



mortgage trusts - what is the future?

corporation : PROPERTY & BUSINESS FINANCE

Background

The decision of the mortgage funds management industry to freeze redemptions in mortgage trusts will have far reaching consequences for fund investors, borrowers and the wider commercial property market generally.

The mainstream commercial mortgage trust sector has approximately \$20bn of funds under management mainly from retail "mum and dad" style investors. These funds are advanced on commercial mortgage loans which are secured against commercial properties throughout Australia. The loans are secured over office, retail and industrial properties with a maximum loan to value ratio (LVR) of generally less than 70%. As these loans have been written over many years the average LVR of these portfolios is considerably lower than 70%.

The borrowers are typically commercial property investors and business owners with significant net worth who provide personal and company guarantees in addition to 1st mortgage security.

In summary the portfolios managed by the mainstream mortgage trusts are 'vanilla' loans to long term and proven borrowers secured over income producing commercial property.

The Australian Government's decision to guarantee bank deposits has had a number of unforeseen consequences. One of these was the flight of cash investments from the mortgage funds (not guaranteed) to the banks (guaranteed). This flood of outflows from their respective mortgage funds caused the funds managers, who typically managed the fund with 10-20% liquidity, to freeze redemptions to preserve some degree of liquidity as the underlying investments in the trusts (commercial mortgages) are not immediately liquid.

At the present time the major trusts have stopped all further lending to further preserve liquidity and are offering quarterly redemptions to investors depending on the excess cash generated from mortgage repayments. This, however, is only a short term situation. The industry is being forced to reconsider its long term future.

There is an added complexity in that most commercial mortgage loans are for a term of 3-5 years. On expiry a significant number of these loans (probably in excess of 80%) will be renewed ('rolled over') with the same lender. The loans are only ever fully repaid when the property is sold or the borrower seeks to refinance with another lender for some reason. Roll-overs are part of the standard commercial lending practice for all lenders including banks and mortgage trusts and seasoned loans to proven borrowers are considered valuable assets by commercial property lenders.

With mortgage trusts potentially unwilling to roll-over loans in the current environment (to enable investor redemptions to be paid) borrowers are being forced to refinance with new lenders or, more disastrously, sell the properties. In the current credit strained environment the ability of even AA rated companies to raise finance is under question so the ability of over 10,000 commercial mortgage fund borrowers to refinance is in considerable doubt. If the mortgage funds elect to take a hard-line approach with borrowers unable to refinance the consequences to a property market flooded with forced sales will be significant. The funds themselves will consequentially also suffer as LVR's soar, credit quality becomes impaired and investor capital is threatened.

Option 1: Do Nothing

In this scenario the mortgage trusts continue their respective redemption freezes and repay investors as and when mortgages are repaid. In the event the mortgage funds come back into favour they will recommence lending and continue business as usual and if conditions do not improve, the funds will simply fade away and die.

The problems with this scenario are manifold but the following points are particularly pertinent;

- The investors in the funds have no certainty of returns either 'on' or 'of' their investment. Their investments are 'locked up' and unable to be redeemed other than in a protracted fashion over the 3-5 years it will take to have all of the mortgages repaid;
- If forced mortgage repayment is undertaken without due regard to the consequences to the property market then property asset values will be disaffected potentially to the further detriment of the funds with a significantly increased likelihood of capital losses to the fund investors;
- The balancing act of forcing borrower repayments whilst maintaining a balanced fund is almost impossible. 'Richer' borrowers, by default, will be able to repay most easily hence the 'poorer' ones will be left resulting in a portfolio of considerably weakened credit quality unsupported by 'quality' loans;
- The likelihood of the funds re-opening without a flood of redemptions is questionable therefore the chances of these funds ever being able to re-open must be considered low.
- In consequence funds managers collectively lose the entirety of their funds management fee income which is currently guess-timated assuming an average management fee of 1.25% on \$20 billion of funds at in the order of \$250m per annum; and,
- As the funds reduce in size the fund managers will be unable to provide their management services without running at significant losses hence loan servicing and administration becomes threatened.

