National Asset Management Agency

Opening Statement by
Mr. Brendan McDonagh, Chief Executive of NAMA, to the
Public Accounts Committee
Thursday, 29 September 2016

Chairman and Deputies,

We welcome this opportunity to set out NAMA's response to the C&AG's Section 9 Special Report on the sale of the Project Eagle loan portfolio. It is remarkable that the C&AG does not form any view on value for money but still makes the following comment: *"the decision to sell the loans at a minimum price of £1.3 billion involved a significant probable loss of value to the State."* In the time available to me, I will focus my remarks on this comment which NAMA very emphatically rejects.

Sales price

The C&AG's view is that a discount rate of 5.5% would have been appropriate to derive the market value of this portfolio. Not only does the report fail to provide any market or expert support for this view but it inexplicably ignores strong market evidence from international loan sales experts which would have supported the use of a discount rate in the 10%-15% range.

This report has adopted a position which would not be accepted by anyone engaged in actual loan sales in Ireland or anywhere else. That C&AG position holds that there should have been no divergence between the end-2013 proxy accounting value of the portfolio (£1.465 billion, based on a 5.5% discount rate) and its market value (about £1.3 billion, based on a 10% discount rate) and that, therefore, NAMA should not have accepted anything less than its accounting value.

The accounting value of the portfolio was derived using EIR[1] discount rates which are based on the IFRS accounting rules that NAMA has been required to follow since inception. They were not market rates and no potential purchaser would have applied them to value the portfolio. Valuation of the portfolio at EIR rates may be appropriate for ongoing NAMA accounting purposes but clearly not appropriate when determining a market sales value.

NAMA's view, which is supported by expert market evidence from four internationally recognised loan sales experts and which we provided to the Committee last week, is that a discount rate in the 10%-15% range was appropriate to apply to the cash flows associated with the Eagle portfolio. This reflects the cost of capital that bidders would have incurred in early 2014. It is also very much in line with the range of discount rates (10% to 15%) which were applied in a number of our other major loan sales.

It also reflects the inherent risk associated with a loan portfolio which was secured, for the most part, by a granular portfolio of non-prime assets, located mainly in Northern Ireland and in northern parts of Britain.

The positions on this issue are very stark: NAMA and the loan sales market have one view on the appropriate discount rate; the C&AG report appears to be alone in its view. It would not have been difficult for the report's authors to have consulted market experts on this crucial point – something the NAMA Board requested them to do. For some reason, however, this was not done.

A second major difficulty with the report's understanding of the valuation issue is that it assumes that debtor cashflow projections are fixed and certain. In reality, cashflow projections are no more than estimates of the income and disposal proceeds that assets may generate in the future. They are a point-in-time exercise. NAMA carries out a formal impairment review each 30 June and 31 December. There can be no certainty attached to the timing of cash flows or that they will remain constant. This uncertainty is compounded in the case of a granular, secondary portfolio.

For instance, cash flow projections associated with Dundrum Town Centre have a reasonable level of certainty attached to them because of the attractiveness of the asset to shoppers, to tenants and to potential purchasers – this is a strong income-producing asset with strong tenants. On the other hand, the cash flows attaching to small assets in Northern Ireland and in

[1] EIR is an IFRS term - Effective Interest Rate

certain regions in northern England and Scotland are much less certain, both in terms of projected disposal proceeds and projected income. Some assets had no income stream – 31% of the NI portfolio comprised land and development assets. The top 55 assets in Eagle accounted for almost two-thirds of the portfolio's value. That left the rest of the portfolio with about 870 assets which had an average value of about £600,000. It made sense, through a loan sale, to bundle poorer quality assets with the better quality and higher value assets.

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 risk premium and therefore the discount rate that will be applied by buyers.

The report's valuation approach involved the mechanistic and rigid application of a spuriously precise and abnormally low discount rate to cashflows which are assumed, unrealistically, to be fixed and certain. In both respects – the level of certainty attached to cashflows and the discount rate – the report's understanding of loan portfolio valuation is seriously at odds with how distressed debt portfolios such as Eagle are actually valued by investors and purchasers in reality.

The minimum sales price set by the NAMA Board was £1.3 billion. This falls within the mid-point 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 £1.35 billion; a 15% discount rate produces a value of £1.25 billion. **The £1.322 billion achieved on the sale, which was above the minimum price of £1.3 billion, was therefore well within the expected range of expected market values.**

Misinterpretation of Board decision of June 2013

The only evidence offered in the report to support the use of a 5.5% discount rate is a NAMA Board decision of June 2013. However, for some reason, the report ignores important caveats which were applied by the Board in the case of its approved discount rate methodology and which were clearly set out in the paper on which that decision was based.

