Address by Frank Daly, Chairman of the National Asset Management Agency, to the Leinster Society of Chartered Accountants Ireland

Wednesday, 5 May 2010

Thank you for the invitation to be the Guest Speaker at the Society's May Luncheon.

It is both a great privilege and an enormous challenge to have been asked to become Chairman of the National Asset Management Agency. The Agency's activities will have a significant bearing on the economic wellbeing of Ireland for the next decade and probably well beyond. The story of why it was necessary to establish NAMA has been well documented. We now know all too well of the extraordinary expansion of bank balance sheets in the middle part of the decade, the reckless rush to direct too much lending into one sector, the associated failure to secure or document loans properly, the apparent absence of any recognition that markets fall as well as rise and, of course, the failures of regulation and oversight. In the goodness of time, we will have a better understanding of why all this happened or was allowed to happen. My focus today is to look forward and to outline how NAMA might contribute to a resolution of this crisis.

The Minister announced the decision to establish NAMA in April 2009 and a huge amount of work was carried out between then and its formal establishment, not least the drafting of one of the most complex pieces of legislation ever to be enacted by the Oireachtas. The Agency has been in existence now since November and I was appointed Chairman just before Christmas. The NAMA model itself is relatively straightforward although the practicalities associated with giving effect to it are not. It is a workout vehicle, not a mechanism for liquidation, and it has the breathing space to take the longer view on borrowers and assets if it makes commercial sense to do so. It is not a "toxic" or "bad" bank but an asset management agency which will acquire loans from the five institutions which applied and were accepted as participants in the scheme by the Minister. Financial institutions in Ireland have been paralysed in recent years by the burden of their commercial property loans. Cleansed of these exposures and provided with securities which can be used as collateral with the ECB and with the market, the aim is that institutions will revert to their core business of business and personal lending and thereby facilitate the process of economic recovery.

NAMA will acquire about €81 billion of loans. In exchange, it will pay consideration in the form of senior and subordinated bonds to a value which will be much less than the €81 billion. It was always the intention that NAMA would acquire both performing and non-performing loans on the basis that it would not be acceptable from a public policy perspective that institutions could pick and choose which loans were transferred to the State. In addition, it was envisaged that interest on the performing loans would offset the interest cost of securities issued by NAMA.

The price paid for a loan by NAMA will be based, to a large extent, on the current market value of the underlying property which, in turn, will incorporate local supply/demand considerations. In the case of many properties, the current market value may be uplifted to reflect NAMA's view of its long-term prospects. This is the price that NAMA can realistically expect to realise on the property over a seven to ten year horizon and is known as its long-term economic value. In Tranche 1 our experience has been that this has led to an uplift in values of about 11% compared to current market values. This approach and its associated valuation methodology were approved by the EU Commission in late February. Each loan will be valued individually on behalf of NAMA and, in addition to the value of the underlying property, other factors taken into account include any other collateral offered by the borrower and whether the loan is performing or non-performing. I should point out also that where the underlying security on a loan is deficient, NAMA will apply a further discount. In cases where the security is non-existent, NAMA will acquire loans for no consideration at all.

After acquisition of their loans, the largest 100 borrowers - which comprise about 60% of the portfolio - will be intensively and directly managed by NAMA with key credit decisions and relationship management carried out by its staff. Loan administration will continue to be performed by participating institutions. For other NAMA borrowers (of which there are expected to be about 1,400), credit decisions will be made by NAMA with some very limited authority delegated to the participating institutions. Each of the institutions is currently in the process of setting up segregated NAMA units which will carry out relationship management and loan administration for borrowers other than the largest. Acquired loans will be managed so as to achieve an optimal return for taxpayers. Income from performing loans will accrue directly to NAMA and, where a borrower defaults and NAMA takes over the underlying asset, the proceeds from the sale of those assets will also accrue to NAMA.

In essence, NAMA's core commercial objective will be to recover for the taxpayer whatever it has paid for the loans in addition to whatever it has invested to enhance property assets underlying those loans. It is expected to have a lifespan of seven to ten years. . When it has achieved its core objective, it will be wound up. It is almost unique in that the more successful it is, the closer it will be to extinction. After 2012 and every five years thereafter, the Minister will review the extent to which NAMA has made progress towards achieving its objectives and will decide whether its continued existence is warranted. It is unusual among financial institutions in that it starts off with a huge balance sheet and will be working to eliminate it over its life. If, by the time its work is finished, NAMA has made a surplus, that surplus will accrue to the taxpayer. If, however, it has made a loss over its lifetime, a tax surcharge will be applied to the participating institutions to make up the shortfall.

