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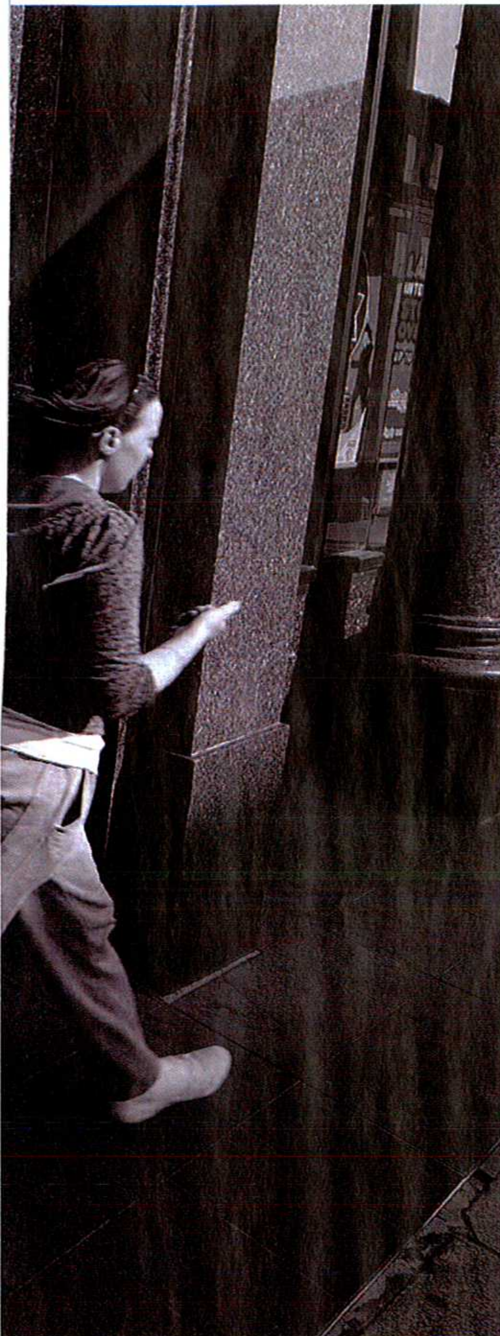
AFTER THE FALL

With Lehman Bros' collapse and both HBOS and Merrill Lynch falling to takeovers because of their exposure to the ailing real estate market, last week was a turbulent time for property lenders. At last Wednesday's Association of Property Bankers' conference, the banking crisis took centre stage as a developer, a financial risk consultant, an accountant and an agent tried to make sense of what has happened and to look ahead



The developer's view
Paul White, managing director, Frogmore Property

Banking and finance in the UK is a fundamentally good industry, with many good and experienced people working in it. So how come these good people have got into this mess? Why did we forget the lessons from history and seemingly lose sight of the fundamentals of sensible real estate lending?

Commercial real estate financing, in most cases, should be one of the simplest and dullest forms of lending there is, backed as it is by bricks and mortar with underlying residual land values and without the variable factors that other forms of corporate finance possess. It's not rocket science!

However, over recent years we have seen pure financial investors – with little experience or understanding of property – buying assets purely based upon cash flow and the expectation of yield compression. Banks have welcomed these new entrants. Debt was made easily available at ever higher leverage to what were often thinly capitalised entities. Never has so much been lent to so many with so little experience and so little to lose.

A big part in what has happened in the commercial market has been the rise in activity of the investment banks and the securitisation market. Until fairly recently, balance sheet lenders have dominated the real estate finance market, lending at sensible loan-to-value ratios and with pricing that was stable and sustainable.

This changed when the securitisation lenders started to operate. The focus shifted from property to pure cash flow, and as more banks entered the market it seems to me that it became a case of quantum over quality – banks endlessly chasing new lending to make more and more profit and grow bigger than the competition. In turn, individuals within the banks have been rewarded for their success in meeting short-term targets, regardless of how the loans might perform in the longer term.

Alongside this we have had the "rocket scientists" in the banks, building complex funding structures which were just fancy ways of disguising the real risk. Traditional credit risk teams/underwriters became the dinosaurs of the banking industry – largely peripheral figures, laughed at as out of touch with the modern world.

It could be said that this has a lot to do with the banks' and individuals' egos, making what should fundamentally be simple loans into "sexy" investment opportunities to be sliced and diced, given AAA ratings and sold to investors who perhaps had been blinded by the science and by ultra-smooth salesmen.

My view is that the people selling these bonds were not 100% certain as to what they were selling, and investors most definitely didn't always understand what they were buying. I say, beware well-packaged crap. I say bring back the dinosaurs and good old-fashioned credit analysis – too little attention was paid to what was underlying these fancy financial instruments.

There has also been a trend towards banks taking equity stakes in deals on which they are providing debt. This goes against traditional bank protocols and surely leaves those banks facing a potential conflict of interest as the market deteriorates. What is best for the recovery of the senior debt might not be best for the equity – so who will win?

The banks are in trouble and scared to lend, even if they have the money to do so. Credit risk teams are now running the banks and many individuals face losing their jobs. I think it is a pretty safe bet that we will soon start to see more forced sales, and I have no doubt that over time the same banks will finance properties that they previously forced the sale of.

WHITE ON THE DEATH OF RELATIONSHIP BANKING

As for relationship banking, this seems to have lost its attraction for quite a few lenders. While it has to be acknowledged that some new and not-so-new investors have demonstrated a complete lack of respect for the bank/client relationship and simply taken the most aggressive offer available, equally, some banks have taken good, steady and loyal clients for granted.

Even with our strong background and relationships, we have struggled to raise low-leverage debt in this market. For example, we have a 50/50 joint venture on prime property with another leading developer. This was financed earlier this year with a 65% loan. No one bank was able to provide this debt on its own – we had to put two lenders together!

We are seeing increased fees and margins for low loan-to-value transactions. I wonder whether these increased fees and margins are overdone. Are the conservative borrowers being exploited and good relationships forgotten? It feels like we are now paying the price for the banks' mistakes. In addition, credit teams and lawyers are now running the show, and draw-downs have become protracted and painful affairs, with abrupt changes in terms at the 11th hour. Are lenders unable to tell the good from the bad any more?

In recent years, a facility letter from a bank has probably been 100 pages long as opposed to the five pages when I was a lad. I wonder if all the extra pages have ever really prevented anyone from losing money.