Evaluation of Options for Resolving Property Loan Impairments and Associated Capital Adequacy of Irish Credit Institutions:

Proposal for a National Asset Management Agency (NAMA)

Abridged Summary of Report

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Summary Conclusions & Recommendations

1. At the heart of the banking crisis being experienced in Ireland is concern of capital markets with the adequacy of banks capital to meet future loan impairments and institutions' capacity to obtain additional capital externally, in the event that proves necessary. Future impairments are of concern because, for the past decade now Ireland has experienced rapid inflation in property values and lending to the property sector has been an increasingly important component in credit institutions' lending. In addition, there have been several well publicised regulatory failures and dubious practices carried out by management at a number of institutions, which have heightened international concern about the health of the financial sector.

Banks Deposit Liabilities

2. Banks throughout the world have difficulties accessing international liquidity.

Substantial Impairments to the Property Loan Portfolios to Be Faced

3. As regards their property loan portfolios the six guaranteed credit institutions face cumulative economic impairment on their land and development loan exposures and associated property investment loans of around €XBn [Figure deleted. Market sensitive] on loans outstanding of about €80-90Bn. In considering these projections it needs to be borne in mind that the results are sensitive, to certain of the assumptions made in deriving the estimates. The implications of this sensitivity need to be incorporated when considering the implications of the projected impairment or devising propositions as to how they should be dealt with.

Initiatives to Date Insufficient

4. The initiatives taken to date by Government are considered to be insufficient to achieve rates of capital adequacy that would encourage investors to hold and invest further equity in Irish credit institutions, when prospective impairments are considered. As long as this remains the case share values are likely to remain depressed and deposit liabilities are likely to experience continued attrition and foreshortening in duration. Such a prospect would hinder economic recovery, complicate further the required adjustment of the public finances and leave Ireland's international credit rating subject to downward pressures and speculative attacks. Therefore additional and far reaching measures need to be undertaken, as soon as possible to place the banking system on a sound footing.

Public Finance Position & Banks Capital Adequacy Issues are now intertwined

5. Deterioration in the Government Debt/GDP ratio is underway, as the general government deficit widens. A significant part of this deterioration arises from the effects of cyclical downturn. Moreover, discretionary budgetary adjustments to curtail the widening deficit will be partially undone by the deflationary impact of the discretionary measures themselves. To some degree, in the absence of international recovery and/or gains in competitiveness and productivity in Ireland the domestic fiscal adjustment process has the characteristics of a vicious spiral comprising weakening economic activity leading to widening of the Government deficit and indebtedness leading to discretionary fiscal adjustments leading to further erosion of economic activity and so on.

6. The deterioration in Ireland's credit terms associated with fiscal position has been compounded by the additional contingent liabilities of €440Bn assumed by Government by virtue of the necessity to guarantee the deposits of credit institutions from September last. Capital markets are uncertain how to value the additional liability of the Government on foot of the guarantee and the resulting confusion is causing Irish bond spreads to widen unfavourably. Moreover, the fact that it is evident that deposits have not been stabilised as a result of the Guarantee is compounding the perception that the contingent liabilities could become real.

7. Against the backdrop outlined above it is imperative that initiatives should be undertaken that will lead to stability in banks deposit and term debt liabilities and eliminate the need for a renewal of the guarantee. **To achieve this requires removing all doubts about capital adequacy of the credit institutions and their capacity to deal with prospective loan impairments.**

Additional Supporting Initiatives

8. It is appropriate that additional supports should focus on the asset impairment issue and associated implications for capital adequacy. There are a number of broad approaches (which are not mutually exclusive) to bank capital support schemes. These revolve around: Recapitalisation Programmes involving stress testing against expected losses; Asset Guarantee Schemes and Asset management arrangements.

Recapitalisation Programmes

9. The key features are:

- Future Capital shortage is anticipated by testing adequacy of current capital in stress scenarios;
- The adequacy of capital (quality and quantity) to absorb losses is assessed;
- The regulatory authority may then require more capital, which may be raised from the market (e.g. by way of rights issue) or attraction of new shareholder, which may be either private or State;
- Approach needs to take account of implications of market conditions for cost of capital to bank; dilutive implications for existing shareholders; protection of State capital if the external shareholder is Government;
- There have been many recapitalisation programmes put in place in the US and EU in the current crisis including in Ireland where Government have agreed to invest, subject to due diligence, €3.5Bn by way of preference shares in each of AIB and Bank of Ireland.

