National Asset Management Agency

Opening Statement by

Mr. Brendan McDonagh, Chief Executive of NAMA, to the

Public Accounts Committee

Wednesday, 26th October 2011

Chairman and Deputies,

In our discussion today on the NAMA 2010 Annual Report and Accounts, I propose to refer to some of the key issues arising from the Accounts, to update you on progress made this year and to outline some our plans for the years ahead.

2010 was a pivotal and challenging year in the evolution of NAMA. As an organisation, we began the year with seven members of staff and a Board that had been appointed only days before the start of the year. We ended the year with over one hundred staff and a portfolio of loans with nominal balances in excess of €71 billion. The securities we paid as consideration for these loans meant that over €30 billion could be injected into the banking system during the year. We also began the process of engaging with the major debtors whose loans had been acquired and we set in train the necessary asset enhancement and workout programmes of asset disposals and setting of debt repayment targets for debtors which, in turn, will enable NAMA to pay down its debt over time.

There was an enormous effort involved in 2010, and again this year, in conducting the necessary due diligence and valuation of the loans transferred from participating institutions. A recent transfer of close to €2 billion completes our acquisition and brings the total portfolio of acquired loans to €74.2 billion. For this we have paid €31.7 billion to date; the consideration will be finalised when we have completed due diligence and valuation, although the final figure is unlikely to deviate materially from the consideration paid to date or the overall discount of 58%.

Impairment

The loan assets that we acquired generated a net operating profit of €305m for us in 2010 but the requirement to take an impairment charge of €1,485m resulted in an overall loss of €1,180m.

As the accounting issues involved are not necessarily straightforward, I would like to dwell briefly on the question of the impairment charge. Under International Financial Reporting Standards (IFRS) rules, we are required to review our loan portfolio for impairment at each year end reporting date i.e. 31 December. A loan is considered to be impaired if its recoverable value (as updated) is less than its carrying value on our books at the reporting date. Under IFRS rules, we were required to assess impairment by reference to whether or not a debtor was deemed to be individually significant. For an individually significant debtor, the question that arises is whether there is objective evidence of impairment in each particular case. As for debtors who are not considered to be individually significant, the question becomes whether there is evidence of impairment, either individually or collectively?

The debtors deemed to be individually significant as at the end of 2010 were those whose loans were acquired in the first and second tranches and whose Business Plans we had assessed. These loans had a carrying value of €13.3 billion or 44% of total NAMA debt. The valuation methodology approved by the EU Commission required the adoption of a standardised approach to the valuation of loans, including standardised assumptions about the timing of asset disposals and the treatment of certain asset classes. As part of the detailed engagement with the Tranche 1 and Tranche 2 debtors, many of these standardised assumptions had to be revised to reflect the outcome of our review of debtor business plans and to reflect the market environment and economic conditions in Ireland and outside of Ireland. It also included updated valuations of certain property assets. Loans had initially been valued by reference to property valuations as they stood on 30th November 2009. As prices in the Irish market continued to fall subsequently during 2010, this obviously had an impact on the value of the property collateral securing the loans and, therefore, ultimately on the proceeds likely to be realised from planned asset disposals by debtors.

Based on this case-by-case review, we recorded an impairment provision of €719m, or 5.25% of the carrying value, against the loans of individually-assessed debtors. It should be pointed out that one of the features of IFRS rules is that, where NAMA projections of expected cashflows indicate that it will realise more than the carrying value of the loans, it is precluded from recognising such potential gains unless and until they are realised. On the other hand, potential expected losses must be recognised immediately. The impairment provision is not reflective of an actual loss that has occurred but a possible projected loss.

Debtors in the third and later tranches, representing loans and related derivatives with a carrying value of €16.1 billion (56% of NAMA debt), had not been individually assessed at the end of 2010 and these debtors were therefore included in the collective assessment. In the absence of relevant historical data on likely default rates and given that we had very limited knowledge of the debtors as neither due diligence nor business plan reviews had been completed, the collective impairment assessment was particularly challenging.

We considered the best guide available to us was the impairment information derived from the review of the individually-significant debtors. The average impairment rate for the individually-significant debtors was applied to the collectively assessed loans, with some adjustments being made for specific outlier impairments which are deemed not to be relevant to collectively-assessed debtors. Arising from this, a collective impairment provision of €766m, or 4.8% of carrying value, was recorded against the collectively-assessed loans. This resulted in a combined impairment charge of €1.485 billion for 2010.

I would point out that the assessment of impairment on a portfolio of loans which has just been acquired is an inherently subjective and complex exercise. The projection of cash flows for individual debtors and of future realisation values and timings of disposal of property collateral is obviously fraught with uncertainty, particularly in current market difficult conditions domestically and internationally. Notwithstanding these constraints, we adopted the stance that we would be utterly prudent and conservative in terms of our expectations of what can be realised from the acquired loans and the underlying collateral. Obviously we will undertake another rigorous exercise at the end of 2011.

