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## NAMA versus Nationalization – How to Deal with the Banks’ Toxic Loans?

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# **NAMA versus Nationalization – How to deal with the banks’ toxic loans?**

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Banks are indispensable to the efficient functioning of the economy. Right now they are unable to carry out their normal functions (e.g. providing lines of credit to individuals and business) because they are underfunded. They are rationing credit because they do not have enough funds. The funds they need to lend to borrowers come from deposits, equity and bonds. During the ‘boom period’ banks did not have enough funds from deposits and had to rely on the inter-bank market to borrow the funds they needed in order to lend. According to the Central Bank ‘net foreign liabilities’ of commercial banks in Ireland, (a proxy for bank borrowing from other banks and the international market, rose from 10% of GDP in 2002 to 60% of GDP in 2007. To borrow this money the banks issued bonds or IOUs. (Incidentally, analogies with the Swedish experience are misleading because Swedish banks at the time were not exposed to inter-bank lending).

With the collapse of the sub prime market and the onset of the credit crises, banks became unwilling to lend to each other because of fears of the quality of their loans books and the fear that they would not get their money back. The end game came when Lehman

Brothers collapsed and inter bank flows of funds completely dried up. In essence the property bubble has burst, the banks are broke and we need to rescue them.

The solution is to take these 'toxic' assets off the banks balance sheets.

The NAMA route is to force banks to take losses on loans *now and not over time* and this will start the recovery quickly. The quicker this is done the more likely it is that lenders and investors will supply capital to banks because of the reduced risk. This is one of the advantages that NAMA has over nationalization which requires a restructuring, reorganization and a subsequent refloating. The time dimension is important because the life-blood of business is liquidity.

Much of the debate surrounds the valuation of the loans that NAMA will buy. I put forward my views on valuation methodologies in the last issue of the Property Valuer Summer 09. The burning issue is how much should be paid for these loans? (Incidentally NAMA is buying loans and not property.

Proponents of NAMA say that the State won't pay anything to banks. Instead it will issue them with IOUs (bonds) which the banks can sell to the ECB in exchange for cash. But if the properties are disposed at a price less than their long term economic value it will mean a transfer of wealth from taxpayers to banks.

However, proponents (Alan Ahearne in particular) suggest that NAMA is likely to generate surplus cash for the taxpayer and at worst break-even. The department of finance and the national treasury management agency estimate 40% of the loans being

taken over are paying interest at on average 3.5% variable - remember NAMA is talking over 'good' loans as well as 'bad' loans. The interest paid by the government on these bonds issued to the banks will be 1.5%. This surplus, is estimated at (assuming €54bn bond issue to buy the loans and a €68bn book value on the loans) at circa €330m annually. This assumes that when interest rates rise property developers will be able to pay the higher interest rates. But NAMA or indeed any other solution will only work if policies designed to boost the economy's competitiveness are undertaken at the same time. Furthermore because the governments holds options worth a 25% stake in AIB and BOI the state has benefited to the tune of €825million as a result of the recovery in the market value of the banks shares. This is in addition to the €560 million return per annum the taxpayer gets from the government's €7billion injection into the banks.

By applying realistic long term economic valuations on these properties, disposal by NAMA in the future would be enough to pay off the bonds in full (and possibly make a profit). It is also worth noting that c20% of the loans relate to foreign property mostly in the UK where the indications are that recovery has started.

Although it is difficult to come up with a figure of the possible drop in values, the government has put 47% on peak-to-trough and because NAMA will dispose of properties over time the appropriate valuation is long term economic value.

Assuming a book value of €68bn and a loan to value ratio of 77% gives the underlying properties a valuation of €88billion at their peak. Giving a 47% drop in value from peak

to trough implies an underlying value of €47bn. Adding to this the estimated €9bn in long term economic value NAMA will pay €54bn - a write down of 30% on the loans.

This process, suggests Alan Ahearne, may understate the value of the properties because it assumes that all properties were bought in the boom. So, as an example (using my own calculations), suppose that an asset was bought, say 10 years ago for €100 with a loan of €77. Ten years on at its peak this asset would be valued at, say, €300. A 47% drop in value now would imply a valuation of €159 on a loan of €77. Given the 30% write down on loans, NAMA will purchase this loan for €54 which has an underlying value of €159.

In addition, Aherne suggests that many of the loans particularly on buy to let investment properties bought in the boom and which are now in negative equity might be worth more than the underlying property as investors may choose to pay off the loan rather than default.

Under nationalization all BOI and AIB shares will be bought by the state at a price which will be determined by the level of bad debts. All bank loans will then be transferred to the proposed Asset Recovery Trust at 'current market value'. Banks would then be 'reorganised' and at some stage in the future their shares will be re-floated. In addition, there would be a 're-negotiation' with existing bond holders. In other words, it is proposed to swap the banks debt for equity. The argument for a re-negotiation with bond holders is based on the unfairness of asking the taxpayers to guarantee bondholders who receive higher returns to take on the risk of possible default? Even allowing for a debt:equity swap it is likely that the banks will need further capitalization by the state,

i.e., nationalization (a wipe out of shareholders) and removing the banks from the stock market.

In September 2008 when the government was faced with an institutional run on deposits from Anglo Irish Bank it responded by guaranteeing all liabilities, except equity holders (deposits and bank bondholders). So, any attempt at a debt :equity swap would effectively mean a default and a possible flight away from risks associated with Irish government denominated debt (and therefore a complete collapse of public services) or at least a significant increase in the marginal cost of government bonds.

A research report by Bloxham stockbrokers concludes that shifting all banks liabilities onto the balance sheet of the state (nationalization) should be avoided at all costs. This, they suggest, would have serious implications for the country's ability to fund its own borrowing requirements. "*The full nationalization solution to the crises would cost the taxpayer upwards of €21billion*". So it is not just the €54bn of NAMA bonds we need to consider, it is all government bonds.

The bond market is positive about NAMA and the view from the bond market is that they won't be positive about nationalization.

In addition, opponents of nationalisation say that it ignores the inherent value that a stock market listing has in terms of the information it provides to investors. The research shows that this information is valuable and has a positive influence on the investors who provide funds to listed companies.

Because it is meant to be a 'temporary' nationalization, re-floitation will mean (sometime in the future) the government, ironically, will have to find some ways of finding some true long term value of the shares (a process that everybody agrees is difficult). In order to incentivize potential investors to buy these shares, they will have to be sold at a discount, which effectively means transferring some taxpayers' wealth to private individuals.

Nevertheless, as Dr Anthony Leddin of the University of Limerick points out there is no guarantee that banks will lend to the domestic market and will instead lend to overseas markets or just sit on the cash. So the NAMA option won't necessarily solve the banks' liquidity problem.

He further notes that the value of NAMA bonds combined with annual budget deficits could triple national debt by 2010. Because households recognize that high deficits will mean higher taxes in the future they increase their savings thus reducing their demand further and thus prolonging the recession. But I'm not sure whether this is not an argument in favour of nationalization. The cost to the taxpayer of nationalization could be more pronounced. Having a sale now will mean full scale nationalization and a tripling of the national debt by 2010. Either way the size of the national debt is going to soar.

Whatever option is taken the opportunity cost to the state is huge. Imagine the huge actual returns that could be made, at little or not risk, if the €54bn of government bonds were issued to invest in the long term improvement in the education of our children, the improvement of the nation's health and the public services generally. Politicians, bankers,

developers, regulators, valuers should all hang their heads in shame at the mess they collectively have sunk us in.