

**Opening Statement by  
Mr. Brendan McDonagh, Chief Executive of NAMA**

**Joint Committee of Inquiry into the Banking Crisis**

**Wednesday, 22 April 2015**

Good morning Chairman and Inquiry members,

In this brief opening statement, you have asked me to address five topics in particular:

- The acquisition process of eligible assets from participating institutions
- The quality of documentation and underlying collateral of acquired loans
- The governance models in place in respect of loan/asset acquisition and management.
- The asset valuation methodologies utilised by participating institutions prior to acquisition as compared to that used by NAMA
- The extent of commercial due diligence conducted by borrowers.

Before addressing these points directly, I wish to emphasise that my comments are informed largely by NAMA's experience of acquiring and managing a portfolio of loans with a face value of €74 billion acquired from the participating institutions in 2010 and 2011 for a consideration of €31.8 billion. Regarding some of the points on which you have asked me to comment, I do not, and could not, have the level of detailed knowledge or insight that would be available to senior lending managers or to the credit committees in the financial institutions or to staff of the Financial Regulator or the Central Bank. By the time of NAMA's establishment, the property lending crisis and the losses created by poor lending decisions were already irreversible and while, in this

statement, I may draw certain inferences about the causes of these losses based on what we found when we acquired the loans, I do not claim to have access to the full picture. In particular, as I was outside of the banking system, I do not have an insight into the motivation behind the poor lending decisions of the financial institutions or indeed the borrowing decisions of the debtors in the years up to the end of 2008. I trust, Chairman and Committee members, that you will accept my comments in that spirit.

## **Acquisition process**

The acquisition process has been described in detail in the C&AG's first Special Report on NAMA – **Acquisition of Bank Assets** - which was published in October 2010. The key elements of the process are outlined below.

The institutions were required to identify assets which were eligible for transfer by reference to the criteria specified in the NAMA Act 2009 and in the regulations made by the Minister for Finance in December 2009 and in March 2010. They were also requested to provide detailed information on their eligible loans, including legal due diligence reports and up-to-date valuations of property and other assets which were pledged as collateral for the loans. The reference date for the market valuation of property was 30 November 2009.

NAMA then went through a process of validating key information provided by the financial institutions. Legal due diligence reports submitted by the institutions was reviewed by NAMA's external legal panel: the reviews were required to highlight any issues which would give rise to legal difficulties for NAMA in managing the loans or in engaging in enforcement actions in respect of them. Particular attention was paid to the enforceability of security, any deficiencies in title to property and the implications of such deficiencies.

The validation process also covered property valuations supplied by the institutions. A key element in the valuation of each loan was the current market value of the property or other collateral securing the loan. This valuation was, in the first place, provided by a

professional property valuer commissioned by the institution but also owing a duty of care to NAMA. Each property valuation submitted by the financial institution was referred by NAMA to its own property valuation panel which reviewed it and provided an opinion as to whether it considered it to be correct. If the NAMA property panellist disagreed with the valuation, it was referred to an independent property valuer for adjudication. This third-party property valuation was accepted by NAMA and used as part of the loan valuation.

The valuation methodology used to value bank assets (usually loans but also including derivatives) had to receive the approval of the European Commission because there was an element of State Aid incorporated in the transfer price. Bank assets were acquired at an acquisition value which was determined in line with Part 5 of the NAMA Act and the valuation regulations which were made by the Minister and published in March 2010. The acquisition value of each bank asset was its long-term economic value. Various factors are taken into account in the calculation of the long-term economic value, including the current market value of the security (typically property but also including non-property assets, such as shares) and, in the case of property, its long-term economic value. The valuation regulations required that NAMA apply an uplift adjustment factor ranging from 0% to 25% to the current market value of property to reflect its long-term economic value.

Following completion of the property and legal due diligence processes, a loan-by-loan valuation was carried out by one of five loan valuation firms employed by NAMA. The loan valuation process was independently audited by KPMG, which acted as Audit Co-ordinator. The Audit Co-ordinator provided audit certification to the EU Commission that the valuations were in line with the methodology approved by the Commission. By 2014, the Commission had confirmed its approval of the transfer of all nine loan tranches. Ultimately, of the €31.8 billion that NAMA paid as consideration for the acquired loans, €5.6 billion was considered to be State Aid i.e. NAMA paid the financial institutions €5.6 billion more than the private sector market would have paid them at the time of acquisition.

