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SOLVING THE PROBLEM OF TOXIC PROPERTY AND CONSTRUCTION LOANS – THE CASE OF IRELAND’S NATIONAL ASSET MANAGEMENT AGENCY.

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KEY WORDS: *inter-bank lending; toxic assets; nationalisation; sovereign debt; debt deflation*

ABSTRACT

Ireland experienced rapid economic growth between 1994 and 2004. This economic performance prompted the Economist magazine to coin the phrase ‘*The Celtic Tiger*’ to describe the Irish experience. However, during the ‘boom period’ banks did not have enough funds from deposits and had to rely on the inter-bank market for funds. Consequently with the collapse of the sub-prime market and the global banking crisis, the banking systems reliance on inter-bank lending resulted in toxic property and construction loans. In essence the property/construction bubble burst, the banks are broke and there is a need to rescue them. The government’s solution is to take these ‘toxic’ assets off the banks balance sheets via the National Asset Management Agency (NAMA).

This paper investigates the potential costs/benefits of NAMA, the mechanics of its workings, the alternative proposals and the lessons that can be learned from the Irish experience.

CONTEXT

The Irish economy experienced rapid growth rates from 1994 to 2007. Average growth rate since 1994 was three to four times the average for the EU and the OECD and recorded even higher growth rates than the Korean economy. The characteristics of this growth were rapid growth in exports which far exceed the EU and the OECD averages. In addition sustained domestic demand was a multiple of the OECD and EU average (Arrow, 2000). Interestingly, all of this occurred despite a reduction in government expenditure as a percentage of GDP. A key feature is that growth was achieved simultaneously with low inflation. In 1981 Ireland’s inflation rate was 20% while during the boom inflation rates average circa 2.5%. Since all variations in living standards are attributable to differences in countries’ productivity (Mankiew, 2001), Irish living standards were driven by fast productivity growth without a comparable increase in wages. (Krugman, 2000). The rate of wage increases was less than the rate of increase in profits.

The role of past investments in education created a stock of labour force skills which was one of the advantages that Ireland had in attracting foreign direct investments (FDI). The role of FDI is at the heart of understanding the Irish economic miracle. Ireland had favourable ratings in terms of labour markets, corporate taxation and exchange rate policy. FDI was 50% higher per capita

in Ireland than the UK and six times higher than France and Germany. An explanation for Ireland's success in attracting FDI suggests that the way nations' trade tilted the geographical balance in favour of Ireland (Krugman, 2000). Transportation costs became less important than they used to be compared to delivery time, communications and personal contact. Ireland's insular location was no longer a problem leading to significant gains in value to weight ratios. The role of convergence - how lower income economies can grow more rapidly than richer economies - is useful in explaining Ireland's performance. For Sachs, lagging economies 'catch up' through the "importation of technology and capital and through high returns on domestic investments" (Sachs, 2001, P. 54). Furthermore, the source of Irish growth has been linked to EU subsidies (Fuente, and Vives 2000) although this particular explanation has been over stated.

FROM BOOM TO BUST

The OECD's grouping of thirty economically advanced nations have undergone the most severe recessions since World War 2, with Ireland suffering the most acute contraction of all with GNP falling by 13.5% from peak (Larkin, 2009). The origins of Ireland's crises are multifarious. Larkin suggests the primary causes are macroeconomic imbalances, particularly in housing. National average house prices rose from €75,000 in 1996 to €287,664 in December 2006. This is a nominal increase of 283%, with the capital city Dublin experiencing a rise of circa 366% in the same period (Global Property Guide, 2010). The macroeconomic drivers of this growth in property prices were the rapid growth in GDP which averaged 9.8% between 1995 and 2000. The housing boom was assisted by mortgage market deregulation and by the entry of foreign banks and significantly by housing equity withdrawal. In 1990 Ireland's per capita income was about 75% of the EU average. In 2007, according to the OECD, Ireland was the most prosperous country in Europe apart from Luxembourg Since 2007 Ireland's "resources per head have been reduced to – but not below – those of the rest of Western Europe" (Fitzgerald, 2010). The boom to burst in housing has seen investment in housing fall by more than half with both private and public sector incomes adjusting accordingly. This adjustment has been necessary because during the period of prosperity Ireland lost the principle driver of the boom – productivity. Our cost base in terms of wages, salaries, bonuses and other input costs ran far beyond the sustainable capacity of any European country (Fitzgerald, 2010). Once the global banking crisis emerged this loss in productivity led to the collapse of the Irish economy.

The origin of the banking crisis was the sub-prime mortgage market in the U.S. In their efforts to clean up banks' balance sheets of these very risk sub-prime loans, collateralized debt obligation managers packaged these loans and sold them to financial institutions world wide. Ironically Irish banks were not exposed in any meaningful way to those securities. During the 'boom period' Irish 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 Irish 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. With the collapse of the sub prime market and the onset of the credit crisis, banks became unwilling to lend to each other because of fears of the quality of their loan 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 had burst, and banks needed to be rescued. Banks are indispensable to the efficient functioning of the economy.

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 Irish government's solution is to take these 'toxic' assets off the banks balance sheets via the National Asset Management Agency.

