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The National Asset Management Agency (NAMA): some possible implications for Northern Ireland and lessons from international experience.

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Research and Library Service

This paper considers the development of NAMA as a response to the financial crisis in Ireland. An explanation of how the Scheme will work is followed by some international case studies of asset-management measures. Finally, some considerations for Northern Ireland are presented.

KEY ISSUES

- **NAMA is an asset-management agency set up to enable eligible banks operating in Ireland to cleanse their balance sheets of risky loans secured on land, property and for development. The use of asset-management agencies is not a new idea, but there are some features of the Scheme that may be a cause for concern for Assembly Members.**

- **Just over 6% of the loans that are likely to be transferred to NAMA relate to property or other assets in Northern Ireland. The value of these loans is approximately £4.36bn.**

- **Some academics believe that NAMA will be paying too high a price for the loans transferred to it. This may have the knock-on effect of meaning that the banks that the Scheme is designed to support are still considered high-risk by the international money markets and so may not be able to increase lending to the real economy.**

- **There is concern that if, partly because of overpayment for the loans, NAMA finds that it is unlikely to realise good value for the assets it may choose to dispose of large numbers of assets. This may have a damaging effect on the Northern Ireland economy.**

- **Other structural issues may be a cause for concern: it is not entirely clear that the staffing of NAMA will be suitably independent of the institutions that originated the loans and got into difficulties in the first place; it is also not clear what the ultimate balance of non-performing and performing loans transferred to NAMA will be. This will have an impact on the agency's ability to generate a profitable return for the Irish State.**

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1. WHAT IS THE NATIONAL ASSET MANAGEMENT AGENCY?

The National Asset Management Agency (better known as NAMA) is the proposed 'semi-state' entity to be established by the Irish Government in response to the financial crisis and subsequent recession. NAMA is part of the efforts to stabilise the financial system; protecting the functioning of banking (especially, perhaps, lending to business) is seen as "critical to the smooth running of the economy and in supporting economic recovery".[1]

It will be established under the governance, direction and management of the National Treasury Management Agency (NTMA).[2] It will buy property-related loans from certain banks (i.e. those that are included in the scheme – see section 3 below) at a discounted rate. These will be paid for by the issue of government bonds directly to the banks.

Income from the assets and the proceeds from their sale will accrue to NAMA; the intention is that the income from these sources will "mitigate the cost to the Exchequer of servicing the additional debt" that will result from the bonds issue. [3]

NAMA is not intended to be a permanent agency. When it is wound-up, any profit will remain with the Irish Exchequer. If it makes a loss, the Irish Government intends apply a levy to the banks to recoup that loss.

2. WHY ESTABLISH NAMA?

NAMA is designed "to address a serious threat to the economy and to the systemic stability of credit institutions in the [Irish] State".[4] The banking system relies on confidence. Banks with risky loans secured on property - in a market which is experiencing severe difficulties – find it difficult to attract finance from international markets. Because the scale of potential losses in each bank is hard to judge, confidence in the banks has reduced; this also has the effect of making finance more expensive.

A consequence of this lack of confidence has been nervousness about banks' capital and reluctance to provide credit to new customers, or to extend credit to existing customers.[5] Credit is necessary for businesses to invest and to underpin any economic recovery.

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[1] Minister's Speech on NAMA to Committee on Finance & the Public Service 31 August 2009 http://www.finance.gov.ie/viewdoc.asp?DocID=5903&CatID=54&StartDate=1+January+2009&m=p

[2] NTMA press release 'Quarter 1 Update' 08 April 2009 http://www.ntma.ie/Publications/2009/QI_Press_Release.pdf (see Appendix II)

[3] NTMA press release 'Quarter 1 Update' 08 April 2009 http://www.ntma.ie/Publications/2009/QI_Press_Release.pdf (see page 9)

[4] Explanatory memorandum to the National Asset Management Agency Bill 2009 http://www.oireachtas.ie/viewdoc.asp?fn=/documents/bills28/bills/2009/6009/B6009D-memo.pdf

[5] Minister's Speech on NAMA to Committee on Finance & the Public Service 31 August 2009 http://www.finance.gov.ie/viewdoc.asp?DocID=5903&CatID=54&StartDate=1+January+2009&m=p

In April 2009, the NTMA produced a report evaluating options for improving the situation. It argued that previous government initiatives had been "insufficient to achieve rates of capital adequacy that would encourage investors to hold or invest further equity in Irish credit institutions".[6] In other words, those institutions did not seem safe enough for people to put their money in.

The report argues that there must be initiatives brought forward to stabilise the banks' deposit and term-debt liabilities so that the Irish Government would not be required to extend the deposit guarantee issued in September 2008.[7] (The guarantee is considered in more detail below – see section 2.1) To achieve this stability "requires removing all doubts about capital adequacy of the credit institutions and their capacity to deal with prospective loan impairments."[8]

Three options are then presented and subjected to a comparative analysis. These options are: recapitalisation programmes; asset guarantees or risk insurance, and; asset management arrangements. (For more detail, the abridged report is available on the NTMA website.[9]) The conclusion drawn is:

> *The Asset Guarantee/Risk Insurance approach contains intuitively attractive features – notably, it doesn't involve upfront cost. However, when considered in the context of characteristic features of the Irish situation, in particular taking account of the contingent liability aspect; the implications of loans remaining on banks balance sheets and the continuing capital requirements of property related projects, it appears that the Asset Management approach has the potential to offer greater assistance to achieving resolution of the impairment issue upfront and maximising taxpayer returns, over the longer term.*[10]

In other words, setting up an agency (i.e. NAMA) to manage the troubled assets is seen to offer benefits that outweigh the fact that this approach has a large up-front cost. This up-front cost is explained below in section 4 on how NAMA will work.