The Board decision of June 2013 noted that a 5.5% rate **should <u>not</u> 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*"**.**

A discount rate of 5.5% may have been appropriate for overall portfolio accounting purposes and indeed for some individual transaction evaluations but would not have been appropriate for all segments or assets within the portfolio. The flexible approach approved by the Board in June 2013 was clearly designed to deal with the evaluation of transactions and lower quality assets such as Eagle which was not typical of the NAMA portfolio as a whole. As I indicated above, discount rates in the 10% to 15% range were applied to cash flows in later loan portfolio sales.

There was very good reason why the Eagle portfolio would have been subject to a higher discount rate, including the relatively poor quality of the underlying assets and the underlying weak economic conditions in Northern Ireland and in parts of northern England and Scotland.

The discount rate would also have reflected the inherent macro risk associated with a high concentration of assets located in the small Northern Ireland economy. The Northern Ireland property market did not have the capacity to absorb a large volume of asset sales over a short time period; this lack of market liquidity was evidenced by the fact that, in the four years from 2010 to the end of 2013, sales of NAMA-secured assets in Northern Ireland realised a total of only £100m. This consideration would not have applied to the Dublin or London markets.

Project Tower, a better quality portfolio than Eagle, was launched to market at the same time (Q1/2014). UBS, our loan sale advisor for Tower, advised that a 10% discount rate was appropriate. In Project Arrow, a portfolio with similar characteristics to Eagle, Cushman & Wakefield advised in mid-2015 that a 15% discount rate was appropriate. This demonstrates that NAMA's position on discount rates reflects the market reality of loan sale pricing.

The C&AG's claim – that Eagle involved a significant 'probable loss' of value to the State – rests on its mistaken view that the Board adopted a 'standard' discount rate of 5.5% in June 2013 to be used subsequently for all future evaluations. The Board firmly rejects this C&AG interpretation of the Board's own decision: **it is clear from the June 2013 decision itself (as quoted above) that the Board did not intend that 5.5% should be a one-size-fits-all discount rate.** When it became clear to the Board that the C&AG's examination team was unwilling to accept the Board's understanding of its own decision on the £1.3 billion minimum price, it offered to meet the C&AG directly to discuss this issue and to discuss other key points. The Board's offer, however, was refused by the C&AG.

Recognising market evidence

The C&AG's Office has not been consistent in the application and guidance it has provided in writing to the NAMA Audit Committee and Board. In his end-2013 Management Letter issued after his unqualified sign-off of the 2013 financial statements, the C&AG acknowledged that NAMA's strategy was evolving from individual asset-by-asset sales to a greater focus on bulk loan portfolio sales. In that context, both NAMA and C&AG staff would have agreed in 2013 and 2014 that we could not have maintained the previous carrying value of the portfolio once the strategy changed from individual asset sales to a loan sale of full debtor connections. This is evident from the end-2013 Management Letter (issued in May 2014) in which the following is stated by the C&AG:

> *Where a change in strategy is effected which results in either (i) a change in the sale of underlying collateral to a loan sale/portfolio sale or (ii) a change in the sale of a loan/loan portfolio to the sale of the underlying collateral,* ***cash flows should be updated to reflect the most up to date position to mitigate the risk of an incorrect impairment provision being recognised.***

Two things are clear from this. One is that senior C&AG staff in 2013 took the view that the carrying value of assets included in a loan sale could differ from their carrying value as individual items of collateral. Secondly, it shows that senior C&AG staff in 2013 would have expected NAMA to update the portfolio's carrying value in response to a change in strategy and to the emergence of up-to-date information relevant to judgements on impairment.

Ultimately, the value of any loan portfolio, including the Eagle portfolio, is what credible bidders are willing to pay for it at a point in time taking account of demand/supply and economic conditions. If we had halted the Eagle loan sale, we would have had to adjust our carrying value to bring it into line with the market price indications that we had received from potential bidders. This is absolutely consistent with the IAS39 IFRS accounting guidance and in line with NAMA's own understanding. **Indeed, it is very much in line with the C&AG's own 2013**

Management Letter recommendation, although not apparently in line with the view adopted in this Section 9 report.

What all this means, in layman's terms, is that if the best bid for Eagle had happened to be £1.1 billion and NAMA had therefore decided not to sell, the C&AG's Office would have insisted, based on its end-2013 Management Letter, that NAMA write down the portfolio to £1.1 billion. NAMA could then have sold the portfolio later in 2014 at £1.1 billion and there would have been no talk of a 'probable loss' to the taxpayer, merely because the accounting adjustment - with a higher impairment - would already have been made at that stage. Ironically, because NAMA was guided by the Section 10 NAMA Act objective of getting the best price achievable, it set the minimum price at a more aggressive £1.3 billion. It achieved in excess of that price target. As a result, it is now being accused of losing £190m because of the C&AG report's misplaced attachment to an accounting value rather than the real world market value which is ultimately what matters.