2011

I would like to take the opportunity to update the Committee on the further progress we have made in 2011, particularly as regards our engagement with debtors. You may be aware that our intention is to deal with the largest Top 188[1] debtors directly, with over 600 debtors being managed by the participating institutions under delegated authority from us.

Of the 188 debtors which are being managed directly, 143 business plans have now been assessed by us and the rest are at various stages of review which will be completed by end-year. Of the debtors whose plans have been assessed, about 30% are subject to full or partial enforcement; the others are implementing strategies which have been agreed with NAMA or are at an advanced stage of negotiation with us. Good progress has also been made on business plans by debtors whose loans are being managed by the participating institutions on our behalf.

Engaging with debtors has meant that we have to deal with a substantial flow of credit applications, averaging about 300 a month and including applications for credit advances, sales approvals and insolvency appointments. To date, we have approved advances of over €900m and asset sales in excess of €4.6 billion. Some 91 insolvency appointments have been approved across both NAMA-managed debtors and those managed by the institutions.

The proceeds of asset sales and the associated debt repayments by debtors have contributed to the strong cash position of the agency and this, in turn, has enabled us to make significant inroads in terms of repaying NAMA debt. To date, we have repaid €1.55 billion: €1.25 billion of NAMA securities redeemed plus loans totalling €299m repaid to the Minister for Finance. We expect to be in a position to make a substantial additional redemption of securities before the end of the year.

One issue which is raised on a regular basis and about which there appears to be some misunderstanding is the extent to which debtors are expected to repay all of their debt to NAMA. The position is that debtors remain legally obliged to repay all of their debt. NAMA will pursue all debts to the maximum extent feasible. As of today we have to acknowledge that some of the property securing loans has fallen in value by about 60% on average in Ireland since the peak of the market. Therefore, if we were to enforce against each and every debtor and sold the property securing the loans, we know that we would realise only the current value of the property collateral as the debtor has no other assets and the pursuit of debtors would not be economic. Frankly, in the case of some debtors, this is all that we can ever hope to recover and, in some of these cases, we have initiated, or expect to initiate,

[1] Subject to ongoing review depending on associated connections

enforcement but rest assured we will pursue every penny where it makes economic sense to do so.

In the case of other debtors, we have every reason to expect that, by working with them over time, we can generate a lot more than the value of the collateral. This may be for a number of reasons: because of their knowledge of the assets, their managerial ability and their willingness to co-operate, including the extent to which they are willing to give us a charge over unencumbered assets and their agreement to reverse earlier asset transfers to relatives and others. In these cases, by working with the debtors, we expect to optimise the return to the taxpayer. In some cases, we will consider incentivisation arrangements which are designed to extract best value for NAMA. For instance, if in six or seven years' time, a debtor were to achieve a key financial milestone, such as the repayment of all NAMA's loan acquisition costs plus 10%, an incentive could be put in place which would enable him to retain ten cents of every euro achieved above that financial milestone. Momentum towards the initial target will largely depend on the asset mix and the performance of the property markets in which the assets are located. The key point I wish to stress is that debtors will not be allowed to walk away from their debts as soon as they reach the initial repayment targets set for them; these targets are the very least that they must achieve. If the Irish and other property markets should experience any price gains over the next five to seven years, debtors will be in a position to repay well in excess of their initial milestone targets and NAMA will capture that.

Property exposure

Within Ireland, our loans are secured by about €11 billion of property in the Dublin area with another €7 billion of property in other parts of the Republic and some €1.3 billion in Northern Ireland. Property in the London area accounts for €6 billion with another €4.7 billion in other parts of England, Scotland and Wales. The residual €1.5 billion of property is located outside of Ireland and the UK, mainly in Europe.

In terms of asset types across all geographies, about €14.5 billion of assets securing our loans are commercial assets, including retail, office and other investment assets. Residential assets account for about €5 billion and hotels for about €3 billion. The residual is land (€6 billion) or assets under development (close to €3 billion). We are currently developing strategies for each of these market segments by asset type and geography.

Commercial property

Our exposure to the Irish commercial market is of the order of €5.3 billion and we are reviewing a number of strategies in order to monetise this segment of the portfolio. One initiative involves the provision of vendor finance to purchasers. Against a background in which financial institutions are reluctant to underwrite a high proportion of lending to individual property ventures, liquidity continues to act as a serious constraint on market activity. With a view to generating sales transactions which would not otherwise take place and to attracting new equity into the Irish market, NAMA is willing to provide up to 70% vendor debt finance to purchasers of commercial property which is either under the control of its debtors or of NAMA receivers. Purchasers, such as pension funds, insurance companies, private equity firms and sovereign wealth funds, will be expected to be in a position to inject significant equity capital upfront. The assets most likely to attract interest include large office buildings, shopping centres and other retail and industrial properties. The first financing under this programme has recently taken place and the programme is likely to gain significant momentum next year as more properties are offered to the market.

