THINKTANK
Think Commercial Lending

PARLIAMENT OF AUSTRALIA

SENATE ECONOMICS COMMITTEE ENQUIRY ON

COMPETITION WITHIN THE AUSTRALIAN BANKING SECTOR

SUBMISSION BY THINK TANK COMMERCIAL PROPERTY FINANCE

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1. BACKGROUND & POSITION IN THE BANKING INDUSTRY

Think Tank Property Finance ("Think Tank") is an independent commercial property lender to Australian SME owner-occupiers and investors. Commencing operations in September, 2006 Think Tank has originated and currently manages a portfolio of $150 million comprising 300 first mortgage loans with an average size of $500,000. With a maximum borrowing of $5m, Think Tank loans support the purchase, equity release and refinancing of commercial properties used in retail, industrial, office, child care, strata complexes and accommodation among other common commercial property types.

The Role of Wholesale Funding & Securitisation

Think Tank operates under an Australian Financial Services Licence and makes loans available to SME's through a wholesale warehouse facility of $200m with the senior funding provided by a major Australian bank. Think Tank and associated parties contribute approximately 10% of the subordinated or risk funding of each new loan and currently has in excess of $20m invested in drawn and undrawn facilities within the warehouse funding structure.

The principles of the funding structure involve the utilisation of the warehouse facility in conjunction with the accessing of longer term capital via securitisation. To date, Think Tank has not initiated a securitised transaction which would nominally fall under the banner of a small ticket Commercial Mortgage Backed Security (*"CMBS"*) and can be closely aligned with the fundamental characteristics of Residential Mortgage Backed Security (*"RMBS"*).

One of the major contentions we seek to highlight as part of our submission to the Committee is that the major banks in Australia play an integral part in the fostering of competition and promotion of depth in the market across a range of asset classes including, for the most part, residential and commercial mortgages. The banks, predominantly through their institutional arms, provide essential wholesale funding lines to a broad cross section of secondary lenders, most particularly to a significant proportion of non-bank financial institutions (*"NBFI's"*) such as Think Tank.

Prior to the GFC, a number of international banks were active in the Australian market and provided a wide theatre of wholesale funding alternatives on accessible terms and at efficient pricing. Yet as we stand, many of the international banks have withdrawn from the domestic market leaving very few wholesale funding alternatives outside the Australian majors to provide these facilities. Industry commentators are generally of the view the foreign bank exodus will not substantially reverse in the near to medium term.

The viability of the NBFI's therefore, inherently relies upon banks with significant balance sheets continuing to have the motivation and appetite to make these funding lines available on commercial terms. Equally, it must be highlighted that while the balance sheets of the major banks are essential in this regard, they are not sufficient of their own accord to service the needs of a competitively diversified market. Expanding the funding capacity of the banking sector is only likely be achieved in a meaningful way through mechanisms complementary to bank balance sheet funding, with securitisation presenting as the most recognisable.

Competitive Position & Performance

Think Tank operates in competition with the major and second tier banks, a handful of regional financial institutions and now a very small number of remaining independent operators. Although Think Tank loan products, lending parameters and underlying risk dynamics are consistent with those proffered by the banks, as a specialist commercial lender to SME's, we are able to differentiate our loan structures and services in a number of key ways which provides the market with greater competition and balance.

Think Tank loans and borrowers bear a close resemblance to home loans and the demographic profile of residential borrowers. The average loan size is similar and is generally structured around a 20-25 year principal and interest repayment term. The weighted average Loan to Valuation Ratio (*'LVR'*) on the Think Tank portfolio is sound at 65.8% while the incidence of payment arrears has tracked consistently below the industry average and losses have been negligible at less than 0.03%. In its four years of operation, the loan portfolio has performed comparably to a bank prime residential loan portfolio.

Impact of the GFC on SME Commercial Lending Competition

As the effects of the Global Financial Crisis began to take hold, from November, 2007 our competitors increasingly began to retract from the market, some suspending new lending with a view to returning to the market later, some amalgamated with other institutions, and yet many others failed entirely for a variety of reasons that can be associated with tightened credit conditions, an absence of capital markets liquidity and also, poor lending practices.

The competitive landscape in commercial lending to the Australian SME sector has therefore been dramatically altered by the changes seen over the last three years. At the time of commencing business in

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mid-2006, Think Tank had well in excess of two dozen direct competitors between the major banks, second tier banks, regionals, mortgage trusts and several independent operators structured in the same way as ourselves. In addition, there was a selection of private lenders catering for an extended range of property finance needs in the market.