I understand that one of the earlier contributors to this Inquiry made a comment to the effect that NAMA acquired loans at '*rock bottom prices*'. This suggestion, frankly, does not bear much scrutiny. I have mentioned already the overpayment or State Aid element of €5.6 billion in the NAMA acquisition price. In addition, NAMA's acquired loans were valued by reference to a property collateral valuation date of 30 November 2009 and, as a result, NAMA had to absorb losses arising from the impact of the 25%-30% decline in Irish property values which took place subsequently right up to the end of 2013. No private investor would have transacted on this basis i.e. a private investor would have paid only on the basis of the market price at, or close to, the actual dates of the loan transfers in 2010 and 2011; thus, if the participating institutions had to sell to private investors, I estimate that the acquisition price would have been reduced by another €4.5 billion. Essentially, therefore, the institutions would have been paid about €22 billion by the market rather than the €32 billion that NAMA did pay for the loans.

Incidentally, I gather that the same contributor expressed the opinion that NAMA was "*acting more like a debt collection agency than as a property value maximising entity*" and apparently questioning our ethos in that context. I think this reflects a poorly informed view of NAMA although I understand that the contributor indicated that it was only an impression that he had. Of course NAMA collects debts - as would any similar entity, we collect on the loans due to us (indeed due to taxpayers) but, our role has been much broader and much more positive than that. To give you a sense of the scale of NAMA's active role in the market since end March 2010:

- NAMA has acted to stimulate market activity by disposing of close to €6 billion in Irish property since inception, involving over 20,000 individual property transactions. We have worked hard to bring foreign investors to the Irish market.
- It has injected €1 billion in capital to support the development of viable Irish projects which will enhance the value of underlying assets.
- We provided a vendor finance programme for commercial property lending at a time when the banks had stopped lending on Irish property.
- We set up a price protection scheme which addressed a concern about falling prices on the part of purchasers; the scheme involved a deferral of 20% of the cost of a residential purchase for five years.

- A further €3 billion is available in development funding, some of which will help fund the initiatives in the Dublin residential development market and in the Dublin Docklands SDZ.
- We have also worked assiduously to enhance planning permissions and to remove other obstacles to the development of assets so as to enhance their value and to ensure that they are 'shovel ready' as soon as is practicable.
- By end 2015 we expect that we will have made 2,000 residential units available for social housing.
- NAMA has supported businesses whose debt we acquired and who employ some 15,000 people.

All of this work requires an intensive commitment by us in terms of time and resources involving experienced staff brought together from a wide range of disciplines for this unique asset management challenge. All in all, Chairman, I would suggest that well-informed commentators would not regard these activities as those of an agency solely concerned with debt collection.

## **Quality of documentation and underlying collateral**

The legal due diligence process involved the submission by the participating institutions of comprehensive legal due diligence reports which included the disclosure of any matter which could materially affect the value of either the loan or the underlying security for the loan. NAMA retained a panel of legal advisers to review the legal due diligence reports and report on the disclosures made and other matters not disclosed. In particular, their expertise was focused on highlighting any issues which would give rise to legal difficulties for NAMA in managing the loans or in engaging in enforcement actions in respect of them. As part of the acquisition process, the participating institutions provided a certificate and warranty to NAMA that, save as disclosed in the legal due diligence reports, the loan and security documentation are legal, valid and binding against the obligor, represent the entire agreement between the institution and the obligor and are fully enforceable against the obligor.

Since the acquisition of loans commenced in 2010, NAMA has reviewed the legal documentation on its acquired loans for purposes of restructuring, sales, enforcement and providing new finance. Each participating institution had different operating practices concerning its legal documentation which included the use of standard form facility and security documents and general terms and conditions, the use of bespoke loan and security documents drafted by their external lawyers and a combination of both standard and bespoke documents.

Recurring issues which NAMA encountered with legal documentation included items of security not actually taken, guarantees not confirmed on the granting of a new facility and development loans with no security over work in progress or step in rights. Other issues included defective land registry dealings and, in a few cases, missing original documents (such as title). Where a documentation issue was identified following acquisition, it was generally capable of remediation and remediation was carried out. Where remediation was not possible, NAMA sought to revisit the acquisition value of the loan in question and to claw back any amounts that may have been overpaid.