The Irish Government Guarantee of bank deposits

In early October 2008, the Irish Government passed emergency legislation guaranteeing the deposits and certain borrowings of the following domestic banks and building societies:[11]

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[6] http://www.nama.ie/Publications/2009/NAMAsummary.pdf (paragraph 4)
[7] See BBC news report 30 September http://news.bbc.co.uk/1/hi/northern_ireland/7643572.stm
[8] http://www.nama.ie/Publications/2009/NAMAsummary.pdf (paragraph 6)
[9] [9] http://www.nama.ie/Publications/2009/NAMAsummary.pdf
[10] http://www.nama.ie/Publications/2009/NAMAsummary.pdf (paragraph 21)
[11] The Credit Institutions (Financial Support) Scheme 2008 is available here: http://www.finance.gov.ie/documents/publications/statutoryinstruments/2008/si4112008.pdf (accessed 02 December 2009)

- AIB;
- The Bank of Ireland;
- Anglo Irish Bank;
- Irish Life and Permanent
- EBS; and
- Irish Nationwide.

Following questions from both the European Commission and Irish-authorised banks owned by parent companies from elsewhere further banks were included:

- Ulster Bank and First Active;
- Halifax/Bank of Scotland Ireland
- IIB Bank; and
- Postbank.

The Scheme covers a period up to and including 29 September 2010. The intention is that the creation of NAMA will prevent this guarantee having to be extended.[12]

3. WHICH INSTITUTIONS DOES THE NAMA SCHEME COVER?

The National Asset Management Agency Act 2009[13] sets out a procedure for institutions to apply to the Minister to be designated as participating institutions; the legislation itself does not name individual banks.

Clause 65(2) of the Bill sets out the criteria that must be applied by the Minister in making the decision to designate an institution or not:

> *(2) The Minister shall not designate an applicant credit institution as a participating institution unless he or she is satisfied that—*
>
> *(a) the applicant credit institution is systemically important to the financial system in the State,*
>
> *(b) the acquisition of bank assets from the applicant credit institution or its subsidiaries is necessary to achieve the purposes of this Act, having regard to—*
>
> > *(i) support that—*

[12] A helpful summary of the Scheme was produced by the International Law Office http://www.internationallawoffice.com/Newsletters/detail.aspx?g=05aaa180-7a5b-4c34-80a9-3d505c0488aa&redir=1 (accessed 30 November 2009 – free registration required)

[13] The text of the Bill as introduced and as passed, explanatory memorandum and records of the debates in the Dáil can be found here: http://www.oireachtas.ie/viewdoc.asp?DocID=12724&&CatID=59 The relevant sections are 59 to 66 'Designation of Participating Institutions'.

(I) is available to,
(II) has been received by, or
(III) in normal commercial circumstances might reasonably be expected, or might reasonably have been expected, to be or to have been available to, the applicant credit institution or its subsidiaries from the State, any other Member State or a member of the group of the applicant credit institution,

(ii) the financial situation and stability of the applicant credit institution and its subsidiaries,

(iii) the financial situation and stability of the applicant credit institution's group in the event that bank assets are not acquired from the applicant credit institution or its subsidiaries, and

(iv) the resources available to NAMA and the Minister, and

(c) the applicant credit institution has complied with all of its applicable obligations under this Act[14].

In other words, the Minister will be required to asses the importance of each institution that applies, other State supports available to the institution, maintenance of financial stability and facilitating the flow of credit to the economy.

Institutions that apply will be required to supply certain information and confirm that it will accept the designation of eligible assets by NAMA and will accept the NAMA valuation of those assets.[15]

4. HOW WILL THE SCHEME WORK?

Loan purchase

NAMA will buy loans from the participating banks at a discounted rate. The loans will be from the riskiest part of the bank portfolios - land (including property) and development loans.

It is intended that this will take these riskier loan classes away from the balance sheets of the banks concerned; the banks will therefore be safer and more secure for depositors and investors. This should ensure they are better equipped to extend credit to the real economy.

[14] http://www.oireachtas.ie/documents/bills28/bills/2009/6009/B6009D.pdf
[15] 'NAMA ASSET MANAGEMENT AGENCY FAQs' available on the NAMA website (accessed 05 October 2009) http://www.nama.ie/Publications/2009/NAMAFAQs.pdf answer to Q10

Payment for loans

NAMA will pay the banks concerned for the loans. The legislation provides for valuations in accordance with a pre-defined valuation methodology. NAMA will not be buying the loans at the banks' book value; the banks will have to show a loss on their books at the time of the transfer. This loss will be the difference between the book value and the amount paid by NAMA.

The loan purchase will be paid for with Government securities and/or guaranteed securities. The principles of the valuation methodology (see Part 5 of the NAMA Act 2009 – *Valuation Methodology*) are set out in the legislation: detailed regulations will be based on those principles. The valuation methodology (along with all other State aid aspects) of the NAMA scheme is subject to approval of the EU commission.

It is intended that the method of payment will ease pressures on the banks arising from the tighter liquidity conditions that have arisen during the current crisis. It provides access to cash or near-cash assets in place of the much less liquid property loan assets. Again, the intention is that this will make for more stable and secure financial institutions; more stable institutions should be able to lend and support the domestic economy

What will it cost the Irish State?

At the end of 2008, Ireland's Debt/GDP ratio was 43% gross.[16] This would increase as a result of the bond issue. However, under European national accounting rules, the acquisition of the assets from the financial institutions by NAMA may be treated as off-balance sheet. In other words, it will not increase the general government debt ratio and neither will the Irish budget balance be directly affected by the NAMA initiative.[17]

This accounting treatment is allowed by Eurostat on the basis that a special purpose vehicle will be created to hold the assets. It should be noted, however, that this statistical treatment of the debt does not change the fact that operations of NAMA will lead to an increase in the amount of the Irish State's potential liabilities.