Think Tank Continues to Lend Through GFC

Right throughout the period of the most severe capital constraints produced by the GFC, Think Tank continued to lend although under a reduced capacity of around $3m per month. The cap on new lending was primarily a result of the impact of the severe constriction in capital availability affecting the entire industry. At certain points during this period, the board of the company considered the ability to continue lending and hence the survival of the business to be under serious threat. However, with the continuing positive yet measured support of our funders and our shareholders, we committed to a strategy of adapting the business to the conditions in order to survive the worst of the financial market disruption with the aim of emerging a stronger organisation when conditions began to improve.

Constraints on Independent Lending in 2010 & Beyond

By early 2010, Think Tank was eventually able to re-embark on a path of growth in new lending having attracted additional risk funding requested by our senior funder. For Think Tank, this has involved more than doubling the original risk funding requirement from $10m to in excess of $20m, or around 4% of the loans under management increasing to over 8%. This in turn has affected borrowers as the cost of the risk or subordinated funding is substantially greater than the bank provided senior funding. Combined with the increased cost of funds globally, it has meant that Think Tank's weighted average cost of funds on the margin it pays above the bank bill swap rate more than doubled and this has inevitably fed through to the real cost of SME borrowings. The cost of funds may well recede over time however, the medium term expectation is for the basic cost of funds to remain somewhat elevated above levels recorded prior to late-2007.

Further, although Think Tank's funding infrastructure is highly scalable and was originally conceived on the basis of increasing the loans under management to multiples of its current warehouse limit by accessing securitisation markets, at present, the capacity for Think Tank and all other non-bank lenders, is directly constrained by two over-riding and related factors touched upon above.

Firstly, the banks as the senior funders are providing the majority of these wholesale facilities on a 364 day revolving basis and are relying on securitisation, or an alternate off balance sheet longer term funding option, to periodically refinance the drawn balance. Whilst the ongoing securitisation of Australian mortgage pools remains selective, uncertain and effectively inaccessible to many issuers, the banks are questioning the merits of continuing to fund warehouses that were designed to supply securitisation transactions and importantly, refinance the bank's exposure in the process. Should the major banks lose their appetite for these warehouses due to the prolonged disruption to the business model and cease to renew them going forward, it will be highly detrimental, if not fatal to the majority of non-bank lending competition. With no comparable wholesale lending alternatives available at present, Think Tank would be forced to wind its portfolio of loans down and the business would likely cease. There is little doubt other NBFI lenders would be faced with much the same predicament.

Secondly, the ability of non-bank lenders to expand their market presence, thus providing greater competition and options for borrowers, is substantially held back by the absence of a properly functioning securitisation market. From the early 1990's through to 2007, securitisation was a primary driver of competition, product innovation and the lowering of borrowing costs for home loans, equipment and vehicle finance and commercial loans. Facilitating the return of cost effective securitisation for a range of assets broader than just prime RMBS and to the width of potential issuers will have an immediate positive, and indeed a lasting, impact on the Australian banking sector and those businesses directly affiliated with it.

2. THE CURRENT LEVEL OF COMPETITION BETWEEN BANK & NON-BANK PROVIDERS

Indisputably, competition in all of the various segments of mortgage and asset lending in Australia has been devastated as a result of the GFC. Furthermore, the change in the operating environment for banks, and in capital markets more generally, has made it extremely difficult for non-bank providers to regain anywhere near the traction they once had. While institutional investors with mandates to invest in capital markets issuance arranged by Australian banks and non-banks remain only partially engaged and the domestic banks must continue to operate within the confines of existing streams of funding and with an un-changed approach to capital management, the present competitive environment in Australia will not be empowered to move forward in any meaningful way.

The nature of the present level of functioning in capital markets is such that only those with sufficiently strong and highly rated balance sheets can operate at anywhere near normal levels and many of the non-bank providers are reliant upon those stronger institutions rationing capital down to them. This focal point of capital reliance places the majority of NBFI's in little more than suspension mode and only able to originate within the limits afforded them by the banks and the individual bank's capital capacity.

Prior to the onset of the GFC, mortgage trusts provided a significant channel of funding, particularly into the commercial property and construction sector. The model however, remains under a sustainability cloud whilst bank deposits continue to offer attractive rates while also being under the protection of a federal government guarantee. To compete, the mortgage trusts are forced to offer their investors an even higher rate than the banks but must then also on-lend it at rates some percentage points higher again which propels them further out along the risk spectrum and further away from offering any real competition in the bank space. Notwithstanding an easing in the bank deposit rates and the eventual removal of the bank guarantee, mortgage trusts will still have to grapple with the issue of matching relatively short dated deposits with longer dated, comparatively illiquid mortgage loans, an arrangement which fundamentally contributed to the widespread freezing of funds over the past three years.

