

**Opening Statement by
Mr. Brendan McDonagh, Chief Executive of NAMA, to the
Public Accounts Committee
Thursday, 24 November 2016**

Chairman and Deputies,

I wish to address first an issue which, in my view, is at the core of the debate about whether the best price reasonably achievable for Project Eagle in the first quarter of 2014 was in fact achieved.

There no longer appears to be any dispute about the appropriate discount rate that should have been used for deriving the market value for a loan portfolio such as Eagle in late 2013 and early 2014. There would now appear to be general acceptance that the market would have discounted the cash flows in this portfolio at a rate in the range of 10%-15%. This has been our position all along and it has been supported by a number of market experts. By that criterion, it is reasonable to contend that £1.3 billion was in the ballpark of what a buyer would expect to pay for this portfolio.

The position of the C&AG, as recently articulated to this Committee, appears to be that he accepts that a discount rate of 10%-15% was indeed appropriate for determining the market value of the Eagle portfolio in the context of a loan sale. However, if I understand his position correctly, he is now saying that this higher discount rate would have been appropriate for potential buyers of the portfolio but not for NAMA as the seller.

A 5.5% discount rate may indeed have been appropriate for estimating the **accounting carrying value** of the **overall portfolio** but it was not appropriate for estimating its fair value (the best proxy for market value) and it most certainly was not appropriate for

assessing the market value of Project Eagle. The Board made a strategic decision in 2014 to sell the Eagle portfolio once that option became available. The C&AG has stated that he has no view on this strategic decision.

Up to late 2013, in the absence of any alternative strategic option, the default option had been to dispose of the underlying collateral of NI debtors on a piecemeal basis up to 2020.

From NAMA's perspective, and indeed from the perspective of any commercial entity, the report's position on the discount rate does not make commercial sense for reasons which I will now set out.

1. Major restriction on commercial flexibility

It would rule out the sale of any loan portfolio comprised of granular, multi-debtor and lower value assets as, quite frankly, the market would never buy these portfolios at a 5.5% discount rate. There would always be an unbridgeable gap between the market's valuation of a granular loan portfolio and NAMA's valuation. This would mean in effect that NAMA could never sell these portfolios and thus, the strategic option of locking in their market value upfront when an opportunity arose could never be utilised.

We drew attention at the first Committee meeting on 29 September to the fact that we were advised by UBS that a 10% discount rate was appropriate for Project Tower, a better portfolio than Eagle which was launched to market at the same time (Q1/2014). In Project Arrow, a portfolio with similar characteristics to Eagle, Cushman & Wakefield advised in mid-2015 that a 15% discount rate was appropriate. If one accepts the report's position, the market's view of a portfolio's valuation is irrelevant if it does not match a valuation based on a 5.5% discount rate – that, in effect, would rule out all but a handful of loan sales.

2. Statutory commercial mandate

Given that NAMA has been tasked by the Oireachtas to operate on a commercial and expeditious basis, the report's view that NAMA cannot apply a market discount rate to its loan portfolios is simply not commercially feasible for NAMA if it is to fulfil its statutory mandate under Section 10 of the NAMA Act.

Had we adopted such an interpretation, it is difficult to see how we could have deleveraged our overall portfolio to the extent that we have done over the past three years. Thus, instead of dealing with a residual senior debt burden of €3.6 billion (12% of the original €30.2 billion), we would be dealing with a multiple of that residual amount and facing into the major uncertainties that have emerged, both for property markets and for the global economy, over recent months.

NAMA's strategy was set out in 2010: it was to be an orderly and phased disposal but we stated that we would be alert and ready to avail of market opportunities as they arose. If we had not lived up to our promise, I am satisfied that, instead of discussing the Project Eagle sale, we would now be appearing before this Committee and having to explain why we had failed to take advantage of the favourable and unprecedented market opportunities and the influx of capital that became available over the past three years. Irish taxpayers would rightly be concerned as to why they were still left with a major contingent liability exposure backed by property in Ireland and elsewhere. This report takes no account whatsoever of these major and very real strategic considerations.

