Loan equity LVR and lower rental yields will crash the Australian property market as massive apartment over supply crushes valuations and banks demand additional loan equity.

Loan equity LVR and rental yields crash the Australian property market

If you were around in the 1990's for the real estate crash, Australian banks caught up in the massive credit crunch were pressuring borrowers to top up loan facilities as prices fell below the banks LVR policies, forcing many into mortgagee in possession. Regardless of a bank customers ability to service a loan facility, the banking undertakers dropped the hammer on 10,000's of customers purely on the pretence of increasing loan equity requirements.

LVR Loan to Value Ratio is the proportion of money borrowed from a financial institution such as Westpac, NAB, CBA or ANZ bank for a home loan compared to the value of the property. The LVR is the assessed 'risk factor' to mitigate market fluctuations and loan defaults should the lender have to 'fire sale' or quick sell the property asset to recover the loan amount.

Australia's most reputable news papers and expert journalists have been giving lots of attention recently to off the plan apartment settlement risk, the Chinese credit crunch, loan VOI fraud and, of course apartment oversupply, APRA and economic 'transition'. It has undoubtedly been a media frenzy full of surprises, twists and speculation, all of which spell out doom and gloom for Australia's property market.

With the oversupply of 200,000 dwellings by the end of 2016 reported by CoreLogic, off-the-plan valuations are now in free fall or bear market despite banks reducing new loan application LVR's to as low as 60%.

The importance of understanding and comparing the recent LVR policy change of April / May 2016 down to 60% in relation to the LVR policy predating 2015 is an ALARM BELL for investors. Property investors whom already own apartments prior to 2016 with an 80% or higher LVR should be very concerned on what the banks have in store for them if the market goes further south.

In other words, 'the banks' are covering their arses by reducing new loan LVR's to 60% is a prediction or more likely a precaution and, that senior bank executives and their expert analysts have foreseen a devastating property market correction on the horizon.

In the good old days, (pre January 2016) speculating apartment investors could easily obtain finance with an LVR of 80-90% depending on your visa or citizenship status, assets and employment. This segment of the banks lending portfolio (pre January 2016) is the greatest risk to the health of the bank sector as the loan to value ratio that are now edging towards negative equity.

A conservative drop of 10% will easily force the hand of the banks to approach existing borrowers (pre January 2016) to 'top up' and provide further equity to maintain a healthy LVR.

However, we all know this is not the case, postcodes such as the Melbourne CBD and Southbank, certain precincts in Sydney and Brisbane are facing massive oversupply and the market is already seeing re-sale values up to 30% below the original purchase price.

Lets pause and look at this scenario in more detail so the alarmist tone of this article is substantiated by an example: An off the plan apartment purchase that settled in early 2015 for $500,000 would have seen little or negative capital growth and, if your lucky the bank valued it at 5% less of the purchase price at $475,000.

The maximum LVR for a foreign investor in early 2015 was 80% and lets assume that was the case with this loan facility. The bank has advanced $380,000 and taken a first mortgage over the property and the purchaser has provided further equity of $120,000. By the end of 2016 Australian banks may pull out the "LVR Card" and contact customers to advise them that the paper valuation of their investment apartment has been reduced by a further 10% (very conservative) and is demanding further equity to maintain the loan facility 'loan top up'. 10% = $50,000 or in my prediction 20% = $100,000.

These funds will in most cases have to be sourced immediately placing borrowers under immense duress. If the funds are not available the bank customer will be forced to sell the property voluntarily or throw their hands in the air with the bank exercising their rights under mortgagee in possession.

But another twist could eventuate, (as they did back in the 1990's) the banks as they do well often hold other forms of security and will order a formal bank valuation which will be the atom bomb for the investors that have property investments mortgaged with their personal homes in particular, if the investment properties are located in the oversupply high risk postcodes. Forget a conservative drop of 10% or 20% the outcome from a formal bank valuation could potentially be much lower.

This lending LVR scenario is probably sending chills down everyones spines that have purchased apartments prior to 2015 however, is not set in stone and will reveal itself as the banking sector makes policy changes to protect itself from market conditions or the banks undertakers will be very busy.

Banks are clever (we hope) and government policy and lots of cash can evert a banking sector asset meltdown, however there is no holding back the market valuation correction as the oversupply is beyond the control of bank executives.

Now to the double edged knife:

It said Melbourne was set to gain a further 80,503 apartments by April 2018 — almost a third more than was needed for current demand.

With the number of renters not expected to decrease or increase significantly who will be paying the property investors loan repayments ?

High rental vacancy and lower rental yields is undoubtedly, unequivocally the biggest and most obvious threat to existing apartment owners in these high risk precincts. Regardless of what happens to apartment valuations, bank LVR policies or a flood of apartments hitting the market.

A blind man with a dog, with no market expertise or knowledge would agree that the market matrix and human behaviour will support the following opinion. Within the 'Fickle' rental market, tenants currently occupying existing or older stock will be lured by developer incentives to brand new spectacular apartment towers at the same rental amount or less thus, rendering older apartments empty.

There are only a certain number of tenants in the rental market and the turn over is a 12 month season as leases expire and tenants decide to move on to better locations, amazing facilities, modern appliances, brand new finishes (the new car felling), free (holiday) rent periods and lower rents.

This slow moving rental market transition will undoubtedly drive older apartment stock into excessive high vacancy rates in 2016 - 2018 as the rental market absorbs the brand spanking new 200,000 apartments scheduled for completion in Melbourne, Sydney and Brisbane.

An important mention is the 'Big Bucks' that property developers will throw at potential tenants to encourage them to abandon their older loving apartments and move into a spectacular new tower. Developers promote 'peace of mind' and entice purchases to sign on the dotted line by offering rental guarantees and assurances for 1 year, 2 or even 5 I have seen advertised. Lets assume, a developer has offered a 5% rental assurance for 2 years, this is $50,000 that will bleed the developer dry unless her/she can find a tenant quickly to offset the rental guarantee burden.

Lets modestly assume an apartment tower of 200 apartments, 50% are investors, 100 apartments are under a 2 year rental guarantee, could expose a developer to $5,000,000 (yes 5 million) or $208,000 per month. Any property developer exposed to this level of rental guarantee debt will throw enormous amounts of advertising dollars, freebies, rent free periods to secure any tenant with a heart beat, wouldn't you? Developers stuck with rental guarantees are no different to individual landlords and will do 'anything' to get a tenant in a highly competitive rental market. Unfortunately, individual landlords don't have millions to throw at marketing and are highly vulnerable.

The above mentioned is an assumption that property developers actually keep their word and are financially sound to pay investors rental guarantees.

So under these conditions, existing (older) apartment owners will not be able to compete in the rental market. And, just to repeat; this is undoubtedly, unequivocally the biggest and most obvious threat to the health of the apartment market and existing apartment owners in these high risk precincts effected by oversupply.

No rental income, no loan repayments translates to financial duress and/or foreclosure.

The above set of circumstances will start revealing itself over the coming 6 months, will compound and multiply as the Australian real estate market tries to absorb the massive apartment over supply with banks scrambling to secure their positions with tighter APRA policy changes and falling valuations.