NAMA and Irish Banking Policy
Presentation to Labour Parliamentary Party

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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.

Implications of Small/Medium Loan Losses

- When banks make bad loans, this reduces the value of their assets and thus their equity capital.
- What happens next depends on the severity of the losses:

1. Small Losses.
   - These may reduce the bank's capital buffer but this can be rebuilt via retained earnings from profits.
2. Medium to Large Losses: Serious Under-Capitalisation.
   - If retained earnings won't fix the problem, the bank can raise equity capital by selling shares to private investors.
   - But banks CEOs are reluctant to dilute claims of current shareholders.
   - Capital requirements are expressed as a ratio of capital to assets. If you don't want to raise capital, you can improve this ratio by getting assets down via restricting new lending.
   - So under-capitalised banks can be a danger to the health of the economy.

Implications of Large Loan Losses

- If a bank's assets no longer cover its liabilities, then the bank is technically insolvent.
- Accountants generally are slow to apply the full write down of asset values, so a bank may be insolvent even if its books don't yet show it.
- Internationally, regulators usually intervene well before the books officially show the bank is insolvent.
- They then implement a number of possible solutions:
  1. Liquidate: Pay off depositors while other creditors get paid off according to a hierarchy of claims.
  2. Purchase and Assumption: Pay another bank to take it over
  3. Nationalise: This is particularly relevant if the state has guaranteed liabilities, so it's on the hook for paying them back. The bank can be recapitalised by the state and then privatised.
- In all three of these solutions, existing equity holders generally get nothing.

How Big Are The Loan Losses of the Irish Banks?

- Large enough to probably render the main banks insolvent, in my opinion.
- But I didn't see all the loans, so how could I know? Well, there is a lot of information out there:
  1. Anglo Irish Bank estimate that Irish development land was down 70% from peak by March. Little reason to think that was the trough.
  2. Liam Carroll's Zoe Group has admitted that it can only pay back €300 million of its €1.2 billion in loans and the courts have labelled its survival plan "fanciful".
  3. Goodbody Stockbrokers and J.P. Morgan have both estimated that the underlying losses are larger than the core (ordinary shareholder) equity capital.
  4. IMF estimates total losses at €35 billion—not possible without most likely wiping out equity of main banks.
- To put this in context, AIB have €23 billion in property development loans and private equity capital of only €8 billion, so they seem particularly likely to be sitting on underlying losses that would wipe out private shareholders. (The government also has €3.5 billion in preference shares.)

NAMA: An Irish Solution to Insolvency?

- The government has consistently failed in its diagnosis of the scale of our banking problems.
- Initially the losses were viewed as small ("Banks won't need any recapitalisation").
- Then the losses were viewed as medium-sized ("A small recapitalisation is required.")
- Now, despite the clear evidence of insolvency, the government is unwilling to take the standard steps that are applied internationally to insolvent banks.
- Instead, it proposes NAMA: Use taxpayer funds to pay more for the loans than they are worth. This certainly makes insolvency go away but at a huge unnecessary cost to the taxpayer. Even a small percentage of €90 billion is a huge amount of money.
- Because the stock market now expects the property loan portfolios to be transferred at far above their real value, bank share prices have recovered.
- Amazingly, the Minister is using this development as evidence that the underlying loan losses are not large enough to make the banks insolvent!

The Official Argument Against the Insolvency Diagnosis

- Lenihan to the Sunday Tribune: "I have made it quite clear, a majority state stake is not a problem. But if the valuations of certain commentators were accepted, the Bank of Ireland board, the Allied Irish Bank board would have resigned by now, because they couldn't perform their duties as directors, presiding over insolvent banks."
- The Minister has said he will order NAMA to re-do their sums on loan valuation if they come back with losses that wipe out equity. Lenihan to Oireachtas Committee: "Why would I outline the fact that there may be a residual or substantial shareholder interest left in these institutions if valuations established that their entire shareholder value was wiped out? The reason is on the basis of the information that I have at my disposal. This is not information that only I have at my disposal because markets have assessed that information in the context of their current share prices and rating agencies have used it in their assessment of these institutions. Were these institutions in the condition which Deputy Bruton suggests they would not have these positive market ratings and they would not have the degree of shareholder value they do."