3. Long-term piecemeal workout

The C&AG has stated that he considers it beyond his remit to comment on the strategic and commercial rationale underpinning the decision to sell the loan portfolio. It may not have been his intention to comment on strategic or commercial issues but the position he has adopted is, in effect, a position that favours one commercial strategy (long-term hold to 2020) over another (portfolio sale in 2014). If one accepts the position that he has adopted in relation to the discount rate, namely that NAMA is not entitled to use the

appropriate market discount rate to estimate the market value of granular portfolios of this type, then he is clearly proposing a position which favours a long-term piecemeal workout in preference to an upfront loan sale. In that sense, without the support of any knowledge or experience of dealing with distressed assets, the report is implying that a long-term workout will always be superior to a loan sale regardless of the risks involved, given that a portfolio discounted at 5.5% will invariably have a higher valuation than a portfolio discounted at a market discount rate of 10% - 15%.

If NAMA accepted this perspective, which given its statutory commercial remit it cannot do, it would never adopt a loan sale strategy in preference to a piecemeal workout. In fact, we would be around much later than 2020.

It is worth bearing in mind, however, that NAMA was not established with a restricted mandate to work out assets on a piecemeal basis over the long-term; it was set up with a mandate to act commercially and expeditiously and that meant taking advantage of any opportunities to sell loans and property, either in bulk or individually, subject to the requirement that the best achievable price is obtained. This view of NAMA's mandate was also articulated by the Minister for Finance in his Section 227 review of NAMA in 2014.

4. Reliance on 5.5% rate

I believe that the rationale for the report's position is not sustainable, particularly in its assumption that it would have been appropriate to use a 5.5% discount rate to estimate the long-term workout value of the Eagle loans. We have repeatedly drawn attention to the fact that a 5.5% discount rate was not a 'standard' NAMA discount rate and it is inaccurate and unreasonable to characterise it in those terms. It was a rate which the Board, in its decision of June 2013, stated was appropriate for use **for some, but not all, commercial evaluations.**

The Board decision of June 2013 could hardly have been clearer: a 5.5% rate should not be used as an over-arching discount rate to evaluate all potential transactions. It was

important that flexibility should be maintained. In particular, “***care should be taken to ensure that both (a) alternative NPV scenarios are generated using alternative discount rates and (b) that qualitative information would be considered as part of the decision-making process***”.

The key ‘***qualitative information***’ in the evaluation of this transaction was the relatively low quality and granular character of many of the assets in the Northern Ireland debtor portfolio which was not typical of the NAMA portfolio as a whole. A discount rate higher than 5.5% was commercially appropriate, given the risks associated with its asset quality and with underlying weak economic conditions in Northern Ireland and in parts of northern England and Scotland.

This Eagle portfolio was very granular: the fact that the top 55 assets accounted for two-thirds of its value left the remaining one third of the portfolio with about 870 assets with an average asset value of about £600,000 each. The cash flows attaching to these smaller valued assets were much less certain, both in terms of projected disposal proceeds and projected income, than was the case with larger assets. It is accepted market practice that the less attractive the assets and the income stream securing a loan portfolio and the less certain that the associated cash flows will actually be received, the higher the risk premium and therefore the discount rate that will be applied by buyers. For that reason, it made perfect sense, through a loan sale, to bundle the large number of poorer quality assets with the better assets.

The discount rate would also have incorporated a risk premium arising from the high concentration of assets located in the small Northern Ireland economy. As we have pointed out, the Northern Ireland property market did not have the capacity to absorb a large volume of asset sales over a short time period, as is evidenced by the fact that, in the four years from 2010 to the end of 2013, sales of NAMA-secured assets in Northern Ireland realised a total of only £113m.

The report’s conclusion that there was “a probable loss of £190m” rests entirely on the view that NAMA applied, or should have applied, a standard discount of 5.5% to all evaluations. This can only be deduced by comparing an estimate of workout value

(£1.49 billion) to 2020 with the minimum reserve price of £1.3 billion from a 2014 sale. As the report puts forward no external evidence in support of 5.5% as being an appropriate market discount rate or indeed being an appropriate workout rate, everything rests then on the report's interpretation of the Board decision of June 2013. The key question then becomes whether one takes the Board's June 2013 caveat about other factors, including risk assessment, into account or whether one arbitrarily decides to ignore it.

If you accept the objective evidence offered by the actual decision that the Board took in June 2013 – including the major caveat to which I have drawn your attention – you cannot reasonably contend that the Board intended that 5.5% would become a standard, one-size-fits-all discount rate for all strategic commercial evaluations. Therefore, by extension, the whole basis for the conclusion of a 'probable loss of £190m' does not hold.

