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# NAMA one year later – A Lombard Street Research Report for the Construction Industry Federation November 2010 NAMA – a flawed idea and a failure

Lombard Street Research

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# Lombard Street Research

# NAMA one year later – A Lombard Street Research Report for the Construction Industry Federation

November 2010

## NAMA – a flawed idea and a failure

One of the stark lessons to be drawn from the events of October/November 2010 leading up to the EU/IMF bailout of Ireland is this: The National Asset Management Agency (NAMA) was a flawed idea and it developed into a failure.

*We can in good conscience say this because we warned of the dangers in a report commissioned by the CIF in May 2009 and passed on to the Irish authorities.*

This is not to say that the Irish government was wrong to try to save the country's banking system. But the method used was from the start contaminated by secondary objectives, which meant that it could never work

The key flaws in the NAMA structure were

- NAMA was **not** a bad bank; it was **not** intended to remove only toxic loans from banks' balance sheets. Instead, NAMA was to be used as a vehicle to restructure radically the Irish construction industry. This meant removing performing – unimpaired – loans as well. But, in turn, this further eroded the health of the banking system.

- NAMA's insistence on no debt restructuring. This ties in with the above. If there were any chance of banks getting repaid in full for their loans, there would be no need for NAMA. By reiterating this point, NAMA further drove down the values of bank loans and their collateral, deepening the crisis.

- NAMA's *de facto* discouragement of outside capital. Foreign investors were always going to be one key source of funds for NAMA. But by rejecting any debt restructuring, NAMA also ensured that the interest of such investors was kept to a minimum.

In these – and other – ways, NAMA, ostensibly intended to save the Irish banking sector, actually hastened its demise, along the way adding to the burden of the Irish taxpayer. To quote Mr. Michael Somers, former head of the National Treasury Management Agency (NAMA's parent body) in *The Irish Times* 20th November 2010: "What an irony, what a mess!"

A FRIEND in Lombard Street.

# Contents


A report on NAMA by Lombard Street Research 2

- Introduction 2
- The 2009 Report 2
- NAMA – one year on 5
- Recommendations for NAMA 6
- Achievements vs business plan 8
- Operation of NAMA 13
- NAMA's working capital 15

The macro issues 16

- Macro Charts 20

# A report on NAMA by Lombard Street Research

## Introduction

In May 2009 Lombard Street Research Ltd was commissioned by the Construction Industry Federation (CIF) to produce a report on the Irish government's proposal for a National Asset Management Agency (NAMA) to deal with the Irish financial and banking crisis.

Upon completion of the report, the CIF passed it on directly to the government rather than make it public. Much of the analysis has since been proven to be correct. Had the warnings and recommendations been accepted and implemented they might have assisted in further alleviating the fall-out from the crisis.

**As a result, in September 2010, we were commissioned to follow up on the original report with a review of how NAMA has progressed over the course of the past year. This review highlights what the alternative solutions might have been – and indeed might still be – as well as recommending improvements to fulfil NAMA's current mandate.**

## The 2009 Report

In assessing the NAMA proposal in May 2009, it was assumed that the government's goal must be that Ireland requires a banking system that enjoys the confidence of the public and of the international investment community; and also needs to retain a viable property sector in the future.

The main recommendations and warnings were:

1. General recommendations – assuming the implementation of NAMA

- *Establish political consensus before embarking on any action.*

This is one of the key lessons from the Swedish episode of the early 1990s. While rapid action in a crisis is important, it is equally important to establish political consensus before embarking on any more long-term strategy such as NAMA. Otherwise, the political debate risks quickly derailing the strategy, prolonging the uncertainty in the sectors involved. Moreover, establishing consensus avoids the risk of a new government reversing the policy within a couple of years.

We understand that the NAMA proposal was not preceded by consultation, either with the political opposition or with any of the sectors concerned. Given the substantial and complex changes that NAMA would bring to the Irish economy – and the downside risks of getting it wrong – the need for ongoing consultation and achieving at least a modicum of consensus is obvious.

- *Only shift bad loans to NAMA.*

NAMA is not intended as 'a 'bad bank' but as an asset manager. NAMA is therefore different from the Swedish Securum or the American Resolution Trust Corp, both of which were clearly bad banks, not asset managers.

**By taking over good loans as well as bad, NAMA actually impairs the banking system's potential recovery. This would be a departure from previous best practice as experienced in other countries. It would add to the workload and complexity of NAMA at a time when speed and efficacy are of the essence.**

- *Set up individual bad banks for each participating bank and/or let the originating bank administer the loan work-out under NAMA supervision*

Letting NAMA take over and administer loans means that the borrowers lose their bank contacts. Since loans taken over by NAMA will by definition be perceived as tainted, it may be difficult for them to find other banks. In turn, this complicates developing projects to the point of sale. By contrast, letting banks administer impaired assets makes

use of the skills inherent in the banking sector; as well as individual banks' knowledge about individual clients. This could ideally be done by letting each participating bank set up its own bad bank under NAMA supervision (somewhat similar to the Swedish experience); or by NAMA returning impaired loans to each originating bank on an agency basis. In this situation, NAMA would act as an overseer, rather than directly be involved in the work-out process. While this seems to be the preferred strategy as of late 2010, it is not the one envisaged in the Bacon Report or in the original draft business plan of October 2009. An added advantage with this set-up is that it makes it easier to include loans to Irish property developers originated by foreign banks or syndicated loans with foreign banks included.

**It is important that this strategy not only involve an upside for the taxpayer – the more important consideration – but also for the banks, in order to give them a further incentive to finance projects to completion instead of succumbing to the temptation of a fire sale.**

- *Actively encourage private participation*

A subsidiary goal in the NAMA proposal is to cap the Irish government's liability. As part of this, NAMA should consider actively encouraging private developers to buy loans off its books and proceed with the development without taxpayer financing. **However, such deals need to be structured so that any sale of the underlying collateral involves a firm commitment to development within a clearly stated timetable.** This should be part of NAMA's exit strategy (see also below).

- *Set a clear exit strategy.*

**NAMA will severely distort the Irish property/real estate sector. In order to avoid the temptation for a near-monopoly to perpetuate itself, the government should from the start set out an exit strategy, including a time-frame – eg, 5-7 years – after which NAMA will be wound up.**

**Possible other options**

- ***Temporarily nationalise failing banks.***

The Irish banks need to be restored to health and – crucially – to be seen to be healthy. The complications involved in valuing banks' assets in a rapidly changing economic environment are such that it is difficult to guarantee that all impaired assets have been removed. In addition, there are substantial legal pitfalls involved. Full nationalisation of the banks, with subsequent carve-out and rapid privatisation of cleansed banks could be a better approach. It permits speed and assured inclusion of all the bad loans, plus the skilled personnel to deal with them. The compensation of stakeholders is feasible as the stock market capitalisation of Irish banks is readily affordable by the Irish state. Subsequent profits on work-out and privatisation of "clean banks" could be shared, to the extent they exceed the book values implied by the original stakeholder compensation. It needs to be stressed that the banks should be government-owned for the minimum time possible.

Nationalisation is a contentious option. Governments do not have an impressive track record when it comes to running banks – or other businesses. That being said, the measures already implemented – the deposit guarantee, the recapitalisations – amount to a *de facto* nationalisation of Allied Irish Banks, in addition to the already *de jure* nationalised Anglo Irish Bank. The rationale behind moving to a full – if temporary – nationalisation is to enable a more thorough cleansing of the Irish banking system, as well as avoiding the negative effects of attempting to put a value on banks' assets at a time when their market value is at its most depressed.

- ***Put failing banks into conservatorship***

If nationalisation is rejected, a possible alternative option could be to put the failing banks into conservatorship. Essentially, this can be described as 'nationalisation lite'. It is similar to what was done in the US by the RTC, and also to what more recently has been done with Fannie Mae and Freddie Mac. It involves taking the banks under the government wing without changes in governance structure and, without risking the creation of a monopoly. But the government owns the shares and is clearly in control of the top management appointments, meaning that is it has complete flexibility to identify, isolate and work out bad loans.

For Ireland, this enables the current, already-accepted responsibility for the banks' actions (via liability-side guarantees) to be matched by such proactive power as is necessary, without the government being on the hook for every commercial decision, etc., in the banks (ie, no attempt to 'pick winners' in the property sector). Government

due diligence on the loan book can then be done with urgency, but without specific deadline pressure. Clearly, healthy sections of the banks can be hived off and privatised.