Another initiative being explored is the creation of monetisation vehicles which are attractive to potential investors, mainly international. When it currently enforces against debtors, NAMA seeks to maximise debt repayment through the appointment of receivers or other insolvency professionals so as to realise the value of underlying property assets. NAMA will likely acquire property assets, on an arm’s length basis, from receivers (or for debtors to cede secured property directly to NAMA) and package them into various combinations which could then be monetised through sale to investors.

It should be possible to assemble portfolios based on asset types (office, residential, retail, etc.) or geographical region (Ireland, Dublin, UK, etc.) and to secure international investment based on specialist investor preferences.

Residential property

NAMA's exposure to the Irish residential property market is of the order of €4 billion. As is the case with commercial property, liquidity has also been a major constraint on activity in this market. The majority of the residential stock is located in Dublin, Cork, Galway and Limerick and, not surprisingly, much of the stock is in the form of apartments as this was what the planning system catered for. We are currently in advanced discussions with a number of government departments on an initiative which could be used to target a particular segment of the market i.e. potential house buyers who have an interest and a capacity to purchase but who are constrained by fears that prices may fall further from current levels. If a decision is made to proceed with the initiative, it will first be offered on a pilot basis for a small number of properties and further rollout will depend on the response to the pilot project.

We also see a possible synergy between NAMA housing stock and the potential demand for social housing and we are in discussions with the Department of the Environment and the Irish Council for Social Housing on that matter to try and satisfy a mutual accommodation.

Loan sales

The sale of loans provides NAMA with another option to monetise its portfolio. There has been substantial interest to date from investors wishing to purchase particular loan sub-portfolios. The loan sale market is well developed in the US but less so in Europe. However, with a requirement on financial institutions under Basel III to hold more capital which may involve reducing their balance sheets, the market in Europe is expected to develop significantly in the coming years.

In order to ensure that it is well placed to avail of loan sales opportunities, NAMA is establishing a panel of loan brokers in each of its main jurisdictions to manage its loan sales process. It has initiated a tendering process under EU Public Procurement rules to appoint a panel of loan sale advisers in Europe and the US. It will look to sell loans which can be packaged in a number of different ways, including the sale of all loans of a single debtor or debtor connection and the sale of loans held in individual SPVs or corporate entities with no recourse beyond the assets of the SPV/corporate entity. Another option is to sell sub-portfolios of loans assembled by reference to underlying property asset types or locations.

I would emphasise that we currently insist on a competitive process for any assets that are being sold by our debtors or by receivers and we will follow the same practice in our sales of loans or loan portfolios. I make this point because we are aware that certain parties have been complaining that NAMA is not willing to do business with them. What they invariably mean is that NAMA is not interested in offering them exclusivity; in other words, a minority of these potential buyers appear to believe that they should be allowed to acquire property or loans at ‘low ball’ prices and in off-market transactions without any element of competitive bidding. This is certainly not in our interest or in the interest of the taxpayer: whether we sell loans or approve the sale of property, we aim to obtain the best attainable pricing and that can rarely be achieved without some element of competitive bidding.

There has been some comment also on the question of how NAMA might best contribute to the social and economic development of the State, which is one of the purposes set out in Section 2 of the Act. Clearly, NAMA will make major progress towards fulfilling this purpose if it succeeds over time in making a positive return on its management of acquired loan assets. However, there is a belief that, challenging though this commercial mandate may be, it is not sufficient and there is an expectation that NAMA must also meet certain social objectives.

I would emphasise that, within the context of its commercial remit, NAMA is at all times open to considering proposals aimed at contributing to broader social and economic objectives. For instance, Deputies may be aware that NAMA participated in the Working Group set up by the Government to examine the issue and extent of unfinished estates in Ireland and has committed to funding the €3m estimated cost of carrying out the necessary remedial work in those Category 4 estates which are under the control of NAMA debtors. We are working closely with the Minister for Housing and with his officials to identify properties which may be suitable for social housing. We have recently made available to Dublin City Council a list of properties which may be suitable for the needs of residents evacuated from Priory Hall and we have committed to provide funding for costs of completion, where required, even though the Priory Hall loan is not in NAMA. Our Board has committed to giving first option to public bodies on the purchase of property which may be suitable for their purposes where they have requirements such as schools, hospitals, parks and so on. We have constructive engagement with the Departments of Education, Health, Arts, universities and the HSE to try and identify mutually beneficial solutions. Although we do not directly control our debtors' property, we are happy to facilitate dialogue between our debtors and parties interested in acquiring property for social or public purposes.

Chairman and Deputies, I have tried to address some of the key issues that may be of interest to you and am happy to respond to any additional points you may wish to discuss this morning.