# ESA95 accounting treatment of the National Asset Management Agency (NAMA) and related majority privately owned SPV

## 1. Introduction

In order to restore stability to the Irish banking system in the context of the financial crisis, the Irish Government is establishing the National Asset Management Agency (NAMA), which will arrange and supervise the purchase of approximately €77 billion worth of property related loan books from certain financial institutions. The draft legislation to enable the creation of this body was published on 10 September 2009 (the National Asset Management Agency Bill 2009 ("the Bill")[1]). The Bill was presented to the Dáil (National Parliament) on 16 September[2], and it is planned that the Bill will pass into law in October.

We have been informed that NAMA, once established, will create a separate Special Purpose Vehicle (SPV) to purchase certain assets from participating institutions in order to further the purposes of the legislation – most of these assets will be loans associated with property development. This SPV will have a majority of private equity. It will fund the purchase of the loan books from financial institutions by issuing securities, most of which will be backed by a guarantee from the Irish Government.

CSO has been asked to advise on how NAMA and this SPV will be classified in national accounts.

This note provides details of the entities and CSO's views on how the units should be classified. Because of the large amounts involved, CSO would be grateful if Eurostat would examine the details and advise if it considers CSO's analysis to be consistent with Eurostat's Decision on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, which was published on 15th July, 2009.

Given the critical national importance of the issue, CSO would ask Eurostat to deal with this matter as soon as possible. If it would help Eurostat to arrive at a decision, CSO staff would be happy to travel to Luxembourg along with representatives of the Department of Finance and of NAMA to meet the relevant officials.

## 2. Structure and operation

### 2.1. NAMA

The Bill provides that NAMA will be established on a statutory basis, as a separate body corporate with its own Board appointed by the Minister for Finance and with management services provided by the National Treasury Management Agency (NTMA – currently classified within General Government).

NAMA will arrange and supervise the identification and valuation of property-backed loans on the books of qualifying financial institutions in Ireland, but will delegate the purchase and management of these loans to a separately created SPV (see below).

### 2.2. Master SPV

We are advised by the interim management of NAMA that, once established, it will create a Special Purpose Vehicle ("the Master SPV"), which will be responsible:

a) for the purchase, management and disposal of loan assets identified and valued by NAMA, and
b) for financing the asset purchases by issuing debt securities: these will consist of securities guaranteed by the Irish Government (95%) and subordinated debt securities (5%) – the latter may only be redeemed if the SPV makes a profit.

The Master SPV will be a separate legal entity and will be jointly owned by private investors, who will own 51% of its equity, and by NAMA, which will hold the remaining 49%. The subscribed capital of the Master SPV will be €100m.

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[1] http://nama.ie/Publications/2009/NAMABill10Sept2009.pdf
[2] Speech by Minister of Finance: http://nama.ie/Publications/2009/Second_Stage_Speech_16SEP09.pdf; Supplementary documentation: http://nama.ie/Publications/2009/Supplementary_Documentation.pdf

The Master SPV will have its own Board, with members appointed by NAMA and the Private Sector equity investors. However, since the State is guaranteeing the securities issued by the Master SPV, the NAMA representatives on the Board will maintain a veto over all decisions of the Board that could affect the interests of NAMA or of the Irish Government.

The Master SPV will be run with the objective of making a profit on the purchase and management of the assets it purchases. The profits earned by the SPV will be distributed to the shareholders according to the following arrangement, which reflects the fact that the debt issued by the Master SPV will be guaranteed by the Irish Government:

- the equity investors will receive an annual dividend linked to the performance of the Master SPV
- On winding up of the Master SPV, the equity investors will only be repaid their capital if the Master SPV has the resources; they will receive a further equity bonus of 10% of the capital if the Master SPV makes a profit.
- All other profits and gains of the Master SPV will accrue to NAMA.

The Master SPV may create a number of subsidiary SPVs, each of which will be responsible for the loan book of an individual financial institution. Any such subsidiary SPVs will be 100% owned by the Master SPV. Whether these subsidiaries should be classified inside or outside of the General Government Sector (S.13) therefore depends on the classification of the Master SPV. For this reason this note considers only the classification of the Master SPV.