Option 2: Do Something

This is a more complex alternative but one that should be designed to:

- deliver earlier returns of capital to investors;
- maintain some value for the funds managers; and
- enable sensible treatment of borrowers to help insulate the property market and the credit quality of the underlying assets.

There are a number of alternatives all of which would need the support of the investors, their advisors and the funds managers, but here are three that we believe are possible.

SuperFund Scenario

Despite the uncertain times Australia's superannuation guarantee levy is still driving massive liquidity to the nation's superannuation funds. With volatility on world financial markets and havoc in the equities markets it is not unreasonable to assume that these funds are looking for secure, reliable and quality yielding investments.

Under our super scenario the wholesale superannuation sector (SuperFunds) replace retail investors as the natural investors in mortgage trusts. There are a range of reasons as to why this would make sense, including:

- SuperFunds are long term investors and are more able to cope with long term assets (less liquid such as commercial mortgage assets). This obviates the primary flaw of mortgage funds ... borrow short and lend long;
- SuperFunds, as wholesale investors, would no longer require the funds to carry liquidity as they would invest 'at call' thereby enhancing the yield of the fund;
- The cost of administering a wholesale mortgage fund is significantly lower as distribution (fund raising) costs disappear;

Under our super scenario the superannuation sector acquires the units of investors in mortgage trusts or acquires the underlying mortgage assets of the trusts from the managers. This would allow the manager to repay investors and wind down these retail trusts.

From an investors point of view they would receive their funds back quickly but would no longer be invested in the commercial mortgage sector. The commercial property borrowers could continue on with their loans in the knowledge that their lender was a long term investor and the manager would then be in a position to manage these investments on behalf of wholesale investors subject to agreement on a suitable MER.

Clearly it is a big call for the superannuation sector to bail out retail mortgage trusts but a scenario where these investors enter the commercial mortgage sector in some form gains credence each day.

Public Listing Scenario

Mortgage trusts have long been an Australian only phenomenon. Structurally they are questionable as they mismatch short term funds (investors' cash) with long term illiquid assets (commercial loans secured by commercial property). The inadequacy of this structure can be seen clearly right now.

In other parts of the world this issue has been resolved through listing mortgage trusts on public markets. In the US this structure is known as Mortgage REIT's (Mortgage Real Estate Investment Trusts) which are listed vehicles that have similar properties to our listed property trust sector except that the underlying assets are loans over commercial property rather than the commercial properties themselves.

In our listing scenario the mortgage trusts units become shares in a new public company which are 'trade-able' in a secondary market. The fund manager must now account to its investors as a normal public company with regular revaluations to establish NTA and distributions become dividends. Consequentially accountability of the manager is increased and unit-holders (now also shareholders) have a real say in the future direction of the company.

From an investors point of view a listing scenario would give them access to a secondary market to redeem their investments. Whilst this may be a significant discount to NTA (or premium in better times) it will enable investors to make their own decisions as to when to buy and sell into an unrestricted market place.

It would allow commercial borrowers to continue to borrow in confidence from an industry that is not threatened to be shut down as it is funded by 'permanent' equity not capable of being withdrawn.

Again the mortgage fund manager is left out in the cold unless some shares in the new company are retained by the previous fund managers.

Mortgage Bank Scenario

It has been suggested by the government that mortgage trusts seek APRA assistance to become banks. This notion has been dismissed in the press by trust managers as they state the requisite capital to become a bank is not available in today's market. The Mortgage Bank scenario however seems to have been overlooked.

Under this scenario both of the mortgage fund investors and the mortgage fund managers become founding shareholders in a new Australian Registered Bank (Mortgage Bank) on an agreed apportionment of shareholdings. The Mortgage Bank would have similar characteristics to the Public Listing Scenario (permanent but trade-able capital, elevated compliance, cost savings, etc) and would continue to lend money into the commercial mortgage sector.

