Summary of Findings

The National Asset Management Agency (NAMA) was established in December 2009. Its purpose is to acquire assets in the form of property-related loans from banks. The overall objective of this process is to bring stability to the banking system by removing impaired loans from the balance sheets of individual banks.

This initial review of NAMA outlines the asset acquisition process that has been established, the outturn of the first loan acquisition round and the arrangements for governing and resourcing the Agency. Its purpose is to give an early account of the process based on documentation examined by my Office of the structure, systems and procedures put in place by NAMA. The systems and outturns are currently being audited as part of the financial audit of the first accounting year of NAMA.

The NAMA Scheme

Under the scheme, NAMA acquires loans from participating banks at a long-term economic value. The National Asset Management Agency Act 2009 and associated regulations made by the Minister for Finance prescribe the types of loans that NAMA may acquire and how they are to be valued. Five financial institutions applied to take part in the scheme. All were designated as participating banks by the Minister.

The scheme operated by NAMA required the approval of the European Commission as it involves the provision of state aid to the participating banks. The Commission gave its approval for the establishment of NAMA on 26 February 2010. It stated that it will reassess the aid granted in light of the adequacy of restructuring plans submitted by the banks. The Commission will also review the transfer prices of the bank assets on an ongoing basis. On 3 August 2010, the Commission stated that it found the transfer of the first tranche to be in line with the approved scheme and with its guidance on the treatment of impaired assets.

Acquisition Process

As part of the acquisition process, NAMA had to determine the bank assets that are eligible for transfer, gather and assess information related to those loans and borrowers and value the eligible loans.

In practice, the valuation of loans is, in most cases, directly related to the value of the associated collateral and much of the valuation process focuses on the establishment of a value for that collateral.

As an initial step, the participating banks identified the eligible bank assets and provided NAMA with information about the loans and borrowers using standard templates provided by NAMA. The information included legal due diligence reports, current market valuations of properties pledged as collateral for loans and information about security, other than real estate, pledged as collateral by borrowers. The current market valuation of properties was to be made at 30 November 2009, a date stipulated by the NAMA Board.

NAMA validated the information through a process which included

- legal reviews that examined the accuracy and completeness of the information supplied by the banks as well as the validity of loan security, the soundness of title and whether any legal actions were outstanding for loans

- property valuation reviews which included a determination of the long-term value of property and
- valuations of financial derivative contracts associated with the loans and of non-real estate collateral.

In accordance with the Act and associated regulations, loan valuers, using a model developed by financial advisors, calculated a long-term value for each loan. These loan values took account of the value of the loan collateral - the present value of the cash that is expected to flow from the real estate collateral (after uplift for long-term economic value) and the current market value of non-real estate collateral. Adjustments were made to take account of due diligence and enforcement costs likely to be incurred by NAMA, collateral in excess of borrower obligations arising on some loans, legal discounts and the value of associated financial derivatives.

A firm acting as audit coordinator reviews all loan valuations and certifies whether they have been accurately calculated in accordance with the valuation model and whether the valuations of real estate collateral have been determined on a consistent basis in accordance with criteria determined by NAMA.

NAMA anticipates that it will acquire loans that have a book value including accrued interest of around €73 billion made by banks to approximately 850 borrowers.

Outturn on Transfers

The loans of ten of the borrowers with the highest debt were acquired in the first round of transfers.

Features of the first tranche of acquisitions were

- Borrowers' cumulative debt was €15.4 billion. NAMA paid around 50%, €7.7 billion, of the book value for the loans and associated financial derivative contracts that the borrowers had entered into for risk management purposes.
- The amount paid by NAMA to banks ranged from 35% to 58% below book value. The amount paid for individual loans ranged from 0-100% of the book value.
- The consideration paid was the lower of the loan obligations outstanding or the value of the associated collateral calculated as outlined below.
- The property associated with the acquired assets was valued at around €7.5 billion. The average uplift for long-term economic value was 11%. The post-uplift value was €8.3 billion.
- €5.9 billion, or 71% of the long-term value of the property, was accounted for by completed residential and commercial properties including hotels.
- After discounting all the projected cash flows from property (taking account of uplift factors) the present value of the loans exceeded the current market value of the properties derived using market valuation methods by almost 9%.
- The amount of other collateral, including cash assets of €162 million, in the first tranche which was included in the loan valuations amounted to €369 million accounting for just under 5% of the total consideration paid.
- The total value of the collateral (valued after uplift adjustment to take account of long-term economic value) that was provided by borrowers was €8.5 billion. €8.1 billion of this was the present value of property cash flows and €0.4 billion was made up of cash and other non-real estate collateral.

- There was €518 million of collateral in excess of borrower obligations. However, this would only be available to NAMA for offset against deficits in collateral in the case of other loans to the same borrowers in limited circumstances. No payment was made in respect of excess collateral.
- The consideration paid by NAMA was reduced by the application of a discount to the loan valuations to provide for due diligence and enforcement costs, the present value of this being €266 million.
- The estimated costs associated with a full enforcement process are 15%. It is not possible for NAMA to predict the extent to which full enforcement proceedings will be required. However, assuming a 15% enforcement cost, the amount deducted from the acquisition value of loans in the first tranche would cover the cost of enforcement proceedings for around 25% of the collateral.
- Following direction by the Governor of the Central Bank and Financial Services Authority of Ireland and the acting CEO of the Irish Financial Services Regulatory Authority, no discount was applied to advances made by banks to borrowers after 7 April 2009 provided that it could be shown that the moneys were advanced as part of normal commercial banking arrangements. For loans that transferred in the first tranche, NAMA accepted that €299 million of those loans, issued after 7 April 2009, qualified for payment in full.
- The value of state aid as represented by the difference between the net loan value for purchase purposes (€7.7 billion) and the current market value of bank assets was €1.7 billion or 28% greater than the loans' current market value.