An Alternative: NAMA Plus Nationalisation

- NAMA deals with two problems that the banks have right now:
  1. Solvency: By overpaying for the bad assets, the banks never become fully insolvent, though the government will still have to recapitalise because the NAMA purchases involve a discount.
  2. Liquidity: With the reduction in international wholesale money market lending, Irish banks are now very dependent on borrowing from the ECB. But this borrowing requires eligible collateral and dodgy developer loans don't count. NAMA bonds will count.
- But solvency and liquidity problems can also be dealt with by nationalising and then setting up a NAMA:
  1. Solvency: Money spent on overpaying shareholders can instead be used to produce well-capitalised state banks that are fully owned by the state. The state can get a return on this investment by selling off the banks at a later date.
  2. Liquidity: A NAMA operation can be set up after nationalisation. This is the way Asset Management Companies are usually set up. The loans can be exchanged at a discount for government bonds, which can be used as collateral for ECB loans.

Part II

NAMA

What Do Economists Mean by Long-Term Economic Value?

- The government plans to pay *long-term economic value* for most assets.
- This is higher than current market value, which is defined in the legislation as the "amount that would be paid between a willing buyer and a willing seller in an arms length transaction where both parties acted knowledgeably, prudently and without compulsion."
- In economics, the LTEV approach is an attempt to figure out what assets *should* be worth. It relies on mathematical models of various sorts.
- These models are interesting. And there is even some limited evidence that over very long intervals, asset prices may tend to return to the values that these models churn out.
- But, trust me, these models have not supplied economists with any special crystal ball to accurately predict asset prices.
- In any case, in the hands of many economists, the LTEV models would not predict increases in Irish property prices over the coming years.

What Does *NAMA* Mean by Long-Term Economic Value?

- In the hands of NAMA, LTEV is a license to price assets based on optimistic scenarios. It's "the value that the property can reasonably be expected to attain in a stable financial system when current crisis conditions are ameliorated and in which a future price or yield of the asset is consistent with reasonable expectations having regard to the long-term historical average."
- What constitutes "amelioration of crisis conditions"? Unemployment returning to five percent? How long will this amelioration take?
- What does "reasonably expect" mean?
- On what basis is the long-term historical average yield calculated? How do we know that these yields won't change in the future, with investors only willing to buy at lower prices because higher expected yields are required.
- And remember, if NAMA says LTEV pricing makes the banks insolvent, the Minister has said he will send them back to do their sums again.
- Essentially, in the hands of NAMA, LTEV is a vehicle designed to rule out nationalisation.

But the EU Commission Recommends LTEV?

- We're told paying LTEV is recommended by EU guidelines.
- Well those same guidelines state "As a general principle, banks ought to bear the losses associated with impaired assets to the maximum extent."
- And this: "Once assets have been properly evaluated and losses are correctly identified, and if this would lead to a situation of technical insolvency without State intervention, the bank should be put either into administration or be orderly wound up, according to Community and national law. "
- LTEV only comes in here: "Where putting a bank into administration or its orderly winding up appears unadvisable for reasons of financial stability, aid in the form of guarantee or asset purchase, limited to the strict minimum, could be awarded to banks so that they may continue to operate for the period necessary to allow to devise a plan for either restructuring or orderly winding-up. In such cases, shareholders should also be expected to bear losses at least until the regulatory limits of capital adequacy are reached. Nationalisation options may also be considered."

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 unguaranteed 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.

What About the Levy?