In a recent article, Karl Whelan, Professor of Economics at University College, Dublin wrote:

[16] http://www.nama.ie/Publications/2009/NAMAFrequentlyAskedQuestions.pdf answer to Q5.2
[17] Press release issued by Minister of Finance (20 October 2009) http://www.nama.ie/Publications/2009/EurostatDecisionPressRelease.pdf (accessed 30 November 2009)

sovereign bond markets are well aware of the costs to the Irish taxpayer of the banking bailouts, irrespective of whether some statistician includes them in the GGD or not. These costs are substantial.[18]

The argument he makes is that the important thing is not the statistical treatment, but the impact on Ireland's debt in the eyes of international financial markets, rather than the EU statistical body. The purpose of NAMA is to convince international financial markets that it can set the public finances back on a path towards long-run solvency.

According to a recent article in *The Banker*, the Irish Government may be paying over the odds for the loans:

Forty-six academics wrote to the Irish Times criticising NAMA. "Current estimates are that the state may issue agency bonds worth upwards of €60bn in total for the €90bn book value," they write. However, judgements from court cases indicate the true value of the loans to be closer to €30bn - so NAMA will pay double what it should, allege the academics. By overpaying, the state will end up transferring to private individuals a sum close to the entire tax take[19]*.*

Asset management

NAMA will perform an asset-management function with the loans that are transferred. It will attempt to obtain the best achievable return from them. While it holds the assets, it will collect the interest due on them and can pursue debts. The purpose is to ensure its own income stream and to recoup the Irish Government's investment over time.

In effect, NAMA puts itself in the place of the bank that made the original loan. It will have all the same rights to pursue debts, where necessary. Borrowers who continue to meet their contractual obligations and make their repayments will have their rights protected.

Illustration of a loan purchase[20]

The illustration below gives an example of how the loan purchase will work on a sample loan of €100m and the loss that would be recorded against the originating bank's books. The lower the borrower's equity in the asset, the higher

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[18] http://www.irisheconomy.ie/index.php/2009/11/26/no-connection-between-bank-bailouts-and-budget-crisis/#more-4767

[19] http://www.thebanker.com/news/fullstory.php/aid/6903/Reg_Rage:_Irish_government_backs_banks_with_bad_loan_purchase.html (free registration required) (accessed 30 November 2009)

[20] Source NAMA http://www.nama.ie/Publications/2009/NAMAmetrics.pdf (accessed 27 November 2009)

the potential commitment of NAMA and the loss to the bank (which is important for loans with higher Loan to Value ratios that the 65% shown in the example).

Example of metrics of loan transfer to NAMA from Bank X - illustrative purposes only			
		€m	Bank X Loan to Original Asset Value was 65% NAMA Loan to Original Asset Value is 40%
Original Asset Value	01/02/2006	100	
Developers/borrowers equity	01/02/2006	35	
Bank X Loan to borrower/developer NAMA	01/02/2006	65	
Buys Loan from Bank X	01/07/2009	40	
Two Consequences of NAMA		€m	Bank X's Loan of 65m is sold to NAMA for 40m The asset value will have to decline by more than 60% from 1/2/2006 for NAMA to be in a loss making situation.
(a) Bank X records a loss on loan of €25m	01/07/2009	(25)	
(b) NAMA has acquired a Loan with an original asset value of €100m for €40m This is a 40% loan to original asset value by NAMA.	01/07/2009		

How long will the scheme operate for?

According to the NAMA draft Business Plan, the lifetime of the entity is expected to be ten years.[21] Ultimately, this timeframe will be dependent upon recovery in the property market and how well NAMA performs in the management and disposal of assets.

The transfer of the initial largest borrower exposures across all institutions should be completed by the end of January 2010. The phased transfer of remaining borrowers should be completed by the end of July 2010.[22]

5. WHAT PROPORTION OF THE TRANSFERRED LOANS RELATE TO NORTHERN IRELAND?

The table below[23] illustrates the proportion of loans in the expected portfolio by location. At this stage, the numbers are estimates only based on information

[21] The draft Business Plan is available online at: http://www.nama.ie/Publications/2009/Business_Plan_13OCT09.pdf

[22] Presentation by NAMA Interim Managing Director to University College Dublin Law Conference on 26 November 2009. Available online at: http://www.nama.ie/Publications/2009/NAMAPresentationNov2609UCD.pdf (accessed 30 November 2009)

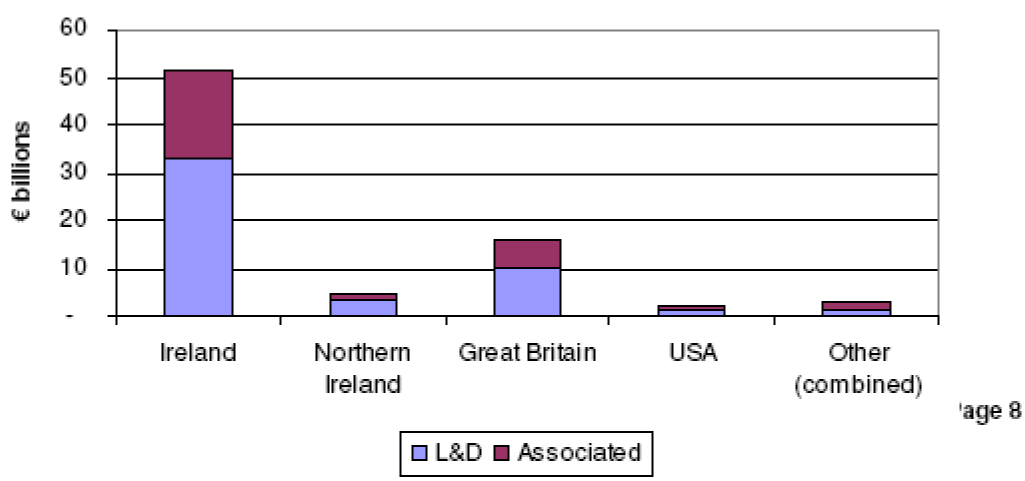
[23] http://www.nama.ie/Publications/2009/Business_Plan_13OCT09.pdf see page 8 (accessed 27 November 2009)

provided by the banks. They will not be finalised until each loan has been individually valued by NAMA in accordance with the valuation methodology.

€4.8bn is equivalent to about £4.36bn.