## **Governance models**

As regards the governance model in place in respect of loan/asset acquisition, NAMA dedicated substantial resources towards ensuring that the loan valuation and acquisition process was managed to a highly professional standard. This was important not least to ensure that the process and the valuations which emerged from it received the approval of the European Commission. I have provided an outline earlier in this statement of the comprehensive and rigorous approach that we adopted, particularly as regards the valuation of property collateral and the review of legal due diligence, both of which were key towards safeguarding the integrity of the process.

As regards the governance model in place in respect of post-acquisition loan management, the C&AG's second Special Report on NAMA – **NAMA Management of Loans** (February 2012) - provides a detailed account of the approach that we adopted to the management of loans and debtor relationships. NAMA decided that it would

engage directly with its largest debtor connections (initially 189 NAMA-managed debtor connections with €61 billion in par debt) and that it would delegate the day-to-day relationship management of another 583 debtor connections (with €13 billion in par debt), within tight and specific delegated authority limits, to the participating institutions (PI-managed connections). We put in place a process to oversee the institutions in their performance of credit and operational functions on our behalf.

As part of our initial engagement with debtors, we asked them to prepare business plans which set out how they proposed to repay their liabilities. Following review of each connection's draft business plan, we adopted strategies which involved one or other of the following: debtor support, early asset disposal or enforcement. In return for support from NAMA (including funding of commercially viable development projects), debtors were expected to agree to a number of conditions including asset sale disposals, reversing asset transfers to third parties, ceding unencumbered assets to NAMA as additional security, giving NAMA control over rental income from investment assets and agreeing to cuts in overhead costs. NAMA retained control of credit decisions through a cascading system of credit limits and delegated authority ranging from NAMA Board down successively to the Credit Committee, to NAMA senior management and to the NAMA Units in the participating institutions.

## **Asset valuation methodology**

As regards loans acquired by NAMA from the participating institutions, banks would ***not*** have been required to measure them at fair value while they were still on their books. An asset valuation would only have been carried out on a loan portfolio if it were mooted for sale or transfer. The participating institutions would have measured their loan books in accordance with International Financial Reporting Standards (IFRS), specifically IAS 39. This accounting mechanism requires loans originally arranged and advanced by them to be measured on an amortised cost basis; this was done on the assumption that the loans would remain on the institutions' books until maturity.

At least once a year the banks would have performed an impairment exercise in accordance with the accounting rules of IAS 39. IAS 39 requires banks to recognise an impairment provision against the book value of 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, banks **cannot** provide for expected future losses.* As the impairment methodology operates on an incurred loss model, there can often be a time delay until those losses are identified (“**the emergence period**”). Depending on the duration of such emergence periods, it may be some time before the losses in a loan portfolio are actually identified and have to be recognised as losses by the financial institution.

Following the banking crisis in 2008/2009, it was widely accepted among accounting practitioners that the IAS 39 impairment methodology did not appropriately reflect potential losses in a loan portfolio or did not do so on a timely basis. As a result, the International Accounting Standards Board has redrafted IAS 39 and the new standard (IFRS 9) will, when implemented later in this decade, change the impairment methodology to allow for future expected credit losses to be reported on a more timely basis.

In summary, there were significant differences between the valuation methodology used by NAMA and that used by the banks given that the latter did not have to apply a fair value method to their loan portfolios. Because they originated the loans, they could deal with them on an amortised basis. NAMA, by contrast, did not originate the loans and had to value them at acquisition on a fair value basis in accordance with IAS 39 rules i.e. we recognised, on NAMA’s Balance Sheet on Day 1, that €31.8 billion was the fair value, not €74 billion.

I should point out that the valuation methodology used by the Irish financial institutions was no different to that used internationally and that they were in no way departing from conventional accounting standards in the approach that they adopted.

If anything, the accounting standard lagged the market reality wherever IFRS was used.



One of the misguided comments directed at NAMA in its early days was that it crystallised a massive loss in the banking system through an overly stringent valuation approach. It acquired loan balances of €74 billion for €31.8 billion, equivalent to a discount of 57%. By contrast, it was argued, the banks, left to their own devices, would eventually have recovered much of the €74 billion par debt. I strongly disagree with this contention and would suggest that much of the €74 billion was never going to be seen again.

The NAMA acquisition process forced the institutions to recognise their losses earlier than their own IAS 39 accounting valuation methodology would have required of them. In the absence of NAMA, you would probably have seen a phased unveiling of losses over a period of three, four, five or perhaps more years with a consequent drip-drip effect in terms of the need for capital replenishment and a corrosive impact on the creditworthiness of the sovereign. The NAMA process enabled the Irish banking system to recognise and address upfront the loan loss difficulties that it had created for itself long before NAMA was ever conceived. The fact that the asset management company model is now being copied in other countries suggests that, belatedly, it is recognised that impaired banking systems do not tend to rectify themselves – an external body is needed to bring a fresh independent approach to resolution.