Settlement Arrangements

The loans are acquired by a NAMA group entity, a majority privately owned special purpose vehicle NAMA Asset Management Ltd. This entity issues debt to fund the consideration payable. Debt issued to pay for the first tranche of loans comprised

- €7.3 billion in securities guaranteed by the Minister for Finance and
- €0.4 billion in subordinated debt.

The guaranteed securities pay interest at a variable rate, which is reset twice annually. The rate up to 1 September 2010 was 1%.

The subordinated debt carries an interest rate linked to the yield on 10-year Irish Government Bonds. Payment of interest on the subordinated debt and its ultimate redemption are dependent upon NAMA's financial performance.

Risk Management – Interest and Foreign Exchange Risk

NAMA faces the risk of adverse movements in exchange rates in cases where it has purchased loans denominated in foreign currencies. It has addressed this risk through the use of cross-currency swaps designed to give NAMA some certainty about the rate at which it will exchange future receipts in foreign currencies for euro.

NAMA also faces the risk of upward movements in interest rates. Interest rate swap contracts can give NAMA certainty about the interest rate it will pay on some of its borrowings. It has hedged a portion of its borrowings for the next four years using these swap contracts.

The hedging strategies have been adopted on the basis of certain assumptions about the timing of foreign exchange receipts and the proportion of performing loans. A residual risk related to the actual realisation of the predicted cash flows remains and gives rise to a need for NAMA to manage its hedging strategies actively in order to be able to respond appropriately to changes in predicted outcomes. On the interest side, there is some additional cost compared with interest rates prevailing at the contract date but this cost must be weighed against the certainty achieved.

Post-Acquisition Management

Borrowers will continue to owe the balances that are outstanding at the date their loans transfer to NAMA. NAMA requires each borrower to provide a detailed business plan setting out how the borrower intends to repay the amounts due. Following assessment of the plans, NAMA may continue to support the borrower or take enforcement proceedings. In circumstances where it takes enforcement proceedings, NAMA will acquire property which it will have to manage in a way that maximises the return to the State.

Structures and Resources

The report outlines the steps taken by the Board of NAMA to introduce systems and structures to assist it to govern and manage its operations. While these are evolving, the steps taken to date are reasonable and will be kept under review in the course of financial audit.

Since December 2009, NAMA has increased staff numbers to 75 with the aim of having a total staff complement of around 100 by end of 2010. Pending the recruitment of these full-time staff, NAMA uses the services of staff provided by accounting firms.

NAMA has also used the services of external advisors, either procured directly or on its behalf by the National Treasury Management Agency. Services procured include legal and financial services, real estate advice, financial derivative and loan valuations, loan valuation reviews and borrower business plan assessments. Procurement of providers of other services (e.g. enforcement and insolvency services) is currently taking place.

A major risk to be managed in NAMA's resourcing relates to its capacity to manage a very large set of services bought from private providers while at the same time integrating recruited personnel into a cohesive streamlined operation.

Next Steps in Audit

The practical operation of systems and practices established by NAMA are currently being reviewed in the course of ongoing financial audit by my Office and I will report on these in due course. That audit work is focused on the confirmation of the functioning of the controls and the evaluation of the transactions of NAMA.

Acquisition Process – Key Steps

The steps in the loan acquisition process are summarised below.

Identifying Eligible Assets

Banks participating in the NAMA scheme were required to notify NAMA of all eligible bank assets. NAMA intends to acquire eligible assets with a value in excess of €20 million in the case of Allied Irish Banks and Bank of Ireland, those in excess of €5 million from Anglo Irish Bank and all eligible assets from the smaller banks. By September 2010, the value of loans and associated derivatives that NAMA intended to acquire was estimated at around €73 billion.

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Gathering Loan and Borrower Data

Banks provide NAMA with data including legal due diligence reports which provide NAMA with specified information about each loan including details of loan balances, associated derivatives, property and other assets pledged as security for the loans as well as notifying NAMA of any legal issues associated with the loan or underlying security. The banks also provide their valuations for all real estate offered as security for loans.

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Assessing Loan and Borrower Data

NAMA has appointed legal advisors, property valuers, experts in financial derivatives and, where necessary, experts in other assets offered as security for loans to review the information provided by the banks and, in some instances, to carry out further valuations of property and other security. When NAMA is satisfied that the information provided about a loan is complete, it sends the loan for valuation to one of the firms on a panel of loan valuers it has appointed.

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Valuing Loans

Loan valuers, using a valuation model that derives from the Act and the asset valuation regulations made by the Minister and approved by the European Commission, value loans by calculating the present value of the cash flows associated with the loans' underlying securities. Two values are calculated for each loan – its current market value and its long-term economic value. Loan valuers send the results of their valuations along with supporting documentation to another firm, appointed by NAMA, referred to as the audit coordinator which carries out a series of validation checks to confirm the values calculated by the loan valuers.

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Acquiring Loans

When satisfied that the loan values are correct, the audit coordinator issues an acquisition schedule to the relevant bank setting out the loans being acquired by NAMA and the price it is paying for them. NAMA is acquiring the loans in tranches with all of a borrower's loans, regardless of which bank the loan is in, being acquired in the same tranche. The audit coordinator issues one acquisition schedule for each borrower to each bank.

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Payment

NAMA pays for the loans it acquires by issuing debt. It issues 95% of the debt in the form of Government Guaranteed Securities. NAMA pays interest to the banks on these securities while the banks may exchange the securities for cash by lodging them as collateral with the European Central Bank. The remaining 5% is issued in the form of subordinated debt, redemption of which is dependent on NAMA's financial performance.