THE NATIONAL ASSET MANAGEMENT AGENCY (NAMA)

NAMA is established as an asset management company that will acquire 'good' and 'bad' loans from the financial institutions and can hold those assets, dispose of them, or indeed develop them over a ten year time frame. NAMA is buying loans at a discount (average 50%) from participating institutions. It will operate like a bank because it will have the same "rights to pursue the debts" (www.nama.ie). The price paid is based on the current market value at the time of valuation adjusted for its long term economic value (LTEV). The intellectual justification for applying LTEV is provided by (among others) William Isaac who headed the US Federal Deposit Insurance Corporation during the financial crisis of the 1980s. According to Isaac, assets should be valued not on the basis of their current value but on their anticipated cashflow (Maister, 2009). The LTEV will be significantly lower than the outstanding loan given to the borrower who will be pursued to the full amount.

The NAMA discount or "haircut" refers to the discount that is applied to the loans that NAMA is buying. The actual discount depends on the quality of the underlying asset secured with the loan. NAMA will pay for these loans by issuing guaranteed government securities that will pay a floating rate of interest. 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 (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%. The book value of the loans been transferred is €80billion (www.nama.ie). Income from loans will accrue to NAMA and the taxpayer and where a borrower defaults the subsequent sale proceeds will accrue through NAMA to the taxpayer. If NAMA makes a loss over its lifetime a levy will be applied to the banks. The procedure for borrowers (once their loans have been acquired) is to submit a detailed 3 year plan to NAMA which in turn will assess the plan's viability. Where business plans are not considered viable a statutory receiver may be appointed.

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.

VALUATION OF LOANS

Much of the debate surrounds the valuation of the loans that NAMA will buy. 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 European Central Bank (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 suggest that NAMA is likely to generate surplus cash for the taxpayer and at worst break-even. 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. 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 circa 20% 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 for the possible drop in values, for illustrative purposes let's assume 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. For example, 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 (Power, 2010)

This process, may understate the value of the properties because it assumes that all properties were bought in the boom (Ahearne, 2009). So, as an example, 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 (Power 2010).

TEMPORARY NATIONALISATION

A proposed alternative to NAMA was full temporary nationalization. Under this proposal all Bank of Ireland and Allied Irish Bank shares would be bought by the state at a price which will be determined by the level of bad debts. All bank loans would then be transferred to a proposed Asset Recovery Trust at 'current market value'. Banks would then be 'reorganised' and at some stage in the future their shares would 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 would need further capitalization by the state, i.e. nationalization (a wipe-out of shareholders) and removing the banks from the stock market.

UNINTENDED CONSEQUENCES

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*" (Bloxham 2010). So it is not just the value of NAMA bonds that need to be considered, it is all government bonds.

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. Staying private provides information that 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-floatation will mean (sometime in the future) the government, ironically, will have to identify ways of establishing the 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, 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.

Furthermore the value of NAMA bonds combined with annual budget deficits could triple national debt. 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.

However, the cost to the taxpayer of nationalization could be more pronounced.

Whatever option is taken the opportunity cost to the state is vast. Imagine the actual returns that could be made, at little or not risk, if circa €50 billion of government bonds were issued to invest in the long term improvement in the education system, the improvement of the nation's health and the public services generally.

CONCLUSIONS

Ronald Regan once quipped that if the game of trivial pursuit was invented for economists it would have a hundred questions and a thousand answers. The debate on how to deal with the toxic property assets of banks provoked a furious debate. In general, economists disagree because they differ in terms of their scientific and value judgments. Economics is no different to other sciences in this respect. For example, meteorologists have debated whether the earth is experiencing global warming. The truth is out there and scientists can disagree about the direction in which truth lies (Mankiew, 2001). Economists can disagree for the same reason.

For Irish policy makers, Nama will cost money but in terms of the alternatives it will be the least costly to the taxpayer. Any attempt at a debt:equity swap would risk a flight away from Irish government denominated debt and with loan to deposit ratios ranging from 150% to 300% there would be a massive deleveraging of the system and a collapse of GDP. A default would lead to distressed selling of property, distressed fall in prices and a collapse of the economy. This is the classic debt deflation scenario. Therefore the NAMA solution is not a 'sop' to bondholders but an effort to prevent a complete collapse of the economy. Full nationalisation risks a sovereign debt default.

The approach taken by the government is seen as key for bondholders, key for investment, consumer confidence and expectations. NAMA provides stability to the banking sector and cleans up their balance sheets and buys time for an orderly return to property markets. Without a properly functioning banking system there cannot be a properly functioning property market. The size of the Irish banking loan book to GDP is far greater than was the case in Sweden, Finland, and Japan during their banking crisis. Therefore the potential cost of nationalising Irish banks is far greater to Ireland's debt raising capacity than in previous cases. Rather than moral hazard, NAMA acts as a buffer against the recognition of lumping all banks liabilities onto national balance sheet. Nevertheless banks face considerable difficulties particularly in terms of capitalisation. Banks will recapitalise themselves – keeping them private has an inherent value. These options will work once the economy recovers from recession. Lack of Credit is not uncommon in a recession. What NAMA has done is put banks back into an area where loan deposit ratios are at (normal) 125-130%. Will this mean that banks will provide credit? Not necessarily but it does create the commercial conditions where it is possible to start lending.

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