Let me emphasise that NAMA will be acquiring loans in the first place, not properties. The extent to which NAMA acquires actual property will depend on the viability of borrowers and the extent to which they are willing to co-operate. To the extent that borrowers continue to service their loans, little will change from their perspective. However, we know, of course, that many borrowers engaged in the property business are at various stages of distress and in no position to service all the debts that they have accumulated. NAMA will be in a position to assess each borrower's viability more rigorously and impartially than banks have done to date. Moreover, this assessment will be based on the borrower's aggregate exposure to all institutions, not the limited view that each institution has had to date.

After their loans have been acquired by NAMA, borrowers will be asked to produce business plans which will set out detailed and credible targets for reducing their debt, including any asset disposals which will contribute to that end. We expect that NAMA's engagement with some borrowers will be robust. Not all of them have yet abandoned the extravagant mindset of the 2003-2007 era. At this stage, the first ten borrowers or their representatives have all had face-to-face meetings with NAMA and are now fully aware of what is expected in terms of the thoroughness and stringency of their business plans. Their detailed plans, based on a three-year horizon, must be submitted within a thirty-day deadline and NAMA will then approve the plans, reject them or refer them back to borrowers for amendment.

Where plans are approved, NAMA will monitor the borrowers' subsequent performance to ensure adherence to approved targets. Some borrower projects will be commercially viable but may need investment in order to be completed and to generate cash flow through rental activity or through sales. NAMA may advance funds directly to such projects or may enter into partnerships or joint ventures to ensure project completion. Borrowers may also be required to sell non-income producing assets to generate cash to support their own operations.

Over the coming year or so, NAMA will be engaged in the difficult but necessary process of rigorously assessing the viability of borrowers. The onus will be on borrowers to demonstrate their viability, not on NAMA to make a leap of faith based on a borrower's reputation or record. No borrower, in NAMA's perspective, is too big to fail. The cornerstone of NAMA's approach to business plans will be a sense of realism: realism about the current over-supply of property, realism about the prospective demand for both finished and unfinished developments, realism about the sales prices or rents which can be achieved and realism about the extent to which investor funding will be available in future for the property sector. It is inevitably the case that the outcome of this process cannot be positive for all borrowers and the result will be foreclosure. NAMA will take whatever actions it considers necessary to protect taxpayers' interests, including the appointment of Statutory Receivers or the use of vesting orders or other enforcement mechanisms.

In evaluating borrower business plans, NAMA will, in fact, be evaluating the viability of each property asset that forms part of those plans. Assets being acquired by NAMA fall into three distinct categories: undeveloped land, unfinished developments and developments which have been completed and are available for rent or sale. In the case of a plot of land which was initially purchased by the borrower at a multiple of its current value, NAMA will assess its development potential in the light of supply/demand conditions. One of the features of a review of the lists of eligible assets submitted by the participating institutions is that there is a large concentration of borrowers in the €5m to €20m range of indebtedness. Many of these are not professional property developers: they are people with other full-time occupations who got involved in the purchase of undeveloped land. It is very difficult to understand how borrowers on relatively modest incomes could have been advanced large sums of money to invest in undeveloped sites in unpromising locations. It is a matter for another time and another forum to consider but there are serious questions to be asked about the governance of institutions which created a system of incentives for their staff which enabled this lending to take place. I can say that, from NAMA's perspective, most of these undeveloped sites will be valued at no more than their agricultural value.

For completed developments, the challenge will also be to assess viability by reference to prospective demand. As regards prospective demand in Ireland, the core underlying assumption will be that the economy will revert to moderate rates of growth over a medium-term horizon. Contrary to what some commentators have suggested, NAMA's success in extracting value from assets does not depend on Ireland achieving the extraordinary rates of growth recorded between 1994 and 2007. Geographical and sector factors will also play a part: the supply/demand picture will look somewhat different depending on whether the development happens to be an office development in central London or a hotel in certain parts of Ireland.