Under this method, once the bad loans are deemed to have been stabilised, remaining good ones can be sold off on the domestic or even international market. Even the bad loans may well then be sold off, at a deep discount. The government should not need to raise new money at all to develop projects further – to the extent such projects are deemed economic for further loans (ie, marginal future revenue vs. marginal future costs yielding a positive discounted present value) the asset should be discounted out of the door as fast as possible if it cannot be funded from within the "conserved" bank as part of normal operations. The real problem will be in the hard core of loans that are to dead projects, not ones that have some (even limited) future life.

## NAMA – one year on

The CIF brief for the latest 2010 Report is as follows

- Recommendations for NAMA, its targets and operations
- An assessment of NAMA in relation to its establishment and progress to date in addressing key issues that it was established to resolve including setting out where NAMA is now in relation to its task.
- Operation of NAMA:
    - Assess adequacies/deficiencies in current NAMA structure and operations to deliver upon its objectives;
    - What are potential pitfalls for NAMA;
- An analysis of the adequacy of the €5bn working capital available to NAMA and the impact this will have for review of borrower Business Plans and targets set by the NAMA board to pay down NAMA debt.
- An assessment of the macro market issues that will impact upon NAMA;
    - The general economic background of the economy and the requirement to stimulate economic activity;
    - An assessment of sustainable demand for commercial and residential developments in the short to medium term;
    - Role for NAMA in ensuring that a viable development industry exists to address macro issues for future;
    - Impact of current NAMA Business Plan Targets in supporting longer term viable development companies.

## Recommendations for NAMA

"Recommendations for NAMA, its targets and operations"

Recent financial turmoil has resulted in some changes to NAMA's mode of operation. However, it also provides the opportunity to take a step back and make a broader judgement on NAMA and its role. Based on the analysis in this report, we make the following recommendations:

- **NAMA should be a developer not just a liquidator**

  The best way for the Irish government and taxpayer to avoid losing money through NAMA is for the construction sector to stabilize and recover. The impression gained by developers is that NAMA currently sees itself as a liquidator much more than as a developer – certainly so when it comes to projects longer than three to five years. By acting in this fashion, NAMA is destroying value at a time when it is crucial to try to put a floor under property prices in order to stop the downward spiral in valuations. The current position undermines values and prolongs the uncertainty over the Irish real estate sector, thus exacerbating the losses that may ultimately be suffered by the Irish taxpayer. It also has a knock-on effect beyond the construction sector by hurting companies supplying the sector.

- **NAMA should accept an element of debt restructuring**.

  By continuing to insist that it will pursue debtors for every cent, NAMA is helping to drive down the value of its assets, denying a return to taxpayers. NAMA should welcome investors prepared to pay more than NAMA has paid for loans, the more so since NAMA's payments presumably represent the estimated long-term economic value of the asset. The refusal to accept that some loans will not be repaid in full risks a destructive two-stage outcome. Stage one is a paralysis where NAMA rejects bids because they do not cover the full nominal loan value. Stage two is a fire-sale when it turns out that this goal was never possible. This would exacerbate the loss for Irish taxpayers and work against NAMA's stated objectives. While it is true that recent statements, eg, by Mr Frank Daly, the Chairman of NAMA to the Committee of Public Accounts on 18th November 2010, show a readiness to contemplate some debt restructuring and/or rescheduling, this is still couched in relatively uncompromising language.

- **NAMA should be more receptive to outside capital.**

  NAMA has limited resources considering its current dominant role in the construction sector. While there is a strong case for NAMA's working capital to be increased, the poor state of the public finances makes this difficult at present. But there will be a need for further capital. If this can be sourced elsewhere, it should be seen as positive for Ireland and for the Irish taxpayer. There is no doubt that there will be very limited need for significant house building over the next few years. However, there is a clear need for commercial and industrial development. Indeed if Ireland is to successfully rebalance its economy towards industry and exports as its competitiveness improves, then the industrial capacity to facilitate this shift will have to be supplied. In turn this will require a flow of capital to be maintained to the construction sector, However, there is a fundamental contradiction here between NAMA's attitude of refusing to accept any debt restructuring and foreign investors, who are unlikely to provide capital unless some such restructuring is in place.

- **NAMA should cease to acquire unimpaired loans.**

  Since NAMA's acquisition process will be completed by the end of 2010, this point is now moot. However, we consider it important enough as a partial explanation to the current troubles of Irish banks to reiterate it. Moreover, there is still a case to be made for unimpaired loans to be managed by banks, leaving NAMA to concentrate its resources on managing impaired loans. By acquiring unimpaired – ie, 'good' – loans as well as impaired – 'bad' – NAMA undermines the Irish banking system that it is ostensibly set up to save. It also

has an incentive to underpay for such loans, which exacerbates the situation by further eroding banks' balance sheets. Finally, it means that NAMA is wasting part of its limited resources on something that is not a problem. Worse, it risks destroying value in these assets as well. By contrast, concentrating on impaired loans would potentially speed up NAMA's work – whether liquidating projects or developing them to completion – further saving the Irish taxpayer money.

- **NAMA should drop its "objective" of radically restructuring the Irish construction industry.**

  This is, needless to say, not an openly stated objective of NAMA. Yet, as this report will show, it is implicit in much of NAMA's set-up and operation. Like any country, Ireland will in the medium- and long-term need a viable construction industry. Attempting a root and branch restructuring of the existing industry is not necessarily in Ireland's long-term interest.

## Achievements vs business plan

**“An assessment of NAMA in relation to its establishment and progress to date in addressing key issues that it was established to resolve including setting out where NAMA is now in relation to its task.”**

Following the bursting of the Irish real estate bubble in the mid-2000s, the Irish banking system was rapidly approaching collapse. In September 2008, the government introduced a liability (ie, deposit) guarantee that covered the banking system. In the spring of 2009 the government commissioned Dr Peter Bacon to evaluate whether it should introduce some form of asset relief mechanism.

The proposal for the National Asset Management Agency (NAMA) was outlined in the Bacon Report in the spring of 2009. The aim was to take over the impaired real-estate connected loans from the banking system, leaving the banks with healthy balance sheets. However, it is clear from the Bacon Report that there was another, equally important object, namely a major restructuring of the Irish construction industry.[1] The Bacon Report is replete with references to ‘crony capitalism’ and the harmful effects this has had. That this was crucial to the whole idea behind NAMA is confirmed by the fact that NAMA specifically was <u>not</u> set up as a ‘bad bank’ on the American or Swedish models, but as an asset manager that would take over <u>all</u> real estate-related loans from the banking system, <u>not</u> just impaired ones. NAMA’s continued insistence that it will recover every cent of the nominal value of the loans it has taken over – a clear impossibility – supports this view of NAMA’s objective. NAMA thus had a dual role from the start, with a potential conflict between its two aims.

Following legislation, NAMA was set up in the autumn of 2009 and began operations in the spring of 2010. However, the financial turmoil of the last few weeks have altered NAMA’s working environment. This makes it important to attempt to gauge how NAMA has managed so far, in particular relative to its stated objectives. It also affords the opportunity to evaluate the NAMA business model and mode of operation.

NAMA’s purpose and objectives are set out in the Draft business plan dated 13th October 2009. (The emphasis is in every case added and the bullet points in the original are replaced by numbers.)

“PURPOSE AND OBJECTIVES

1. After four months of preparatory work and intensive drafting, the National Asset Management Agency Bill 2009 was published on 10 September 2009; an earlier draft had been published as a consultative document on 30 July 2009. The NAMA project is intended to address a serious threat to the economy and to the systemic stability of certain credit institutions. The Bill describes NAMA’s powers and functions as including the acquisition of certain bank assets, taking all steps necessary or expedient to protect, enhance and better realise the value of those assets and, by so doing, *facilitating the restructuring, in line with EU Commission requirements, of credit institutions of systemic importance to the economy*.

2. The eligible assets to be acquired from participating institutions are land and development loans and associated loans. These pose the main systemic risk to the Irish banking system and *their acquisition by NAMA is intended to ensure that bank balance sheets are cleansed of impaired assets*. However, it should be noted that a significant proportion of the assets which will be acquired are not impaired and that about 40% of them are estimated to be cash-generating. The NAMA due diligence process will establish the bone fides of all data as part of loan valuation and transfer.