It would be clearly absurd if NAMA's commercial activity were to be driven by accounting valuations rather than by real world values. In effect, the practical consequence of the position now adopted by this report is that NAMA would never have sold the Eagle portfolio or any other similar loan portfolio if the market value failed to match NAMA's accounting value. It is worth bearing in mind that an accounting value is no more than a provisional estimate of value until confirmed or otherwise amended by evidence of market value.

NAMA, under legislation enacted by the Oireachtas, has to operate by reference to commercial principles. Acceptance of the C&AG's unrealistic and uncommercial position would make commercial decision-making impossible. That is why this issue goes to the heart of NAMA's commercial mandate and why we have no alternative but to contest the C&AG's current stance as evident in this report.

C&AG's examination process

The issue of valuation and of the appropriate discount rate is closely bound up with the procedure adopted by the C&AG in preparing this report. Prior to commencing his examination of Project Eagle, the C&AG sought external specialist advice to assist him in his examination.

This was, in effect, an acknowledgement of the reality that he needed external expert advice if he was to conduct the examination in a properly informed manner.

Ultimately, the fact that no external advisors were commissioned by C&AG to advise the examination meant that the report's conclusions are based entirely on opinions formed by staff who, to our knowledge, have no market experience and no expertise in loan sales. By contrast, when the C&AG's Office was preparing an earlier Special Report on NAMA's **Management of Loans** (*Special Report No. 79, February 2012*), the then Comptroller, Mr John Buckley, commissioned external expert advice on the property valuation process and on legal issues. Mr. Buckley stated that he did so "***in order to gain assurance***" about two elements of the process on which his Office had no expertise, namely, the valuation of properties and the legal due diligence process. Mr Buckley relied heavily on that expert advice in arriving at his conclusions.

Likewise, we are aware of at least one other instance in which Mr Buckley sought external expert advice from property consultants. Contrary to recent press reports, NAMA is not the first State body to contest C&AG findings on matters which are outside of the C&AG's expertise. In December 2010, during a discussion at the Public Accounts Committee on the OPW Vote, where the OPW disagreed with the C&AG's position, Mr Buckley stated the following:

> ***Normally when we carry out assessments, we operate on the basis of our own work. Here, however, we are dealing with an area of expertise that is outside of our comfort zone. As a result, we employed consultants.***

The current C&AG, in his evidence to the Banking Inquiry, stated that external experts were engaged on four occasions between 2010 and 2014 to provide specialist assistance on issues relating to NAMA. He stated as follows:

> *Matters which are taken into account in the decision to engage an expert include the competence, capability and objectivity of the expert; the significance of the accounting area or nature of the matter to which the expert's work relates; and the significance of that expert's work in the context of the audit or reporting work.*

It is all the more extraordinary therefore that external expert advice was not utilised on this review given that loan sales are new to the Irish market and are certainly more esoteric than property or other matters on which external expert advice has been utilised in the past.

Other sales processes

During the same discussion in December 2010, Mr Buckley went on to point out that "*when one is examining the performance of the OPW, there is no point in using the way it operates as a yardstick to judge that performance*". In other words, good practice requires that you judge performance by reference to some objective external benchmark.

In that context, we note that the current Section 9 report on Project Eagle reviews the Eagle sales process by reference to later NAMA loan sales processes, not by reference to the numerous non-NAMA sales processes which also took place in Ireland and elsewhere in 2014. In effect, the C&AG benchmarks NAMA against itself, not against the wider market at that time.

It would have been instructive, for instance, to have compared the due diligence information in the Eagle data room with the quality of information available to bidders for the IBRC loan portfolios which were being sold at the same time in 2014. That would have been a very relevant and useful comparison.

It would also have been instructive to compare the targeted sales process applied in Eagle with the targeted sales processes applied by the RBS and Lloyd's loan sales in the UK. That would have shown that the targeting of major investors is a regular feature of the loan sales market.

Unfortunately, these very relevant comparisons, which would have placed the Eagle sales process in a proper market perspective, were not carried out. Why not? It would not have required a huge amount of effort. Are these not obvious comparators which one would expect to find in any major review of Project Eagle which purports to be authoritative?

Conclusion

It is difficult to understand why the well-established C&AG precedent of using external expertise on specialist matters was not used in the case of NAMA's sale of Project Eagle. The area of loan sales is very much a specialist area and is not one on which the C&AG's staff could reasonably be expected to have detailed expertise. There would have been nothing wrong in acknowledging that fact.

The view of the NAMA Board is that if the C&AG examination had been informed by external market knowledge and expertise in loan sale valuation and sales processes, its comment on this key valuation issue would have been different. Given that this very unsound comment stems directly from the inadequate examination process that was adopted, it would be entirely unsatisfactory if it were to be the last word on the matter.

A report which is prepared to make such a resounding and serious comment must be properly supported by convincing, formidable and sufficient evidence. Evidence that is based on accepted market valuation methodology. Evidence that would be accepted by market experts. Evidence based on market comparators.

Unfortunately, the evidence produced in this report falls well short on all of these counts.

Thank you.