Tithe an Oireachtais
Houses of the Oireachtas

Joint Committee of Inquiry into the Banking Crisis

Witness Statement of

John Buckley

Strictly Private & Confidential

As indicated on its cover page, the document(s) contained within are confidential unless and until the Joint Committee decides otherwise including where the Joint Committee publishes such document(s). For the avoidance of doubt, "documents" include witness statements in this context. Further to section 37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013 ("the Act"), while the documents remain confidential, you must not disclose the document(s) or divulge in any way that you have been given the document(s), other than:

> "(a) with the prior consent in writing of the committee,
>
> (b) to the extent necessary for the purposes of an application to the Court, or in any proceedings of the Part 2 inquiry, or
>
> (c) to his or her legal practitioner."[1]

Serious sanctions apply for breach of this section. In particular, your attention is drawn to section 41(4) of the Act, which makes breach of section 37(1) a criminal offence.

[1] *See s.37 of the Houses of the Oireachtas (Inquiries, Privileges and Procedures) Act 2013*

Theme C4b

Establishment, Operation and Effectiveness of National Asset Management Agency (NAMA)

Valuation Methodology

What features, if any, of the valuation methodology used by NAMA would you regard as beneficial for incorporation into a best practice general market model?

Context

The assets acquired by NAMA were impaired loans that were associated with property development. The impairment arose out of the fact that the amounts owed by developers to banks were, at that time, far in excess of the amounts which the developers could recover in the market. In the main, the security held by the banks consisted of the assets that were constructed or purchased using the funds advanced[1]. This in turn, meant that the value of those properties or work-in-progress was central to the loan valuation.

The audit concern in regard to valuation at take-on was

- That the valuation methodology reflect best market practice and
- That it accord with the scheme set out in the NAMA Act[2].

The valuation method at take-on involved making assumptions about

- When the property collateral would be disposed of and
- What cash would be recovered from loan debtors prior to disposal[3].

The assumed disposal proceeds included a statutorily underpinned uplift to adjust the value to long term economic value i.e. the value that would pertain when the then market conditions had ameliorated. The 'present value' of these cash flows was determined by discounting projected future receipts (including the assumed uplift) so as to take account of the time value of money i.e. to express the projected future cash receipts, whether from rents or sales, as one current value.

Following acquisition of the loans, the relationship between NAMA and the developers was one of lender-borrower with NAMA essentially 'standing in the shoes' of the banks who had previously owned the loans.

[1] Other elements of security and valuation are outlined in Special Reports 76 and 79.
[2] National Asset Management Agency Act 2009.
[3] 71% of the value of loans were associated with completed developments.

Reply to Inquiry Question

In conducting the initial audits of NAMA, the central concern was to ensure that industry best practice was employed in the valuation methodology that was used and that standard accounting and financial valuation processes such as discounting future projected cash flows were employed in the estimation process.

Since the value of the loan assets being acquired by NAMA was largely based on the value of the underlying property security, that security was valued using the Red Book methodology[4].

As outlined in Special Report 79 expert advice was obtained by my office on the valuation and legal due diligence processes adopted by NAMA.

The objective of this was to get assurance for purpose of the audit of the financial statements of NAMA that the asset valuations were carried out in accordance with standards prevailing in the industry. The required assurances were received[5].

In accounting for those transactions subsequent to their acquisition, the audit objective was to ensure that the assets be valued in accordance with accounting standards (essentially at their fair value at take-on and thereafter at amortised cost) with any subsequent impairment or diminution in value being captured and reflected in the financial statements[6].

Since most of the features in these valuation processes (both at take-on and in subsequently accounting for the assets) derived from pre-existing market practice, accounting standards and financial management techniques such as discounting or were specifically required under the legislative scheme, the extent to which they could, in turn, contribute to a best practice market model is likely to be quite small.

Clearly, however, there has been considerable thought put into the construction of this model for purposes of bank resolution actions. In that context, it has the potential to inform valuations in the case of schemes that entail deferred sales of assets. Such schemes are approved by the European Commission.

[4] In normal market conditions valuations are made to inform bids for property assets. These valuations are conducted in accordance with the Royal Institution of Chartered Surveyors Red Book. Valuation under this methodology involves estimating 'the amount for which a property would exchange between a willing buyer and a willing seller in an arm's length transaction.'

[5] See Special Report 79, paragraph 2.26 et seq.

[6] In practice, this involves reviews so as to get the accounting value of the assets at each year end. As a result, impairments (further write-downs in value) of €2.8 billion were reflected in the first two sets of accounts of NAMA.