Assets Guaranteed/Risks Insured By the State

10. The key characteristics of this approach are:

- Troubled assets remain on the balance sheet of the banking system;
- Troubled assets are not subject to upfront mark-to- market write downs;
- The bank usually is liable to a relatively small first loss tranche and the State covers elevated losses for a fee;
- Equity capital is not affected as assets do not have to be sold at the current marked-down levels;
- No initial outlay is required from the State and a fee, premium or compensation arrangement is paid for the guarantee;
- Compensation to the State in the form of convertible preferred shares or warrants is dilutive, of existing shareholders;
- Such schemes have been implemented at ING, Citigroup and Bank of America, and RBS.

Asset Management Arrangements

11. The key features of this approach are:
    - Troubled assets are transferred from the balance sheet of the banks at an agreed price;
    - Mandatory participation required;
    - The banks take the impairment loss to profit and loss account now;
    - The bank is cleansed of troubled assets making valuation of the remaining part of the bank less complicated;
    - The removal of impaired loans reduces the risk weighted assets of the bank and releases capital (or reduces the shortfall in capital required)
    - A discounted sale of assets may result in a significant reduction in the equity of the seller;
    - Significant financing may be required from the State for the Asset Management Company, impacting negatively on the fiscal position;
    - Examples include UBS and Securum/Nordbanken in the 1990s Swedish crisis

Comparative Analysis

12. A summary comparison of the general attributes of the Asset Guarantee approach compared with the Asset Management Approach from the point of view of Government and banks respectively is contained in Table A below. A perusal of the main points indicates some seemingly comparatively attractive features to both Government and banks from the Asset Guarantee approach. Notably, from the Government and banks point of view: there is no initial outlay for the Government and therefore no impact on the fiscal deficit. For the banks, risk is transferred but equity capital does not require to be written down and the assets remain on their balance sheet and crucially, under their control. Conversely, in the case of asset sales the deficit of the government is adversely impacted from the outset, since it must directly or indirectly purchase the impaired assets. For the banks sales of assets at written down values will adversely impact equity investors and may require them to recapitalise, as losses are realized upfront. Intuitively, these aspects alone tend to favour the guarantee approach over sale of assets. However, in the current Irish context, consideration of certain other aspects of these approaches tends to reverse this conclusion. These relate to the contingent liability problem inherent in the bank Guarantee approach; the implications of continuity of management of the impaired assets and future financing requirements of impaired assets.

Contingent Liability Aspect

13. The very features which make the asset guarantee approach intuitively attractive - no money upfront from government; no write down in banks' balance sheet assets, - contain also an inherent fundamental weakness. Namely, that a contingent liability is created in the balance sheet of the Exchequer. The situation has significant parallels with the bank Guarantee of the six credit institutions. It too was adopted on the basis that it involved no up-front outlay on the part of the Exchequer and on the basis that it would not be 'called' and therefore the premium payments by banks would be a net receipt to the Exchequer. In the event, capital markets have not grappled well with the contingent liability of €440Bn created by the deposit guarantee. The tendency has been to price Irish sovereign debt unfavourably, reflecting a view that more issuance of Government debt will be required. Indeed, an argument has developed that if any part of the guarantee came to be called, in effect all would be called and that would lead to extreme problems for the Exchequer! The point of relevance here is that contingent liabilities are inherently uncertain in nature are often evaluated in an ill informed way with resulting errors and the potential for further adverse speculation against Ireland. As a result of the need to guarantee the debt liabilities of Irish credit institutions the credit rating of sovereign Ireland has become inextricably bound up with the issue of Irish banks capital adequacy. A further guarantee approach, this time in respect of banks' property related loan assets, would create a further layer of uncertainty through the creation of another

contingent liability on the Exchequer. This would further entwine the sovereign rating with Irish banks capital adequacy problems without actually providing any clarity as to how capital adequacy would be achieved, other than through a calling of the contingent liability.