3. NAMA will purchase bank assets through the issuance to participating institutions of a combination of Government securities or NAMA-guaranteed securities along with NAMA subordinated debt at a discount to the nominal value of loans being acquired. Subordinated debt will amount to 5% of the total amount of securities issued.

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[1] Those in favour of this objective would probably refer to it as “reshaping the Irish construction industry to a format better aimed at serving the people of Ireland” or similar. But the result is the same.

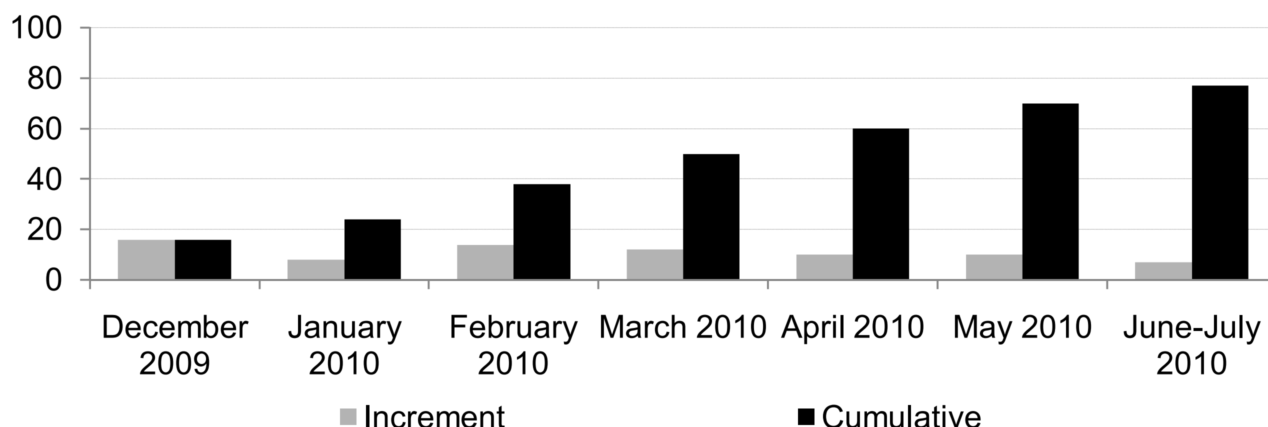
4. Participating institutions may use the securities as collateral with the ECB and/or with market counterparties in order to obtain cash. It is expected that the resulting injection of cash into these banks should enable them to *facilitate the flow of lending into the economy*.

5. NAMA's commercial mandate is to *obtain the best achievable financial return* on the assets acquired by it. It will have all the necessary commercial powers of a financial asset management company to establish subsidiaries, to operate through agents, to buy and sell assets, to manage loans and work with borrowers, to borrow, to lend, to provide guarantees and to take whatever action it considers appropriate in relation to the debts owing and the underlying security. In order to enhance market liquidity and demand for its assets, *NAMA will engage with domestic and international investors interested in opportunities to invest* in one or more of its sub-portfolios."

Judging NAMA's success against these objectives makes dismal reading.

In terms of the acquisition of assets (object 1), NAMA clearly under-estimated the task facing it.

The original business plan assumed that a total of €77bn worth of loans would be acquired from participating institutions (ie, banks; the participating institutions were Allied Irish Bank, Anglo Irish Bank, Bank of Ireland, the Irish Nationwide Building Society and the Educational Building Society) over a period of six or seven months. NAMA was expected to acquire these loans at a discount averaging around 30%, paying a total of €54bn.




By October 2010, the total value of expected acquisitions had risen marginally to €81bn. But much more importantly, the amount acquired had fallen substantially short of plans. In the first tranche, completed by May 2010, NAMA had acquired €15.3bn worth of loans at an average discount of 50%. The discounts varied by bank, ranging from 35% in the case of Bank of Ireland to 58% in the case of the Irish Nationwide Building Society. The long-term economic value of the properties underlying these loans was estimated in May 2010 at €8.27bn, giving NAMA a potential profit of €820mn or 11% of the value paid (€7.69bn).

At this stage, the numbers for the second tranche were expected to be €13.5bn, with a third tranche expected at €8.5bn. This would account for 46% of total expected acquisitions. By mid-July, when most of the second tranche loans had been acquired (but none from Anglo Irish Bank), to second tranche stood at €5.2bn, acquired at a 52.4% discount. When, by late August, further loans had been acquired from Anglo Irish, the total of the second tranche stood at €11.9bn with an average discount of 55.6%. The third tranche was now estimated to total €12bn, compared with an initial estimate of €8.5bn.

However, the September-October events – revelations of further capitalisation necessary for Anglo Irish Bank and Allied Irish Banks once again changed the picture. NAMA has now announced first, that all remaining loans will be taken over in a single tranche and loans smaller than €20mn and originating from Allied Irish Banks and Bank of Ireland would not be administered by NAMA but by the original lender. This is a change from an original figure of

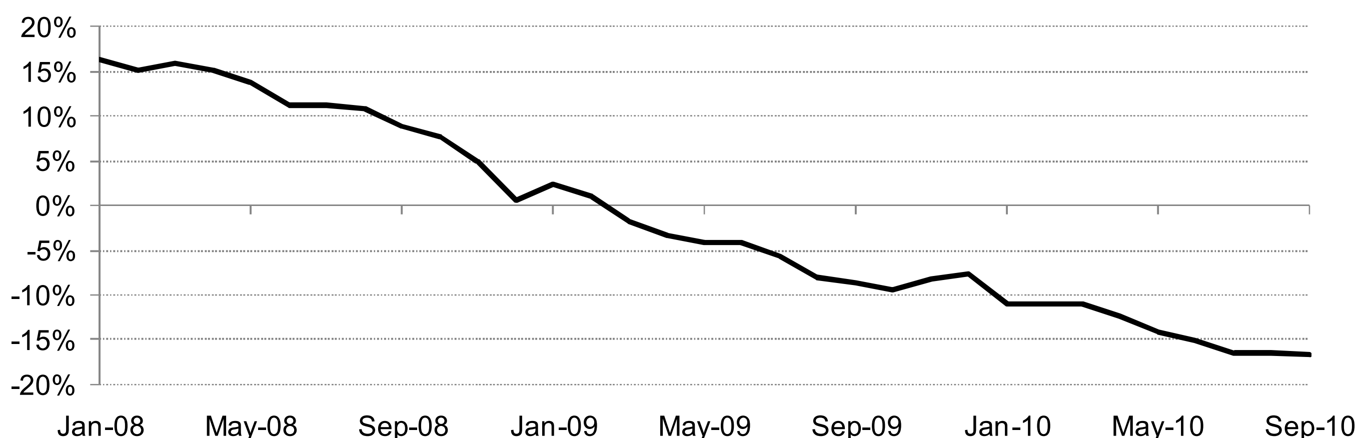
€5mn.These repeated delays in reaching NAMA's acquisition targets and the downward revisions of the long-term economic values of assets acquired have contributed to the uncertainty of the Irish construction sector and the downward pressure on prices.

The further turmoil that engulfed the Irish banking system in September and October 2010 is clear evidence that, in so far as NAMA's brief was to rescue the Irish banking system, it has been at best a very qualified success. This is partly due to circumstances beyond NAMA – or even Irish – control, namely the fall-out from the sovereign debt crisis in Greece and the rest of southern Europe over the spring and summer. But, importantly, the impact of those issues has been exacerbated in part due to a flaw in the idea of NAMA. Rather than following the Swedish model and nationalising the failing banks, removing impaired loans to a bad bank and then re-privatising the now healthy banks, the Irish government attempted to keep the banks (with the exception of Anglo Irish, which was nationalised early on in the crisis) as going concerns. This failure to ring-fence 'good' loans and so boost the health of the banking system, laid part of the groundwork for the secondary problems. To quote Mr. Michael Somers again:

"Namaism was supposed to take toxic loans off the banks' balance sheets to free them up and it would be funded with cheap money from the ECB. So what actually happened? Namaism has created a monster that has done the opposite to what was intended. With its haircuts and discounts and its immediate crystallisation of losses, it has wrecked the balance sheets of the banks and has ensured that there will be no net new lending by them.