Asset Sales and Bond Schedule

The Chairman of NAMA claimed in the course of the Banking Inquiry hearings that 'thoughtful, well-aligned asset sales in the Irish and UK markets in particular' were key to very strong cash generation. Did the data and information available to you as C&AG support or contradict that claim? Please elaborate.

In your opinion as C&AG, was the NAMA senior redemption bond schedule and associated asset disposal programme aligned appropriately to secure the most favourable financial return (insofar as that was within the control of NAMA)?

Since these two questions appear to be related, I have dealt with them together.

Context

Section 10(1) of the NAMA Act requires that NAMA, having acquired the impaired assets, deal expeditiously with them and protect or otherwise enhance the value of those assets in the interest of the State.

NAMA was required, to the extent possible, to obtain the best achievable financial return for the State while having regard to

- The costs of asset acquisition and enhancement
- NAMA's cost of capital
- Any other factors considered relevant to the achievement of its purposes.

From the audit perspective, this requirement was likely to be met in circumstances where

- Disposals took place within a structured property management framework
- Transactions were, in the round, conducted at or above breakeven levels.

A structured property management framework would entail NAMA operating on the basis of explicit asset management strategies for specific asset types taking account of the differing conditions in the markets where the property assets existed.

A key purpose of these strategies would be to guide NAMA decision makers in regard to sell or hold decisions for classes of assets within different markets and in deciding the phasing of sales.

In regard to cash management, sale proceeds are either applied to redeem debt in accordance with a bond redemption schedule adopted by the Board or invested[7].

[7] Most of NAMA's surplus cash was invested with State Institutions including the NTMA and the Central Bank. This had the effect of making funds available to the State at a reasonable cost and reducing the need for an equivalent amount of external borrowing. By the end of 2014, I note that the outstanding bonds are more or less equivalent to the carrying value of outstanding loans.

Reply to Inquiry Question

The asset management strategies referred to above were only applicable for property sales approved from the second half of 2011. From the viewpoint of managing the risk associated with this aspect of its operations, the existence and application of these strategies would, in my opinion, be a key indication that a thought-out strategy was being pursued.

Accordingly, Special Report 79 recommended that NAMA

- Review them on an ongoing basis in the light of changing market conditions and
- Monitor their application, in practice, in order to ensure compliance.

The audit looked at the outturn being achieved in respect of sales in the first two years of operation[8].

In this regard, NAMA had, up to the end of 2011, received €2.9 billion from the sale of property and €0.9 billion from the sale of loans. The bulk of the property sales were outside the State (89%) with the UK (predominantly the London market) accounting for 81% of the proceeds.

Sampling done in the course of audit showed UK sale proceeds were coming in higher than the take-on valuations by about 2.5%.

The samples for the Irish properties suggested a drop in value of around 5%.

In regard to the sale of loans (3 in all) NAMA made a gain (€114 million).

Overall, what can be said from audit work up to end-2011 and the outturn of actual sales is that

- From mid-2011 NAMA had begun to adopt explicit strategies to guide asset management decisions, though it was too early to judge their efficacy at that point
- The outturn on sales prior to end-2011 (which would have occurred before those strategies were adopted) was mainly in a market area where conditions were improving allowing for recovery of the NAMA financial outlay taking all transactions together.

While the Chairman's quote refers to cash generation, the statutory requirement is to manage the work-out in a way that obtains the best achievable financial return for the State. The statutory scheme envisages this cash generation should be achieved <u>while</u> pursuing the best financial return[9]. In doing so, NAMA is required to balance a number of factors and, in particular, to manage the work-out process expeditiously while taking account of the carrying cost of assets or portfolios of assets and NAMA's cost of capital.

[8] See Chapter 4 of Special Report 79.

[9] I note that the C&AG recommended (Special Report 81) adopting target rates of return as a means of focussing on this objective. In conjunction with asset management strategies and the monitoring of financial outturns for transactions globally and in market segments this would help operationalise the statutory objective expressed in the Act.

Bearing this in mind, in its early sales i.e. those in 2010 and 2011, NAMA appears to have achieved a reasonable balance between generating cash, doing so without incurring an accounting loss on disposals and beginning the deleveraging process.

In regard to the alignment of bond redemptions with cash generated, the senior bond redemption schedule is largely indicative i.e. a target that is adjusted by the NAMA board from time to time in the light of projected cash resources from asset disposals and rental income. No specific redemption targets were set as part of the statutory scheme.

