NAMA and Irish Banking Policy
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Part I

Bank Capital and Loan Losses

What is a Bank's Equity Capital?

- Banks have assets and liabilities.
- Liabilities:
  - Deposits from customers
  - Debt securities (Bonds they have issued)
  - Short-term borrowings (e.g. from Central Bank.)
- Assets:
  - Loans made to customers.
  - Cash and reserves
  - Other assets (stocks, bonds, property)
- Equity capital is Assets minus Liabilities: Banks are required by regulators to maintain assets far enough above liabilities so that depositors can be assured that their money is safe.
- Specifically, they are required to hold a minimum amount of equity capital relative to a risk-weighted sum of their assets.
- Banks that don't have sufficient equity capital find it hard to raise wholesale funds without a state guarantee, as international investors worry about getting their money back.

Implications of Loan Losses

- When banks make loans to people who do not pay them back, then the accountants write down the value of these loans, thus reducing the bank's assets and thus its equity capital.
- What happens next depends on the severity of the losses:

1. Small Losses: These may reduce the bank's capital buffer but these can be rebuilt via retained earnings from profits.
2. Under-Capitalisation: If a bank is expecting to go below its required minimum capital ratio it can raise more equity capital by selling shares to private investors. But this dilutes the claims on future dividends of the current shareholders, so bank executives tend to be very reluctant to do this.
3. Insolvency: If the bank's assets no longer cover its liabilities, regulators are supposed to intervene (usually well before the books officially show the bank is insolvent). They either liquidate (paying off depositors while other creditors get paid off according to a hierarchy of claims), pay another bank to take it over or nationalise.

How Big Are Irish Bank Loan Losses?

- The size of property-related losses clearly threatens to wipe out the equity capital of the Irish banks.
- Examples: Goodbody Stockbrokers and J.P. Morgan have both estimated that the underlying losses are larger than the core (ordinary shareholder) equity capital.
- Very recent developments tend to confirm this. For example, Liam Carroll's Zoe Group has admitted that it can only pay back €300 million of its €1.2 billion in loans.
- To put this in context, AIB have €24 billion in property development loans and equity capital of only €8 billion.
- So, if anything like the Zoe level of losses were to be repeated across AIB's other loans, their equity capital would be wiped out.

How NAMA Will Operate

- NAMA will purchase a large amount of property-related loans from our main banks. Most will be purchased at a discount, which will crystallize losses on the banks balance sheets.
- The loans will be paid for with special government-issued "NAMA bonds."
- If the NAMA-triggered losses leave the banks undercapitalised, the government has said it is ready to re-capitalise and take ordinary shares in compensation. This will likely be necessary because international investors have shown no interest in acquiring large shares in Irish banks.
- By taking problem loans off the books of the banks, it is hoped that this will:
  1. Free up the banks to concentrate on their core businesses rather than chasing bad loans and managing large property portfolios (which they have little experience of.)
  2. Convince international capital markets that the banks have a sound capital base, so that at some point, the government can remove the liability guarantee and the banks can still obtain funds.
- NAMA will then look to recoup as much as it can from the portfolio loans over time.

Part II

Risk of Overpayment

Will NAMA Overpay for the Assets?

- There are strong signals that the government is going to purchase the NAMA loans for a lot more than they are currently worth.
- Why do I believe this?
  1. The government has not put a framework in place, like the UK's new Special Resolution Regime, for dealing with banks that are chronically undercapitalised or insolvent.
  2. The government has repeatedly stated that the banks will either not be nationalised or that this is a very last option.
- These statements imply that the price paid by NAMA for property-related assets will trigger losses much smaller than implied by current market value, leading to to a smaller re-capitalisation.
- The government has promised to follow EU guidelines but these guidelines allow for asset transfer based on "long-term economic value" which can mean whatever the government wants it to mean.
- There is widespread agreement among analysts about the impending over-payment.

J. P. Morgan, May 26

- We see chances of government applying a smaller haircut than that a proper economic analysis would suggest, based on the actual overvaluation of the assets collateralizing the loans. Our base case implies a 40-45% loss embedded in whichever loans are transferred to the bad bank (implying c.€850mn capital shortfall for BOI and higher €3.9bn for AIB if only residential developer loans are transferred), but we believe it is likely we see a scenario where the final haircut sits around 20-25%, and hence both banks are presented as being adequately capitalized at this point.
- In theoretical terms, we believe the government should apply an impairment of 35-50% over the acquired loans, our estimate about the underlying loss embedded in property loans granted at the peak of the cycle. However, we expect an outcome where the government tries to minimize the capital injection in both banks at this point, and applies a smaller haircut, at the expense of bearing most of the losses in the future. A 20% haircut looks like a feasible figure, as it would imply little or no capital injection for BOI, in line with managements comments. For AIB, the haircut at which no capital is required sits at c.10%, which looks too low, and hence some public ownership looks almost inevitable

But Does the Pricing Really Matter?