The more sophisticated mortgage trusts were able to work in combination with bank balance sheet funding and securitisation markets. By taking advantage of the benefits of scale and an efficient funding mix, they offered genuine competition to the banks in the prime space and broader product choice to borrowers. The effective cessation of two of the three streams of funding has seen these operators cease with some confirming they will not be returning to the market. The competitive environment has been further eroded by the withdrawal of overseas lenders at both the wholesale and retail level. Once a major contributor to competition, the domestic market for commercial lending in particular has felt the impact of the withdrawal acutely.

All of these factors have fed into a situation whereby the lending market now suffers from a significant overhang of loans tied up in a large number of entities and funding vehicles that are being wound down or put up for sale. With no new or increased competition to absorb the rate of forced run off, this means many borrowers are caught with lenders, often on higher rates, who are encouraging them to refinance or sell but have very few options with which to manage that result. This is exacerbated by a softer commercial property market whereby borrowers may have obtained a loan when their property was valued somewhat higher and with current valuations coming in lower, they are unable to meet current, more risk averse lending standards.

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3. THE LIKELY DRIVERS OF FUTURE CHANGE & INNOVATION IN THE BANKING & NON-BANKING SECTORS

We are of the belief that nothing breeds innovation and change in an industry better than competition. Where this is little or no competition, there is little or no motivation to commit to, or invest in, change.

What the industry needs in the first instance however, is the restoration of the foundations of competition and we should not be distracted by an overt need for greater innovation ahead of restoring a constructive equilibrium between those providing credit and those who seek credit. At present, we have less credit available than the market requires to sustain itself in servicing the needs of borrowers, and this is before looking ahead to the financing of economic growth over the next ten and twenty years.

It is the therefore the contention of Think Tank as the central part of this submission that change and innovation in the banking and non-banking sectors will naturally evolve from the stimulation of competition and in this regard, we put forward the following points and areas of potential action which we believe will contribute to the fostering of greater competition through the facilitation of improved access to wholesale funding across the industry:

1. The major banks should be encouraged, if not incentivised, to continue to support non-bank lenders in terms of:
   a) Greater certainty over the availability and renewal of existing wholesale warehouses
   b) Extending facility terms to greater than 364 days
   c) Increasing existing limits where performance has been sound & NBFI risk capital is committed

2. The efforts in support of the re-emergence of the securitisation industry should be broadened from the focus on RMBS to equally incorporate the other primary asset classes that service and support the SME sector to include small ticket commercial mortgages and asset backed securities;

3. The AOFM mandate be extended to:
   a) Include small ticket commercial mortgage backed securities
   b) Invest in tranches at investment grade ('BBB') and above

4. Alternate funding sources to the industry be promoted, including the superannuation sector being encouraged to diversify investment mandates into banks and more specifically into mortgage debt, which may involve tax incentives to retail and/or wholesale investors;

5. The assessment on the introduction of covered bonds in Australia be made swiftly one way or the other to allow the energies of the market to move on; and

6. The Government and industry work collaboratively with ratings agencies as the market adapts to a tighter ratings environment and the implications that has for the practical re-alignment of expectations between investors, agencies and issuers.

In advocating these measures, we must strongly emphasise that any steps to enhance the cultivation of greater competition should in themselves be appropriately measured in their implementation. Improved access to funding should be directed to those that can be relied upon to deploy it with proper intent and with due compliance to standards above the minimum. Increased funding channelled into the hands of sub-standard originators and servicers will inevitably be detrimental to the industry as has been shown time and again under the light of past experience.

The NBFI originators and servicers that have proven themselves through the GFC and who are able to commit the necessary ongoing risk capital, or "skin in the game", should be supported. We are not in any way advocating that new entrants should be discouraged however, they should be obliged to comply with the same or greater standards as those that have proven track records and who have managed to contend with the harshest elements of the recent credit and economic cycle. The over-riding objective should be to encourage sound lending practices and quality credit growth.

In this regard, wholesale warehouses and securitisation transactions offer extremely high standards of compliance and a level of detail in monthly reporting which provides excellent transparency to senior and junior funders, investors, ratings agencies and regulators. It is to these standards that beneficiaries of greater access to funding should fundamentally be skilled and resourced to adhere.

4. REGULATION THAT HAS THE IMPACT OF RESTRICTING OR HINDERING COMPETITION

Disparity in APRA Capital Treatment of Small Ticket Commercial Mortgages

The way in which APRA currently elects to assess capital adequacy requirements in relation to small ticket commercial mortgage lending is, in the view of many, causing an un-necessary distortion between the risk attached to the underlying loans and the capacity of the senior bank funder to allocate and price its associated commitment of capital.

