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No magic bullet for banks' property crisis

Property prospects : Renovations and extensions will be the order rather than new build - until values rise to well above replacement costs

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It is going to take more than a decade to unwind the excess property assets financed by the banks during the noughties

The banks in Ireland, including IBRC and Nama, have more than €30 billion of Irish loans relating to property which they need to unwind over the next five to seven years in order to meet the Basel capital adequacy requirements and also repay the temporary ECB loan support. This unwinding process has started by the sale of overseas assets and loan books but is mainly outstanding in Ireland.

Can this deleverage be achieved? What will be the timescale and what will be the nature of the property market during the process? Should the Government provide further help to the industry?

These are key questions for all close to the banking and property industries. In a comprehensive discussion note* I have tried to join the dots of the many intertwining factors. I have drawn on two recent studies on the overall European property markets published by the Urban Land Institute and by Morgan Stanley, which reach much the same conclusions for Europe as I do for Ireland.

A summary of my conclusions is as follows:

1. There is no magic bullet to resolve deleveraging in the banks and kick-start the property industry. It is going to take many years (10+) to unwind the excess property assets financed by the banks during the noughties. The direct sale of property at the scale necessary to achieve this unwinding is not achievable due to the limited size of the Irish property market – probably a max of €1 billion per annum. There will be further erosion in values if too much property is brought to the market in a dash for cash by all or any of the banks.

2. The sale of loan books will make some contribution to the unwinding process for quality books, but it will be slow and limited for the non-quality loans. In the UK, two-thirds of the properties financed by banks are secured against non-prime property and probably higher here. For lower quality books, any purchaser will be looking to the underlying property market to directly or indirectly get his pay-off. He will seek to discount his price to reflect a long-haul, high-risk investment with ultimate dependence on the property market to achieve the intended result.

3. Internationally, funds are limited and contracting. Ireland is in competition with most countries in Europe for such funds. For Europe, Morgan Stanley estimates a €400-€700 billion loan gap for commercial property lending. The volume of funding available for Ireland to buy loan books or lower quality property will be limited and highly priced. The high returns expected by buyers with funds, mainly overseas, may make the route impracticable as it would involve too big haircuts for the banks who may just decide to “sit it out”.

4. Property in the early noughties was a sexy, exciting, high-reward activity and every Irishman thought he could make his fortune by being a “player” – mainly with someone else’s money. That paradigm of investing with someone else’s money has changed to “no leverage or low leverage”. That’s the way it used to be up to the start of the banking madness in the mid-1990s.

5. Most banks, here and in Europe, are heading back to their old knitting – to being lenders for commercial property for a period not exceeding five or seven years. This lending period is not compatible with lending for property investment where fixed terms of 15 years-plus are needed to match the relatively low cash flows generated by property. Banks will not be lending significant money to new borrowers to solve the problem.

6. Property is back to being primarily a long-term equity-based investment, giving ungeared income returns of 7 per cent plus inflation. But the banks will be unwilling holders of property, directly or indirectly, for many years.

7. The property market and the real economy are heavily intertwined. While the core elements of the economy will be driven by external forces, the Government, by giving further support to investors and owners in the commercial property industry (not to be confused with the construction industry), could accelerate the transition from a property market based on selling distressed assets to a market driven by equity investors.

8. Helping the property market recover would give a direct boost to the rest of the domestic economy by:

   a) Growing property values and thereby stabilizing the capital base of the banks.

   b) Giving confidence to consumers

   c) Getting the building industry moving.

   d) Encouraging the repatriation of overseas deposits.

10. The Irish commercial property industry will be smaller and focused. Deals will be smaller and take more work. Clients will be different: they will comprise equity investors (not borrowers), bankers and insolvency practitioners, and, of course, tenants, owner-occupiers and distressed borrowers. There won’t be too many developers around, renovations and extensions will be the order rather than new build – until values rise to well above replacement costs – probably several years away.

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*The author is happy to share his discussion note

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