- Journalists have regularly characterised the pricing decision as unimportant.
- They say there's no point in buying the assets for a fair (i.e. low) price because we'll then just have to spend the money saved on recapitalising the banks.
- For instance, if we pay €5 billion less, then the banks may just €5 billion more from the taxpayer in the form of re-capitalisation investment. The "cost" is then the same, it is argued.
- However, this assumes that the re-capitalisation investment is worthless. This isn't the case. If we remove the bad loans and re-capitalise, then shares in these cleaned-up and profitable banks will be valuable. These can be sold by the state at a later stage.
- Over-paying for bad assets, we've just overpaid, providing funds for an equity share, we've invested.

An Allegory

- Two old friends meet in a bar. Mr. A says "Hey dude, I'm in big trouble. My balance sheet says my business is worth €20 million but actually I've made some really bad investments and when the accountants come in next month, they'll see that I actually owe €5 million more than I have in assets."
- Mr. B wants to help Mr. A. Let's consider two possible reactions:
  1. Ok, I'll help out. I'll pay off your debts of €5 million. And then I'll invest €20 million in your business to get it back in healthy shape. But, look, there are limits to my charity. You've run your business into the ground and I'll only do this for you on condition that I own the new company worth €20 million.
  2. Ok, I'll help out. Here's €25 million for you. And you know what? I couldn't be bothered taking an ownership stake in your company, so just carry on and keep up the good work.
- It's true that the amount of money paid out by Mr. B to fix the companys problem is €25 million in both cases. However, to say that the Mr. B is equally well off in the two cases is clearly wrong.

What About the Levy?

- I have described a scenario in which the government substantially overpays to acquire the NAMA assets, implying large costs to the taxpayer.
- However, the government has promised that if it loses money because of NAMA, it will introduce a levy on the banks.
- I am not at all convinced that any levy will recoup NAMA-related costs:
  1. The levy will not be part of the legislation. Brendan McDonagh (Interim NAMA CEO) told the Public Finance Committee: "If there was a clawback within the NAMA legislation affecting the balance sheets of the banks, they would not be able to reduce the assets transferred to NAMA because effectively there would be an unpriced option in terms of what the clawback would be in the future. One cannot do this because it would not be possible to take risk weighted assets off the balance sheets of the banks if the levy was imposed in the NAMA legislation."
  2. If a levy is introduced, we cannot be sure that the legislation will correctly calculate the true economic costs of NAMA, which include the interest on the bonds, or that the levy will correctly operate to recoup these costs.

Honohan's Proposal: NAMA 2.0

- Patrick Honohan has proposed that NAMA should deliberately underpay for the assets but then give the bank shareholders (not the banks themselves) a right to share in any profits made by NAMA.
- This "NAMA 2.0" proposal allows us to defer the question of what the assets are really worth. If they do indeed turn out to be worth more than they were purchased for, the bank shareholders can end up getting money back.
- I think this is a good proposal though I think there is little chance the government will implement it.
- It is hard to find agreement on what exactly these assets are worth, so it is hard to know what a "too-low" price is.
- However, a mechanism to allow banks to share in NAMA profits may be a useful way to convince bank shareholders that low prices paid for assets are not an attempt to unfairly fleece shareholders.
- I doubt if anything like the NAMA 2.0 will be adopted because a strict approach to pricing seems likely to lead to the state could end up owning all (or almost all) of the banks which the government clearly does not want to do.

Costs of Overpayment?

- AIB are believed to be selling €30 billion (book value) of loans to NAMA while BOI are selling €20 billion.
- A discount of one-third would wipe out all of AIB's core equity capital and could also see other capital instruments such as other subordinated debt hit, before any recapitalisation takes place.
- Similarly, a discount of a third would wipe out essentially all of BOI's core equity capital.
- If the discount turns out to be 20% instead, then both banks could avoid nationalisation. However, the state would be paying an additional €6.7 billion. And this is before we factor in the cost of loans from ILP, INBS and EBS.
- To put these figures in context, the combined full-year effect of the measures taken in the April budget was €5 billion.

Part III

International Support for NAMA?

Wasn't This Done in Sweden?

