

**APRIL 2008 NEWSLETTER**

Hi John,

**Abnormal was then - Normal is now**

The shenanigans in the international finance markets continue.

Inflation continues to be a worry for the central banks, which are torn between holding interest rates up to fight inflation and reducing them to combat the debilitating effects of the credit crisis.

And opinions as to how deep the credit crisis is, and how long it will last, continue to vary wildly. According to Lehman Brothers chief financial officer, recovery for the securities industry may take until next year; whereas Goldman Sachs chief executive reckons "we're closer to the end than the beginning" of the crisis.

The good news is the feeling that the U.S. Fed will do whatever is necessary to avoid a global meltdown in the financial markets. The Bear Sterns rescue was a real turning point as they showed their arsenal was not limited to raising or lowering interest rates. For a very good reaction to this from U.S. commentator John Maudlin, [click here](#)

The question remains as to how much the problems in the U.S. will have an effect on other economies including New Zealand. It's interesting to read a recent article in the Economist on this "decoupling" debate, especially in view of our recent free trade agreement with China. [click here](#)

But whatever the outcome of the U.S. economy, in New Zealand we're facing the same inflation problem. It continues to rise and annual inflation is now well above the 3% guideline for the New Zealand Reserve Bank. So the Bank is unlikely to drop interest rates.

And while the New Zealand economy continues to be sound - on the back of the worldwide agriculture and commodities boom - we've not been isolated from the credit crunch.

Last week Reserve Bank Governor Alan Bollard told the Marlborough Chamber of Commerce "The New Zealand economy remains fundamentally sound and credit worthy". He told the conference the significant financial market disruption in the Northern Hemisphere is having only a limited effect on the economies of New Zealand's trading partners with the exception of the U.S.

But the disruption has seen funding costs rise and credit conditions tighten in New Zealand and Australia. "Banks, businesses and households alike need to recognise the new external environment and adopt a cautious approach - but don't go into hibernation, the underlying economy remains robust," he said.

He noted that while there has been a lot of pessimistic commentary in the media, the Bank saw the current situation as a cyclical adjustment. "Because we have been so strong so long, some people have forgotten what a slower economy means," he said. (Normal is now). To see the entire news release [click here](#)

High interest rates are hurting business and consumers alike and anecdotally at least we're seeing the signs of a slowing economy. Tell me you don't get a fright when you fill the car or go to the supermarket!

The fact is growth in the western world in recent years has been consumer driven – largely on the back of the equity available from increasing house prices. No longer is that happening. House prices in the U.S.

have been dropping and whatever the price statistics coming from REINZ, house sales are down here. March saw sales halve on the previous March – but that was largely properties under \$400,000. In fact the median sale price was up on the February figure. Demand for quality homes at the high end of the price range continues.

Of course for owner occupiers buying and selling their house on the same market there's little difference. But for investors needing to realise an asset because they cannot service the debt in this environment, it's a different story as their equity gets eaten away.

So what's all this mean for the property finance markets here?

Last week we invited many of the local people we deal with in banks, finance companies and other non-bank lenders that are active in the market, to a drinks and barbecue function at our Parnell office.

It was a social event but inevitably bits of the conversation drifted to the financial markets – and finance for property in particular.

I don't think there was any disagreement that cheap money and easy credit had led the global "credit crunch".

So it was interesting to hear their views of whether these practices had crept into New Zealand, how they were affecting the availability of money and credit here, and their current lending criteria. This confirmed the view I've expressed in previous newsletters that we've been in an abnormal position in the past and it's more normal now

- Most of us have seen it all before and the cost of funds now is more like normal. (At the other end of the abnormality scale, floating residential mortgage rates reached over 20% in 1987, and about 15% in 1991.)
- The ease of obtaining loans over the last five or so years has been abnormal and loan criteria have tightened (back to normal).
- It has been in the residential loan market that credit criteria have been the most lax - fortunately not as lax as it seems it was in the U.S. Most non-bank lenders here have increased the requirements for lo-doc and highly leveraged loans (back to normal) and some have suspended lending completely.
- For short term commercial loans there has to be a clearly defined and achievable way for the loan to be repaid – the exit strategy. This has put the pressure on developers.
- Far more emphasis is placed on how the debt on the loan will be serviced.
- There's a lot of miss-information out there about who's lending and who's not - and the criteria different lenders take into account when assessing loans.

The reality is, there are commercial (and residential) lenders out there - and new ones to boot.

Let's look at the commercial loan market in two groups.

The first is the prime lenders. And this includes lenders other than just banks. They do lend larger amounts and have similar credit criteria to banks including loan to valuation ratios and interest cover. They charge similar interest rates and fees as the banks – especially now that the banks' cost of funds has risen as a result of the credit crunch. For example funds from offshore are more expensive and banks such as the ANZ and BNZ have raised money onshore through the issue of perpetual bonds where investors are being paid rates around 10%.

Some prime lenders have been trying to take advantage of the current shortage of funds to charge higher interest rates and fees, but we can see that changing as competition for quality loans increases. After all they have to make loans to make money. And if they don't, they still have to pay interest to "depositors" - in whatever form that may be.

The big advantage non-bank lenders have over banks is they are more likely to lend on stand alone security. We've always recommended borrowers isolate loans to separate securities to avoid the cross collateralisation banks tend to demand. The last thing you need is one difficult loan to adversely affect your other performing assets or your house.

The second group is the "second tier" lenders. Those with dodgy loans are in receivership or out of the market, but there are many who are far from being in trouble. Some are currently selective in their lending as they look to re-balance their loan portfolio by restricting loans on property versus other assets, or are not lending on property in geographical areas where they feel they already have enough exposure.

Finance companies funded by issuing first debenture securities are having trouble raising money – and who would wonder after the string of collapses like Bridgecorp. But many do not rely on debentures as a source of funds, or for whatever reason are receiving good reinvestment ratios. Then there are those that are truly equity funded by their own shareholders or sell down to a group of long standing investors.

So there are new and existing second tier lenders out there who have money and are competitive. The only restriction some have is the size of the loan they will consider.

We're also finally seeing a sensible approach from lenders who do have a troubled loan. Instead of taking a sledgehammer view they are looking at how they can negotiate a deal with the borrower that will lead to a win win approach. This includes agreeing to such things as allowing a slip in priority for another lender to provide a first mortgage for a sensible amount that will allow a development to be completed, or sold down.

After all an incomplete development is worth nothing and while everyone is arguing, interest accrues. This adversely affects balance sheets and makes it even more difficult to fully recover the loan. We expect to see more of this as financiers realise the difficulty of selling down a distressed asset in this market.

Which brings me back to the subject line of this newsletter. For those waiting in the sideline for bargains to come out of the property sector it's likely they're going to be disappointed. If it hadn't been for the abnormal lending conditions at the time many would never have got off the ground in the first place.

Cheers

JP



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