We have considered a model where the Mortgage Bank would raise conservative debt (say 45% of gross assets) with the balance of its funding requirements provided from government guaranteed deposits (being a conversion of investor units to term deposits matching the profile of the underlying mortgage assets), equity from unit-holders (being a conversion of the balance of investor units) and equity from mortgage trust managers (being the surrendering of their substantial management fee income to the Mortgage Bank).

The Mortgage Bank would have to pass regulatory muster by proving up its capital, credit, servicing, reporting and administration capacity but this should not prove insurmountable as these skills are already part of, or provided to, the industry.

We have considered detailed scenarios for the Mortgage Bank and the value shifts that must occur but they are all typified by the following characteristics:

- A significant return of capital to investors from day one as a result of the conservative gearing applied to the Mortgage Bank;
- The balance of the unit-holders capital is converted to government guaranteed deposits (earning market interest) and shareholding in the Mortgage Bank of significant value;
- The mortgage fund managers receive value for their loss of previous businesses in the form of shares in the Mortgage Bank of significant value;
- Borrowers benefit from permanent capital provision to their lender;
- The need for forced sale of assets is removed; and
- The shareholders earn significant dividends.

The value of the Mortgage Bank will be enhanced significantly over time as lending margins improve, wholesale debt becomes more efficient, economies of scale start to impact and the property and retail debt markets recover.

It is worth remembering that with just four banks lending on commercial property in Australia the price of retail debt will only go up. As a very conservatively geared bank already showing healthy dividend yields the Mortgage Bank is ideally positioned to take advantage of its market.

What next?

The situation facing the mainstream mortgage trust sector is not dissimilar to that faced by the unlisted property trust sector in 1989. Funds like Austwide and Growth Equities Mutual had thousands of retail investors and suffered a flood of redemption requests (as a result of the property collapse in 1990) which funds could not meet in a timely fashion. Redemptions were frozen and the funds, that were essentially sound, well run and possessed of good quality assets, eventually listed with the support of the unit holders.

The mortgage fund industry of today does not need to look far back into history to see its own solution. Speaking with a single voice, a single programme and acting decisively would greatly benefit its cause. As always such initiatives need to be driven by a motivated, well-informed cadre of like-minded individuals prepared to enduringly canvass, cajole and convince regulators and stakeholders of the urgency of this situation and the solutions that may exist. The industry has to go on to war-footing and should not solely rely on IFSA and the Mortgage Finance Association of Australia to do its bidding.

Conclusion

The scenarios suggested here are certainly not definitive. However at whatever outcome is arrived the industry needs to remember the funds managers only serve two stakeholders, those who invest and those which borrow. At the end of the day it is the very structure of the mortgage trusts that, after many years of heady returns for the funds managers, is causing the problems today.



Michael Holm
Executive Chairman, Balmain NB Corporation Limited

Level 14, 60 Castlereagh Street, Sydney, NSW, 2000, Australia
GPO Box 3570, Sydney, NSW, 2001
Tel +61 2 9232 8888 Fax +61 2 9232 8588

Michael Holm is the founder and Executive Chairman of Balmain Corporation Limited which is Australia's largest non-bank commercial mortgage originator. He is a Director of AMAL Asset Management Limited, Australia's largest administrator of commercial mortgage assets for the non-bank sector and he is also Chairman of Mirvac Aqua Funds Management Limited a mortgage trust with \$250m of investor funds under management which has currently frozen redemptions.

© Michael Holm 2008

This work is copyright. You may download, display, print and reproduce this material in unaltered form only for your personal, non-commercial use or use within your family or organisation. Apart from any use as permitted under the Copyright Act 1968 (for example, "fair dealing" for the purposes of reporting news under section 103B of the Copyright Act), all other rights are reserved. Requests for further authorisation should be directed to Michael Holm 02 9232 8888