TABLE 2: Geographical breakdown of NAMA portfolio (€ bn)

Location	L&D loans	Associated loans	Total	% of total
Ireland	33.13	18.35	51.48	66.8%
Northern Ireland	3.29	1.51	4.80	6.2%
Great Britain	10.34	5.59	15.93	20.7%
USA	1.39	0.66	2.05	2.7%
Germany	0.05	1.01	1.06	1.4%
Portugal	0.46	0.14	0.60	0.7%
France	0.39	0.13	0.52	0.7%
Czech Republic	0.11	0.07	0.18	0.2%
Italy	0.04	0.09	0.13	0.2%
Spain	0.05	0.07	0.12	0.2%
Other	0.13	0.11	0.24	0.3%
TOTAL (€ billions)	**49.38**	**27.73**	**77.11**	**100.0%**



Data on total mortgage lending in Northern Ireland is difficult to obtain to put this figure into some kind of context. At the UK level the likely value of transferred loans is €20.73bn, equivalent to about £18.89bn. According to the Council of Mortgage Lenders, there are 11.1m mortgages in the UK with loans worth over £1.2 trillion. £18.89bn is 1.57% of that total – so the proportion is relatively small. Note, the proportion in Northern Ireland may be greater than in the UK as a whole, because of the proximity to lenders eligible for the NAMA scheme.

6. HOW DOES THE NAMA SCHEME FIT WITHIN EUROPEAN RULES?

Is the NAMA scheme a form of state aid?

The European Union has very complicated rules in relation to state aid. State aid is defined by the European Commission in the following terms:

> *The objective of State aid control is, as laid down in the founding Treaties of the European Communities, to ensure that government interventions do not distort competition and intra-community trade. In this respect, State aid is defined as an advantage in any form whatsoever conferred on a selective basis to undertakings by national public authorities. Therefore, subsidies granted to individuals or general measures open to all enterprises are not covered by Article 87 of the EC Treaty and do not constitute State aid.*[24]

In this regard it is immediately clear that the NAMA proposals do constitute a form of state aid: enabling domestic banks to cleanse their balance sheets of riskier loan classes could clearly be seen as a distortion of competition. This has been acknowledged by the Irish Government.

During the Seanad Committee Stage on the NAMA Bill (on 10 November 2009) Finance Minister Brian Lenihan confirmed that the NAMA proposals are subject to approval by the European Commission, in response to a question by Senator Eugene Regan:

> ***Senator Eugene Regan: […]****Does the valuation methodology, including the figures, calculations and assumptions, have to be verified by the European Commission before this project can go ahead? Is that the case?*
>
> ***Deputy Brian Lenihan:*** *Yes. Absolutely.* [25]

Unauthorised state aid is illegal. But the state aid rules do not necessarily prohibit the NAMA scheme. The Commission can grant that in some circumstances a state aid may be legal.

Although the final approval has not yet been granted, there has been a number of key developments and reports by various EU bodies that are relevant to the establishment of NAMA.

[24] http://ec.europa.eu/competition/state_aid/overview (accessed 30 November 2009)
[25] Seanad Eireann Official Report Vol 198 No.1 Tuesday 10 November 2009, available at: http://debates.oireachtas.ie/Xml/30/SEN20091110.PDF see page 128

Opinion of the European Central Bank

On 30 July 2009, the Irish Minister for Finance requested an opinion from the European Central Bank (ECB) on the NAMA Bill. On 31 August the ECB released its opinion – some of the findings are detailed below.[26]

Firstly, the ECB found that the proposed NAMA scheme was broadly consistent with the seven guiding principles for asset support measures identified by Eurosystem. It also welcomed that the NAMA scheme had been designed to comply with the state aid rules.[27]

The ECB did, however, make two specific comments:

1. that the role of the Governor of the CBFSAI (the Central Bank and Financial Services Authority of Ireland) should be limited to consultation and be compatible with its institutional and financial independence; and

2. noting that NAMA and its assets will effectively be under the control of the Irish State.[28]

The European Commission's Communication on the Treatment of Impaired Assets in the Community Banking Sector

In February 2009 the European Commission (EC) issued guidance to Member States when designing and implementing assets-relief measures to tackle the financial crisis.[29] The EC recognised a need for common and co-ordinated action by Member States. To this end it offered guidance on the application of state aid rules to asset-relief measures.

The general principles are that measures should be: necessary; proportionate; and should minimise the distortion of competition. The aim of these principles is to prevent Member States joining in a 'subsidy race' and drifting towards financial protectionism; such an effect would fragment the internal market. Participation in any scheme, therefore, should rely on "clearly defined and objective criteria, in order to avoid that individual banks take unwarranted advantage."[30] Moreover, effective asset-relief measures should lead to the maintenance of lending to the

[26] The full text of the Opinion is available on the NAMA website: http://www.nama.ie/Publications/2009/ECB_opinion_re_NAMA31AUGUST2009.pdf (accessed 30 November 2009)

[27] http://www.nama.ie/Publications/2009/ECB_opinion_re_NAMA31AUGUST2009.pdf see paragraphs 2.4.1 to 2.4.7.

[28] http://www.nama.ie/Publications/2009/ECB_opinion_re_NAMA31AUGUST2009.pdf see paragraphs 3.1 and 3.2

[29] The full text of the Communication is available on the NAMA website at: http://www.nama.ie/Publications/2009/ImpairedAssets.pdf (accessed 30 November 2009)

[30] http://www.nama.ie/Publications/2009/ImpairedAssets.pdf see paragraph 16.

real economy – in other words, lending to businesses that need credit for investment or expansion.

Further rules resolve around:

1. appropriate identification of the problem and options for solution: full ex-ante transparency and disclosure of impairments and an upfront assessment of eligible banks;
2. burden-sharing of the costs related to impaired assets between the State, shareholders and creditors;
3. aligning incentives for banks to participate in asset relief with public policy objectives;
4. eligibility of assets;
5. valuation of assets eligible for relief and pricing;
6. management of assets subject to relief measures; and
7. procedural aspects.