Section 3.81 of the report outlines the C&AG's case for relying on a 5.5% discount rate, based on three statements which are all factually incorrect:

1. The report states that "*no reference was made in the papers presented to the Board in June 2013 or in December 2013 that a rate higher than NAMA's standard 5.5% rate would be appropriate*". For reasons outlined above, NAMA does not accept the C&AG's contention that 5.5% was a 'standard discount rate' to be used for all evaluations as the June 2013 Board paper clearly provided for exceptions if and when appropriate.
2. The report states that NAMA's cost of funding was 1.2% in 2013, much lower than the funding costs that would arise for the purchasers of loan portfolios. This statement, designed to illustrate that NAMA could have continued to carry the portfolio at a low cost for all future years, is misleading. NAMA's average actual and projected cost of operations from 2014 to 2020, the period of time during which NAMA would have had to work out this difficult portfolio, was 4.95%, not 1.2%. This is significantly higher than funding costs for banks and some other comparable institutions. It also implies a risk premium of 0.55% if you regard a 5.5% discount rate as appropriate. I

cannot imagine that any informed analysis would regard such a low risk premium as appropriate for the Eagle portfolio.

3. The report states that NAMA already took account of the poor quality of the underlying Eagle assets in its impairment review. This is not the case. As discussed further below, International Accounting Standards allow impairment reviews only to consider circumstances and known incurred losses at the time of the review i.e. end-2013. Losses due to future events or conditions from 2014 onwards, no matter how likely, were not permitted. The fact that the accounting impairment review does not capture future losses means that a higher risk premium must be built into the discount rate. Hence, the report's assertion that overlaying a high risk premium on the technical impairment calculation would represent 'double counting' is factually incorrect. In any event, the market ignores accounting carrying values and tends to value portfolios by reference to the price of risk.

Unsupported conclusion of 'probable loss'

We note that the C&AG, in his evidence to the Committee on 29 September 2016, stated that it was not possible to be absolute or definite regarding the alleged 'probable loss of £190m'. He indicated to Deputy Kelly that there was a margin around it but stated that it was impossible to estimate what that margin might be. Based on the magnitude of possible margins put to him on that date, he did not rule out the possibility that the margin may have been plus or minus £200m or more.

Therefore, depending on the parameters of the margin, the 'probable loss' could have been much higher than £190m or indeed, at the other extreme, that there may have been no 'probable loss' at all. Such a wide-ranging margin leaves us in the realm of speculation. In our view, **compelling and objective market evidence** is required to support a finding that there was a probable loss that would not have been incurred if NAMA had held on to the portfolio to 2020 rather than selling it in 2014.

While the C&AG's qualification at this Committee of his original report conclusion is to be welcomed, it only goes to highlight the difficulty of positing and estimating a 'probable loss' in the absence of any objective market evidence of a loss. Objective market evidence would be evidence that a credible buyer was willing to offer £1.49 billion – or some other sum greater than the £1.322 billion achieved by NAMA - for this portfolio. No such evidence has been produced because there can never be any such evidence – it is pure speculation.

I cannot imagine that a court of law or any other judicial forum would regard the interpretation of the NAMA's Board decision which ignores a crucial element of that decision as a fair or reasonable basis for concluding that there was a 'probable loss' of any magnitude.

Adjusting for accounting rules

NAMA had taken a cumulative impairment of £478m on the Eagle loans up to the end of 2013. We were well aware that it was highly likely that additional impairment charges would have to be taken in the 2014 and in future years' Financial Statements. Indeed this emerged in the form of an accounting loss of £162m on the sale of the Eagle portfolio. IFRS accounting rules, and specifically IAS 39, require NAMA to recognise an impairment provision against the book value of its loans where there is a reduction in the amount likely to be received or a change in the timing of future loan cash flows – commonly referred to as '***objective evidence of impairment***'. IAS 39 operates on an ***incurred loss*** basis as opposed to an ***expected loss*** basis.