However, NAMA's first intermediate debt redemption target was noted as part of a commitment of the Irish authorities in the Memorandum of Understanding agreed with the Troika[10].

NAMA has met its published redemption targets to date and more recently has brought redemptions fully into line with available cash resources.

More generally, one of the policy objectives of the Act[11] is to facilitate the restructuring of credit institutions of systemic importance to the State. Removing the impaired assets from the balance sheets of financial institutions and ultimately paying for them in cash was a key part of this restructuring process[12]. Redemption of bonds completes the payment process and the timeliness of this redemption process is relevant to market perceptions of improving financial soundness of the institutions.

---

[10] It noted Ireland's commitment to restore the Irish property market in the course of meeting the asset disposal targets established and monitored by the NAMA board, including redemption of €7.5 billion worth of senior bonds by end 2013.

[11] See short title to the NAMA Act 2009.

[12] The other major action was to recapitalise the banks since losses that were crystallised on acquisition by NAMA impacted directly on the capital or shareholders' funds of banks.

Quality of Assets

When C&AG, what was your assessment of the quality of assets, distinguishing between commercial and residential, to be disposed of by NAMA at that time? Generally, how did these assets compare with those already disposed?

Context

During 2010 market transactions while running at a much reduced level, were taking place in the investment property and the residential sectors. The most problematic sectors from a marketing viewpoint were development land and hotels. There was almost no market activity in the case of development land and in the case of hotels there had been little activity over the previous two years.

From an accounting perspective, in the absence of actual transactions the best measure of quality is market value.

The market value of the assets was estimated in two ways around the time of take-on, firstly, from the perspective of their value as a portfolio of loans and secondly, by valuing the underlying collateral.

If one were to focus on the loans and consider their valuation for purpose of immediate disposal using a methodology set by the EU Commission for the valuation of impaired loan assets across the Union they would have been valued at 23% less than was paid for them[13].

In that context, it is important to note that the assumed cash flows used in the EU impaired loan valuation methodology were the same as the take-on cash flows under the NAMA scheme except that no statutory uplift associated with the holding period of the properties was taken into account.

The lower financial valuation under this method was, therefore, a reflection of the generally higher rates of return that would be demanded by potential purchasers of such loans which, in turn, varied with their loan-to-value ratios.

Turning to the NAMA scheme valuation methodology, as indicated in the answer to question 1, we were generally satisfied with the valuation process at take-on.

However, we considered that, in the light of subsequent market movements and reassessments of the timing of sales, the values that were placed on the collateral required further write-down. Following audit engagement with NAMA, cumulative write-downs of €2.8 billion to end-2011 were included in the financial statements.

[13] The discount rates that were set varied depending on loan-to-value ratios.

Reply to Inquiry Question

Looked at from NAMA's marketing perspective, 71% of the value of loans held by NAMA was backed by collateral that was fully developed. A further 20% related to land. Consequently, the bulk of the assets acquired were in a marketable condition.

However, transactions only occur when finished product or work-in-progress can be sold to willing buyers. In this regard, the market had collapsed, even after a write-down of some 57% of the financing cost of the underlying assets. This appears to be due to the assessment by potential investors and purchasers that, at that point, the assets could not be gainfully brought into use due to a combination of reduced demand, constrained credit and oversupply.

Cumulatively, the take-on value of assets has been reduced by around €4 billion following impairment reviews. Therefore, for assets of those debtors, the amount paid by NAMA to acquire them exceeded the amount currently considered realisable by a considerable margin.

On the other hand, it needs to be acknowledged that probable gains have also been identified in the case of some debtors but under standard accounting conventions these are not reflected in the financial statements until sales occur[14].

Early sales at or around take-on values suggest that the quality of the assets disposed of in 2010 and 2011 was generally in line with that implicit in take-on valuations.

However, the sales were concentrated into one market area which suggests that the other market segments had not recovered by end-2011 to a point where NAMA's outlay could begin to be unlocked.

In practice, since a large proportion of NAMA's current assets are in Ireland, future transaction prices will be influenced by the extent of recovery in the economy generally and the demand that recovery creates for the type of assets held in the NAMA portfolio.

[14] In this context, accounting reviews of projected cash flows are done at debtor level. Debtors may have a number of loans. Potential gains and losses on those loans are netted for debtors. Any net shortfall by comparison with carrying cost is treated as a bad debt write-down (loan impairment) while gains are deferred until the assets are sold.