National Asset Management Agency

NAMA response to the C&AG Special Report on the sale of Project Eagle

14 September 2016

The C&AG's Special Report on the Project Eagle transaction, which has been prepared under Section 9 of the *Comptroller and Auditor General (Amendment) Act 1993*, has now been published. Since October 2015, NAMA has engaged openly and extensively with the Office of the C&AG in providing the information sought by its examination team and in reviewing the various drafts of the special report.

Key points

- The NAMA Board disagrees fundamentally with many of the key conclusions reached by the C&AG in this report. This document sets out NAMA's view on four key issues, namely the sales price, the sales process, the broader strategic context and the particular examination approach which has been adopted by the C&AG.

- The C&AG's report states that NAMA's decision to sell the Eagle portfolio at a minimum price of £1.3 billion involved "*a significant probable loss of value to the State*". NAMA categorically rejects this conclusion which is based on an analysis of the transaction which is fundamentally flawed by reference to the conventional market-standard valuation methodology and the appropriate discount rate for estimating the market value of a loan portfolio such as Eagle.

- The NAMA Board is strongly of the view that achieving £1.322 billion for the Eagle portfolio in 2014 – in excess of Board's minimum sales price - was the best commercial outcome achievable either in 2014 or now.

- The report implies that the alleged 'probable loss' was of the order of £190m which is the difference between the minimum price set by the Board and the C&AG's view of what it considers to have been the portfolio's 'probable' accounting value. The report's view of the 'probable' value of the portfolio is based on a discount rate of 5.5% which the C&AG alone considers an appropriate discount rate for estimating the market value of a portfolio with the characteristics of Project Eagle.

- By contrast, NAMA's position, supported by expert market evidence from four internationally recognised loan sales experts, is that a discount rate in the 10%-15% range was appropriate to apply to the cash flows associated with the Eagle portfolio. If the evidence of market experts on the discount rate is accepted, the price actually achieved on the Eagle sale was the best price achievable in the market and there was, therefore, **no** 'probable loss' by reference to the market price of £1.322 billion achieved.

- NAMA has the utmost respect for the C&AG and his staff but this report was prepared by staff who have no experience and expertise in the loan sale market. The report fails to provide any market or expert support for the use of the 5.5% discount rate on which its main finding is based and it ignores strong market evidence which would have supported the use of a discount rate in the 10%-15% range. **This key finding of the report is therefore fundamentally unsound and unstable and cannot be left unchallenged.**

- Ultimately, the value of any asset, including the Eagle loan portfolio, is what credible bidders are willing to pay for it. It would have been commercially naïve of NAMA to maintain that a portfolio valuation derived from a discount rate of 5.5% could have been realised in the face of overwhelming actual expert evidence that the market's valuation was lower.

A. Sales price

1. NAMA and the C&AG agree that the appropriate starting position for analysis is the end-2013 Eagle cash flow position as audited and certified by the C&AG. From this, the C&AG derives a discounted accounting value of £1.465 billon. The key point of difference between NAMA and the C&AG is a technical valuation point and relates to the appropriate discount rate used to discount projected future cash flows arising from the Eagle loan portfolio.

2. The view of NAMA, supported by expert market evidence from four internationally recognised loan sales experts, is that a discount rate in the 10%-15% range was appropriate to apply to the cash flows associated with the Eagle portfolio. This is because the Eagle loans were secured, for the most part, by a granular portfolio of non-prime assets, located mainly in Northern Ireland and in northern parts of Britain.

3. The minimum sales price set by the NAMA Board was £1.3 billion. As is clear from the table below, this falls within the range of sale values generated by the 10%-15% range of market discount rates that would have applied to a portfolio such as Eagle during the first half of 2014. A 10% buyer discount rate produces a value of £1.357 billion; a 15% discount rate produces a value of £1.249 billion. NAMA achieved £1.322 billion which is well within the expected range of values:

TABLE 1: Portfolio cash flow analysis based on various discount rates

Discount rate	Net Present Value (£m)
5.5% - NAMA internal discount rate – favoured by C&AG	1,465
10% - lower end of range of market discount rates	**1,357**
15% - higher end of range of market discount rates	**1,249**
Eagle portfolio – price achieved by NAMA	**1,322**

Relevance of discount rate

4. The appropriate discount rate is necessary to account for (i) the time value of future cash flows and (ii) the risk associated with the receipt of those cash flows. Cash flows arising from property assets are inherently uncertain; this uncertainty is much greater in the case of granular, non-prime and non-income producing assets than it is in the case of prime commercial assets with a strong income stream located in sought-after locations. **In general, the less attractive the assets and the income stream securing a loan portfolio and the less certain that the associated cash flows will actually be received, the higher the discount rate that will be applied by buyers.** This is widely accepted in the loan sale market.