We are advised at present, APRA requires the bank to place small ticket commercial mortgages within the category of "specialised finance" for capital adequacy purposes. This puts it in the same basket as other forms of considerably riskier lending which bear no correlation with the risk profile of small ticket commercial loans which have similar characteristics to, and a track record of performance with, prime home loans.

This situation, which APRA moved to some twelve months ago, is forcing the bank to allocate a much higher proportion of capital against the wholesale facility and price its lending margin accordingly. This is in turn being passed on to SME borrowers and is un-necessarily making the cost of SME borrowing higher than it need be should the capital requirement be more closely aligned with the risk of the credit actually being provided.

We submit that the current methodology be reviewed and a reversion to the prior capital treatment, or transition to a more appropriately aligned capital measure, be pursued immediately by the Committee in consultation with APRA and the major banks.

Capital Treatment of Longer Dated Wholesale Facilities

We further submit, in reference to our comments in 3.1(b) above, that capital relief be considered for the banks where wholesale facilities are provided for terms greater than 364 days.

NBFI's are inherently constrained by the uncertainty attached to wholesale lines of credit being subject to review and extension on an annual basis. This affects their ability to commit to their business model, it requires their auditors to include "going concern" limitations in audited accounts, it inhibits the raising of equity to maintain or expand operations and it causes all stakeholders associated with the NBFI, including the senior funder, to adopt a very short term and qualified view of their undertakings.

Should capital relief be extended to the banks and allow wholesale facilities to be committed for terms of 2-4 years it would have be enormously beneficial in terms of removing a great deal of the uncertainty that inhibits much needed longer term commitment by all parties within the sector. With the removal of uncertainty comes a lower cost of doing business which makes the provision of credit to SME's more efficient.

We suggest that this would need only be a temporary measure until capital markets return to greater levels of activity, reliability and efficiency. Thereafter, the unwinding process would be relatively seamless by virtue of the improved ease of refinance into the capital markets thus allowing the dependence on longer term bank capital to diminish and return to current settings.

5. OTHER POLICIES, PRACTICES AND STRATEGIES THAT MAY ENHANCE COMPETITION IN BANKING

Our primary contentions with respect to this section of the Enquiry are contained within 3. above.

6. SUBMISSION CONCLUSION

Think Tank is one of a number of Non-Bank Financial Institutions that services the SME sector and contributes to the competitive tension in the provision of finance to that sector. Currently, our business and that of many other NBFI's, is entirely dependent on the major banks to maintain their wholesale lending platforms while the banks themselves are constrained by their access to sufficient sources of viable funding and regulatory compliance measures associated with their management of capital. In the absence of efficiently functioning capital markets, the greater balance of competition inhabiting the market beyond the first and second tier banks is reliant on an uncertain and distorted relationship.

Broadening the base of competition within the banking sector has been achieved successfully in the past and it is only by virtue of circumstances having origins predominantly outside of this country that has led to the situation over the last three years that has seen an historic reduction in competition. The foundations of greater competition however, currently exist and the opportunity and the will to meaningfully foster that competition also exists. Australia has the advantage of stable institutions, globally acknowledged prudential practices, established infrastructure and an industry of financial services providers with all of the requisite skills and resources to restore the desired breadth and depth in competition. Reliable, sustainable and seamless access to efficient wholesale funding in scale and without overt bias to one part of the sector or another is ultimately the key.

We recognise that achieving such a goal is likely to take time and involve a series of iterative and appropriately considered steps. Our contentions contained in this submission are based on that understanding and seek to focus on those areas presenting with the most significant signs of vulnerability but also the greatest opportunity to effect positive change.

We submit that, in the near term, the major banks be given every means of encouragement in providing ongoing and increased support to non-bank lenders with the objective of reducing uncertainty and increasing the lending capacity for those lenders. Causally related to the banks provision of wholesale facilities, we further submit that efforts to stimulate the securitisation industry be broadened to include those other asset classes vital to the SME sector and the AOFM program be extended to assist those other asset classes from an investment grade rating level upwards. We additionally support initiatives to expand the range of funding options available to the bank and non-bank sector, most particularly when considering the potential for greater constructive interplay with the superannuation industry.

For Think Tank and other Non-Bank Financial Institutions to contribute to a greater and compelling competitive dynamic within the bank and non-bank sector, efforts must first be directed at motivating the major banks to continue supporting the provision and expansion of wholesale facilities. Ultimately

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however, material and sustained competitive change will primarily stem from what can be achieved in capital markets in terms of securitisation across all of the relevant asset classes and in driving generational change in the sources of funding available to the broader sector.

We would like to thank the Committee for the opportunity to comment on the matters under consideration within this forum.

Signed by author & authorising officer:

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