Table A: Comparative Analysis of Asset Guarantee vs. Asset Sale Approach

Asset Guarantee	Asset Sale
Government Considerations	
• Earns premium with no initial outlay;	• Purchase assets with significant outlay or government issuance or guarantee; • Earns net income after financing cost;
• Has no immediate impact of General Government deficit or Exchequer debt;	• Each asset purchased has to be financed. The higher the price paid the larger the deficit to be financed;
• There is risk sharing with first loss retained by the bank providing an incentive;	• Risk sharing also, since the bank has to write off the difference between book value and the current value of the security;
• State may be able to impose restrictions on asset management.	• State gains control over asset management but may assume downside risk; however, this latter aspect can be avoided.
Bank Considerations	
• Risk is transferred , though assets remain on the balance sheet; • Fees/premiums are determined based on credit risk alone;	• Banks balance sheets are cleansed of troubles assets; • Asset prices assume a discount for credit losses as well as an illiquidity premium, so sales may result in considerable losses • Will pricing of assets at one bank be carried across at all banks?; • Loss guarantees provided to buyer can help improve pricing and lower loss on sales;
• Equity Capital is not affected as assets are not removed from the balance sheet; • Regulatory capital ratios improve because of reduced risk weight of assets and increases further if compensation to State is in the form of preference shares	• Sale of assets at market prices will significantly worsen equity capital and may require re-capitalisation of banks as well as the AMC; • In current market conditions it would be difficult to achieve recapitalisation without Government support
• Equity investors have to estimate losses on asset portfolios and the true extent of the risk transfer	• Position for equity investors is made clearer as they can concentrate on the valuing the franchise of the bank net of the bad assets
• There is flexibility in structuring attachment/detachment points for asset guarantee such that the bank can optimise risk transfer and the fees; • Fees for the guarantee can be in terms of cash premiums or preference shares and warrants.	• Clean asset sale with no downside risk retained by the bank is best for equity investors. However, it is possible to keep investors on the 'hook' after transfer.

14. By contrast the asset sales approach, while involving the recognition of 'pain' at the outset has the merit of certainty and clarity, provided of course the projection of the extent of impairment is accurate in the first place. In current Irish circumstances there is much to be said for recognising and crystallising prospective property related loan losses explicitly, rather then allowing them to remain on banks' balance sheets with a concomitant *additional* contingent liability on the Exchequer.

Continuing Management Control

15. A feature of the Guarantee approach is that the assets remain on the balance sheets where they have been created. Another side to this is that they continue to be managed by the officers and executives of banks which created the problem-assets in the first place. In the case where assets are complex financial instruments, such as many of the assets acquired by banks that were originated in the US and based on sub-prime borrowers then their valuation and resolution may best be undertaken in the banks which acquired them and which have the financial skills appropriate to this task. The nature of impaired loan assets simply is not of this character. They are loans created and secured by property assets (i.e. development land, work in progress, completed but unsold residential stock and under-performing property investments), which are now worth significantly less than was envisaged by the loan. There is not a great deal banking skills can do to resolve this dilemma. Moreover, the property development companies involved in these transactions are almost entirely privately owned, championed by entrepreneurial characters and mostly without equity or recourse to equity markets, and in many cases do not have the depth of management skills to engage in the kind of portfolio sales and work-outs which ultimately are required to resolve the impairment issue.

16. AMCs seem to offer tempting prospects for avoiding many of the shortcomings associated with a continuation of the existing bank-property developer relationship. Potential advantages include: (i) economies of scale in administering workouts (since workouts require specialized, and often scarce, skills) and in forming and selling portfolios of assets, (ii) benefits from the granting of special powers to the government agency to expedite loan resolution and (iii) the interposing of a disinterested third party between bankers and clients, which might break "crony capitalist" connections that otherwise impede efficient transfers of assets from powerful enterprises. The latter may seem particularly beneficial in circumstances markets, where ownership concentration and connections between borrower and banks are often very close.