5. There is clear market evidence (please see Table 2 below) that the target return requirements for purchasers of loan portfolios in early 2014 was in the 10% - 15% range.

TABLE 2: Market LTV and Funding Costs during the first half of 2014

Portfolio	LTV %	Debt spread (basis points)	Target Investment Return
Holly (NAMA)	65	400	12% - 14%
Rock (IBRC)	65	375	12% - 14%
Salt (IBRC)	65	375	12% - 14%
Stone (IBRC)	70	375	11% - 13%
Eagle (NAMA)	**55**	**450**	**14% - 16%**
Pebble (IBRC)	67	375	12% - 14%
Tower (NAMA)	70	350	10% - 12%
Adelaide (Nationwide)	70	400	11% - 13%
Button (RBS/Ulster)	70	350	11% - 13%
Octopus (Commerzbank)	65	400	13% - 15%
Avon (Lloyds)	70	375	12% - 14%

Source: Department of Finance, Section 227 Review, July 2014

6. The target investment return comprised (a) a blended cost of capital (8% -10%), based on the LTV (loan-to-value) and the debt funding margins that applied at the time and (b) a risk premium to reflect the level of risk associated with the transaction. The target investment return is a reasonable proxy for the discount rate that bidders use for cashflow valuation. Given this portfolio's characteristics and its limited appeal to investors (by contrast, for instance, with NAMA's later Project Jewel portfolio), there is little doubt that the target return (and therefore the all-in discount rate) for Project Eagle bidders would have been towards the higher end of the 10% to 15% range.

7. Contrary to this evidence and to the views of loan sale experts, the C&AG's report alone holds that it would have been appropriate for NAMA to use a 5.5% discount rate to assess the Eagle portfolio's sale value in 2014. The only support for this position appears to be an interpretation of a Board decision of June 2013; the report's interpretation of the Board decision ignores the important caveats which were applied by the Board in the case of its approved discount rate methodology.

8. A discount rate of 5.5% may have been appropriate to apply for overall portfolio analysis for accounting purposes and indeed for many individual transaction evaluations but would not have been appropriate for all segments or assets within the portfolio. The Board decision of June 2013 noted that a 5.5% **rate should not be used as an over-arching discount rate to evaluate all potential transactions and that flexibility should be maintained**. In

particular, the Board approved the position that "*care should be taken to ensure that both (a) alternative NPV scenarios are generated using alternative discount rates and (b) that* *qualitative information* *would be considered as part of the decision-making process*".

9. The key qualitative information in the case of Eagle was the fact that the assets securing the portfolio were, in the main, secondary and tertiary regional assets and, therefore, would have required a higher discount rate than 5.5%. The flexible approach approved by the Board in June 2013 was clearly designed to deal with the evaluation of transactions such as Eagle which was not typical of the NAMA portfolio as a whole.

10. There were considerable and unique risks in the Eagle portfolio that were not a feature of many other NAMA portfolios including the relatively poor quality of the underlying assets, the underlying weak economic and market conditions, the cross-jurisdictional aspects and the often-difficult engagement with many NI debtors. It would have been necessary to incorporate these additional risks when selecting a discount rate to determine a reliable portfolio value.

11. The appropriate discount rate for Eagle would have to have reflected the inherent macro risk associated with a high concentration of assets located in the small Northern Ireland economy. The inability of the Northern Ireland property market to absorb a large volume of asset sales over a short time period would therefore have resulted in a high risk-adjusted discount rate being utilised by any potential purchaser. The lack of market liquidity in Northern Ireland was evidenced by the fact that NAMA debtors and receivers disposed of only £100m of assets between 2010 and the end of 2013. This was not a consideration in the very liquid London market nor has it been a major consideration in Dublin given the strong increase in market liquidity since 2014.

12. The C&AG's contention – that Eagle involved a significant 'probable loss' of value to the State – rests on its claim that the Board adopted a 'standard' discount rate of 5.5% in June 2013 which was to be used subsequently for all future evaluations. The Board firmly rejects this interpretation of its decision: it is clear from the decision itself (as quoted above in Par. 8) that the Board did not intend that 5.5% should be a one-size-fits-all discount rate. The C&AG report adopts the position that its own interpretation of the Board decision is more valid than the interpretation and intention of the Board itself. It would seem reasonable in the circumstances that the C&AG would accept the Board's invitation to engage with it directly on this and other key issues. This would have provided him with first-hand evidence as to how the Board exercised the discretion provided in its June 2013 decision regarding the

appropriate discount rate to be applied in cases such as this. The C&AG, however, refused to meet with the Board.