The procedure for notifying asset-relief measures is set out in Annex 5 to the Communication. Member States must notify a "detailed description of the valuation methodology and its intended implementation involving independent third-party expertise."[31] If the Commission is satisfied with this description, it will grant permission for a period of six months, on the condition that the member State then undertakes either a restructuring plan or a viability assessment for each institution participating in the scheme.

This part of the process has not been completed in respect of NAMA, because the detailed regulations are yet to be designed. Once this has happened, and assuming approval is granted, the Irish Government will be required to report on the functioning of the scheme every six months.

7. WHAT LESSONS CAN BE LEARNED FROM OTHER COUNTRIES' EXPERIENCE OF ASSET-RELIEF MEASURES?

<u>International Asset Management Strategies</u>

AMC's come in two main forms, Rapid Asset Disposition Agency/Liquidation Agency or as a Restructuring Agency[32].

The Rapid Asset Disposition Agencies have two main functions:

- To dispose of particular classes of assets that by nature tend to be more easily liquefiable (such as real estate assets, commercial real estate loans or home mortgage loans);

[31] http://www.nama.ie/Publications/2009/ImpairedAssets.pdf see page 28
[32] The World Bank Financial Sector Strategy and Policy Group, Klingebiel, D 2000 The Use of Asset Management Companies in the Resolution of Banking Crises: Cross Country Experience

- To dispose of banks taken over by authorities.

Restructuring Agencies are designed to:

- to restructure and liquidate Non-performing loans of non-viable borrowers to make assets financially viable and attractive to new investors; and
- include, in case of industrial companies sale of non-core assets, reorganising and reducing staff and in case of commercial real estate renovations, etc.

NAMA fits best into the role of a Rapid Asset Disposal Agency, selling off bank portfolios, land and development loans accrued by the commercial banks. However, it will not be disposing of banks owned by the state and will be basing its selling of assets on valuations by experts rather than the book value.

Importantly, in a study conducted by Klingebiel (2000) it was found that only one out of every three restructuring agencies succeeded in meeting its targets, whilst two out of every four rapid asset disposition agencies was successful.

Asset Management Companies (AMC's) have been used by a number of different nations in order to offset bad bank debt. In a similar manner to that of ROI, the main goal behind this was to shift the bad assets from the target banks balance sheets in order to encourage future investment and a restoration of normal business practices.

Some nations, such as China, have used AMC's as part of an overall process of financial restructuring, with the impetus for change growing from previous inefficient banking practices and resulting in the introduction of private business operating methods introduced to state owned banking institutions.

European nations have also introduced AMC's in order to control and restore the financial sector. The Financial crisis that swept across the Nordic nations in the 1990's saw the introduction of AMC's in Sweden, with a quick turn around in the selling off of bad debt.

One of the largest AMC's to have been used was in the United States of America following the financial crisis that swept through the Savings and Loans sector in the 1980's.

The circumstances, methods and results of the introduction of AMC's to these nations is discussed in more detail below.

<u>China</u>

China has been involved in a long term industrialisation programme since 1978. During this period a large number of loans were generated through the banks providing excessive lending to State Owned Enterprises, with large land and property purchases.

Unfortunately as a result of poor financial performance[33] by a large number of these organisations, due to the lack of a true bank credit culture at the state owned banks, a large number of these bank loans became non-performing. This resulted in a loans crisis developing within the nation. Extensive government instructed lending during the command economy period also impacted upon the financial system, with non-viable projects receiving bank funding which would not have been made available under a commercial banking system.

Further exacerbating the situation, a financial crisis in the mid 1990's struck a number of Asian economies including China. In 1999 it became necessary for the central government to create four Asset Management Agencies, one for each of the four major banks, in order to deal with the large number of Non-Performing Loans (NPLs) created during this period. These AMA's were:

- Cinda – AMA for Construction Bank of China;
- Huarong – AMA for Industrial and Commercial Bank of China;
- Orient – AMA for Bank of China; and
- Great Wall – AMA for the Agricultural Bank of China.

As a result of the excessive Bank lending (and exacerbated by the 1990's Asian financial crisis) the AMA's took on RMB[34] 1.4 Trillion[35] (equivalent to $170 billion) in distressed assets. This was around 20% of the combined outstanding loans held by the four big banks, or 18% of China's GDP in 1998.

It must be noted that the amount of debt taken on represented only half of the NPL held by the four big banks. This is a result of the AMA's only taking on NPL generated prior to 1996. Any NPL after this period was handled exclusively by the banks, as a result of a new set of regulations regarding the handling of loans introduced by the central government in 1996 resulting in stricter controls in how they were handled and dealt with in the case of a potential default.

The AMA's had the following roles:

- The removal of NPL's from the state owned banks balance sheets;
- The operation of insolvent SOE's;
- Assisting in the restructuring of SOE's in corporate form; and
- The introduction of modern accounting practices within firms.

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[33] McIver, R, Managerial Finance, *Asset Management Companies, State Owned Commercial bank debt transfers and contingent claims: Issues in the valuation of China's non-performing loans* Vol31, pt12, 2005

[34] Renminbi "People's Currency", the Chinese Yuan.

[35] Fung, B, George, J, Hohl, S and Guonan, M *Financial Stability Institute Public Asset Management Companies in East Asia* February 2004

As with NAMA in Ireland, once the NPL's were transferred it became the AMA's responsibility to manage and dispose of the loans, with the aim of maximising asset recovery.

McIver (2005) noted that by the end of 2002, the four AMA's had disposed of approximately RMB 301.5 Billion of NPL's, recovering RMB101.4 billion in assets. However, in this time period, the four agencies had accrued a further estimated amount of RBN 78.8 billion in interest. As a result of this McIver suggested that the AMA's carried a serious risk of default to the State Owned Commercial Banks, with these organisations accruing unpaid interest on the AMA debt, deferring rather than removing exposure to that part of the NPL transfer.