## 2.3. Assets – valuation and acquisition

The estimated €77 billion worth of loans will be bought at a discount from the financial institutions to take account of the need for write-downs of the value of the impaired loan assets.

The loans purchased will include both performing and non-performing loans. Each loan asset will be individually valued, and the price paid will generally be based on its long-term economic value (LTEV). The LTEV is defined in s.70(2) of the Bill, in accordance with EU Commission guidelines, as the value which an asset "can reasonably be expected to attain in a stable financial system when current crisis conditions are ameliorated."

### *2.3.1. Estimated value and nature of assets*

The market value and LTEV of the loans to be purchased will be determined on a case by case basis after an expert examination of each individual loan and associated collateral. Indicative valuations for the loan books were included in the presentation of the NAMA bill to the Dáil (see 'NAMA High Level Statistics' in supplementary documentation). In summary, these estimated valuations are as follows (rounded to the nearest €bn):

| | Item | Source | | €bn |
|---|---|---|---|---|
| **(1)** | Current book value of loans | Accounts of banks | | 77 |
| **(2)** | Rolled-up interest included in (1) | NAMA estimate | | 9 |
| **(3)** | Book value of loans less interest | [(1) - (2)] | | 68 |
| **(4)** | Average Loan-to-Value % at origination | Estimate by banks | 77% | |
| **(5)** | Property value at origination | [(3) ÷ (4)] | | 88 |
| **(6)** | NAMA purchase price (LTEV) | NAMA est. [(1) x 70%] | | 54 |
| **(7)** | Average fall in property values[3] | NAMA estimate | 47% | |
| **(8)** | Current market value of properties | [(3)x [100%-(7)]] | | 47 |
| **(9)** | Expected difference between LTEV and MV | [(6) - (8)] | | 7 |
| **(10)** | Difference between LTEV and MV as % of MV | [(9) ÷ (8)] | 17% | |
| **(11)** | Subordinated debt included in purchase price | [(6) x 5%] | | 3 |
| **(12)** | % increase over MV needed for NAMA to avoid losses | [[(6) - (11)] ÷ (8) - 100%] | 10% | |

[3] This is a weighted average based on NAMA's estimates of an average decline in market prices of 60% for Irish Land & Development property, 50% for Irish commercial property, and 40% in all property outside Ireland.

It is stated in the supplementary documentation and in the Minister's speech (pp. 10, 11) that:

- The estimated €77bn in loans is held by five institutions, namely:
  a) Allied Irish Bank (€24 billion)
  b) Anglo Irish Bank (€28 billion)
  c) Bank of Ireland (€16 billion)
  d) Educational Building Society (€1 billion)
  e) Irish Nationwide Building Society (€8 billion)
- 36% of the loan assets will be backed by land and 28% by development property. The remaining 36% consists of associated commercial loans.
- The geographical spread of the property associated with the loan assets is: Ireland: 67%, Northern Ireland: 6%, rest of UK: 21%, USA: 3%, Other: 4%
- 40% of these loans are estimated to be cash-flow producing, and it is projected that this cash flow will be sufficient to cover interest payments on the SPV bonds and operating costs.

### *2.3.2. Valuation and acquisition process*

As noted above, each loan asset (and the property underlying that asset) will be individually valued. In detail, the valuation and acquisition process will work as follows:

1) A financial institution applies to participate in the NAMA scheme.

2) If this application is accepted, NAMA is empowered to examine the bank's books and designate assets for purchase by the SPV.

3) A Market Value – defined in s.70(2) of the Bill as "the estimated amount that would be paid by a willing buyer to a willing seller in an arm's-length transaction after proper marketing (where appropriate) where both parties acted knowledgeably, prudently and without compulsion" – is calculated for each designated asset, and for the underlying property.