13. The evidence of NAMA and of professional market experts (KPMG, Eastdil Secured, Lazard and Cushman & Wakefield) - that a discount rate in the 10%-15% range would have been appropriate - is disregarded by the C&AG but no market-based counter evidence is offered by the C&AG to justify a 5.5% discount rate. It would seem reasonable to expect that a Section 9 C&AG report which purports to offer an authoritative view of a major loan sale transaction would be supported by appropriate evidence from market experts in this particular area.

14. In effect, the practical consequence of the stance adopted by the C&AG is that NAMA would never have sold the Eagle portfolio or any other similar loan portfolio as, by definition, a portfolio valued at a discount rate of 5.5% (corresponding to an accounting value of £1.465 billion) could never be matched by bidder valuations (which would have been based on discount rates of 10%-15%). The unorthodox, academic and uncommercial stance adopted by the C&AG is not one that is feasible or realistic for NAMA, or indeed any other commercial entity, to adopt.

15. The report states that NAMA "*took account of what it described as the relatively poor quality of the property collateral in the price it paid for the loans at acquisition*" and it goes on to state that, accordingly, a high risk premium in the discount rate would have meant "double counting" (Par 3.81). The loan acquisition prices paid by NAMA were determined by the bespoke loan valuation methodology which was approved by the European Commission in February 2010. Contrary to what is implied in the comments quoted above, NAMA was **not** in a position to influence the prices it paid for loans nor to adjust them to bring them into line with market prices. As noted in the C&AG's own Special Report 81 (***NAMA Progress Report 2010-2012,*** April 2014), NAMA's acquisition price of €31.8 billion for its acquired loan portfolio included a State Aid payment of €5.6 billion, **an 'overpayment' of 21% on the market value of the loans**. As with the rest of the portfolio, the acquisition price for the Eagle portfolio also included an element of State Aid.

B. Sales process

16. The report's conclusion that the loan sale process adopted does "*not provide sufficient assurance that a different marketing strategy for the loans, or different timing of the sale, could not have resulted in NAMA achieving a higher price from the sale of the loans*" is hypothetical and meaningless in a commercial context. There is no way of establishing what the outcome of hypothetical alternative marketing strategies or alternative transaction timings would have been. No commercial transaction, not even the Project Jewel sale where NAMA earned a profit of close to €1 billion, would ever pass the test implied by this conclusion. Even with the benefit of hindsight, the report's position is unsustainable.

17. The report infers that there may have been some potential investors, then and now unknown to NAMA or Lazard, who could have lodged credible bids for the Eagle portfolio but were not given an opportunity to do so. The evidence strongly suggests otherwise: the nine firms which were admitted to the sales process account for **88%** (by par value) of all European CRE (commercial real estate) loan sales of large portfolios (in excess of €1 billion) transacted over the period from 2013 to 2015. They account for **92%** of all UK/Ireland CRE loan sales of large portfolios (in excess of €1 billion) over the same period. **To suggest, therefore, that a different marketing strategy would have led to a different outcome or that serious credible bidders were excluded from the Eagle loan sale process, is implausible and runs contrary to all available objective evidence.**

18. NAMA does not accept the inference in the report (Par. 4.83) that the sales process restricted the field of **credible** potential bidders and thereby compromised the objective of obtaining best market price. As has been demonstrated by the evidence outlined in Par. 17 above, the nine potential bidders approached by Lazard were all entities which had the capacity to fund and execute a purchase on this scale. Neither NAMA nor Lazard is aware of any other potential bidder who could have participated in the process and who would have been likely to submit a competitive bid for the portfolio. **It is not plausible to suggest, as is done throughout the report, that NAMA set a reserve price for the Eagle portfolio that was substantially less than its market value but that, somehow, all but one of nine top international investment firms failed to spot this excellent arbitrage opportunity and that seven of them refused to bid for the easy profits allegedly on offer through alleged NAMA mispricing.** This is a very naïve view of the commercial acumen of international investors.