## **Commercial due diligence conducted by borrowers**

I do not have direct knowledge of the extent of commercial due diligence conducted by borrowers or indeed conducted by lending institutions at the time the loans were advanced. However, based on NAMA's experience of the loans which it acquired and which it has since sought to manage, I am in a position to make some observations on the lending environment which prevailed prior to 2007.

In that context, I would like to draw the Committee's attention to **Table 1** below which, in my view, provides an eloquent summary insight into some of the issues which are the subject of your Inquiry. The table presents a distribution of NAMA's acquired portfolio

by size of debtor connection (aggregate of loans acquired from the five participating institutions).

**TABLE 1: Distribution of NAMA debtors by size of par debt**

Nominal Debt	Number of debtor connections	Average par debt per connection	Total par debt per category
		€m	€m
In excess of €2,000m	3	2,758	8,275
Between €1,000m and €2,000m	9	1,549	13,945
Between €500m and €999m	17	674	11,454
Between €250m and €499m	34	347	11,796
Between €100m and €249m	82	152	12,496
Between €20m and €99m	325	43	13,932
Less than €20m	302	7	2,117
<b>TOTAL</b>	<b>772</b>	<b>96</b>	<b>74,015</b>

In summary, we acquired the loans of 772 debtor connections who borrowed €74 billion from the participating institutions; this excludes additional amounts borrowed by NAMA debtors from institutions not covered by the NAMA scheme. I do not know how much additional borrowing from non-NAMA banks was involved but I would conservatively estimate it to be at least €10 billion.

- There are 12 debtor connections with debt in excess of €1 billion each, aggregating to par debt of €22.2 billion (an average of €1.85 billion per connection).
- Another 133 debtor connections have debt of between €100m and €999m each, aggregating to €35.7 billion par debt (an average of €269m per connection).
- Finally, there are 627 debtor connections with debt of less than €100m, aggregating to €16 billion par debt (an average of €26m per connection).

As mentioned, the table does not include lending advanced by institutions such as Ulster Bank, Bank of Scotland Ireland and a number of other institutions which were outside of the NAMA process. It also does not include loans advanced by AIB and Bank of Ireland to borrowers whose aggregate borrowing was less than €20m and it also excludes property loans which remained with the participating institutions on the basis that they were not eligible for transfer to NAMA.

## **NAMA Observations**

- ***Concentration risk***

You will note from **Table 1** above that some €34 billion par debt had been advanced to the largest 29 debtor connections. Lending on this scale to relatively few debtors suggests that the banks considered property lending to be almost a one-way bet, notwithstanding the well-established cyclical behaviour of property markets and the steep rise of prices from 2002 onwards. It is clear that financial institutions and debtors shared a groupthink view that prices would remain on an upward trajectory and that there was limited downside associated with property lending. This view was presumably supported by favourable medium-term economic and demographic projections produced by economists and commentators and by the expectation that any setback in the property market would be temporary and minor in line with an expected 'soft landing' for the Irish economy. There was an obvious mismatch that few economists or commentators called into question between, on the one hand, lending which was growing at over 30% on average per annum and, on the other, an economy which was growing at rates ranging from 6% to 9% over the period from 2003 to 2007.

The impact of greater competition amongst lenders was to increase risky and imprudent lending. In particular, lending on the basis of providing very high levels of project funding – sometimes 100% - appears to have been quite common. The equity pledged by the debtor, when required, often took the form of unrealised 'paper' equity from other transactions. Few, if any, financial institutions wanted to be left out of what

was seen as a profitable business due to larger lending margins and relatively low operating costs.

In normal market conditions, a finite number of viable development projects would seek to secure finance from the finite pool of bank funding available for property development; in the perverse conditions which held sway in the Irish market up to 2007, there was far too much bank funding available and ultimately it found its way not only to the finite number of development projects which were viable but also to many other projects which could be viable only on very heroic and indeed often mistaken assumptions. The sheer weight of debt funding that was available caused an overflow effect into riskier projects which would not have been entertained in normal conditions.