4) A LTEV is then calculated for each asset, based on the Market Value, any previously calculated LTEVs of similar assets, and 'adjustment factors', which include, as defined in s.77 of the Bill:
   a. EU State Aid rules;
   b. pricing and macroeconomic trends;
   c. planning, transport and energy implications;
   d. "an appropriate discount rate to reflect NAMA's cost of funds plus a margin that represents an adequate remuneration to the State that takes account of the risk in relation to the bank assets acquired by NAMA".

   The draft Regulation on property and asset valuation, implementing s.77 of the Bill, further provides that:
   - for any property other than land, LTEV = MV (s.3);
   - the LTEV of a particular parcel of land cannot be more than 125% of the MV (s.7);
   - the LTEV of the total portfolio of land assets of a financial institution cannot be more than 120% of the MV (s.7).

5) NAMA offers to buy the portfolio of designated assets from an institution at a price not greater than the sum on the LTEVs of those assets.

6) If the institution believes there are material errors in the valuation of this asset portfolio, it may appeal NAMA's valuation to an independent valuation board.

7) Once the valuation is finally agreed, the Master SPV (or a subsidiary) gives the institution securities (including 5% subordinated debt) in exchange for the asset portfolio.

## 2.4. Risk analysis

### *2.4.1. What are the risks?*

There are two main linked areas of risk, which relate to uncertainty about the current and future state of the property market in Ireland and worldwide:

a) Prices will continue to fall below the purchase-date MV.

b) The adjustment factor applied to the MV to obtain the LTEV is too large, so that the market will not recover sufficiently to allow the assets acquired to be sold for at least the purchase price.

It is difficult to quantify the level of risk involved in (a) and (b) above. However, NAMA have been advised that, while there may be some short-term fall in MVs after assets are purchased, 'based on capital values, the bottom has been reached in the US, UK and Europe', and in Ireland 'the market expects that the bottom may be reached in the last quarter of 2009 or the first quarter of 2010.'

Based on the available expert advice, NAMA and the Department of Finance have concluded that NAMA will be profitable over its expected 10-year lifetime, estimating its net present value at some €6 billion.

#### *2.4.2. Who bears the risks?*

If the Master SPV makes a loss, the equity invested in the majority private-sector owned Master SPV and the associated dividends will be lost.

More significantly, the subordinated debt held by the banks, representing 5% of the asset purchase price, will also be lost. Note that this transfer of risk to the banks covers 35% of the difference between the estimated price paid to the banks by the Master SPV (the LTEV) and the estimated MV of the assets ([(11) ÷ (9)] in the table above).

The remaining 95% of the securities used to purchase the bank assets are Government-guaranteed, so that Government is ultimately at risk if the Master SPV makes a loss and is forced to call this guarantee. In this case, however, the Minister of Finance has committed to the introduction of a levy on the banks involved to recoup the losses made.

### 2.5. Restriction of operation to financial crisis

The legislation provides that NAMA and any associated entities, including the Master SPV, are established to deal specifically with the financial crisis (see s.2 of the Bill). Section 219 of the Bill provides that, at the end of 2012, the Minister of Finance will examine the extent to which NAMA has achieved its objectives, and decide whether its continuation is justified.

## 3. Analysis of the accounting treatment

### 3.1. Classification of NAMA

NAMA is publicly owned. Its primary objective is to arrange and supervise the removal of impaired property related loan books from the balance sheets of qualifying financial institutions. CSO considers that, on the basis of Eurostat's Decision of 15th July, 2009 (The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis), NAMA should be classified within the General Government Sector (S.13).

### 3.2. Classification of the Master SPV

#### *3.2.1. Is the Master SPV a separate institutional unit?*

ESA95 paragraph 2.12 sets out the rules whereby an entity can be considered an institutional unit:

> *"A resident unit is regarded as constituting an institutional unit if it has decision-making autonomy in respect of its principal function, and either keeps a complete set of accounts or it would be possible and meaningful, from both an economic and legal viewpoint, to compile a complete set of accounts if they were required. In order to be said to have autonomy of decision in respect of its principal function, a unit must:*
> *a) be entitled to own goods or assets in its own right; it will therefore be able to exchange the ownership of goods or assets in transactions with other institutional units;*
> *b) be able to take economic decisions and engage in economic activities for which it is itself held to be directly responsible and accountable at law;*

The Master SPV will be a separate legal entity to NAMA. The SPV and any subsidiaries will enter into primary service agreements with the financial institutions to service the portfolio of loans. These will be arms length commercial transactions. NAMA, through the NTMA, will provide management services to the Master SPV and its subsidiaries.

