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Straight Talking, Bill Nowlan - Crash accident investigators required to get to the bottom of the Irish property meltdown

A forensic examination of the property smash in this country reveals that its key cause was a total systems failure

Warnings ignored: new apartments being built in Smithfield in Dublin in 2004

Karl Marx said religion was the opium of the people: Well, property was the opium of the Irish between 2000 and 2007 and we are now in a massive detoxification that has brought our economy into the control of the IMF. But do we understand what really went wrong?

As an avid follower of things aeronautical I am fascinated by the multi-dimensional approach applied to air accident investigations. Was it the pilot, the airframe, air traffic control, the navigation aids, weather or the quality of the fuel that caused the accident? All are forensically investigated to make sure that it does not happen again. One striking thing about most air accidents is that they rarely have one single cause. Generally one mistake by the pilot, one engine failure, one overshoot is rarely fatal. It is when you get pilot errors and an engine failure plus bad navigation plus fog that people get killed.

Applying the same forensic approach to what went wrong in property in the last decade might help to reduce some of the anger and finger-pointing and help us learn some important lessons.

In aviation the regulatory authorities decide who can fly, what can fly and to where. There is no equivalent of an aviation authority for property development and investment in Ireland. The function of regulating the property market is split between multiple agencies full of self-interested factions including government, the Financial Regulator, the departments of finance and environment, bankers, planners and county councillors making development plans.

The property crash was caused by multiple players from the taoiseach to the proverbial taxi driver who bought flats for his pension. He may seem like an innocent victim but he did play a major role in causing the property smash by putting pressure on all the other players to provide more and more 'product' – all driven by individual greed.

More or less blame can be attached to individual players but, when I look at all the evidence, the key cause of the accident was a system failure. Firstly, no one in authority understood (or yet understands) the dynamics of the Irish property market; secondly, few appreciated that the main credit base for the country was property (and still is). Virtually all big loans are secured on property. Property has been used as security for bank lending for hundreds of years.

The concept is simple: you borrow money and pledge your farm, your shop, your house as security to the bank for that money. If you don't repay the debt, the bank can sell the property and use the proceeds to settle the loan. Banks usually only lend 60%-70% of the value of a property to give a margin for error. This formula was applied for most loans during the boom. Most of the banks genuinely believed they had security in the assets they held using this formula. They had property valuations on their files to prove it. Unfortunately they were not looking at the real value of the property, only the nominal value. They did not realise their security was being diluted from about 2002 onwards and diluted by themselves. They did not realise that only a certain amount of property can be traded at one time – exceed that and the system crashes.

In previous property cycles the limiting factor on the growth in property values was the availability of credit from banks. In the past, when the property market got too hot, a self-correcting mechanism automatically operated – the banks ran out of money and the price of credit went up. This stopped the boom and the value dilution. It used to happen before the property market system crashed. However, this time, due to the euro and the large pool of savings in Europe, the cash did not run out, so some other part of the Irish system had to take the strain. This strain fell on the property market as measured by individual valuations.

As a property valuer I can see how the property valuation system reacted and contributed to the debacle. Valuers were doing what valuers are trained to do. They were looking at sale prices and giving valuations based on those ever-increasing prices. Their role was not to manage the property market,but indeed no one was managing the system and it was this weak link that caused the crash.

The graph below shows property capital value movements for 25 years from 1984. This is based on the IPD (Investment Property Databank) statistics for commercial property. I have also included a graph showing a notional investment in the cost of living index for the same period.

Included in the 25-year period are the property slumps of 1988-90, the currency crisis of 1992 and the dotcom debacle of 2000-2001. There are four main features: first, how steady the growth and its alignment with inflation up to 1996; second, the sudden upturn from 1999-2000 onwards; third, the rocketing of values from 2002 onwards; and finally the collapse in 2007, bringing values back in 2010 to the CPI line in the graph – their 'natural' territory.

This shows that property values are primarily driven by inflation. The initial departure from the inflation trend in 1997 arose because values had fallen behind inflation during most of the 1980s and early 1990s and there was a rapid catching-up but then the impact of the dotcom collapse levelled things off again. The demand of the Celtic Tiger caused a real scarcity of new building in 2000-2002. But then the market overreacted and this forced up property and site values.

At this time the warning signals should have been flashing back in the government's 'control tower'. Those warning signals were the emerging oversupply of buildings, land prices going into the stratosphere, and the conventional site-value ratio of 25% land to 75% bricks and mortar going off the radar. (It got as high as 75% land and 25% building by 2006.) Instead of the normal credit brakes being applied, an uncontrolled supply of cash came from Europe. House buyers, investors, speculators and developers wanted some of the action.

What actually happened is now a matter of record: investors clambering for a bit of the action got it, developers developed, banks provided cash raised overseas. Property values were artificially forced up mainly by yield compression rather than rental growth.

The sustainable growth in property values finished in about 2003; after that we were into full value dilution and significant oversupply. Realising that trees cannot grow all the way to the sky, savvy investors got out of the market from then on. Those who sounded warning bells were drowned out by salesmen on the bandwagon or told they should commit suicide.

I have two recommendations. First, the government and the Financial Regulator need to get heavyweight property experts to advise them on how the industry works systemically. Second, the property valuation process and its relationship with lending must be reviewed, to ensure that valuations used by banks reflect the real value of an asset and not a diluted one.

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