As I have said, decisions in relation to loans for undeveloped land or completed developments will involve assessing the borrower's capacity to service those loans in the context of any prospective cashflow from the underlying assets. This brings me to the most demanding of the challenges facing NAMA: what to do with loans advanced for developments which have not yet been completed. You may know that, under the legislation, NAMA can advance up to €5 billion to provide working capital and other funding to borrowers. This is a limited resource which NAMA must utilise prudently. NAMA will take a strictly commercial view of unfinished projects and there is no question of throwing good money after bad. We can be fairly certain that aggregate borrower demand for funds will be much higher than €5 billion. Clearly, therefore, given the limited funds available, there will be difficult decisions to be made as regards the completion or otherwise of projects.

We know, however, even at this early stage, that it does not make commercial sense to complete many unfinished developments. They should never have been started in the first place. One of the more baffling features of the past decade is that banks, in some of their lending, seem to have been completely oblivious to the fact that other banks were lending for similar developments within the same geographical area. How many shopping centres or apartment developments can a medium-sized town accommodate? It goes without saying that the fact that this was allowed to occur does not reflect well on our planning process either. From NAMA's perspective, given where we find ourselves, there are some tough decisions to be made. One of the options will be to demolish some developments. But there are other options and NAMA will be innovative in terms of looking at possible alternative uses for completed and uncompleted developments.

Let me update you about progress on the acquisition of the first tranche of loans. We have acquired some €10 billion of the loans of the largest ten borrowers with AIB, Bank of Ireland, Irish Nationwide, EBS and Anglo Irish Bank. For these, the consideration paid was €4.85 billion, a discount of about 51%. That discount is unlikely to change very much after we have acquired the residual of the first tranche loans from Anglo. This will bring the total first tranche transfer to about €16 billion. With the second and third loan tranches amounting to about €21 billion transferring over the coming months, we aim to have close to half of the overall transfer completed by the end of July. We expect that the pace of loan transfers will accelerate during the second half of the year as smaller and less complex loans can be valued and transferred more easily. Our objective is to transfer the remaining loans from the five institutions by the end of the year and certainly no later than end February 2010, the deadline set by the EU Commission.

As you can appreciate, this has required an enormous effort on the part of NAMA and of the five participating institutions. There has been some comment to the effect that the due diligence and valuation process has been too detailed. We are aware that the larger institutions have had to dedicate hundreds of staff to due diligence work but we make no apologies for the thoroughness and rigour of the process. Taxpayers are entitled to the assurance that the loan assets being acquired on their behalf are properly secured and fairly valued. Our approach has been fully vindicated by what has emerged to date in terms of sub-standard loan documentation and of assets not properly secured. These flaws have been more widespread than we had reason to expect and, as a result, the overall discount on loans acquired as part of the first tranche was higher than originally envisaged.

In passing, I wish to address a misconception that seems to have taken hold among some commentators about the cost of the professional services that NAMA utilises as part of its due diligence process. The cost of such services has been low to date, not least because a very competitive and thorough public procurement process has driven costs down. Furthermore, NAMA will recoup the cost of these services from the banks through an upfront deduction of 5.25% from the price it will pay the institutions for loans.

As Chairman of the Board of NAMA, I have a clear sense of the enormous challenge facing us. Much has already been achieved. The approval of the EU Commission for the NAMA scheme has been obtained. An elaborate infrastructure has been put in place to conduct a detailed valuation of some €81 billion worth of loans. One-fifth of these loans have already been valued and transferred and we aim to transfer the rest of the portfolio by February 2011. The NAMA SPV structure has been established and private investors have contributed €51m to the subscribed capital of €100m. The NAMA Board has set up some six committees, including advisory committees dealing with Northern Ireland and planning issues. The staffing of NAMA is well underway and all of the key senior positions have been filled at this stage. Most of its recruitment will have been completed by mid-year. Arrangements are being put in place to ensure that participating institutions continue to service borrower loans to a high standard. A credit approval framework has been put in place to enable funding requests from borrowers to be assessed and approved or rejected as appropriate. A panel has been set up to facilitate NAMA in its appraisal of borrower business plans. Funding and hedging programmes are being established for NAMA.

The NAMA Board will, over the coming months, dedicate itself to developing strategies for managing its portfolio of loan assets and any property assets that it may acquire. As I mentioned above, some key decisions will need to be made about borrowers based on their assets and their prospects of significantly reducing their debt. Strategies will need to be developed for the potential sale of loans or loan portfolios. A key project will be an extensive analysis of supply and demand factors at work for different regions and asset classes; this will enable NAMA to develop appropriate and informed strategies for regions and asset classes. The challenges ahead remain daunting but I believe that NAMA has made a good start and that the task that has been set for it can be successfully achieved.

I thank the Society for the opportunity to have made these comments.