The Master SPV will have a wide range of powers, including the following:

1. lend;
2. borrow or raise funds, including the issuance of bonds;
3. contract options and other derivative financial instruments;
4. give guarantees or sureties;
5. form or take an interest in companies;
6. enter into partnerships or joint ventures which allow for private sector participation in the form of private equity
7. establish trusts;
8. borrow or lend securities, including equity and debt instruments;
9. purchase other property, assets or rights;
10. invest;
11. sell or dispose of property or investments;
12. give or take property leases;
13. undertake land and property development so as to realise the full value of its assets.

Because of the large amounts of debt that it is guaranteeing, NAMA will maintain a veto on all decisions of the Master SPV and its subsidiaries that could affect the interests of NAMA or of the Irish Government.

The Master SPV will at regular intervals prepare full sets of accounts giving details of its sales and purchases and a balance sheet showing its assets and liabilities.

In summary the Master SPV will be

- a separate legal entity entitled to own goods and assets in its own right;
- have autonomy of decision in its day to day operations;
- be able to incur liabilities on its own behalf; and
- have complete accounting information

On this basis the CSO considers that it will satisfy the requirements to be considered a separate institutional unit.

### *3.2.2. Is the Master SPV market or non-market?*

The SPV will purchase both performing and non-performing loans. Performing loans will be held to maturity and non-performing loans will, if necessary, be foreclosed and the property used as collateral taken instead. As explained earlier, the loans will be bought at a discount to take account of the need for write-downs of the value of the impaired loan assets. This will reflect the distressed state of the Irish property market, prices in certain segments of which have fallen 50 to 60 percent since the market's peak in June 2007.

It is intended that the SPV will be profitable, and it must fulfil the obligation placed on NAMA in the legislation to maximise yields from the assets it acquires. The current target is that it should make a return of 45% on its investments over 7 years.

Note that the subordinated debt assets which will make up some 5% of the payment to the institutions will only be redeemable if the SPV makes a profit: this measure is designed as a further protection against the risk of losses.

As noted above, NAMA estimates that the aggregate LTEV will be some 15% higher than the Market Value, so that the subordinated debt, at 5% of the portfolio acquisition price, is equivalent to 35% of this LTEV/MV premium.

Based on these estimates, the Master SPV will only make an aggregate loss if the market value of the assets acquired increases by less than 10% in the 7 to 10-year lifetime of NAMA. (see (12) in the table on p.2).

Since the loan assets are being purchased at objectively established discounted prices that are based on the expected future return on these assets, the CSO considers that the Master SPV is unlikely to incur losses and, on the basis of the Eurostat Decision of 15$^{th}$ July, can be considered a market unit and classified accordingly.

### *3.2.3. Ownership of the Master SPV*

As mentioned above, the Master SPV will be jointly owned by private investors and by NAMA. The private investors will subscribe 51% of the capital, and stand to lose all of this if the Master SPV does not make a profit.

The CSO therefore considers that the SPV will be a majority privately owned entity.

### *3.2.4. Conclusion*

In summary, the Master SPV

- will be a separate institutional unit
- will be established for a temporary duration specifically linked to the financial crisis
- will have as its sole purpose the purchase and management of loan books from financial institutions that are currently in distress as a result of the financial turmoil
- will be majority owned by private investors
- will purchase the loan assets at significantly discounted prices based on the expected future returns on the assets acquired. The SPV therefore will have a commercial profit making objective and is not expected to make future losses. The payment of 5% of the acquisition price in subordinated debt securities represents a further protection against losses.

On this basis the CSO considers that in line with the Eurostat Decision published on 15th July, 2009 (The statistical recording of public interventions to support financial institutions and financial markets during the financial crisis), the SPV should be classified in the Financial Corporations sector (S.12).

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