URBANISED

Level 14, 77 King St
SYDNEY NSW 2000

5 February 2020

Mr Dominic Lambrinos
Chief Executive
Chifley Securities Pty Ltd
1 Bligh St,
SYDNEY NSW 2000

Dear Mr Lambrinos

Urbanised Pty Ltd is an advisory firm specialising in economics and public policy. It has undertaken numerous research reports on the Non-Bank Lending Sector (NBLS) in Australia. Chifley Securities has requested that Urbanised provide an overview of the potential growth in this sector of the Australian financial market. At the outset, the purpose of this letter is to provide forecasts. These forecasts are influenced by many variables. While due care is taken in preparing the information provided, Urbanised Pty Ltd takes no responsibility for financial decisions based on this information. The recipient needs to undertake its own due diligence prior to making a financial decision based on the information provided.

The NBLS in Australia has experienced significant growth in market share over recent years.

The global financial crisis in 2009 forced non-banks to exit the Australian market which led to the institutional banks (Approved Deposit Taking Institutions – ADI's) absorbing that market share and significantly growing their property loan books. By the end of the GFC, the non-banks share of the property lending market was negligible.

Some key policy changes and shifting economic fundamentals since then has led to non-banks capturing back some market share.

The Australian Prudential and Regulatory Authority's (APRA) introduced capital adequacy requirements on property exposures of ADI's. This forced some ADI's to recapitalise their balance sheets at the time, but also provided a disincentive to increasing future property exposures. The NBLS regained some market share as a result of these regulatory changes.

Around the same time, a relatively high Australian dollar, comparatively high interest rates and strong growth prospects improved the capital competitiveness of the Australian financial market. Overseas investors sought higher returns in the Australian market and further boosted the liquidity of the NBLS. Even though market share was growing again, according to the Financial Stability Board, Australia's share of shadow banking was comparatively low by global standards at 6.2 percent.

Capital adequacy requirements were then perceived by the Commonwealth Government to be constraining the supply of credit to the property sector (by ADI's). So, APRA changed the calculation of capital adequacy requirements and allowed ADI's to use internal ratings-based approaches to lending (which were subject to APRA approval). This was intended to help inject more liquidity into the property sector. But, around the same time (2019), Australian regulators introduced Basel III regulations which unfavourably reweighted ADI's commercial property, land acquisitions and development exposures. APRA also introduced new reporting regulations for non-ADI's.

None of these changes significantly impacted on the market share of the NBLS in Australia. According to Urbanised Pty Ltd, the sector will continue to grow market share for a number of reasons.

We do not believe interest rates will continue to fall (under normal circumstances). Monetary policy effects on consumption and investment behaviour have been neutralised under the latest rate cutting round. The dollar is already at decade lows and risks falling further under another round of interest rate cuts.

There is a counterpoint to this that poses a risk to this view. Coronavirus and the recent bushfires will have an impact on Australia's balance of payment (specifically in services trade) which will impact Australian economic growth. The government may prefer a lower dollar as a means of dampening the effects of these two exogenous shocks. This in turn could place further downward pressure on interest rates.

In terms of the NBLS in Australia, a key growth driver is property market performance and values. Sydney and Melbourne markets have significantly come off the record production highs of 2019 (down around 30% for apartments).

This has not converted to price falls of a similar magnitude. While there were small temporary downward corrections in values, the last quarter has seen values increase between 5 and 7 percent in the Sydney and Melbourne markets. Value growth will continue to be supported by the lack of supply until 2021 when apartment completions will grow strongly according to our pipeline research sourced from Cordells.

Urbanised Pty Ltd does not envisage further material cuts to the migration so population growth will also continue to sustain demand for housing.

Interestingly, there have been historically low levels of loan impairments (0.16%) experienced in the market during the recent market correction. This is probably due to the fact that repayments can be more easily serviced at lower interest rates along with improvements in lending practices in the NBLS.

There is another potential influence to be considered. New regulations relating to construction in NSW will provide risks that ADI's may not immediately be able to cope with in the Sydney market. This will provide further opportunities for the NBLS in this market – as it may influence the treatment of presales for ADI's.

Under the known conditions, demand for non-bank lending will continue to grow relative to ADI's in the Australian market. This will not be due to substantial overall market growth in the short term and will probably be more influenced by the substitution of preferences between where debt is sourced (between ADI and non-ADI debt). In the short to medium term, there should be further growth in the property market and the NBLS will be an increasingly important provider of debt in the Australian government.

The non-ADI sector is moving closer to achieving pre-GFC market share for commercial property finance. It is expected that a 70/30 split between ADI and non-ADI sectors will be achieved within the next three years. The Reserve Bank of Australia has identified that the movement in these ratios is the most important in explaining growth of capital exposures in the non-ADI sector. Over the next two years, non-ADI's could reach commercial property exposures of $81 billion which will be greater than any year since 2006. Non- ADI exposures relating to commercial residential property are expected to be between $17 billion and $20 billion by 2021. Extrapolating data from APRA Quarterly Authorisations, and assuming a return to long term market share trends, non – ADI exposure to commercial property may be between $87.5 billion to $95.4 billion in September 2024. Of that amount, exposure to land development/other residential in the non-ADI sector may increase to $27 billion over the same time.

There are positive structural trends supporting both shorter- and medium-term growth in the Australian NBLS. The extent to which Chifley Securities as a business can benefit from these trends will be determined in part by their continued access to capital and the overall composition of the NBLS – especially the number of new entrants. There is limited information available on the changes in the number of businesses operating in the sector and this has not been considered as part of this analysis by Urbanised Pty Ltd.

Should you have any questions in relation to this letter, please do not hesitate to call Stephen Albin, Managing Director, Urbanised Pty Ltd on 0431 084 651 or email stephen@urbanised.net.

Yours sincerely

**URBANISED PTY LTD**

**Stephen Albin**
**Managing Director**