian press and in this case The Australian newspaper specifically. Here I am sitting at my desk after a nice Saturday morning bike ride with a chronic case of writer's block. I have some vague idea that I want to talk about how badly the general public and even our industry professionals misunderstand banks, but I can't seem to find the right introduction. And then, like a sign from heaven there it is……a banking industry article with the following comment "Interest only loans also allow a borrower to access larger loans, which has helped drive property prices higher".

In what universe a specialist banking journo could make such a comment is beyond me albeit the average punter probably believes the content. Think about it, the article is saying that if you are an interest only borrower you can get your hands on more debt. That's simply not true and here's why. Banks have policies for maximum loan terms and they test the capacity of the borrower to perform based on that term. Let's say you take out a 25-year property investment loan and ask for 5 years interest only. That means you need to be able to demonstrate that you can repay the loan over 20 years, being the total term less the interest only period. You with me so far? The basic principal that applies is pretty simple. The longer the interest only period the higher the eventual P and I repayments. In other words, assuming a fixed income to service debt, the longer the interest only period, the less you can borrow because debt servicing commitments become higher. So now, thanks to one careless comment in the national newspaper, a whole host of punters are out there thinking interest only = bigger loans. Not helpful given the national debate over the role of banks.

The banking misinformation challenge came into stark relief this week when I attended a management rights industry forum and a subsequent industry breakfast. The discussion was centred around industry trends, lending guidelines, the treatment of profit and loss for sale standards and the ever-popular valuation and multiple debate. I was astounded by some of the comments at these gatherings relating to bank policy and valuations with a number of apparently widely held views simply being wrong. Where these things come from who knows but one thing is certain. The current commentary in the industry around the finance and valuation process is deeply flawed and we need to have a hard look at how this may be impacting the sale and settlement process. The reality is that every deal is assessed on its merits and every valuation is a unique document. If industry professionals and advisors are looking for a certainty based utopia be careful what you wish for. The beauty of current bank policy and valuation guidelines is that each transaction can be assessed and approached in a somewhat flexible manner. Relationship managers have an opportunity to present each application in a positive light and argue the point with their credit managers. Valuers, while instructed by the banks, have a reasonable degree of flexibility to interpret the market in the context of the specific contract they are reviewing and table a report that best reflects that asset.

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It strikes me that it is this lack of understanding of flexible bank and valuation policies that is causing some of the angst with industry professionals. A deal gets knocked back, a reason, accurate or not, is proffered and the inference is that the reason is bank policy. In all likelihood the decline is specific to the transaction or the borrower and may not be reflective of a broader bank policy at all. The trick is to ensure that parties to a transaction understand why a deal got declined and to be forthright and honest in that communication. Finance brokers, as intermediaries between the buyer and lender, have a particularly important role to play in the communication process and I think it's our responsibility to ensure that all industry professionals have an appreciation of why banks take particular positions.

In our business we present each transaction on its merits. If the deal has a low chance of approval we either decline to take it to a bank or we workshop the opportunity with a trusted banking industry specialist. If specific weaknesses or risks are present we work to mitigate these in a manner that gives the transaction the best prospects of an approval. In instances where we believe an approval is in doubt we advise our clients of the reasons and work with them and their advisors to provide comfort to the lender. Does it always work? No, but having the flexibility to make the argument is key to ensuring that deals with merit get a fair hearing.

It's the same with valuations. I hear industry professionals calling for certainty on treatment of leasebacks, of multiples and P and L standards and the like. Again, be careful. The present situation where a valuer can make an assessment based on the particular business being valued and take into account any peculiarities in the final report makes sense to me. As an example, let's say the banks and valuers decided to have a hard and fast policy for the treatment of leasebacks. One leaseback or 100, same treatment. Termination on 30 days notice, termination on 2 years notice, same treatment. Review to market rent or lease provisions, same treatment. Holiday, permanent, short stay corporate, same treatment. You can see where this is going. We could potentially have a totally unworkable set of specific credit and valuation standards just for leasebacks. Surely better to stick with the flexibility we currently have to assess on the merits of the overall transaction.

I have worked in banking environments where credit policy and valuation methodology had absolute certainty and make no mistake, it's not much fun!

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