The effect of Namaism has been to destroy confidence in the banks, leading to massive outflows of deposits to non-Irish institutions and increasing reliance on the ECB and the Irish Central Bank. An obsession with process has certainly guaranteed jobs for Namaists and lucrative incomes for lawyers, accountants, property developers and consultants." (*The Irish Times*, 20th November, 2010.)

Nor have NAMA's operations managed to facilitate the flow of lending into the economy. In the year to May 2009, the stock of outstanding credit to Irish non-financial companies and households fell by 4.2%. In the year to September 2010, it fell by 16.7%. Part of this is no doubt due to the necessary deleveraging that had to take place as Irish households and companies attempted to shore up their balance sheets. However, as noted above, NAMA's delays have played an important role in pushing down the price of real assets, further eroding the capital of the banking system and curtailing their ability to extend credit. Neither objectives 2, nor 4 above can therefore be said to have been successfully achieved.




As for objective 5, obtain the best achievable financial return on assets, NAMA's refusal to countenance write-downs on the nominal value of the loans acquired, works against it. To repeat, if there was any realistic chance of these loans being repaid in full, the Irish banking system would not be in trouble, there be no need for NAMA and there certainly would have been no incentive for banks to sell their assets to NAMA at discounts of up to two-thirds. NAMA itself sometimes seems to recognise this: if its purchase price is the long-term economic value, that implicitly means that this value is lower than the nominal value of the loans and hopes of making more money are unlikely to be fulfilled. But it is not just that this is an unrealistic attitude. It also means that another part of the same objective, namely engaging with domestic and international investors, is also impeded. There is substantial anecdotal evidence that international investors interested in paying more for an asset than NAMA has paid, have been at best

coolly received, at worst discouraged. This means that the objective of enhancing market liquidity and demand for assets is more difficult to meet. That cannot be in the interests of the Irish taxpayer.

The NAMA business plan was updated in June 2010. This restates NAMA's objectives as follows:

"NAMA has been established in order to protect the interests of the State and to remove uncertainty about the valuation of certain assets of credit institutions of systemic importance to the economy.

It also contributes partially or supportively to a number of other objectives including resolution of the problems created by the financial crisis in an expeditious and efficient manner thereby accelerating economic recovery, facilitating the restructuring of credit institutions of systemic importance to the economy, facilitating the availability of credit in the economy and restoring confidence in the banking sector.

It is intended that it will achieve these objectives by

(i) acquiring bank assets from participating institutions;

(ii) dealing expeditiously with the acquired assets; and

(iii) protecting and enhancing the value of assets acquired by it in the interests of the State.

NAMA Mission Statement

To manage acquired loans, efficiently, effectively and expeditiously and in the best interests of the State. NAMA aims to attain the best achievable financial return subject to acceptable financial risk. It will conduct its activities in a way which assists the property market to operate efficiently and in a way which achieves longer term sustainability while taking account of NAMA's wider societal objectives.

A key guiding principle of the NAMA Board is to pursue all debts owed to it by debtors to the greatest extent feasible."

The phrasing is slightly more nebulous than that of the first business plan, although the main objectives remain, crucially the attitude towards the construction sector ("NAMA's wider societal objectives") even if the idea of recovering every cent of the nominal value of loans acquired has possibly been slightly diluted.

But a better gauge to where NAMA stands one year later is to look at the risks outlined in the original business plan. These are (for details, see the NAMA draft business plan, 14th October, 2009):

"1. Protracted valuation process – due diligence obligations, legal challenges and/or lack of preparation by institutions

2. Valuations outside expected range

3. Economic risk

4. Risk of prolonged property market depression

5. Market risks, including risks arising from the acquisition of foreign assets.

6. Business Strategy

7. Reputation risks

8. Staff"

We are not qualified to comment on point 8. However, the risks outlined in points 1,2, 3, 4 and 7 have certainly come to pass: the transfer process has been longer than expected, valuations are lower than expected, the economic recovery has taken longer, the property market depression has been prolonged and NAMA is perceived not to be acting in a commercial manner. Surprisingly, none of this seems to have led to a reconsideration of the NAMA model. But there has been one significant change. In the 2009 draft business plan, NAMA is clearly

supposed to be a market-maker, helping the real estate market to function. In the 2010 business plan, this no longer seems to be the case. NAMA comments imply that NAMA is supposed to be market neutral. But NAMA is the biggest player in the Irish real estate market. For NAMA to attempt to adopt a market neutral position is tantamount to saying that there will be no real estate market. Again, it is difficult to see how this can be in the interests of the Irish taxpayer.

In conclusion, it is difficult not to get the impression that NAMA underestimated the task facing it. That was perhaps unavoidable. The Greek fiscal crisis threw a renewed spotlight on prospects of all troubled EA countries, pushing up bond yields and further trashing balance sheets of banks everywhere – including in Ireland. As noted above, that has necessitated further support from the Irish government. But it also means that NAMA had to work faster, as well as be slimmed down. This was also implicitly, if not explicitly, acknowledged by the Minister for Finance on 30th September, where he noted that NAMA's work now must be speeded up; and, crucially, in the decision to leave more of the smaller loans with the originating banks. But, as outlined in our recommendations, this is not enough.

It is not only that NAMA has not been successful relative to its stated goals. The long delays in getting NAMA operational and the uncertainty that this has involved, have also had a major negative impact on the construction sector and on any hopes for its near-term recovery.

## Operation of NAMA

"Assess adequacies/deficiencies in current NAMA structure and operations to deliver upon its objectives; and what are potential pitfalls"

In the course of the preparation of this report, we have spoken with a number of developers about their perceptions of and experience with NAMA. Inevitably the views expressed in relation to NAMA's operation varied among borrowers. On the one hand, the words "fair and hardworking" have been used; lower level NAMA staff have been praised for their professional attitude, and their willingness to listen and learn where they may be less informed about the construction and development sector has been highly lauded. However, some more critical comments arose so consistently that we have concluded that it is reasonable to consider them to be a common experience. Those views have highlighted a civil service mentality, a fear of saying 'yes', a lack of business sense and a confrontational attitude. Moreover, the experience is also that NAMA clearly underestimated its task (see above); and that everything takes too long, occasionally to the detriment of potential business.

**Main Conclusion**

The best way for the Irish government and taxpayer to avoid losing money through NAMA is for the construction sector to stabilize and recover. A desire to bleed the sector of all its assets acts contrary to this aim. Moreover, the impression given is that ***NAMA currently sees itself as a liquidator much more than as a developer. By acting in this fashion, NAMA is destroying value at a time when it is crucial to try to put a floor under property prices*** in order to stop the downward spiral in valuations. The current position undermines values and prolongs the uncertainty over the Irish real estate sector, thus exacerbating the losses that will ultimately be suffered by the Irish taxpayer.

**NAMA's approach to the construction industry**

Because NAMA has, contrary to our recommendations in our previous report, taken over good loans as well as bad, it has the means to restructure the construction industry as it sees fit. NAMA material makes clear that this is part of its remit, eg an explanatory note to the NAMA Act says "NAMA's duties: managing and protecting acquired loans/properties and ***avoiding undue concentration/distortion in the market."*** Similarly, NAMA has made it clear (eg, in NAMA Chairman Frank Daly's presentation to the Fianna Fail parliamentary group on 14th September 2010) that "NAMA ***controls*** the relationship with the borrower and makes all the decisions." The reaction of NAMA to representations made by the CIF strengthens the impression of an institution determined to exercise full control over the Irish construction sector. The unchecked exercise of such monopoly power is highly unlikely to result in an efficient outcome, either for the construction sector or the wider economy.

**Economic incentives for NAMA**

***NAMA has no financial incentives in place to develop the projects it controls; but substantial incentive to liquidate them***. This is the unavoidable consequence of a team hastily put together, often staffed and led by people who have little understanding of the construction industry or commercial experience. Inevitably NAMA has a risk-averse culture where there is a strong incentive to allow only projects which are virtually guaranteed to be profitable. In projects with any material degree of risk - and hence of ex post failure - the clear incentive is to refuse development, thereby eliminating the chances of opprobrium should a project subsequently be judged to have failed. Not surprisingly, the impression is that NAMA will not give the go ahead to projects, even if they already are fully pre-let, if there remains a need for further financing; or that NAMA will only lend to projects that are within 80% of completion. The fact that NAMA has so far lent little (and thus not undertaken much development) is apparently described by NAMA representatives as a "good thing". Yet it is hard to see how either NAMA or the Irish economy can benefit by a continued high level of uncertainty and prolonged paralysis in the construction industry.

