Just How Sound is the Irish Banking System?

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While there has been a lot of interest lately in the possible risk to banks from sub-prime loans, nobody seems terribly concerned by the large and rapidly growing exposure of Irish banks to property speculators. Irish banks are now owed almost as much by builders and developers as they are by mortgage holders, and are now more exposed to commercial real estate than Japanese banks were when they crashed in 1989.

While mortgage lending has slowed since the middle of last year, lending to builders and developers continues to grow rapidly and now stands at almost €100 billion, an increase of €20 billion on last October.

To put these numbers in perspective, €20 billion is twice the market value of Bank of Ireland shares; while €100 billion is the approximate value of all public deposits with retail banks. Effectively, the Irish banking system has taken all its shareholders' equity, with a substantial chunk of its depositors' cash on top, and handed it over to builders and property speculators.

In fact, if you leave out the quarter of mortgages that are for buy-to-let property, itself a small time form of property speculation, lending to developers is now €20 billion more than lending to people to buy their own homes.

Back in 2000, lending to construction and real estate made up only 8 per cent of Irish bank lending, much like other European countries. Now it has risen to 28 per cent. By comparison, just before the Japanese bubble burst in late 1989, construction and property development had grown to a little over 25 per cent of bank lending.

Increased lending for construction and development is driven by banks' urgent need to meet earnings expectations, and is unavoidably risky. While most home owners will continue to pay mortgages even with negative equity, international experience shows that developers will walk when markets turn down, leaving banks, and often governments, to pick up the pieces. Diversification for lenders is difficult, moreover: when one developer goes bust they typically all go bust.

While lending to builders, at €25 billion, is a good deal smaller than the €75 billion lent to real estate speculators, many of the loans appear to be in difficulty already.

During the property boom of the last decade, a mutually profitable symbiosis emerged between banks and builders. Banks would provide lines of credit at a generous markup over wholesale interest rates for builders to buy and develop sites, and builders would pay off the loans once they sold the new property, which they were often able to do before a single brick had been laid.

The arrangement between banks and builders was fine so long as sales of new houses did not slow, leaving builders unable to repay loans. Since the start of this year sales of new houses have not slowed, they have entirely collapsed.

A Dublin estate agent told me that whereas last year they sold over 3,000 new units, this year they have sold fewer than 100. They are about to try to launch one of their new developments for the third time, the first two launches having netted exactly no buyers.

While the market for secondhand houses still limps along, people have stopped buying new houses because they are afraid that developers will subsequently slash prices and leave them with negative equity. They are right to be afraid. My contact told me of one heavily marketed development where they have taken deposits on €750,000 apartments and are now anxious to get the buyers to sign contracts so they can cut the prices of the many remaining units to €600,000.

It is ironic that the government's decision to abolish stamp duty for first time buyers has allowed them to escape entirely from the new housing market. What was intended as a dig out for the building industry may turn out to be one of the last nails in its coffin.

Given that nobody wants new houses, it is natural to ask who is going to buy the 80,000 or so units that will be completed this year, and the 60,000 that are on stream for next. The answer, although they may not know it yet, is the shareholders of Bank of Ireland, Anglo-Irish and other builder-friendly banks.

While we can see banks starting to make a show of turning up the heat on smaller developers, they have lent too much to large builders to allow them to fail. It is one thing to chop a developer in Kilkenny off at the ankles if he owes you €16 million; it is quite another to admit that a developer in South Dublin owes you €160 million, let alone to force him into bankruptcy. Were any one of the several Dublin developers who are reputedly unable to service any of their large borrowing to be driven into bankruptcy the ripple effect on Dublin house prices and the value of other loans would be unpleasant.

Along with the many loans to builders that are already in the non-performing category, the exposure to commercial real estate poses a grave threat to bank solvency, because of the large sums involved and the highly leveraged nature of the borrowing.

Commercial real estate borrowing during booms follows the same pattern everywhere. You put up 20 per cent of the price of an office block or warehouse and borrow the rest. As prices rise, you use the equity gained in the first property as collateral for an 80 per cent loan on a second property, and so on as long as prices keep rising.

In Dublin the 5 per cent rental yield allowed banks to charge a 5 per cent interest on commercial real estate loans so investors could use rental income to cover interest payments while they sat back and enjoyed double digit capital gains.

With lending rates based on 5 year Euro swaps now risen to over 6.5 per cent and rental yields fallen to 4 per cent, new investors cannot cover interest from rent and are entirely reliant on capital gains from rising prices. With commercial property prices slowing rapidly and loans taken out a few years ago needing to be rolled over, there is a strong risk of a sudden exodus from the market, and a collapse in prices. Because real estate loans are collateralized mostly by equity in other leveraged real estate, they can rapidly become almost worthless.

US experience shows that commercial property markets usually follow residential markets downwards with a lag of twelve to eighteen months, and the Japanese market shows how commercial real estate can fall in value by 80 per cent within a few years.

The large exposure of Irish banks to property speculators does not mean of course that large losses are inevitable. What it does mean is that, if a crash occurs, or even if already nervous overseas bond markets cut off liquidity to Irish banks (foreign banks have over €400 billion on deposit with Irish banks, and hold another €200 billion of bonds), it will be very costly to fix, dwarfing the bailout of AIB in the 1980s.

A partial bailout of Japanese banks cost their government 10% of national income, while re-floating Finnish banks cost its government nearly 15 per cent of national income. In Irish terms this would translate into a bill for taxpayers of €15 to €20 billion.

Bankers are well known for getting carried away during bubbles which is why governments appoint central banks to keep an eye on them. You probably think that the fact that Irish banks have given speculators €100 billion to gamble with, safe in the knowledge that taxpayers will cover most losses, is a cause of concern to the Irish Central Bank, but you would be quite wrong.

At a recent Irish Economic Association discussion of house prices, the Central Bank official in charge of financial regulation (whose publications with the ultra-libertarian Cato Institute strongly oppose any form of bank regulation: a real case of an atheist being appointed an archbishop) stopped the proceedings to announce that the view of the Bank was that, as long as international markets were happy to buy debt issued by Irish banks, there could be no problem with their lending policies.

We can only hope that this insane logic is correct, and that the refusal on ideological principle of bank regulators to regulate banks does not lead to the same debacle here that occurred with Savings and Loan Institutions in Reagan-era America.