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Investment Opportunities Arising Out of Ireland's Recently Established "Bad Bank" Scheme

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After intense legal and political debate in Ireland surrounding the establishment and structure of the National Asset Management Agency ("NAMA"), recent announcements regarding the process by which distressed assets are to be transferred from the five institutions participating in Ireland's "bad bank" scheme (namely Anglo Irish Bank Limited ("Anglo Irish"), The Governor & Company of the Bank of Ireland ("Bank of Ireland"), Allied Irish Bank plc ("AIB"), Irish Nationwide Building Society ("NBS") and EBS Building Society ("EBS"), collectively the "Participating Banks"), are likely to concentrate investors' minds on potential opportunities for acquiring distressed assets in Ireland, the United Kingdom and other jurisdictions.

In this Stay Current, lawyers from the Paul Hastings Restructuring and Finance practice explore recent developments with respect to NAMA, and the potential opportunities such developments may create for investors.

1. Background

On 21 December 2009, the Irish government ratified the National Asset Management Agency Act 2009 (the "NAMA Act") and established a special purpose vehicle known as NAMA. NAMA secured a combined investment of €51 million from three private sources (Irish Life Assurance, New Ireland, and certain major and institutional clients of AIB Investment Managers) in return for 51% of its existing share capital. The Irish government holds the remaining 49% of NAMA's shares, but has veto rights in respect of all matters that diverge from the objective of NAMA as specified in the NAMA Act (i.e. those matters that attempt to devalue possible returns to Irish taxpayers).

According to the NAMA Act, the main purpose of NAMA is to manage the approximately €80 billion in face value of distressed assets that the entity will acquire from the Participating Banks, with a view to maximizing recovery prospects for the Irish state. The majority of the assets to be transferred to NAMA will be performing/non-performing property related loans and associated security (including several development and commercial related assets). Such assets are to be transferred at a price which represents a discount to par or face value, but which may be somewhat greater than the actual open market price for the relevant assets. As discussed below, the substantial discount or "haircut" that NAMA will apply to each tranche of loans/assets that are transferred from the Participating Banks has been the subject of much debate. However, as a result of the substantial discount which will be applied, NAMA is likely to have sufficient scope to explore various options for crystallizing the value of the assets they acquire (including, but not limited to, enforcement of underlying security and/or transfers to investors in secondary markets).

Moreover, as the prospective assets NAMA will acquire are located across a wide geographical spectrum (with 67% of NAMA's prospective assets located in the Republic of Ireland, 6% in Northern Ireland and the remainder based overseas, with the bulk (approximately 21%) located in the United Kingdom) it would seem probable that NAMA will need to adopt a trans-European approach to any disposal strategy it implements, and therefore engage with experienced property and distressed asset investors. However, given the potential cross-border legal, tax, and regulatory risks which may be involved in transferring and managing the assets NAMA acquires, it remains to be seen how NAMA will structure disposals and/or whether NAMA will actively exercise the rights they acquire under relevant loan documentation.

2. Initial Transfer of Distressed Assets

The EU Commission declared that all of the Participating Banks' eligible assets must be transferred to NAMA no later than February 2011. However, NAMA has recently indicated that it intends to complete the transfer process by the end of 2010. Accordingly, with this timeframe in mind, on 31 March 2010, NAMA announced[1] that it would acquire over 1,200 loans with a nominal value of €16 billion as part of the initial tranche of assets to be transferred to it (the "Initial Transfer"). The Initial Transfer is to be completed for a combined consideration of approximately €8.5 billion, representing an average haircut of approximately 47%.

In order to accelerate the Initial Transfer process, the transfer of eligible assets from NBS and EBS took place on 29 March 2010. The initial transfer of Bank of Ireland's and AIB's assets took place on 2 April 2010 and 6 April 2010, respectively. However, at the date of this Stay Current, the initial transfer of Anglo Irish's assets has not taken place (although it is expected that this will occur within the next few weeks), due to the complexity of the underlying loans, the presence of non-real estate collateral (including, for example, wine collections and equity portfolios), and on-going negotiations with NAMA in respect of the final haircut to be applied to the transfer.

3. Haircut

Pursuant to s.75 of the NAMA Act, the value attributable to assets acquired from Participating Banks will be the asset's "long term economic value" (as determined by NAMA) rather than market value. Accordingly, the main talking point amongst investors following NAMA's disclosure of the transfer process was in respect of the "haircut" to be applied to the transferring assets. This "haircut" had been the subject of much debate in Ireland; due mainly to the large discrepancies between the projected aggregate figure of 30%, the average figure of 47% (although some of the discounts applied are higher) that has actually been applied to the assets under the initial transfer and the average write down in property values of approximately 50% in Ireland. However, this discrepancy was recently addressed by Mr. Brendan McDonagh (the Chief Executive of NAMA)[2], who attributed it to the fact that the initial figure was based on information provided by the Participating Banks whereas the revised figure was based on detailed due diligence that had been undertaken by NAMA and its advisers. Unfortunately, it would appear that the market will only be able to decide whether those assets transferred in the Initial Transfer to NAMA are perhaps more susceptible to default risk following disclosure of the haircut to be applied to other assets transferring to NAMA in the future.