**Economic inefficiency of no loan restructuring**

NAMA's attitude is to refuse to countenance any restructuring or losses of the loans it has purchased. Borrowers remain liable for 100% of their loan to NAMA, regardless of the purchase price of the loans. Borrowers will be pursued "to the ends of the earth" for the entirety of their debt. While the motives for this may be understandable, the pursuit of 100% repayment acts counter to NAMA's aims and is economically inefficient. It is vital to recognize that writing off debts – acknowledging the destruction of economic value caused by the bursting of the construction bubble – is an important stepping stone in re-establishing a viable construction sector. It would of course make no

sense for the sector's debts to be completely written off, allowing developers to merely start again debt free. The "moral hazard" in this is clear and it would sow the seeds of the next bubble. But as in other sectors that have accumulated excess debt, the reduction of that debt to a more appropriate and sustainable level involves a combination of debt restructuring and borrower repayments. Moreover, the faster this debt reduction is achieved the sooner a restructured and viable construction sector can emerge.

NAMA's determination to wring every cent from borrowers results in other inefficiencies, notably the refusal to sell assets to interested parties. Anecdotal evidence suggests non-Irish venture capitalists have shown interest in acquiring assets from NAMA. However, it has been reported that NAMA has rejected such approaches, *even if the outside investor would pay more than NAMA has done*. The rationale for this is because selling loans at a discount lets developers off the hook since it signals that the investor is prepared to accept less than full repayment of the original loan. Moreover, from NAMA's perspective, getting paid less than the nominal value of a loan is allegedly seen as a loss, even if it involves being paid more than NAMA itself has paid. But this is an unrealistic approach. If there were any realistic likelihood of borrowers being able to repay their loans in full, there would have been no structural problem for the Irish banking system and no need for NAMA .It is therefore clear that NAMA will eventually have to take losses. Given that this is the case, ***it is puzzling why NAMA seems intent to forego the possibility of saving money for the Irish taxpayer by rejecting expressions of interest from outside parties***

**Approach to outside capital**

A related example where NAMA portrays itself differently from the perception given to the construction industry is in attracting outside capital. NAMA claims it is interested in attracting capital from new sources and welcomes its introduction by borrowers. Yet the impression given by developers is ***that NAMA is not interested in co-financing a project***. (Note that the Bacon Report originally criticised the construction industry for lacking the capacity to raise capital.) Now, if the industry does raise external capital, this is disregarded, since ***NAMA will only lend money if it is the only lender, the lender of last resort and in return takes complete control of the borrower.*** The general impression that developers get is also that NAMA prefers not to develop projects and that development will only be undertaken if the developers can raise their own capital. This is likely to mean that fewer projects will be developed than if there is a measure of co-financing. Moreover, it probably will mean that NAMA ultimately will have to take even greater losses, potentially even relative to the price it has paid for its assets. The refusal to accept that some loans will not be repaid in full, could lead to a two-stage process. Stage one is a paralysis where NAMA rejects bids because they do not cover the full nominal loan value. Stage two is fire-sale when it turns out that this never was possible. That would exacerbate the loss for the Irish taxpayer and work exactly opposite to NAMA's stated goals.

**Effect of delays**

The delays in working with NAMA and NAMA's cumbersome decision-making process have been a recurring theme in our discussions – "everything takes too long". One reason advanced is that those at NAMA vetting business plans lack property or commercial experience. The Board of NAMA rejects this criticism and blames delays on borrowers adopting too legalistic a manner. However, borrowers have advised us that the NAMA process is generating a huge amount of legal work and associated fees that are adding no value to the industry. Furthermore, NAMA's response to the extended approval process refers only to the time when the process is dealt with directly by NAMA personnel. This is misleading, since NAMA's own process involves stages which are processed by the banks as agents of NAMA, as well as stages which are processed by NAMA itself. ***It is in everyone's interests that the work of NAMA is expedited as quickly and efficiently as possible. This would at least improve the chances of viable projects being developed and the non-viable being liquidated*** (subject to the approach to outside capital discussed above). The completion of this process is a prerequisite for the construction sector to be able to move forward and make its necessary contribution to an expanding economy.

To sum up, NAMA's operations are characterised by a strong desire to liquidate rather than develop projects, by an unhelpful attitude towards potential outside investors and by unnecessary delays in its administrative processes. A desire to control the construction industry and to pursue debts with no write-offs seems to be driving this approach. Unless corrected swiftly, the outcomes will be highly inefficient for the Irish economy generally and for Irish taxpayers.

## NAMA’s working capital

“An analysis of the adequacy of the €5bn working capital available to NAMA and the impact this will have for review of borrower Business Plans and targets set by the NAMA board to pay down NAMA debt”

Under **normal market conditions** there would be a stable relationship between working capital and construction output. The fact that working capital is tied up for multi-year periods may result in higher working capital needs, but the recycling of capital from completed into new projects would ensure that total capital needs were kept to an efficient minimum. The long-term size of the construction sector as a proportion of GDP is a matter of debate but on average tends to be in the 5% to 7% range (measured as Gross Value Added as a percentage of GDP). However, we are far from normal market conditions.

Indeed, **under current conditions** there is clearly no recycling of working capital and no prospect of bank lending to the sector in the foreseeable future. Moreover, NAMA has effectively a 100% monopoly on development, so its working capital requirements must be addressed as ***those of the industry as a whole***. With no alternative sources of funding the working capital of NAMA needs to be sufficient to fund current viable projects in order to realise their economic potential. Even allowing for the development of a very small proportion (10% or less) of total available projects, NAMA would require working capital ***considerably in excess*** of €5bn.

In addition to this consideration, a further issue arises from the fact that there is currently no market in property developments. Again, under **normal market conditions** the buying and selling of property is conducted largely through brokers with minimal need for capital. However, **under current conditions** NAMA is set to become in effect a **market maker.** Market makers in any asset require substantial amounts of capital to fund their activities – even more so when a market is in urgent need of resuscitation.

NAMA’s working capital needs on an ideal basis should therefore be enough to provide immediate and rapid development of all the viable projects it has bought in, and to hold the projects, when completed, for a significant period, in order to avoid a forced, early sale in a difficult market. On this basis a substantial increase in NAMA’s working capital, to around €15bn would seem justified. In terms of the construction sector as a whole, the total value of building and construction output is projected to be fairly steady in the range of €10bn to €15bn a year. Allowing for the tying up of capital in multi-year projects, €15bn of working capital seems appropriate.

Given NAMA’s current restrictive attitude towards developing projects, €5bn of working capital may not prove to be a limiting factor. But the current situation is not sustainable. A more positive approach by NAMA would result in more development of projects and therefore an increased deployment of its working capital. This would quickly result in a need for additional resources. ***This goes to the heart of the problem of NAMA exacerbating the downturn in the construction sector by acting in a pro-cyclical fashion during the downturn, reducing property values and potentially increasing ultimate costs to the Irish taxpayer.*** But the precarious state of the public finances and need for fiscal retrenchment mean that the chances of additional, publicly funded working capital for NAMA are minimal in the short to medium-term. On a longer term view the construction sector will require more capital. There is debate about the extent of the overhang in residential dwellings, although there is no doubt that there will be very limited need for significant house building in a number of regions over the next few years. However, there remains a need for commercial and industrial development. ***As a priority NAMA should encourage the use of outside capital to help stabilize the construction industry.***

In conclusion, the adequacy of NAMA’s current working capital of €5bn depends on NAMA’s attitude toward development and outside capital. If NAMA is to take a pro-active role in development then a substantial increase in working capital would be necessary, politically difficult though that would be. There will be a clear economic need for capital to be allocated to the construction sector in coming years, especially to the commercial and industrial sectors. NAMA urgently needs to address how and from whom this capital is to be raised.