- And didn't the former Swedish finance minister back our approach?
- No. The Swedish bank restructuring *did not* feature the government buying assets from private banks.
- All Swedish banks were required to write their bad loans down by very large amounts and to obtain recapitalisation afterwards. Mr Lundgren told the Irish Times that he "favours the more severe mark-to-market writedown of assets rather than a 'through the cycle' valuation."
- Two Swedish banks were insolvent after these write downs. These were nationalised and "bad banks" set up to purchase their assets.
- Again Mr. Lundgren to the IT: "For me, it does not sound like the right solution to buy assets from private banks."
- Also, while the Swedish bad banks made a profit because it bought assets at low prices, the Swedish government as a whole lost money because the insolvent banks had to be fully recapitalised.

Hasn't the IMF Backed NAMA?

- Not quite. Asset Management Companies to take bad assets off the books of insolvent banks have been used around the world and the IMF backs the use of an AMC.
- However, AMCs have almost always been used in conjunction with the nationalisation of these banks.
- The IMF said the following: "Staff noted that nationalization could become necessary but should be seen as complementary to NAMA. Where the size of its impaired assets renders a bank critically undercapitalized or insolvent, the only real option may be temporary nationalization. Recent Fund advice in this regard is: 'Insolvent institutions (with insufficient cash flows) should be closed, merged, or temporarily placed in public ownership until private sector solutions can be developed ... there have been numerous instances (for example, Japan, Sweden and the United States), where a period of public ownership has been used to cleanse balance sheets and pave the way to sales back to the private sector'."
- The IMF estimates losses in the Irish banking system to be €35 billion: This will clearly render our main banks "critically undercapitalized or insolvent" in which case the advice is nationalisation.

Part IV

Other Issues

Should Good Loans Go Into NAMA?

- In my opinion, no.
- IMF "To staff's query regarding the acquisition by NAMA of "good" property-development assets, the authorities responded that markets needed to be reassured that this asset class was fully dealt with."
- Markets needs these reassurances is that the "good" loans may not be so "good." The government should not buy these loans at full face value because of this risk, but I suspect perhaps they will. (This will be a covert overpayment.)
- We should at least have NAMA buy bad loans first, and then wait to see how the "good" loans develop before buying.
- Others argue that good property loans need to be purchased to generate revenues to pay the interest on the NAMA bonds.
- This makes no sense. Why issue extra interest-bearing debt to buy property assets because they generate revenue?
- We might as well issue extra debt to put the money on the stock market or on the 3.30 at Haydock.

Questions About Management of NAMA Loans

- It appears that NAMA is going to have a small core staff and rent out staff from the original lending banks to manage the bad loans.
- What incentive will these staff have to do a good job? What is their career path and where does their ultimate loyalty liefive years with NAMA, then back to work for AIB?
- What personal relationships will NAMA's rented staff from the existing banks have with the developers?
- Will developers be able to borrow money from NAMA to finish projects? Will others who purchase properties being sold by NAMA?
- What experience will NAMA staff have in managing large multi-billion euro property portfolios? This is a very different business from being a lender.

Is This A Final Solution?

- Will NAMA fix our banks over the next year? I fear not.
- The government is trying to do three different things:
  1. Re-capitalise the banks.
  2. Pay a price for the loans that does not appear to high.
  3. Keep state control of banks low.
- These three goals can not be met with the two tools it is planning to use (a price for asset transfer to NAMA and a decision about re-capitalisation.)
- I suspect that the post-NAMA banks will have legal capital levels but still low by international standards. International lenders probably won't lend to them without the guarantee being kept in place.
- More loan losses are coming: Mortgages, credit cards, businesses. The banks will hope to offset these with pre-loss profits and will also try to shrink the size of their balance sheets because capital standards are formulated as ratios to assets, so reduced lending raised the capital ratio.
- Even after NAMA, we may still be in a credit crunch.

But You Don't Want Nationalisation?

- Paying a price that is fair for the taxpayer may result in the state owning our two main banks.
- There are lots of reasons to not want the state to own banks for any extended period of time.
- I believe, however, that a temporary period of nationalisation, in which the bad loans are taken off the balance sheet into a NAMA and the banks are re-capitalised, could produce a bank that is attractive to private investors.
- The state could then start selling shares in these banks to private equity.
- If you don't like this outcome, an alternative is to offer subordinated bond investors a debt-for-equity swap.
- A preference for some private ownership does not have to mean a preference for the *existing* private ownership. Current equity-holders should pay for the upcoming losses by losing their investments.