However, the market may not have to wait long before the discounts to be applied to future tranches of assets are disclosed as Mr. McDonagh has indicated that NAMA intends to transfer the second tranche of assets, representing €13 billion in value, during the second quarter of this year. It is expected that this transfer will be slightly more expedited than the Initial Transfer on the basis that the assets to be transferred are generally smaller, less complex loans which can be diligenced, valued, and transferred more easily. Consequently, it will be intriguing to see whether a similar haircut is applied to the second tranche of assets and thus whether NAMA will continue to have considerable scope to realize value for the Irish taxpayer.

4. Tier 1 Capital Requirement

In conjunction with the Initial Transfer, the Irish financial regulator also published results of its review of Irish banking capital requirements. As a result of this review, new capital levels are being set for some of the main banks covered under the Irish government's guarantee scheme.

In short, the financial regulator has said that a level of 8% of core tier 1 capital is to be targeted for Irish banks by the end of this year. This level of capital must be met after taking account of all future losses, from both NAMA and non-NAMA portfolios, of each bank. This capital will be principally in the form of equity; with a mandatory 7% equity requirement. To meet this 7% equity requirement, institutions will be placed under a considerable burden to secure external investment (whether by rights issue or otherwise). For example, pursuant to the proposed minimum capital requirements, AIB will have to raise an additional €7.396 billion of equity capital and Anglo Irish Bank will, as an interim measure, require an additional €8.3 billion of equity capital, with additional requirements possible pending conclusion of current restructuring discussions. Importantly, the new requirements also mean that banks cannot go below a level of 4% core tier 1 capital even in severely stressed scenarios.

As a result of the revised capital requirements, Bank of Ireland has recently announced that it will seek to raise as much as €3.42 billion to bolster its capital base. This is likely to be achieved by selling €500 million in shares to a group of institutional investors and an additional €1.9 billion of stock in a rights offer. Bank of Ireland also announced its intention to convert some of the government's preference shares into equity, with a view to raising an additional €1.04 billion. In addition, AIB have stated that they plan to sell their UK business, and certain other assets, in order to raise €7.396 billion of additional equity capital to satisfy the newly imposed tier 1 capital requirements. As a result of the sale of its UK business, AIB also hopes to review (with NAMA) the quantum of UK-based loans that would be transferred to NAMA in the future.[3] Notably however, to the extent that such asset sales fail to raise a sufficient amount of equity capital to satisfy the revised tier 1 capital requirements, it is suspected that AIB will request additional funding from the Irish State in order to bridge the deficit.

5. Opportunities

Market expectation is that, because of the recent recovery in value within certain sectors of the UK property market in contrast with the Irish market, NAMA will attempt to sell UK based property assets/loans in priority to Irish-based assets as its first step.

However, as recent press releases in relation to the sale of the "K Club" golf club by its property developer have demonstrated, NAMA may opt to approve the disposal of Irish based assets by developers prior to such assets/loans being transferred to NAMA, in the hope of expediting the overall disposal process.

Other possible opportunities for investment in NAMA will depend upon whether NAMA decides to use joint venture partners or if the anticipated sale of certain assets to specialist distressed asset vehicles materializes.

In addition, NAMA may consider utilizing securitization techniques with respect to the loans it acquires. Consequently, investors may also have the opportunity to purchase asset-backed notes on the open market. Moreover, as recent market speculation has alluded to, NAMA may decide to launch Ireland's first real estate investment trust. As a consequence, investors may be able to purchase stock in a traded institution that invests in real estate directly.

Furthermore, it is worth noting that, as certain aspects of NAMA would appear to be based on the structure of the Resolution Trust Corporation in the United States (including, for example, the prohibition on parties connected to the underlying borrower acquiring the borrower's interest), it is likely that NAMA will seek to implement regulations limiting investors' ability to "cherry pick" assets/loans. It is unlikely that NAMA will want an ever increasing number of non-performing assets/loans to remain within its portfolio. Accordingly, investors should be aware that potential restrictions may be put in place, with a view to ensuring that investors are unable to exploit the disposal process to the detriment of the Irish tax payer.

6. Conclusion

The continued future development of NAMA's enterprise and the resultant impact on investment opportunities for real estate and/or private equity investors is something that will no doubt be of great interest going forward. Indeed, while details with respect to the transfer of distressed assets to NAMA have only been disclosed relatively recently, the time frame during which NAMA is required to complete such transfers, and ensuing pressure it will be put under to realize its investment on behalf of the Irish tax payer as soon as possible, are likely to present ample opportunities for investment in the near future.

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[1] See http://www.nama.ie/

[2] On 13 April 2010, see http://www.nama.ie/

[3] AIB Capital Update, dated 30 March 2010