# The macro issues

**(a) "The general economic background of the economy and the requirement to stimulate economic activity"**

The Irish economy contracted sharply last year with GDP and GNP falling by 7.6% and 10.7% respectively in the year as a whole. So far this year the trend has been flatter and real GDP recorded a 2.7% quarter on quarter increase in Q1, led by a surge in exports. However, GDP contracted again in Q2 and domestic demand has been contracting throughout. But GNP is the more relevant measure as it corrects for the large transfers of income abroad by overseas companies based in Ireland. GNP has fallen for nine consecutive quarters, taking its total decline to 17.3% from the peak. (Real GDP has fallen by 11% over the same period.) The pace of GNP decline has at least moderated with the average quarterly decline in the first half of this year at 0.7%, compared with quarterly falls of between 2.5% and 5% in the depths of recession in 2008/09. In terms of levels GNP is now at around the same level as it was six years ago. However, Ireland remains a rich country and still has one of the highest incomes per capita in the euro area.

Our economic forecasts are summarised in the table below.

| | *2010* | *2011* | *2012-15 average* |
|---|---|---|---|
| ***Real GDP % p.a.*** | -2 | ½ | 2 |
| ***Construction % p.a.*** | -32 | -5 | 3 |
| ***Unemployment % end-year*** | 13 | 13 | 12 |
| ***Private sector credit growth end-year %*** | -10 | -5 | 1 |

Despite the improving economic outlook the Irish economy is likely to contract again this year and at best stagnate in 2011. Ireland is in the process of rebuilding its competitiveness within the euro area: (falling consumer prices and flat wages in the manufacturing sector are evidence of this) and Ireland's export performance has been relatively good within the euro area. But domestic demand prospects in two of its biggest export markets – the US and UK – remains poor and will limit the extent of any export rebound. Domestically there are significant headwinds from fiscal retrenchment, problems in the banking sector, deleveraging in the household sector as well as the continued difficulties of the construction sector. Our projection is for negligible growth in GDP next year of around ½%, followed by relatively modest growth in 2012 and beyond. The latest consensus forecasts are for GDP to contract by 0.7% this year but rise by 1.5% in 2011, led by industrial production and exports.

**Public finances**

The public finances have deteriorated this year, although this is largely due to the recapitalisation needs of Anglo Irish and other banks, which will now total around €45bn. The general Government financial balance will be 32% of GDP this year. Excluding these transactions, the budget deficit this year will be close to 12% of GDP. Ireland's public sector debt situation is of growing concern, not least to international investors. Ireland had a gross debt to GDP ratio of less than 30% before the financial crisis, well below the euro area average, which was not far short of 70%. The Minister's Statement on 30th September announced that the latest banking support measures would take gross public sector debt to 98.6% of GDP this year. This is now comfortably above the average for the euro area, which is projected by the European Commission to be around 85% this year. Even public sector net debt will be close to 70% this year. The Government has published a revised four-year plan, taking account of the latest economic and fiscal data, to show how the public sector deficit will be reduced in line with its commitment to reduce the deficit to 3% of GDP by 2014. There is also the intention to stabilise the debt to GDP ratio in 2012/13. The events of November 2010 have underlined the parlous state of the public finances and economy. The acceptance of a bail-out from the EU and IMF means that severe fiscal tightening is inevitable. It may not differ greatly from the plans already announced by the government but the scope for discretion by the government will be extremely

limited. Irish Government bond spreads have risen sharply over the last three months, from below 300bps above German bund yields to well over 500bps at the time of writing (23rd November). Debt-servicing costs will inevitably rise sharply in coming years with higher interest rates applied to a high and rising level of public sector debt. Around 45% of the current stock of Irish Government debt has a maturity of less than five years.

**Construction sector adjustment**

The Irish construction industry is still suffering a very sharp contraction in activity. The latest GDP data showed construction activity to be a whopping 31.6% lower than in the same period a year ago. The level of construction output (using four-quarter moving average) is now around half the level of three years ago. This makes Ireland's peak to trough fall in construction the largest in the EU, with only the Baltic states coming anywhere close to the magnitude of the collapse in Ireland. As a share of the Irish economy (gross value added) construction has shrunk from 9% to around 4½% over the last three years. Direct employment in the construction sector has fallen by almost 145,000 from the peak and now accounts for 6.7% of total employment compared with a peak of 12½%. For 2010 as a whole construction output is likely to decline by around 20%, led by a further 40% to 50% drop in residential construction. Housing completions peaked at 93,400 in 2007, but have since fallen to just 26,400 in 2009 – a drop of almost 72%. The current rate of housing starts and permissions suggests that completions will probably be between 10,000 and 12,000 this year. Our projection for 2011 is that there will be little change from the 2010 totals. However, there is a strong regional element to housing vacancies: the Department of Environment recently published a survey[2] giving a detailed regional breakdown of housing completions and vacancies. The CIF has combined this survey with estimates of housing requirements out to 2016 supplied by regional authorities in order to calculate the number of months' supply of new, complete or nearly complete housing units that exist in each county or city. There is a wide regional variation with less than two months supply in Limerick and Wicklow, around a year in Kilkenny and two years in Sligo. The greatest extent of excess supply is in Longford and Laois with over 50 months supply. Hence while in some regions there will be no need for housing construction for several years, in others housing demand may exhaust the existing supply within a relatively short space of time. Total construction activity may well flatten out in coming quarters, given that housing starts are approaching the absolute minimum. Overall construction output will trend flat over the next year or so: commercial and industrial construction is likely to remain soft, depending of course on the approach of NAMA to the development of projects.

**The housing market**

According to the ESRI/TSB measure, Irish house prices are down by just under 15% in the four quarters to Q3 this year. The *myhome.ie* website reports in its Property Barometer for Q3 that asking prices fell by 3.9% on average during the quarter. From the peak four years ago average national house prices have fallen by 36% according to ESRI/TSB. The key Dublin housing market remains exceptionally weak with prices down by a further 1.2% in the course of the third quarter and by almost 45% from the peak. Anecdotal evidence implies that falls in prices have been much greater than suggested by official statistics, especially in Dublin where declines of 50% to 60% from the peak are often mentioned. At the top of the boom house prices were on most estimates 20% to 30% overvalued.

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[2] National Survey of Ongoing Housing Developments, 21st October 2010

Hence the total fall in prices over the last three years (on official or anecdotal estimates) implies that house prices are now undervalued to some degree. Continued low mortgage interest rates suggest that affordability is good.

An excess supply of housing in some regions will exert an ongoing downward influence on prices. Moreover, the state of the banking system, still struggling with a large bad debt problem, is hardly a positive environment for mortgage availability. But even if mortgage credit was readily available demand would be negligible from an over-indebted household sector in the process of deleveraging. In a recent assessment[3] of the effect of the financial crisis on the household sector, the central bank of Ireland estimates that household sector debt peaked at 230 per cent of disposable income in 2007 Q3. The ratio has since fallen to just over 200 per cent, considerably higher than in other highly indebted countries, such as the UK and the US. The report comments that “Households are likely to continue deleveraging until the debt burden can be serviced more comfortably from disposable income”. Latest official statistics show total household borrowing down by 4½% in the 12 months to September, including a 1.9% drop in mortgage credit. So far the nominal amount of mortgage loans outstanding has declined by just under 3½%, made up of a combination of debt write-offs and repayments. Mortgage arrears are on a steadily rising trend: the proportion of mortgages 90 days or more in arrears reached 4.6% of the total number of loans in Q2, up from 3.3% in Q3 2009. A prolonged period of household sector deleveraging is likely over the next few years with both continued debt write downs and repayment of mortgage debt.

The outlook for the housing market remains fragile in the near term, as it faces a deleveraging household sector and an impaired banking system restricting mortgage availability. In some regions this is compounded by excess supply. These headwinds will persist at least for the next year or so, possibly much longer. Indeed the current Irish situation is in certain respects similar to that in the US, where oversupply and excessive household sector debt have combined to maintain downward pressure on house prices, even as the wider economy recovered from recession. A similar scenario looks likely for Ireland: the economy should stabilize next year with a modest economic expansion, led by exports and a bottoming out of construction activity. But economic recovery will not immediately feed through into a housing market recovery. This is likely to be delayed until the employment outlook has improved and boosted consumer confidence to some degree. But when the housing market does revive it will be on a modest scale, hampered by deleveraging, negative equity and restricted mortgage availability. Nevertheless, signs of stability in prices may well bring forth buyers keen to take advantage of attractive prices.