- The government has promised that if it loses money because of NAMA, it will introduce a levy on the banks.
- However, the levy is not included in the legislation.
- If a levy is ever introduced in the future, we cannot be sure that it will be based on the true economic costs of NAMA, which include the interest on the bonds.
- Indeed, Minister Lenihan has explicitly said that there are limits to clawing back losses: "There comes a point where you leave so much contingency and risk in the banks that there is no confidence in them. There is a balance you are trying to strike."
- And remember that in ten years, the financial sector will lobby against the imposition of a levy, claiming it will ruin the Irish financial sector, that the sins of the fathers shouldn't be revisited etc.
- Essentially, this is a vague commitment that some other government at some point in the future may impose a levy of some form on banks, calculated on some unknown basis, and imposed in an unknown fashion.

Honohan's Risk Sharing Proposal

- Patrick Honohan has proposed the following plan for NAMA:
  1. Pay a low price for the bad loans. Honohan recommends paying "what can be confidently expected as recoverable on the loans."
  2. Then give the bank shareholders (not the banks themselves) a right to share in the profits made by NAMA.
- This "NAMA 2.0" proposal has a lot of merit. It 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.
- Also, like NAMA, it draws a clear line under the past, with the bad loans now being unconnected to the banks.
- I think that this is a good plan but we should be clear as to its implications.
- The low payment to the banks makes it more likely that they will be nationalised, which Professor Honohan has admitted on a number of occasions (at an Oireachtas Committee meeting in May and in an article in the Economic and Social Review.)

The Government's Leaked "Risk Sharing" Proposals

- Government politicians say they are considering Professor Honohan's plans and that some version of risk sharing will feature in the final legislation.
- However, the proposals floated in the media are not at all similar to Professor Honohan's plan:
  1. The proposals involve both payments going to the *banks* instead of the second, contingent, payment going to bank shareholders. This minimises the banks' need for new capital (and thus the chances of nationalisation) but it keeps more risk on the balance sheets of the banks than is desirable (the Minister is using this as a reason to limit risk sharing.)
  2. Rather than give the banks an equity share in NAMA, the proposals floated in the media involve some class of "subordinated NAMA" bond. Most likely, when the time comes, we'll be told that the NAMA sub bonds need to paid out on no matter what.

Questions About Management of NAMA Loans

- It appears that NAMA is going to have a small core staff and rent staff from the original lending banks to manage the bad loans.
- This runs counter to EU guidelines on asset purchase schemes: "it is necessary to ensure clear functional and organisational separation between the beneficiary bank and its impaired assets, notably as to their management, staff and clientele."
- What personal relationships will NAMA's rented staff from the existing banks have with the developers? Can we be sure that NAMA won't work out these projects by giving the original developers an equity state in return for their help in getting the projects completed?
- What experience will NAMA staff have in managing large multi-billion euro property portfolios? This is a very different business from being a lender.
- What incentive will the banks have to do a good job in recovering money for the taxpayer? How much will we have to pay them to do a good job recovering money from their own bad decisions?

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 RTE: "If you buy assets, you should ... try to do it in a way that you own the banks so you don't have the valuation problem ... Nationalisation is something you shouldn't be afraid of since you can you can privatise later. "

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.

Doesn't the ECB Support NAMA?

- Well, they support it in the sense that they are willing to lend to the banks if they use NAMA bonds as colleteral. But they accept all government bonds as collateral so this isn't a big deal.
- On the substantive issue of pricing, the ECB's recent opinion was not very approving:
- "the ECB considers it important, in line with previous opinions that the pricing of acquired assets is mostly risk-based and determined by market conditions. The preference expressed in the draft law for the long-term economic value of assets, rather than current market values, requires careful consideration in this context."
- In other words, the ECB would prefer if we adopted a different approach to pricing the assets.

Part IV

Conclusions

Is NAMA Going to Finally Fix the Banks?

- 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 too 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 capital levels that are legal but still very low by international standards. International lenders probably won't lend to them without the government 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 raises the capital ratio.
- Even after NAMA, we may still be in a credit crunch.

But Isn't Nationalisation A Bad Thing?

- 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.
- Also, some people (e.g. the Minister for Finance) believe that international markets will not lend to nationalised banks (though remember they won't lend at all to our privately-owned banks without a government guarantee.)
- The state could then start selling shares in these banks to private equity.
- If you don't like this approach, 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.