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Contact Alan Boyne

FAO: Mr. Donal Rooney/Chief Financial Officer

11 May 2016

Dear Sirs and Madam:

Following recent discussions with Mr. Rooney and subsequent receipt of the signed Contract Order for Services, we have considered your question

"Is the carrying value of distressed loans and receivables a reliable indication of their underlying market value?"

We have outlined below our written response.

At the heart of this question is a comparison of two valuations; the first "carrying value" being a value calculated in accordance with accounting standards and the second a "market" value that is not subject to similar limitations and direction.

In addressing the question we have drawn upon both our accounting expertise and loan sale experience of advising banks and private equity firms on large loan sales transactions.

1. Carrying value

Financial statements – underlying basis of preparation

In addressing this question we have firstly reviewed the Group and Agency's audited financial statements for the year ended 31 December 2014, being the latest publicly available audited financial statements on its website. The financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union, the International Financial Reporting interpretations Committee (IFRIC) interpretations and The NAMA Act 2009.

International Financial Reporting Standard (IFRS) 39

The primary standard providing guidance on the accounting for loans is IFRS 39 *Financial instruments Recognition and Measurement*. It sets out the general principles for initial recognition, classification and subsequent measurement of loans.

Loan amount initially recognised

The basic principle is that loans acquired in a direct asset purchase are measured initially in the accounts of the acquirer at fair value at the acquisition date. Normally, the fair value at initial recognition is the transaction price i.e. the consideration paid. Where the transaction is not based on market terms it is then necessary to use a valuation technique to determine the appropriate fair value for initial recognition of the loans e.g. Long Term Economic Value (LTEV).

Loan Classification

At initial recognition, a loan is classified into one of the measurement categories for financial assets set out in IAS 39. Initial classification determines the subsequent measurement of the asset in the financial statements.

The Agency uses the loans and receivables classification category to measure the loans subsequently at amortised cost using the Effective Interest Rate (EIR) method.

Effective Interest Rate (EIR)

Briefly, an effective interest rate calculation is required to determine interest income for loans measured at amortised cost. Therefore, at the acquisition date, the fair value determined for the loans and the cash flows expected over the remaining life of the loans are used by the purchaser to calculate an effective interest rate for the loans.

The effective interest rate is calculated on initial recognition of a loan and reflects a constant periodic return on the carrying value of the loans. It is the rate that exactly discounts estimated future receipts through the expected life of the loan, to the net carrying amount of the loan on initial recognition. There is a presumption that the cash flows and the expected life of a loan, or a portfolio consisting of similar loans, can be estimated reliably.

Calculating loan impairment losses

If there is objective evidence that a financial asset is impaired, then an entity determines the amount of any impairment loss. For a loan carried at amortised cost, impairment is measured as the difference between the loans carrying amount and the present value of estimated future cash flows discounted using the original effective

interest rate. The estimated future cash flows include only those credit losses that have been incurred at the time of the impairment loss calculation. Losses expected as a result of future events, no matter how likely, are not taken into account.

Objective evidence of impairment

Note 2.12 of the Agency's financial statements outlines in detail the matters considered as objective evidence of impairment. These examples of evidence of impairment include both macro economic and debtor specific issues.

2. Market Value

Any valuation exercise by its nature provides a guide to a possible realisation amount as opposed to a definitive view on an exact amount that could be realised as part of a sale. The following definitions of market value from the Royal Institute of Chartered Surveyors ("RICS"), International Valuation Standards Council ("IVSC") and the International Accounting Standards Board ("IASB") all share a common theme around market value i.e. ultimately it requires willing participants and a well designed sales process.

RICS definition of market value

"The estimated amount for which a property should exchange on the date of valuation between a willing buyer and a willing seller on an arm's length transaction and after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion."

IVCS definition of market value:
"The estimated amount for which an asset or liability should exchange on the valuation date between a willing buyer and a willing seller in an arm's length transaction, after proper marketing where the parties had each acted knowledgeably, prudently and without compulsion".

IASB, IFRS 13 definition of market value

"...the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."

Distressed debt sales

The potential buyers for distressed, high Loan to Value assets are typically specialized distressed debt investors who base their pricing decisions on their proposed loan strategy post-acquisition and in particular their exit realisation strategy.

Exit strategies can range from Enforcement, Consensual sale, Discounted Payment Offer ("DPO") as well as variations on all of these strategies in isolation or combination within a portfolio. Consequently, the workout valuations associated with the various strategies may be asset or debtor specific.

Distressed debt buyers will consider many of the same issues that an owner of loans considers when reviewing the carrying value of their loans within the context of preparation of financial statements. However, although buyers may consider the same issues, their estimates of cash flows, property collateral values, property market evolution, timing of cash flows, costs of transaction, legal enforcement landscape etc. their views may vary considerably from those of a seller.

One area where there can be considerable divergence between buyers and sellers is the discount rate applied by each party to the estimated cash flows. In the case of a seller, the carrying value of loans in their financial statements is determined by accounting rules and more specifically the concept of Effective Interest Rate ("EIR"). In contrast, a buyer is free to use whatever discount rate they feel is appropriate to reflect not only the risks associated with the transaction or workout strategies but more fundamentally the financing of the transaction.

Typically, buyers of distressed loans use a mixture of debt and equity to fund transactions. For example, depending on the nature and quality of the collateral, debt funding of between 60% and 70% may be available to fund the transaction; the balancing 30% - 40% being provided through equity. The debt markets are dynamic and rates will vary from transaction to transaction. However, margins of between 400bps – 450bps would not be uncommon. Additionally, investors providing equity to fund the transaction may require returns of between 15% and 20% p.a. The combination of these factors will drive up the discount rate used by buyers.

Finally, in addition to calculating an intrinsic value for a transaction based on discounted cash flows, buyers will also benchmark their pricing against comparable deals and transactions when they have access to such information. It is usual to refer to their bid as a percentage of capped Real Estate Value, as the collateral value is the key driver of value in distressed loan sales transactions.

Conclusion

In answer to your question, we believe that carrying value is not a reliable indication of the underlying market value of loans and receivables due to the limitations and direction that is inherent in the calculation of carrying value under accounting standards, unless the loans were recently acquired.

The carrying value of loans carried at amortised cost in financial statements prepared in accordance with International Financial Reporting Standards (IFRS), as adopted by the European Union, the International Financial Reporting interpretations Committee

(IFRIC) interpretations and The NAMA Act 2009, usually equals its fair value on the initial date of recognition. Thereafter, accounting rules and more specifically the use of EIR considerably restricts the possibility of carrying value equating market value particularly when the loans have been held for some time.

Although buyers and sellers may consider the same issues impacting their valuations, it would be unusual for both parties to form exactly the same quantitative and qualitative assessments within the transaction. Consequently, some divergence in views and resulting valuation is normal.

Finally, even if both parties formed identical views on all estimates input to their discounted cash flow calculations, differing values may still be calculated due to the discount rates used by the parties; the EIR used by the seller in determining carrying value and a market discount rate used by the buyer taking account of the rates of return required by both debt and equity providers.

Should you have any questions or points of clarification in relation to the contents of this letter, please do not hesitate to contact me.

Yours sincerely

Alan Boyne
Partner