**b) and c) “Assessment of sustainable demand for commercial and residential developments in the short to medium term and the role for NAMA in ensuring that a viable development industry exists.”**

The Irish construction sector has suffered a dramatic fall in activity over the last two years – the greatest in the euro-zone. This adjustment was necessary, given that construction’s share of the total economy had become excessive during the boom period. But the “good news” is that the dramatic fall in activity means that the required correction is close to completion. At just over 4% of GDP gross value added in the construction sector is below the long run average and also below what is appropriate in a rich country, such as Ireland. Over the next few years, as the work out in the construction sector continues (especially in relation to the housing stock) it is likely to remain around 4% of GDP. But once the adjustment is complete there will clearly be a need for a viable construction sector, providing an adequate supply of housing, commercial property and infrastructure for an expanding economy. Construction is a highly cyclical industry, boosting GDP growth during upswings and exacerbating downswings – that is the nature of the industry in all economies and will remain so, including in Ireland. But on average we would expect the construction sector to account for around 6% of the economy in gross value added terms.

In terms of employment the construction sector has an important role to play in the economy. Even now after the dramatic collapse in activity the Labour Force Survey shows 125,000 to be directly employed in the construction sector, 6.7% of total employment. (There will of course be a substantial number of jobs classified in other sectors that are dependent on construction.) In terms of direct employment we would expect the long run average to be around 8% of the total – consistent with the EU average. At current levels of employment this would imply direct employment in the construction sector of at least 150,000, up 25,000 from current levels.

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[3] “Irish Households: Assessing the Impact of the Economic Crisis” by M Cussen and G Phelan Central Bank of Ireland Quarterly Bulletin, October 2010

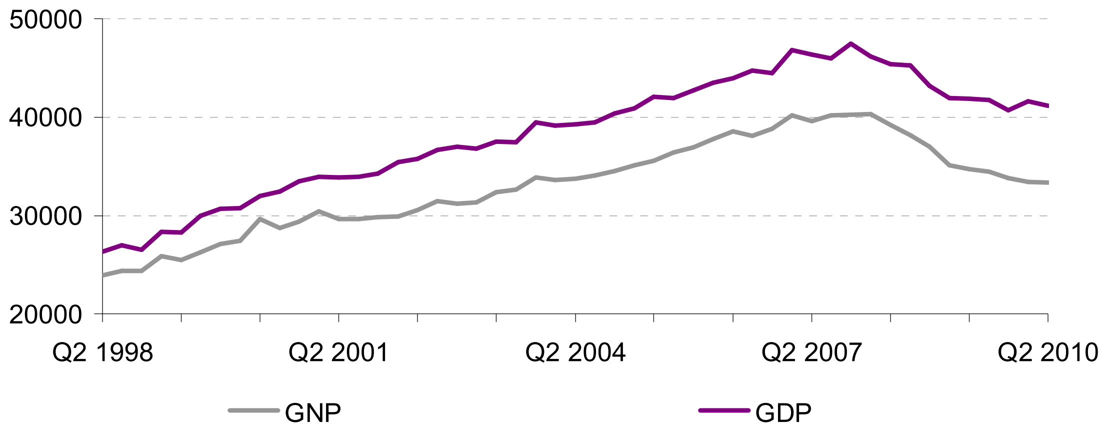
These long term issues should be an important consideration for NAMA in its current decision making process about developing or liquidating projects. If the industry is allowed to fall below a certain “critical mass” there has to be a danger that certain industry-specific skills would be lost and hence the industry would be hampered during the process of returning to its long-run equilibrium size.

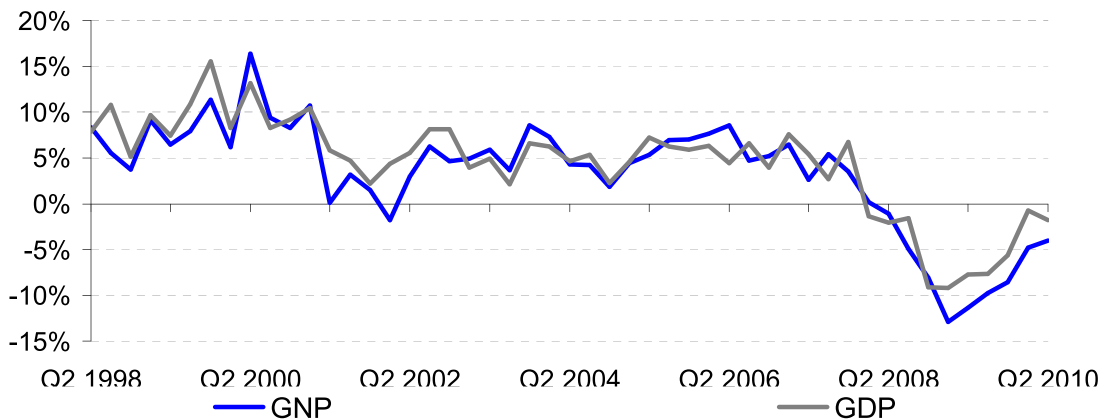
**d) “Impact of current NAMA Business Plan Targets in supporting longer-term viable development companies”**

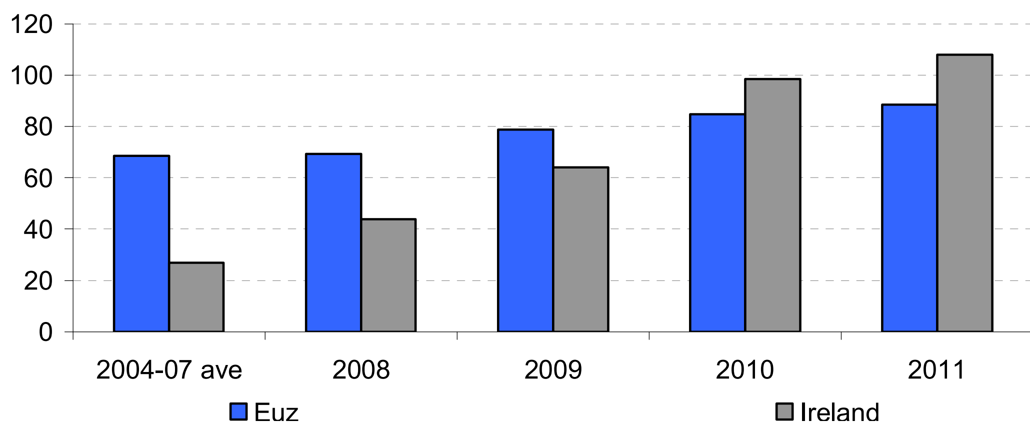
The most important issue here is NAMA’s insistence on pursuing the full amount of loans from borrowers, rather than acknowledging the large losses that resulted in NAMA itself acquiring loans at discounts of around 50%. Other issues relating to this matter are covered in the section on the Operation of NAMA above. But it is important to recognize that restructuring debt – acknowledging the destruction of economic value caused by the bursting of the construction bubble – is an important stepping stone in re-establishing a viable construction sector. It would of course make no sense for the sector’s debts to be completely written off, allowing developers to merely start again debt free. The “moral hazard” in this is clear and it would sow the seeds of the next bubble. But all insolvency/bankruptcy regimes allow for flexibility in writing off a proportion of outstanding debt in order for companies to re-emerge as going concerns. Given the industry-wide (as opposed to company-specific) difficulties caused by the bursting of the construction bubble and the need in the longer-term for a viable construction sector, partial debt restructuring or extended rescheduling terms make economic sense.

To conclude, Irish GDP and GNP are showing tentative signs of stabilizing after a very severe recession over the last two years. The Irish construction sector has suffered the biggest fall in output in the EU with a near 60% drop in activity from the peak. This necessary correction has now reduced the size of the construction industry to below its long-term equilibrium, both in terms of output and employment. NAMA has a vital role to play in ensuring that there is sufficient ongoing activity to ensure that the sector does not fall below a “critical mass” in size. For the same reason, while acknowledging the need to recoup money for the Irish taxpayer, NAMA should also consider relaxing its pursuit of one hundred cents in the euro from borrowers.