19. The report includes lengthy analysis comparing the process adopted for Eagle with those adopted for Tower and Arrow. The processes are not directly comparable: Tower involved a single consensual debtor connection; Arrow, although similar to Eagle in its granularity, did not involve the same unique jurisdictional and political sensitivities as Eagle and comprised consensual debtors. As Eagle was also the first multi-debtor loan sale undertaken by NAMA and it preceded Arrow by over a year, it is unreasonable to suggest that it should have followed precisely the same process. Arrow was transacted during the second half of 2015 and clearly the sales process itself had been subjected to refinement and improvement in the period since Q1 2014. NAMA ran a bespoke sales process in the case of Eagle and did so with good reason. The sale proceeded on the clear recommendation of Lazard.

20. The C&AG ignores the strong evidence which has been provided by Lazard which stated that "*there is no evidence that any other investors existed at that time (Q1 2014) who were as credible and as well qualified such that it appeared that they were in a position to pay a higher price to NAMA than that secured from Cerberus*". Lazard went on to state that "*the process was open to the most qualified and credible potential counterparties. There were fewer participants in this process than in some other transactions because there were fewer investors that were sufficiently qualified and credible.*"

21. C&AG also disregards Lazard's statement, in relation to the firms that were not admitted into the process, that "*they did not meet NAMA's criteria, namely the ability to pay £1.3 billion in cash, the human capital and resources to review such a large, complex and granular portfolio, the ability to purchase the entirety of the Portfolio, and the ability to transact on the basis of the limited information available on the Portfolio.*" Lazard pointed out that "*the fact that seven of the nine suitably qualified investors admitted into the process decided not to submit a bid to acquire the Portfolio suggests that the Portfolio was not particularly appealing as an investment proposition.*"

22. Furthermore, the C&AG disregards Lazard's statement that "*in our experience, it is not uncommon in a transaction of this complexity and scale for the number of bidders to be distilled down to just two or three final bidders. It is crucial to ensure in a process such as Project Eagle that bidders are sufficiently motivated to spend time and money on due diligence in a competitive situation. This objective was achieved in the Project Eagle process.*"

23. The report ignores the expert advice that Lazard provided to the Board on these issues but the C&AG does not offer any evidence from other market specialists which would counter

Lazard's evidence or its advice to the Board. This is another major instance in which the C&AG report would have benefited greatly from the market experience and expertise which was not available in the Office of the C&AG.

C. Strategic considerations

24. The C&AG's contention that a "different timing" of the sale could have resulted in a higher price is not only speculative and hypothetical but also ignores the serious wider consequences of aborting the sales process and attempting to re-run it at a later stage. Crucially, the Eagle sale achieved in excess of the minimum £1.3 billion price target which the Board had set for it and, in that context, aborting the process would have been very damaging, not only for NAMA but for the Irish market in general. Clearly, no Board, acting responsibly, commercially and in the best and wider interests of the State, could have ignored these potentially serious consequences.

25. The scale of NAMA's exposure to property markets in Ireland, Britain and Northern Ireland and the amount of debt that it had to redeem (almost €23 billion of Government-guaranteed senior debt still outstanding at end-2013) meant that it had to take advantage of any commercially sensible opportunities that became available, particularly for the less liquid segments in the portfolio. The overall NAMA portfolio carried huge risks for Irish taxpayers given that NAMA senior bonds carried a government guarantee. Any professional and prudent asset manager faced with risks on such a scale would have reduced them as quickly as was commercially feasible.

26. The intention of the British Government to hold a referendum on EU membership was first signalled in January 2013 and this clearly complicated the risk outlook for Britain and Northern Ireland. No professional and prudent asset manager could have ignored Brexit risk. Nor could the NAMA Board have ignored it in late 2013. The outcome of the Brexit vote and its subsequent impact on property markets **demonstrates clearly how injudicious it would have been for the NAMA Board to have passed up a good opportunity to dispose of regional British and NI assets in the speculative hope that an even better opportunity might possibly have arisen at some stage in the future.** The fact that some UK open listed property funds have stopped withdrawals and that others have discounted their pre-Brexit values significantly gives an indication of the potential impact of the Brexit referendum and the risk associated with property even in a liquid market such as the UK.

27. In the case of Eagle, given the limited market appetite for the collateral, such a strategy would have been commercially naïve and would have left Irish taxpayers with an ongoing exposure to a small regional market which experienced very little price appreciation in 2014 (+2.3%) and 2015 (-0.8%) and which is now facing a very challenging post-Brexit period ahead. It is reasonable to suggest that, had NAMA retained the Eagle portfolio, there would be no investor interest in purchasing it now or for the foreseeable future. Nor would there be very much investor interest in acquiring the vast majority of the individual assets securing the Eagle loans. In fact, if NAMA had not availed of the opportunity to sell the Eagle loans, Irish taxpayers would have been quite entitled to question its commercial acumen in managing its obligations under Section 10 of the NAMA Act.

