Loans to property developers have been identified as posing the greatest risk to our banking system. However, loans to real estate investors could also become an issue for Ireland’s banks.

In essence, the Irish banks have become deeply involved in two distinct areas of commercial property lending. On one hand, they have provided capital for property developers to acquire sites, get planning, engage contractors and market their finished buildings. However, the banks have also supplied commercial real estate investors with credit to buy finished and fully let properties (mostly office blocks and shops) which are expected to generate regular cash-flows over the long term.

So far, the debate about our banking crisis has focused on property developers. Indeed, concerns about this group are well founded. Developers have built too much of every type of commercial property. As a result, vacancy rates have risen rapidly and many developers are now left holding assets that they can neither sell nor let. The knock-on effect is that banks have already seen impairments on their developer books rise sharply.

However, while the threat posed by defaulting developers is now widely understood, the risks associated with investor loans - which heavily outweigh commercial development loans on the balance sheets of our main banks - do not appear to have registered in the same way. The reasons for this may be historical. Traditionally, investor loans have been considered relatively low-risk because commercial property leases have tended to favour the landlord. For example, under the typical Full Repairing and Insurance (FRI) lease, tenants are primarily responsible for risk related to the upkeep of a premises. More importantly, commercial leases usually cover long periods and provide for upward-only rent reviews. Consequently, once investors had locked tenants into lease contracts, it was assumed that they could look forward to relatively safe streams of rental income for the foreseeable future.

Recent developments, however, cast doubt on this assumption. In particular, rents, which represent the stream of cash flows accruing to commercial property investment, are falling precipitously. Overall, rents on new commercial lettings are down 22% in the last year – a decline that
is almost double the highest deflation rate ever previously recorded. Moreover, in some sectors like Dublin offices, the decline has been even greater - rents on new office lettings fell by 30% between June 2008 and June 2009. Perhaps even more worrying is that, according to econometric models which have proved accurate so far, this trend will continue until 2011 at least.

Of course, banks might argue that these rental declines will not affect their existing loan books because they only apply to new lettings. However, it is now obvious that market forces are beginning to overwhelm the terms of existing rental contracts written in better times. As the recession deepens an increasing number of commercial tenants have simply found themselves unable to continue paying top-dollar rents. Furthermore, with commercial vacancies approaching an all-time high (one in five office units in Dublin is currently empty), tenants are in a strong bargaining position. The result has been widespread rent renegotiation. To illustrate this, a recent survey by the Society of Chartered Surveyors showed that, in 87% of cases, surveyors in the retail sector found landlords had been prepared to grant rent variations in the last six months, with rent reductions occurring in 70% of cases.

In addition to all this, a recent amendment to the Land and Conveyancing Law Reform Bill (2008) proposes to ban the standard upward-only rent review clause from commercial leases. As this will not apply retrospectively, existing tenants will be put at an even greater disadvantage by this legislation. This will surely provoke further rent renegotiations.

If we accept that these factors will drag down rents across the board, then it is reasonable to assume some property investors - particularly those that are most highly geared – are going to encounter cash-flow problems and default on their loans. Furthermore, based on a discounted cash flow analysis, lower rents (and rent expectations) will reduce the capital value of commercial buildings. This could create a scenario where highly leveraged property investors might rationally decide to default because the outstanding balances of their loans exceed the collateral value of the properties that secure them. Indeed, the fact that borrowers know their banks have an ‘out’ through NAMA may make this course of action more likely.

The prospect of higher impairments on investor loans raises some interesting questions. Firstly, will this increase the overall scale of the NAMA project? Currently, NAMA is heavily focused on land and
development loans. However, it does make provision for transferring ‘Associated Loans’ – loans not directly related to land and development but which are held by people with an exposure to those sectors. Because many developers are also property investors, some investor loans will automatically be designated ‘Associated Loans’ and are therefore, one assumes, already included in the estimated €90bn of assets to be transferred. However, other commercial property investors (including syndicates and private equity groups) have no involvement in development. If these players begin to default and their loans have to be bought-out, it seems reasonable that the overall scale of the NAMA project could increase.

A further question relates to whether NAMA will be able to buy-out pure investor loans. Certainly, it has left the door open to expand its eligibility criteria beyond land, development and associated loans. But will the timing work out? While many developer loans are already non-performing, defaults on investor loans are likely to creep up more gradually. Will NAMA still be engaged in acquiring assets by the time these loans manifest themselves as a problem? If not, will this mean a further equity injection by the State in our commercial banks?

A third issue arises around the financing of NAMA bonds. It is envisaged that the stream of income from NAMA’s cash-flow generating assets will pay for the interest on these bonds. Assuming, however, that a big chunk of this cash-flow relates to commercial property rents, what provision has been made for rental slippage?

As with many questions relating to NAMA, the answers are not yet clear. We will learn more in September, but the full impact of rental attrition and non-performing investor loans is unlikely to be apparent for some time to come.