In regards the repayment of the NPL's, China's AMA's faced a number of unique barriers. For instance the Great Wall Asset Management Corporation is attempting to recover the bad loans generated by the Agriculture Bank of China. Rather than have to reclaim assets from large industrial companies, Great Wall is attempting to recover loans from small farmers from across China, with nearly 2 million debtors. Adding to the sheer volume of debtors is the difficulties created by the reorganisation of the farm industry in the 1980's with the large collective farms disbanded into the family farming system. As a result, a large number of the original debtors no longer existed with related assets now impossible to even identify let alone collect on.

The Chinese AMC's are supervised by the China Bank Regulatory Commission (CBRC) which was set up in April 2003. Prior to this, oversight was conducted by the Ministry for Finance (MoF), the People's Bank of China (PBoC) and the China Securities Regulatory Commission.

The AMAs have to report their operations to both the MoF and the PBoC on a monthly basis, with regular onsite inspections by PBoC.

Despite this apparent high level of supervision by external bodies, the regulations around the monitoring of the AMC's are vague, with each supervising body prone to interpreting these regulations in different ways. As stated by Fung, George, Hohl and Ma (2004) these difficulties could result in hindering the "*coordination among different government agencies, which is much needed to compensate for an already weak legal environment.*"

Problems also exist in terms of the selection of the AMC governing officials. The state council appoints the Presidents and Vice Presidents of each AMA. However, the party secretary of each of the AMA's is also the President of the related big four bank. In addition, on average around 3,000 staff members of each AMC come from the big four banks, creating issues regarding accountability and effectiveness.

As found by Fung et al: *"there is room for greater transparency regarding the AMC-bank relationship."*

More recently, the CBRC has introduced new reforms to the system[36], resulting in the AMC:

- speeding up the diversification of operations;
- strengthening internal controls;
- optimising structural mechanisms; and
- enhancing risk control capacity.

These changes have also laid the groundwork for further reforms and transformations to the system.

By the end of first quarter 2006 (the most recent data available) the four AMC's have resolved a total of RMB866.34 Billion in NPA's of which RMB180.56 Billion were collected in cash. This gives a cash recovery rate of 20.84 per cent[37].

Key Points:

- **Restructuring of banking system may be necessary in order to ensure future effectiveness of banks;**
- **There should be a clear set of regulations regarding the operation of AMA's in order to ensure effective co-ordination between government agencies and monitoring and evaluation of the process;**
- **There should be a clear demarcation between the AMA's and the banks whose assets are being bought up. This will ensure transparency and accountability for the AMA's operations.**

Sweden

Background to the Development of the AMA's

Sweden's introduction of AMA's occurred after a financial crisis swept across the Nordic countries in the late 1980's and early 1990's.

Following the deregulation of the banking sector in Sweden, there was a resultant lending boom with credit lending jumping from 90% to 140% of GDP from 1987 to 1990. The majority of this spending was in the real estate sector, creating a boom in the market.

[36] China Banking Regulatory Commission, Annual Report 2008

[37] China Banking Regulatory Commission The CBRC released the latest statistics of NPA disposal at AMC's, http://www.cbrc.gov.cn/english/home/jsp/docView.jsp?docID=2460 (first accessed 06/11/09)

In the 1990s Sweden's government introduced tax reforms that decreased the tax deductibility of interest expenses on real estate investments[38]. In addition, there was a tightening of monetary policy and lower inflation. This raised real after tax lending rates, contributing to a sharp drop in property and share prices, with Sweden entering a deep recession.

Sweden, whilst not as badly affected as Finland during the same period, saw an increase in the unemployment rate and inflation rate, rushing the country into recession. The crisis created very high interest rates of up to 500% and a substantial depreciation of the Swedish Krona on the international markets.

In a similar manner to the current financial crisis, the high unemployment rate and drop in property prices resulted in many borrowers being unable to repay their debts precipitating loan losses for financial institutions.

It became apparent in 1991 that two of Sweden's main banks needed to be recapitalised in order to fulfil their capital requirements. Following government intervention it became apparent that the bank's difficulties were more severe than anticipated.

In September 1992, the Gota Bank made it apparent that it would not be able to meet its capital adequacy requirements, with its largest shareholder, Tyrdd Hansa, refusing to provide additional funds. The government issued a guarantee to Gota's creditors, with the bank subsequently declaring bankruptcy.

In November 1992 the government bought the remaining share of another bank, Nordbanken, and split it in two, with all NPL's transferred to the newly formed AMC 'Securum' with the performing loans remaining at Nordbanken.

Securum took over assets of SEK 67 Billion (book value) which accounted for 4.4 per cent of total bank assets, the majority of which were real estate loans.

Following the government take over of Nordbanken, it acquired Gota Bank in December, stating that the bank would be sold immediately. In a similar manner to Nordbanken and in order to make Gota Bank a more attractive acquisition, the government split Gota into two entities, with problem loans being sequestered into an AMC ('Retrieva'), with SEK 43 Billion (3 per cent of bank assets) transferred to Retrieva. This left the remaining entity able to focus on normal banking business.

In 1993, the two banks were merged, operationally restructured and sold to the private sector. The AMC's were also merged. The main task of the AMC's was to maximise the remaining economic value of the loans transferred.

[38] Calomiris, C, Klingebiel, D and Laeven, L A Taxonomy of Financial Crisis Resolution Mechanisms: Cross-Country Experience World Bank Policy Research Working Paper August 2004

Securum became the owner of 2,500 commercial properties with an estimated market value of SEK 15 -20 Billion. The AMC unloaded the assets in one of three ways:

- IPOs (Initial Public Offering) on the Stockholm stock exchange;
- Corporate transactions outside the stock exchange;
- Transactions involving individual properties.

The majority of sales were made in 1995 – 1996 when the real estate market had stabilised.

