Preliminary Remarks by Patrick Honohan

To the Joint Oireachtas Committee on Finance and the Public Service
6th May 2009

In my preliminary remarks to you I would like to highlight a few important aspects of the whole NAMA process as I see it panning out based on my experience with other banking crises.

The first point I want to make is that the NAMA's asset purchase scheme cannot be considered in isolation: it will entail a recapitalization of the banks. Second, that recapitalization should be done in a thorough once for all manner – the so-called stock approach. Third, I will touch on NAMA's operation and the challenges facing that. Lastly I will briefly consider the issue of nationalization.

Asset purchase and recapitalization both needed
The goal of asset purchase schemes such as that proposed for NAMA is threefold. First, it can remove the distraction for bank management of trying to recover on problem loans of the past and allow them to refocus on new sound lending essential for the future of the economy. Second, it can help improve loan recovery by separating that task from the team that made the loans. Third, it can replace assets of uncertain value with safe and marketable assets.

In some countries, asset purchase schemes have also been used as a covert way of recapitalizing banks by paying too much for their problem loans. That is a bad idea, in effect a nontransparent subsidy from the taxpayer to shareholders and other unguaranteed creditors. In the case of NAMA, the Government have stated that it is their intention not to overpay, but there is the risk that NAMA could end up overpaying unintentionally due to over-optimism. (I will mention later a variant which could help reduce this risk).

Since NAMA is not intended to recapitalize the banks, this will have to be done separately. I believe this should be done soon – during 2009 – and thoroughly. The alternative of letting this recapitalization issue drift is called the "flow approach" and could be called the "do nothing" approach. It leads to Zombie banks, an underperforming economy and much higher costs to the taxpayer in the end.

Instead, the economy and the taxpayer will do a lot better with a decisive once-for-all "stock approach", facing up to the full reality of future losses up front. By insisting on purchasing bad assets at realistically low prices, NAMA has the potential to be an important catalyst in ensuring that we go that decisive route.

NAMA-type operations worldwide
I believe the NAMA process is far superior to the alternative mechanisms recently used in the UK (insurance scheme) and proposed for the US (leveraged private asset purchase).

Having said that, it has to be acknowledged that asset management companies worldwide have had a mixed record, whether they were instructed to dispose of the assets purchased quickly or encouraged to restructure the defaulting companies over time. In addition to the famous Swedish case, successful examples were in Spain and US; not so successful in Ghana, Mexico, the Philippines and Senegal.

Obviously an effective asset management company needs to have clear objectives; robust governance, operational independence from government, transparency of operations, strict cost control. Easy to state, hard to follow.

NAMA as proposed, has a number of distinctive features relative to other AMCs. These all deserve scrutiny

- It will take on performing loans as well as delinquent ones (why?); on the other hand it is proposed to ignore even delinquent non-property loans.

- The proposed scale is unprecedented (relative to the economy). I worry about this.

- And it is buying from going-concern private banks – this is not exactly a first, there are precedents from Malaysia and Thailand – but it does make the valuation issue – and the risk of overpaying – tricky.

I believe that the risk of is risk can be eliminated by a refinement of the NAMA purchase procedure involving a two-part payment – only part in cash and the rest in the form of an equity-type claim in NAMA granted to the shareholders of the bank. (This better than the idea of an ex post levy)

Consequences of recapitalization for ownership

- If the realistic loan valuations result in the estimated equity capital (shareholders' funds) being revised to a negative figure*, and if they cannot or will not replenish this capital*, the logic of capitalism implies that ownership control passes to the creditors. There would not in that case be much economic basis for allowing any residual claim to the private shareholders. (A banking license is a valuable privilege granted by the State and is conditional among other things, on the shareholders maintaining a sufficient level of capital – if they can't or won't do that, they lose that privilege).

- Even if equity capital is positive but insufficient, someone – presumably the Government – must inject the necessary additional amount if the bank is to continue.

In this way, the NAMA process is likely to point in the direction of a high percentage shareholding by the Government, perhaps 100 per cent. (When market conditions improve, the Government's shareholding can be sold back to the private sector).

One cannot ignore the extensive international evidence showing that Government-owned banking systems serve their economies poorly. They tend to result in higher interest rate spreads, less private credit, and what credit there is going to larger firms. Greater state-ownership has also been associated with more crises.

Banking can only work as a revolving fund – money lent out is intended to be repaid. Yet under state ownership, banks might be under pressure to provide finance to failing firms that have no prospect of repayment. This pressure might come from a well-intentioned desire to protect economic activity in the recession. But it would be a catastrophe for the public finances if, on top of the disastrous error made by the banks and their regulator in regard to the property bubble, a large new wave of unrecoverable loans was made. The danger in present circumstances that the banking system could in effect open a back door access to taxpayers funds – and without Oireachtas scrutiny – is one which I take seriously. My professional colleagues recently writing in the Irish Times have rightly stressed that a nationalized bank should be operated to maximize shareholder value. I am concerned that this is a goal that will be difficult to achieve. The presence of some private shareholders – even with a small stake – could act as a restraint here, and help maintain a dialectic between government and banks that would be in the long-term interest of the economy.