It was difficult to avoid the impression that the institutions perceived lending as a sales activity and that, in the rush to expand bank balance sheets, a rigorous focus on lending quality was lost. Some bank balance sheets doubled between 2003 and 2008; in one case, the size of the balance sheet quadrupled. Based on our experience of managing acquired loans, it is difficult to fathom a robust rationale for a significant portion of the property lending and, at the very least, it raises the question of whether lenders' remuneration was based on lending volume rather than on the quality of lending. It is unclear to what extent there was analysis by bank strategists, by the Regulator or by economists of the relationship between the volume of lending, by region and by sector, and the projected demand for property assets, by region and by sector. Nor is it clear to what extent did the institutions subject their lending to vigorous stress testing or indeed were required to do so by the Regulator.

- ***Net worth***

In advancing additional funding during the years up to 2007, the lending institutions appear to have relied heavily on assessments of debtors' perceived net worth – the difference between a debtor's valuation of his assets and liabilities. ***Statements of Affairs*** – a list of assets and liabilities and their value – were relied upon to provide comfort that a debtor's financial position could support new lending and that he could

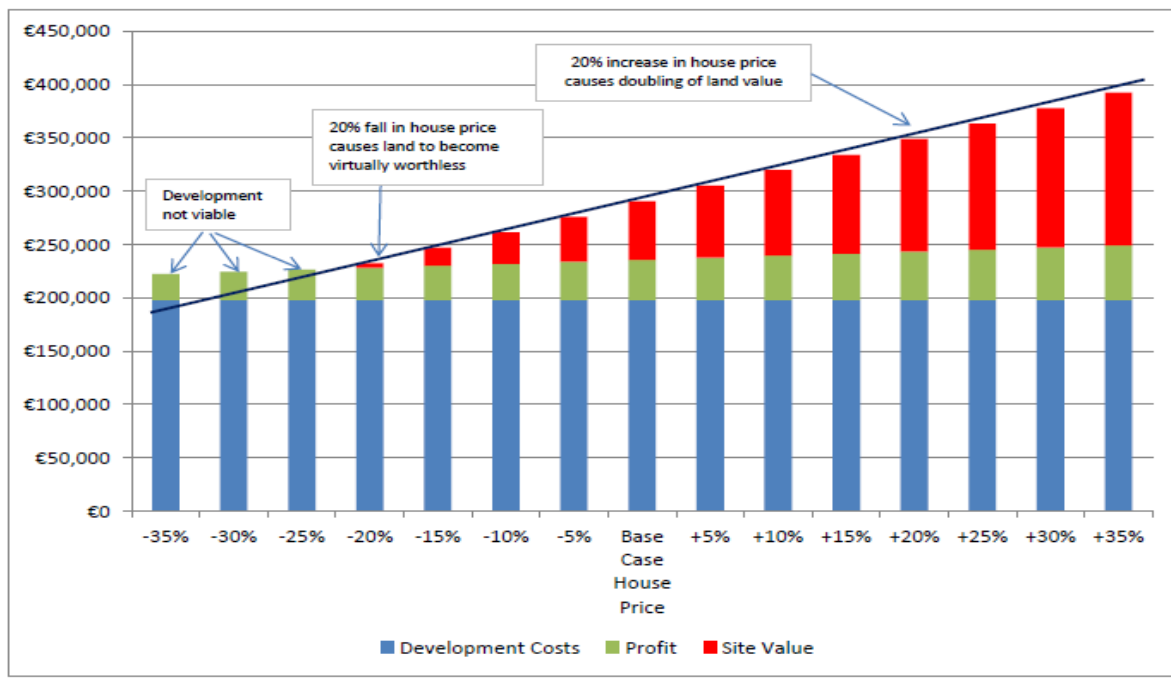
service his liabilities. However, these documents were not always audited and were often self-certified with asset values assessed by the debtors themselves.

Compounding this weakness was the fact that, for most debtors, assets comprised mainly or exclusively property assets so that when the market collapsed, the value of the asset side of balance sheets plummeted and net worth evaporated rapidly. As market prices rose in the years up to 2007, so the self-assessed net worth of debtors also appeared to rise, thereby giving the lending institutions a sense of false comfort over additional security that did not exist.