Whilst it was initially expected that Securum and Retrieva would exist for fifteen years, the merged companies had completed asset liquidation after only four years and ceased to exist in 1997.[39]

The total cost of the AMC's is estimated at around SEK 35 Billion, with a total investment of SEK 71 Billion. The total profits generated by Asset Sales were estimated at SEK 36 Billion. Overall, Sweden used 7% of GDP to fund the Asset recovery mechanism. Following the winding up of the AMA's, it was found that the actual cost (following the selling of assets) was only 0.5% of GDP.[40]

Importantly for the recovery process, the Swedish AMA's had the power to force debtors to file for bankruptcy, allowing the AMA to sell off any remaining assets on the Stockholm stock exchange. This sped up the recovery of assets, with Securum able to complete its operations in 1997.

The AMA's were able to force bankruptcy thanks to a strong judicial framework and efficient judicial system which allowed them to dissolve companies quickly and efficiently rather than being tied up in the courts for months or even years.

Securum was staffed by a large number of experts from within the real estate field, allowing it a greater ability to deal with the property related issues that made up the majority of its stock.

Key Points:

- **One of the main reasons for the success of the Swedish AMA's was the strong judiciary in place which allowed them to force bankruptcy on non-performing companies. This allowed for assets to be broken up and sold quickly, aiding economic recovery; and**

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[39] Magnusson, P Lessons from Swedish Crisis Management Consensus Economics www.consensuseconomics.com/News _and_Articles/Central_Bank_Crisis_Management (first accessed 09/11/09)

[40] Federal Deposit Insurance Company 2003 Managing the Crisis – Speech by Berggren, A. Managing Bank Crises in other Countries http://www.fdic.gov/bank/historical/managing/sym1-09.pdf

- **Staffing by experts from main assets field helped the valuation process of seized property and real estate and enabled a swifter move to selling off NPL's.**

United States of America

Savings and Loans (S and L's) provided a similar function within the USA economy as that of Building Societies in the UK. Savings and Loans provide affordable loans for people wishing to buy or build a home. For example, between 1946 and 1980 the majority of the loans provided were for home mortgages, based on fixed rates and with a maturity of 25 to 30 years.

Prior to the mid 1970's there had been some concerns raised regarding the vulnerability of Savings and Loans to rising interest rates. When the Interest Rate rose, the deposit costs of thrifts rose faster than loan income, resulting in lower interest margins and earnings from thrifts. This was not, however, a significant problem in the US during this period. The economy was strong and the price of homes continued to rise, offsetting any potential difficulties.

However, in the 1970's a series of incidents occurred which resulted in the development of NPL's amongst the Savings and Loans companies.

The oil crisis of the 1970's drastically raised the cost of oil, with interest rates rising in kind. Interest rates rose sharply, leading to large losses for the S & L's across the US. The regulatory body (Federal Savings and Loans) decided to meet the threat to the S& L's by deregulating the market and thereby opening up further competition. The S and L sector expanded into the commercial real estate market, allowing loans for the purchase of not for living houses.

In the late 1980's the real estate bubble burst, further adversely affecting the solvency of a large number of S and L's across the US.

By the end of the 1980's 1,295 out of 3,263 thrifts were insolvent, accounting for 13% of thrift and bank assets, the equivalent of $621 billion.

In order to deal with this sudden increase in insolvency across the market, the government created an AMC, the Resolution Trust Corporation (RTC). RTC had five main areas of activity[41]:

- Liquidation agency for S and L's declared insolvent by the Office of Thrift Supervision;

[41] The World Bank Financial Sector Strategy and Policy Group, Klingebiel, D 2000 The Use of Asset Management Companies in the Resolution of Banking Crises: Cross Country Experience

- Purchase and assumption transactions where healthy institutions bid to assume deposit liabilities in exchange for receiving a combination of assets and cash;
- Accelerated resolution programme through which s and l's that were believed to have good franchise value were sold;
- Deposit payoff and insured deposit transfer; and
- Asset sale.

The RTC was expected to operate until 1996 and had the following objectives[42]:

- to maximise the net value of proceeds from the Savings and Loans crisis resolution;
- Minimise the impact on local real estate and financial markets; and
- Maximise available and affordable housing for low to moderate income individuals.

Initially the RTC was governed by a Board made up of people drawn from the Public and Private sector, with the FDIC supplying the public sector members. The board was responsible for policy, strategic planning and the budget. In 1992 FDIC asked for a new board to be formed as a result of confusion regarding public accountability. As a result the RTC became an independent organisation, with a Chief Executive taking over a number of the roles previously covered by the management board and FDIC.

The Thrift Depositer Oversight Board replaced the previous board, with representation from the RTC and FDIC. This board was responsible for approving requests for government funds and reviewing policy and strategy.

The RTC took on debt of $465 Billion which accounted for approximately 23.3% of all Savings and Loans assets or 8% of total bank and thrift assets in 1989.

Unlike other case studies presented here, the RTC took on both performing and non-performing loans. The breakdown of assets acquired by RTC is:

- 42% mortgage loans;
- 7% real estate;
- 8% other loans;
- 35% cash securities; and
- 8% other assets.

The RTC was wound up in 1995, a year earlier than expected, having met its objectives. In total, RTC resolved 747 thrifts with total assets of $465 billion, 8%

[42] The World Bank Financial Sector Strategy and Policy Group, Klingebiel, D 2000 The Use of Asset Management Companies in the Resolution of Banking Crises: Cross Country Experience

of total bank and thrift assets in 1989. Of these, RTC sold $153 Billion through asset disposition, not connected to the sale of the financial institutions involved.

In terms of recovery, the RTC recovered 87 cents to the dollar on its assets.