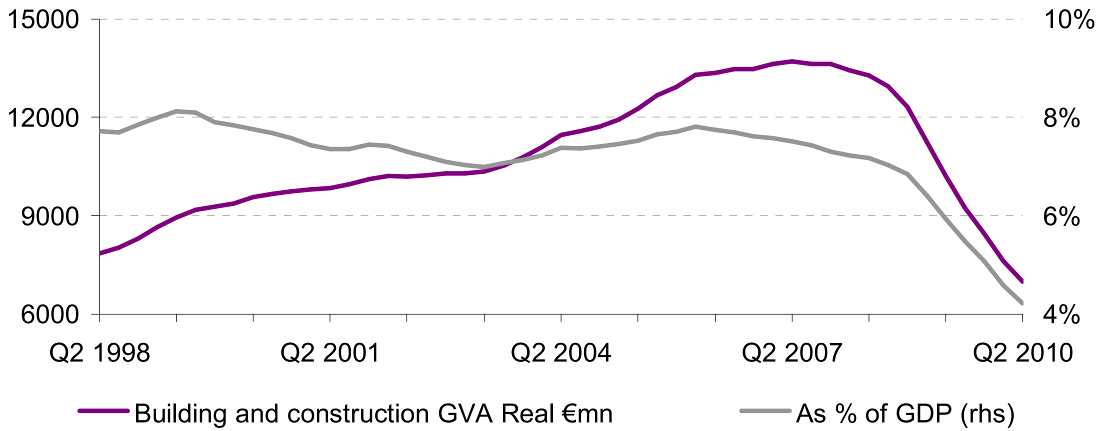
# Macro Charts



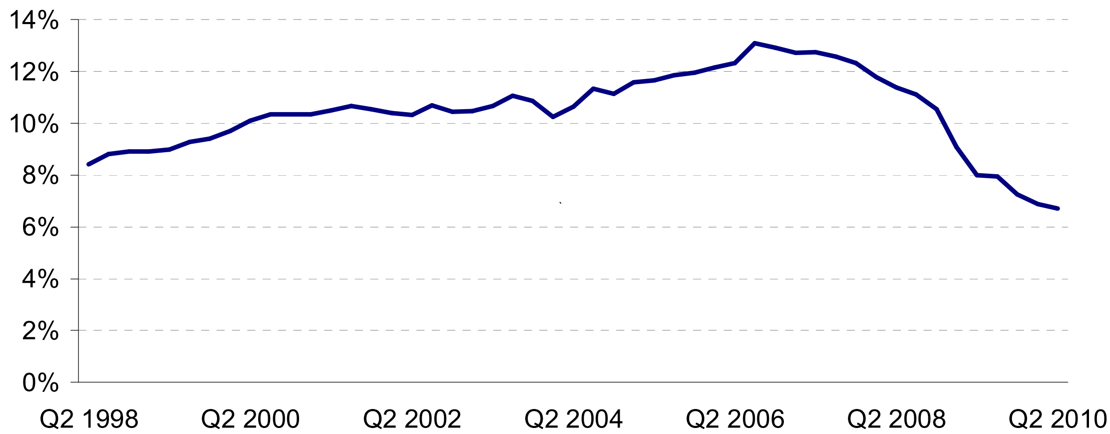



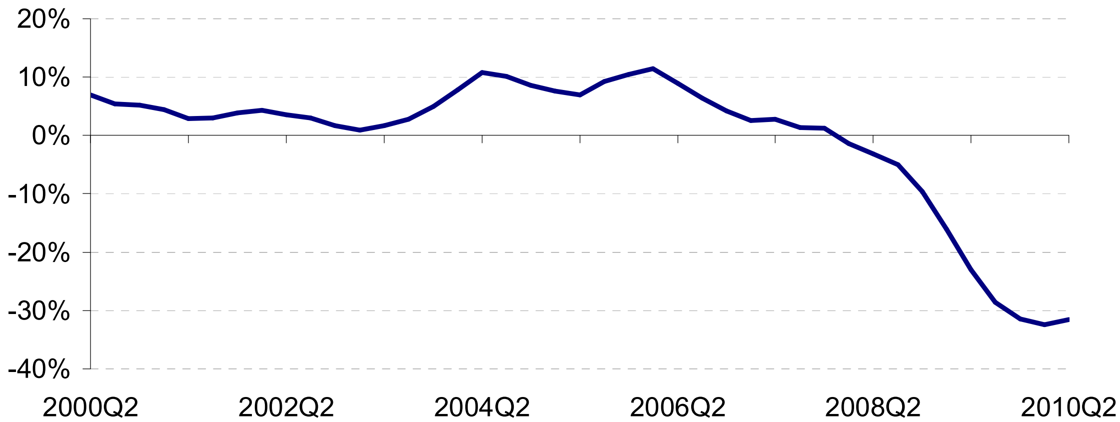
**Ireland's construction correction**
**calculations using 4-quarter sums**



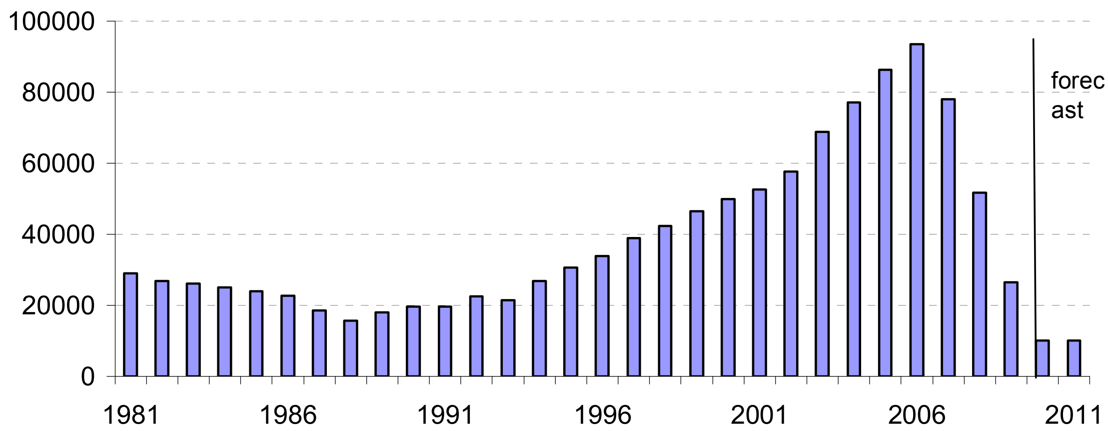

**Construction Employment as % of Total**



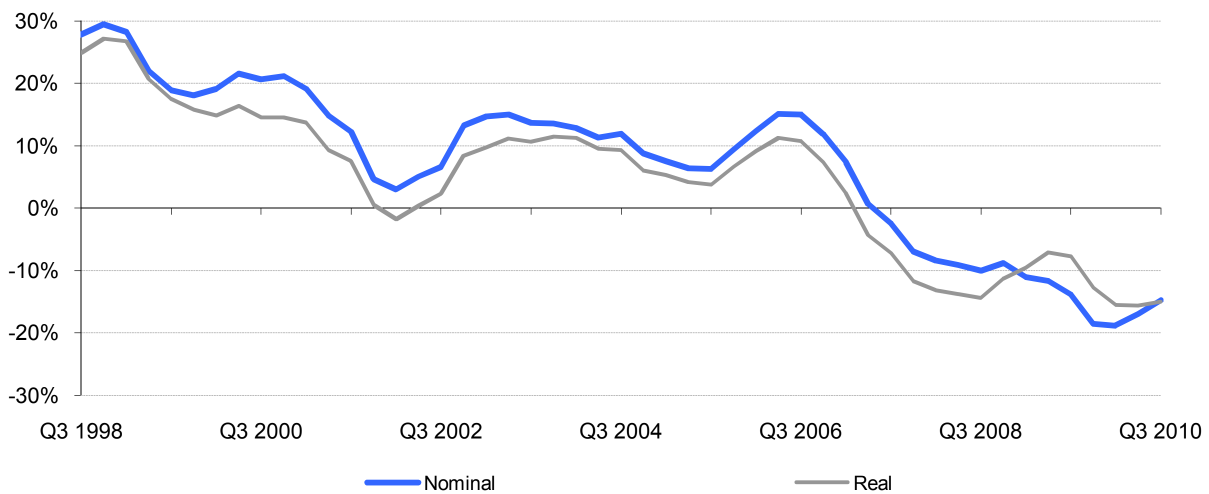

**Construction Output**
**yy, %**



**Housing Completions**




**House Price Inflation**
**12-month percentage change**




**Mortgage Credit Growth**
**(adjusted for securitisation)**