17. Sweden's AMCs provide examples of some of these potential advantages, but other countries have found it difficult to realize them.[1] First, government agents may lack the information and skills of (more highly compensated and incentivized) private market participants. Second, government agencies do not operate in a vacuum; they, too, are creatures of the societies that create them, and government agents must negotiate, rather than dictate, solutions, just as private market participants must do. In negotiations with government agencies and private participants alike, the strength of one's position depends on one's "threat point" (the ability to credibly threaten adverse consequences to one's bargaining opponent, if agreement is not reached).

18. Notwithstanding, it is considered that AMCs, by virtue of the potential advantages they contain (as noted above) have the potential to bring about better economic resolution of the impaired loans of Irish property developers than relying on existing bank management and banker-developer relations, which have brought about the problems in the first place.

Future Capital Financing Requirements of Impaired Assets

19. A further important consideration relates to the future financing requirement of impaired assets. Many of the impaired assets will be capable of achieving higher values if they can be worked-out rather than disposed. A key issue to successful work out will be

[1] See for example *Financial Crisis Policies and Resolution Mechanisms: A Taxonomy from Cross-Country Experience*, Charles W. Calomiris, Daniela Klingebiel, and Luc Laeven Chapter 2 in Patrick Honohan and Luc Laeven eds., *Systemic Financial Crises: Containment and Resolution*. (New York: Cambridge University Press). 2005.

access to additional capital, (equity and debt) required for the work out. It is extremely difficult to see how existing property developers will be able to access capital markets effectively for such equity and banks' capacity to extend credit will be limited by the absence of collateral available from most of them. Potentially the amounts involved are large and a feature of Irish property developers is that they are not publicly quoted and have not had a history of recourse to equity markets for their funding, unlike for example the UK where there are many listed property development and residential house builders. Instead they have relied on retained earnings (for equity) and bank lending for the balance. This shortcoming cannot be put right now and it represents a significant impediment looking forward to resolution of the impairment issue, at least cost.

20. However, an AMC does have the potential to at least mitigate this issue in two respects. Firstly, it has the potential to achieve scale and overview of developments and projects. As it is banks will be concerned about the security they hold and how that can be maximized and realised. In many instances more than one bank will be involved in the security and their individual interests may not correspond. An AMC would be able to achieve project oversight. Secondly, if properly structured and resourced (with relevant property related skills) such an entity would have the potential to attract long term capital in a manner that individual development companies would not.

21. **The Asset Guarantee/Risk Insurance approach contains intuitively attractive features – notably, it doesn't involve upfront cost. However, when considered in the context of characteristic features of the Irish situation, in particular taking account of the contingent liability aspect; the implications of loans remaining on banks balance sheets and the continuing capital requirements of property related projects, it appears that the Asset Management approach has the potential to offer greater assistance to achieving resolution of the impairment issue upfront and maximising taxpayer returns, over the longer term.**

22. Table A establishes the implications for re-capitalisation of realising the projected impairment of property related assets in 2009. [Table deleted. Market sensitive]

23. **The acquiescence of the ECB as to the issue of a bond of the stated face value should be procured *before* any decision is taken by Government to proceed with the recommended approach contained in this report.**

Consequences of Additional Capital Investment

24. Any additional capital required to cover losses on transfer to the AMC could result in substantial State ownership of certain credit institutions, depending on the price at which capitalisation is undertaken and the precise form of the capital investment. However, there is an important distinction between this position and fully nationalised entities. Notably, and similar to the RBS and Lloyd's Banking Group in the UK, both institutions would retain their stock exchange listings and their shares would continue to trade on the Irish and London Stock Exchanges. Accordingly, as and when market conditions improve and the performance of Irish banks return to growth there will be a natural exit mechanism available whereby the Government should be able to divest itself of its majority ownership, should it wish to do this, in an orderly manner that allows it to realise gains on behalf of the taxpayer over time.

Proposal for a National Asset Management Agency (NAMA)

25. Credibility is the overriding requirement of any proposal which is going to be successful at addressing banks capital adequacy issues. This requires firstly that the operation be entirely transparent, that the resulting fiscal costs can be absorbed, and that the government's prospective debt profile is a sustainable one. Another necessary feature is that

NAMA should operate independently and without interference in the discharge of its functions.