Key Points:

- **Adequate government structures such as professional management and extensive use of private contractors for asset disposition aided the success of the project;**
- **The majority of assets that were transferred to the AMC were performing real estate and consumer loan assets, which could be sold off through wholesale disposition mechanisms such as bulk races and auctions; and**
- **The amount of assets transferred was relatively small and were largely performing, making them easier to sell on in order to recoup losses.**

8. SOME CONSIDERATIONS FOR THE OPERATION OF NAMA THAT MAY BE OF INTEREST TO NORTHERN IRELAND

‘Fire sale’ of Northern Ireland-based assets

Concern has been expressed by the Chair of the Finance Committee, among others, that “there would be a potentially catastrophic impact on the northern housing market if Nama decided to release those assets in a quick fire sale.”[43]

The Finance Minister, Sammy Wilson, met his counterpart, Brian Lenihan in September 2008. Minister Lenihan gave an assurance that a ‘fire sale’ of Northern Ireland-based assets linked with loans transferred to NAMA was in the best interest of no-one. He also agreed to establish an advisory panel which would communicate directly with DFP in reference to the management of Northern Ireland-based assets.[44]

Ultimately, however, there is likely to be continuing concern that if NAMA finds that the management of the assets it acquires is not turning out to be of best benefit to the Irish taxpayer, it may chose to dispose some of the assets in a way that may not be helpful to economic recovery in Northern Ireland.

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[43] See Call for all-Ireland alternative to NAMA on Breaking News.ie 20 October 2009 http://www.breakingnews.ie/archives/2009/1020/business/call-for-allireland-alternative-to-nama-428129.html

[44] See BBC NI news report 14 September 2009 http://news.bbc.co.uk/1/hi/northern_ireland/8251402.stm

Overpayment by NAMA for transferring loans

A concern has been expressed by academics that NAMA may be overpaying for some or all of the loans transferred to it (see above on page 9). The rate of discount or write-down that is applied to the eligible loans is crucial. For example, if a 20% discount is applied both AIB and the Bank of Ireland would retain a level of capitalisation that would meet legal requirements: they would not therefore have to be nationalised.

It has been estimated, however, that a discount of one-third would be more realistic to the value of land and development assets now. But this would effectively wipe out the banks' equity capital, prompting nationalisation which the Irish Government is keen to avoid.[45]

If it is indeed the case that the loans are transferred at too high a price, it may be questionable if NAMA can achieve its objectives. If international financial institutions assess that the Irish State is not credit worthy or that NAMA is liable to make a significant loss, then the banks will still probably be seen as high risk. Therefore they will still not be able to access credit on the money markets at attractive rates, and so will be unlikely to extend lending to the real economy.

This may lead to the Irish Government having to extend its guarantee of bank deposits which it also wishes to avoid. In these circumstances, there may be increased pressure on NAMA to dispose of its assets some of which may be in Northern Ireland.

Another related issue is the way that NAMA will transfer the loans. This is to be funded through bond issue, but there is to be no equity stake for the Irish taxpayer in the eligible banks. If, after NAMA, the banks still have to be recapitalised, there will be more cost to the Irish Exchequer. If the transfer included an equity stake, this could more readily be viewed as an investment in the future performance of the banks. An overpayment may ultimately just result in a loss.

In Sweden, banks were required to write down by large amounts and then recapitalise – which the NAMA scheme will not require. Two banks became insolvent. The Swedish 'bad banks' then bought the loans at low prices and were able to record profits. Even so, the Swedish Government as a whole still made a loss. And if NAMA buys at too high a price profit will be harder to obtain.[46]

There are a couple of other concerns about the NAMA scheme that arise from the international comparisons contained above in section 7.

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[45] Presentation given by Professor Karl Whelan available online at: http://www.karlwhelan.com/IrishEconomy/gp-presentation.pdf see slides 8 to 11

[46] http://www.karlwhelan.com/IrishEconomy/gp-presentation.pdf see slide 16

Demarcation of staffing

In the case of China, a need for clear demarcation between the asset-management agency and the banks from which loans were transferred was identified. The NAMA Act does not prevent employees or ex-employees of the banks from which loans are transferred from being appointed to the NAMA Board nor indeed from being employed by NAMA to manage those assets.

In response to a query from Assembly Research the interim Deputy Director of NAMA made the following comment:

> *It is correct to state that the Act does not expressly exclude employees or ex-employees of participating institutions. However, in practice, it is highly unlikely that the Minister would appoint any person who held a senior position or was a member of the Board of a participating institution, particularly during the period within which the current crisis developed.*[47]

'Highly unlikely' is clearly not the same as 'impossible'. The question about staff at lower levels also remains – and where will their loyalties ultimately lie?[48]

Balance of non-performing and performing loans

In the case study from the United States, a key point was that the majority of assets transferred to the Resolution Trust Corporation were performing loans. In the case of NAMA:

> *The key objective is to remove from bank balance sheets a significant proportion of their exposure to an impaired sector. It is estimated that about 40% of the loans to be acquired will be cashflow-producing; these cash flows are expected to cover interest outflows on the NAMA bonds which will be issued to institutions. I would refer you to the Draft NAMA Business Plan for more detail on this aspect (www.nama.ie).*[49]

The proportion of performing loans to non-performing is not prescribed in the NAMA Act, partly because, no doubt, the detailed work on valuing and assessing those loans is not completed. However, a prescriptive legislated approach may inspire greater confidence in the market – business plans are much more easily rewritten.

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[47] Source: personal communication with NAMA interim Deputy Director
[48] http://www.karlwhelan.com/IrishEconomy/gp-presentation.pdf see slide 20
[49] Source: personal communication with NAMA interim Deputy Director

Enforcement of bankruptcy

A final important note is that in the Swedish case study a key message was the ability of the institutions to enforce bankruptcy on non-performing organisations. In the case of NAMA:

> *Where a borrower continues to meet his contractual obligations, there will be no change from his current position with his bank. Where, however, NAMA concludes that a borrower is no longer viable, it will foreclose and it has available to it an extensive array of options to deal with any assets that are acquired as a result. It may dispose of the assets or retain them or enter into joint ventures with third parties in order to further enhance them.*[50]

From an operational perspective, such power is apparently of significance. However, it may not be reassuring to those concerned about the impact of NAMA on the Northern Ireland economy.

There are still details of the scheme to be determined in regulations. These will also require EC state aid approval. There is sure to be continued interest over coming months.

[50] Source: personal communication with NAMA interim Deputy Director