Under IAS 39, NAMA could not have provided for expected future losses. At the end of 2013, the Board expected future losses but could not provide for them under IAS 39. In setting the £1.3 billion minimum price, the Board was, in effect, recognising and bringing upfront, losses of at least £175m. The Board was aware that the end-2013 £1.49 billion carrying value needed to be adjusted to take account of losses that it expected to take in future years but could not yet recognise in its end-2013 accounts

under IFRS. The fact is that there was an actual loss of £162m on the sale which was recognised in 2014 accounts is not in dispute.

The International Accounting Standards Board has redrafted IAS 39 and the new standard (IFRS 9), will, when implemented in two years' time, change the impairment methodology to allow for *future expected credit losses* to be reported on a timely basis. In 2014, however, we were operating by reference to the existing accounting IFRS rules. We note that if the timing of the Eagle sale had been six or twelve months later, additional impairment would have been recognised and I have little doubt that the cumulative impairment at that point would have been close to the £640m total impairment that we ultimately took on this portfolio.

Rationale for NAMA's position

I wish to reiterate NAMA's position. The gross undiscounted cash flows arising from the Eagle loans aggregated to £1.68 billion. The C&AG's report has discounted these cash flows at a discount rate of 5.5% and has produced a NPV of £1.49 billion. The minimum sales price set by the NAMA Board was £1.3 billion. This falls within the mid-point range of sale values generated by the 10%-15% range of market discount rates. This is the range that would have been applied to a portfolio such as Eagle during the first half of 2014. A 10% buyer discount rate produces a value of £1.36 billion; a 15% discount rate produces a value of £1.25 billion. The £1.322 billion achieved on the sale, which was above the minimum price of £1.3 billion, was therefore well within the range of expected market values.

It has been suggested that there is no support in NAMA's contemporaneous records for its use of a 10% discount rate. This is not the case. A 10% rate was used in preparing information required as part of the fair value note in the end-2012 NAMA Financial Statements which was certified by the C&AG. The fair value methodology for the 2012 accounts was based on a discount rate of 10% and, had this fair value discount rate been applied to the Eagle portfolio, the NPV would have been £1.36 billion. This was the prevailing fair value discount rate that applied at the time that the sale of the Eagle

portfolio was being considered by NAMA in Q4 of 2013 and, as such, it is a discount rate with which the Board would have been familiar during its deliberations about a possible loan sale.

In a commercial transaction, there can only be one definitive market value – the price on which a buyer and a seller agree after a competitive sales process. In advance of a sale, a buyer and a seller will in most instances have different views on what a portfolio may be worth but these views are notional unless and until a transaction price can be agreed.

NAMA does not accept the inference in the C&AG's report that the sales process restricted the field of credible potential bidders and thereby compromised the objective of obtaining best market price. The nine potential bidders approached by Lazard were all credible entities which had the capacity to fund and execute a purchase on this scale – in fact, collectively, they purchased 88% of all large loan sales across Europe between 2013 and 2015. There is no evidence that there were other potential bidders who could have participated in the process and who would have been likely to submit a competitive bid for the portfolio.

Conclusion

It is not plausible to suggest, as is done in this report, that NAMA set a reserve price for the Eagle portfolio which, was too low. By definition, any suggestion of a NAMA giveaway of £190m must have involved a gain of £190m for the successful bidder and this is just not plausible.

Are we being asked to believe that, of the nine major international investors approached and the five major international investors which took a detailed look at this portfolio, only one identified the £190m that NAMA was allegedly giving away when it set the minimum price of £1.3 billion? Major astute international investors do not operate in that way – we are being asked to believe that, uniquely on this occasion, they decided to leave easy money on the table.

The report suggests that the concerns that some potential investors may have had about the duration of the sales process or the level of detail available on the portfolio were so serious that they decided to forego the £190m of easy profit allegedly on offer. Again this is not a realistic view of the capacity of major international investors to surmount any obstacle in pursuit of substantial and easy profits.

In reality, as the C&AG has acknowledged to this Committee, the cost of capital of these purchasers would have been of the order of 10% or more.

There was no substantial profit available through alleged NAMA mispricing. It would be more realistic and more credible to suggest that the £1.3 billion minimum price set by NAMA was a commercially reasonable target in early 2014 and that only one of the five investors who looked at the portfolio in detail considered that it represented a potentially profitable opportunity for them. The NAMA Board made a decision to sell in excess of that minimum price and we stand over that.

Thank you.