28. NAMA's strategy from an early stage in its evolution was to exit the UK and other markets outside of the Republic of Ireland as soon as was both commercially sensible **and** operationally feasible and, if possible, to do so by the end of 2016. This has been, by and large, achieved, with only about €700m of UK and NI assets to be realised in 2017 and 2018. The outcome of the Brexit referendum suggests that disposing of the Eagle portfolio, which comprised many of the less attractive assets in the UK jurisdiction, was the right strategy to adopt by NAMA.

29. The sale of Project Eagle allowed NAMA an opportunity to divest itself of a substantial exposure which offered limited upside potential and instead to focus its resources and expertise on opportunities that presented better risk-return reward profiles. This strategic decision to focus its attention on the London and the Irish markets has been justified by the very good commercial outcomes achieved on 2015 and 2016 sales in those markets.

30. The NAMA Board is satisfied that its accelerated deleveraging programme of 2014-2016 has been fully justified and that it acted both prudently and commercially in taking advantage of opportunities in the British, NI and Irish markets when they arose during that period. The positive impact of the accelerated deleveraging programme in reducing the State's contingent liability has been recognised by the credit ratings agencies in a number of successive credit ratings upgrades for Ireland over recent years.

D. C&AG's approach to the examination

31. NAMA does not consider that the C&AG engaged adequately with many of the valid points and supporting evidence submitted by the Board over the course of the examination. The C&AG appears to have formed his views at an early stage in the examination based on a selective focus on a small number of documents. The extensive, market-based expert evidence procured and submitted by NAMA to C&AG during the course of the examination has been given only a token acknowledgement in the report and no serious attempt has been made to incorporate it in any meaningful way into the C&AG's analysis. The Board does not consider that this reflects due process and believes that it is at variance with fair and objective audit procedures and practices.

32. The Board's key decisions in relation to the Eagle transaction were based primarily on its extensive discussion of the issues involved. Accordingly, to get a full understanding of the basis for various decisions taken by the Board, due process required that the C&AG engage directly with Board members, as would be normal for an audit practice. This did not happen.

33. Given Lazard's key advisory role in the transaction, it would also seem reasonable that senior OCAG staff should have engaged directly with Lazard. This did not happen.

34. Prior to commencing his examination of Project Eagle, the C&AG launched a public procurement process seeking external specialist advice to assist him in his examination. This was, in effect, an acknowledgement of the reality that he did not have market expertise within his Office and that he needed external advice if he was to conduct the examination in a properly informed manner. When the attempt to procure such expert advice through public procurement failed, there appears to have been no further attempt to secure expert market advice through some other means.

35. Instead, the examination's conclusions are based entirely on opinions formed by the C&AG and his staff who have no market experience and no expertise in loan sales. The Department of Finance, following a meeting with OCAG staff in early June 2016, indicated to NAMA its surprise at OCAG's lack of knowledge of the loan sales market and advised that they would benefit greatly from external advice to help them achieve a better understanding of loan portfolio sales in general. The NAMA Board considers that it is incomprehensible that a report which purports to present an authoritative view on a major loan sale transaction is not informed by any supporting expert insight or market knowledge.

36. In assessing the process adopted by NAMA in the case of Project Eagle, the only benchmark applied by C&AG is the process adopted by NAMA itself in later loan sales such as Project Tower and Project Arrow. It is inexplicable that no attempt was made by the C&AG to benchmark the Eagle sales process against other sales which were executed by various financial institutions in Ireland and elsewhere during 2013 and 2014 at a time when the European loan sales market was still evolving. This failure appears to stem from a lack of loan sales expertise and market knowledge within the C&AG's Office. In effect, NAMA is being benchmarked against itself because C&AG staff did not have access to the market knowledge and expertise which would have enabled them to identify and review other market benchmarks. This is clearly another serious inadequacy in the approach adopted by the examination.

37. **The NAMA Board is of the view that, had the C&AG examination been informed by market knowledge and expertise, its conclusions on many of the key issues – and, in particular, its conclusion on the sales price achieved by NAMA - would have been different.** Given the Board's fundamental disagreement with this conclusion and given that this conclusion arises directly from the inadequate examination approach that was adopted, notably the C&AG's failure to secure market advice or expertise, the Board considers that it would be entirely unsatisfactory if the C&AG's poorly-informed and flawed conclusion were to be left unchallenged. Taxpayers are entitled to expect that examinations of this nature should be conducted to a high standard and, in particular, that any conclusions reached should be rigorously established and supported by market evidence and expertise.