- ***Land and development assets***

This issue was particularly acute in cases where a debtor's property portfolio had a significant exposure to land and development assets. A rise or fall in market prices has a multiplier impact on the price of land intended for residential or commercial development. The price of development land is a residual value after costs and developer profit margin are deducted from projected sales proceeds. If projected sales proceeds (based on market prices) fall significantly, there may be little or no residual value – the land goes back to agricultural value or less. This effect is illustrated in **Table 2** below:

**TABLE 2: Site values per residential unit under various price scenarios**



This would explain the steep fall – in some cases up to 90% - in the value of development land in the years after 2007. Much of this land had been bought speculatively. This is also why NAMA acquired some loans for only 10% or less of their face value. The fact that a substantial proportion of lending was secured by riskier land and development assets also explains why bank balance sheets suffered such extensive damage to their solvency. Unlike investment assets, there was no income flow associated with land and development assets and in the absence of demand and liquidity, there was nothing to arrest the fall in prices as it gathered downward momentum.

Liquidity in the land market dried up completely; there were no buyers because residential prices had fallen to such a level that the construction of new houses was unprofitable. This point should be borne in mind whenever you hear the contention that NAMA, or indeed other market participants, should have been funding the construction of houses in 2010 and 2011. It simply would not have made commercial sense by reference to market prices then prevailing and neither debt nor equity providers could have made a compelling case for funding speculative development at that stage.

- ***Smaller debtor connections***

While the concentration of lending among the larger debtor connections was clearly excessive, our experience has been that the quality of such lending tended to be better than the lending to some of the smaller debtor connections. As is set out in **Table 1** above, a total of €16 billion was advanced to some 627 borrowers who had aggregate debts of less than €100m each. Generally speaking, the initial discounts on these smaller debtor connection loans were higher and NAMA has had to take higher impairment provisions on them in the interim.

While some of this lending was to professional, well-managed entities, much of it was to individuals or syndicates whose primary business was not property development or who became involved in property development relatively late in the cycle. Much of the lending related to potential development projects in or near towns or in rural areas rather than in the main urban areas. In some cases, one can see how any individual project could have made commercial sense to a bank if assessed in isolation; the problem was that similar projects were receiving funding from other financial institutions and clearly not all of those projects could have ever been simultaneously viable.

- ***Corporate infrastructure***

Some of the debtor connections which received this funding did not have an adequate supporting corporate infrastructure. In particular, some of the property businesses which quickly built up balance sheets of €1 billion or more did not have the financial expertise required to manage balance sheets of that size and it does not appear that the lending institutions made much of an effort to push for improved governance of debtor businesses. By contrast with the Irish situation, property lending in the UK is largely advanced to publicly-quoted companies which are suitably resourced to manage their balance sheets and their risks. For instance, British Land, a listed UK development company which has debt levels comparable to some of NAMA's larger debtors, has more

than 200 employees. As the crisis emerged in 2008/2009, UK property PLCs accessed the equity market and used that funding to pay down debt. That option was not available here given that the majority of debtors were, in effect, sole traders and they were totally reliant on bank debt.

A debtor's track record and reputation appeared to be a paramount consideration for the lenders. There appeared to be a highly accommodating attitude among financial institutions towards the more prominent debtors and a concern that if the institution was not suitably amenable, the debtor would look elsewhere for the funding of future projects. Clearly debtors were not slow to exploit this unusual lending market.

Some of the more professional debtor connections tended to focus on particular sectors in which they had developed an expertise; this was particularly the case for debtor connections whose main asset base was outside of Ireland. However, one of the notable features of the acquired loan portfolio was that many debtor connections had borrowed against a diverse range of assets. It was not unusual to find, when all of the loan information was collated, that a connection had exposure to a number of jurisdictions and to a range of sectors including office, retail and residential, in addition to ownership of one or more hotels as well as undeveloped land interests. After NAMA acquired the loans, it was not always apparent to us what the debtor's strategy might have been in assembling a range of assets which were so diverse by reference to sector and location; the obvious conclusion in some cases was that the compulsion to purchase more and more uncorrelated assets was entirely related to the almost unlimited availability of debt funding.

Many of these asset sectors require specialist business skills which do not appear to have been available to some of the debtor connections involved. The fact that many of them had only small supporting teams meant that they would have found it difficult to devote the requisite skillsets to the range and scale of projects covered by their borrowing. A debtor who is a successful house builder will not necessarily have the expertise to manage a group of hotels or to run a shopping centre but this does not appear to have inhibited the lenders involved.



## **Conclusion**

I hope that these comments are helpful in terms of assisting the Committee to obtain a fuller understanding of some of the issues which we have been asked to address. Following the Chairman's statement, I will be happy to respond to any particular questions you may wish to raise.