Functions to be discharged

26. The functions to be carried out by a NAMA would include:

- Management and control of the assets transferred to it;
- Employment/outsourcing whatever resources required to carry out its functions efficiently and professionally;
- As it will control a large segment of the market, it should be able to regulate against further market failure due to oversupply in the future;
- It will carry no previous baggage and will have a single objective - to maximise value to the State over a long time horizon of say 10-15 years;
- It will not have any other banking functions or aspirations;
- It will not favour any institution or client over another, but can make decisions with the advantage of an overview which individual banks cannot have;
- It will have well marked out procedures to prevent fraud but will encourage a suitable commercial culture;

An extension of the remit of the National Treasury Management Agency (NTMA)

27 For a number of reasons it is considered that the Asset Management function should be carried out under the governance, direction and management of the NTMA and be designated as the National Asset Management Agency (NAMA). The reasons are as follows:

- The international reputation of the NTMA as a centre of excellence in the management of Ireland's national debt is extremely high. Markets would take comfort from the fact that this very important task is being carried out under the aegis of NTMA;
- NTMA has a proven track record in being able to successfully bolt on and manage related complex businesses to its core remit of managing the national debt – as demonstrated by its development of the National Development Finance Agency (NDFA) and the State Claims Agency and the National Pensions Reserve Fund (NPRF);
- Uniquely in Ireland, it has the core managerial competence and critical mass of technical know how to do the job. It would have to further strengthen its management capacity and technical know how, particularly in areas relating to property finance and restructuring but in the overall scale of the task this would not be a major hurdle to overcome.

Legislative Basis

28. The NAMA Initiative would require new legislation (the "NAMA Act") which would create NAMA under the umbrella of the NTMA.

How the NAMA should be capitalised: Bond Issued by Government or with the Benefit of a Government Guarantee

29. The advantage of this approach, from the point of view of the banks is that it severs any link between the bank and the outcome of the impaired loan. Moreover, since the credit quality of the bond is Government there is zero risk weighting with consequential savings in capital. Another advantage is that the bond, in the hands of the banks, should be eligible collateral for the purpose of Repo agreements at the Central Bank and this, could be used by banks to replenish liquidity. The disadvantage, obviously, is that it adds substantially to the national debt.

Impact of Increase in National Debt

30. A key question is whether the measures underlying the bond issue (i.e. the creation of an asset management agency and associated banks' recapitalisation measures) are considered by capital markets to resolve the capital adequacy question about Irish banks and the

associated attrition being experienced in banks' deposit liabilities which in turn has created the need for the Guarantee scheme? Another key factor relates to the underlying public finance position and current efforts towards stabilising the deficit, which is widening beyond expectations. Then there is the question of the impact of such expansion of the debt on the capacity to service the debt. Ireland has the capacity to absorb additional debt service costs if these were to come about. Finally, the proposed issuance would not take place without the support of the ECB. Of itself, that would tend to mitigate adverse speculative reaction. However, there remains the risk however that the market may focus solely on the 'headline' news, pushing CDS levels wider, unless the strategic plan is explained comprehensively and clearly.

Revising the Credit Guarantee

31. A restructuring of the Guarantee consistent with the introduction of the NAMA initiative should be seen as an integral element of a comprehensive strategy. In summary, the aim should be to enhance the credibility of the Guarantee by simultaneously reducing the contingent liability under it and by extending its temporal scope in relation to the sort of long-term bond issuances which are critical to ensuring the covered institutions' survival.

Sharing Unanticipated Gains and Losses on Impairments: Provision for Equity, Warrants and Claw-back Arrangements

32. The projected value of impaired loans is sensitive to the underlying assumptions and there is need to protect the State from potential unanticipated losses. One way of achieving this would be for banks, which are transferring impaired loans to the NAMA to provide a warrant to purchase shares in the bank which can be exercised by the Government in several years time at a price – and here's the key – which depends inversely on the value of the impaired debt at that future date. The future date needs to be set far enough into the future for the market in these kinds of assets to have settled down and their price less imponderable. If the valuation of impaired assets is significantly greater than anticipated at the time of transfer, the warrant will end up too costly to exercise. If the valuation proves to have been wrong and the assets end up worth far less than at the time of transfer the Government will hold an equity stake compensating it in the end for the additional losses it has taken on the assets. Another mechanism would be to use claw-back arrangements in which Government, on the winding up of the NAMA, would determine if it has made a profit or a loss in its lifetime. Any profits would accrue to the State but any losses incurred by NAMA would be clawed back from the participating institutions by means of a levy over a number of years.

Required Characteristics of the Financial Instrument Used to Finance the NAMA

33. Credibility is required at the level of the financial instruments used to replace bad debts in the balance sheet of insolvent banks. There is a temptation to opt for injecting an instrument with low cash outlays now. For example, the NAMA might simply offer the banks a non-interest bearing bullet bond with a long maturity, but the same face value as that of the non-performing assets. The real value of such a bond falls well short of the value of performing loans of equal face value. A bank that is offered no more than that in return for ceding non-performing loans is likely to run into difficulties again, as its operations cannot easily be brought back to profitability. Even if sufficient zero-coupon bonds are injected to bring the *net present value* of the promised payments up to the required level (when calculated at the risk-free discount rate), such an arrangement may not be regarded as satisfactory from the credibility point of view. A government which acts like that will be suspected of temporizing. Market participants will likely assume that it has no clear idea of how it is going to fund the bullet payment at maturity. Accordingly, holders will discount the value of the bond, attaching only a moderate probability to its being honoured in full and on time. Marked-to-market, a bank holding such an asset may still be insolvent, and may feel itself to be insolvent, with all of the incentive problems which that creates. If the bond is tradable in a fairly competitive market, these valuation and credibility problems will come out

in the open and force the government to face up to them. Also this type of bond would be of limited use or no value for the banks in accessing ECB collateral.

Maturity, yield and negotiability of injected assets

34. In the presence of deep capital markets with a wide range of available maturities, as the Euro-area bond market is, the exact maturity of any marketable government bond injected into the bank will be of little consequence for the incentives facing the bank, as the bank will easily and speedily be able to exchange it for assets of the desired maturity, i.e. cash. Even if the injection of funds is large relative to the overall size of the capital markets, the choice of maturity can be left as a matter of overall debt management policy, and not as one of banking policy.

35. The most straightforward approach then, is to inject a type of asset which is more in line with the sort of asset which a bank would voluntarily hold on its balance sheet: with interest rate floating in line with the market. The value of such a bond should move in tandem with the property assets acquired by NAMA In short, with an asset that can readily be regarded as "bankable". Such an instrument can more easily be made marketable, thereby freeing the bank to move forward with an asset-side strategy that is not dependent on its particular failure history.

Valuation Issues at Transfer: Supplementary Assessor Process

36. In the case of mandatory transfer of assets a Supplementary Assessor Process could apply. In this approach, the valuation is done prior to transfer and payment by the NAMA itself, following expedited due diligence. The Assessor structure then follows subsequently at a suitable time to ensure that the amount paid was indeed fair. This has a number of benefits in that the timeframe in which the Assessor operates in is no longer relevant to the timing of the transfer, the NAMA can price more strategically taking into account the market impact of the pricing and there is only upside for the banks when the Assessor ultimately reports (i.e. he will report either nothing further due in compensation or a positive amount).

37. In the case of optional participation, the valuation issues at transfer stage are quite tractable. The first issue will be to categorise and sub-categorise these loans. These could be different as to geography and liquidity, and to ease of marking to market. This would allow certain types or qualities of loan to be filtered out, however it would be best if NAMA had a wider range of assets. The next issue would be to divide the assets between (income producing) Investment Properties and (non-income producing) Building and Development Land.

38. The income producing assets could have the prospect of being written down to a level where the income (in aggregate and with some headroom) would pay interest and yield a profit to the bank. These could then be held to maturity. These could be retained in the lending bank if funds did not permit them to transfer in a balanced portfolio.

39. The non-income producing assets would then be transferred. It could be done as follows:

- Value the underlying security (property) and then mark the loan itself to market, bearing in mind a range of LTV's and other risks. Although this could be done there will be significant argument as to the basis, methodology and quantity of value. For example a pure 'mark to market' exercise, taking into account the almost total absence of credit, could result in what is popularly referred to as a 'firesale' value – this would be unpalatable but nevertheless the correct value if that is what is required. The overriding objective should be to break the link between banks and the property assets, at least at the outset.