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Neelie Kroes
Competition Commissioner
European Commission
1049 Brussels
Belgium

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Thursday, 17 December 2009 [redacted]

Dear Commissioner

I am an Irish citizen and writing about the Irish Government's actions and plans for resolving our banking crisis and about Nama, National Asset Recovery Agency. For convenience, my letter is divided into three parts covering background, concerns and conclusion.

1. Background

I have followed the evolution of the Irish building crisis since 2003 and have been very concerned about recent actions by the Government to address the crisis in the Irish banks.

To see my views, your staff can access my blog which is largely populated by letters published in the Irish media. The following links are most relevant:

- About house prices: http://www.planware.org/briansblog/house-prices/
- About the banking crisis and Nama: http://www.planware.org/briansblog/banks/

Out of a deep concern about the Government's approach to the crisis (viz. 'Nama is the only solution considered and Nama will be applied regardless'), I lobbied TDs and senators against Nama while the Nama Bill was being debated in the Dail and Seanad. Notwithstanding the efforts of many informed observers and widespread public unease, the Nama Bill was, as you know, passed into law. The only area where I can claim to have directly influenced matters related to the inclusion of a section in the Act dealing with whistleblowers.

In my "day job", I run a business that specialises in the development and sale of tools for financial modelling for businesses. As a consequence, I took a particular interest in the draft business plan of Nama (published on 14th October). Here is what I said about this plan in a letter published in the Sunday Business Post on 8th November:

> *What is the point of the Dail debating the Nama Bill before it has undertaken basic research on its prospective loan portfolio and finalised its business plan and strategies? If Nama's draft plan was used to seek €54,000 from investors, it would be rejected out of hand as an extremely poor document. Given that it is being used to raise a* ***million times*** *more, no taxpayers' money should be invested until the plan has been fully researched and approved by the Dail. Only at that point, would it be*

appropriate to consider the Nama Bill. Thoughts of horses, carts and stable doors come to mind.

2. Specific Issues

I have specific concerns about the treatment of rolled up interest during 2010-20 in Nama's plan which I wish to bring to your attention in the following sub-sections. I have sought responses on these matters from the Minister for Finance without success - hence this letter to you.

2.1. Nama's Projections

The focus of attention is the two tables in Nama's draft business plan showing (a) net present value cashflow projections (2010-20) and (b) budget projections (2010-2012).

The attached table reproduces Nama's cashflow projections and adds seven columns which determine annual balances and interest rates and estimate rolled up interest. Everything in this table has been derived from Nama's plan aside from an assumption that the interest rate on borrowers' debt outstanding will be 6% p.a. for 2013-20. For greater clarity and convenience, a copy of this table can be downloaded as a spreadsheet from:

http://www.planware.org/briansblog/resources/Nama-Cashflows%202.xls

Note that references to rolled up interest refer to interest rolled up during the ten years 2010-2020 - interest rolled up prior to this period is included in the €77 billion loans to be taken over by Nama.

2.2. Main Concerns

Based on the spreadsheet's calculations, my main concerns are as follows:

1. Total Interest income from borrowers (col D in spreadsheet) of €12 billion is lower than the Interest outflow on debt (col G) of €16 billion. One would have expected the opposite!

2. The Minster for Finance has stated that the interest rate on Nama's bonds will start at 1.5% in 2010 but column M suggests that the projected rate will be 2.4% for that year and will rise to 5.7% in 2012.

3. According to Nama's budget projections (table 7 of business plan), Interest income for 2010-2012 will total €9.46 billion as compared with cashflow-related Interest income from borrowers (col D in the cashflow projections) totalling €4.5 billion. Presumably the difference (€4.96 billion) is rolled up interest accumulating over these three years (see col R).

   For the following seven years, an estimated additional €5.94 billion of interest could be rolled up. On this basis, €10.9 billion of interest payable by borrowers will be rolled up over the ten years (col R).

Assuming that the cashflow projections in table 5 are complete, then there are only three ways to account for this rolled up interest:

- It is included in the Principal repaid by borrowers (col E) which amounts to €62 billion. In this case, the "real" principal repaid is only €51.1 billion [62-10.9]. This means that the "real" default rate is 34% [(77-51.1)/77)] rather than the 20% indicated in the draft plan.
- Rolled up interest is included in the assumed €15 billion write-down. This would mean that the "real" write-down on borrowings would be only about €4 billion (15-10.9), to yield a "real" default rate of 6% on the total loans.
- Rolled up interest is not being paid at all and written off at some point in unpublished, projected P&L accounts for 2013-2020. As a result it would not appear in the cashflow projections at any stage.

2.3. Key Questions

The key questions arising from the above are:

1. Why is the cumulative Interest income from borrowers (col D) of €12 billion lower than the Interest outflow on debt (col G) of €16 billion?
2. What is the total rolled up interest arising over the ten years?
3. When is this interest repaid and how is it accounted for in the cashflow projections (table 5)?
4. After excluding rolled up interest, what is the default rate on the €77 billion of loans?

2.4. Implications

The business plan states that "a 20% default rate assumption has been made". Depending on the answers to the foregoing questions, this analysis suggests that the "real" default rate on the €77 billion of loans taken on by Nama could be either 6% or 34%. The implications of this are as follows:

- A projected "real" default rate of 6% would be extraordinarily low and viewed as completely unrealistic given the scale of write offs already incurred by banks and widespread expectations about the depth and duration of the banking/building crisis.
- A "real" default rate of 34% (with write offs amounting to €26 billion before any recoveries) indicates that the crisis is far more serious than indicated in Nama's plan and could prove catastrophic for the economy in general and extremely costly for taxpayers. This rate could transform Nama's projected cash surplus into a deficit of at least €5 billion. This would be tantamount to a major additional subsidy to the banks and their developer clients.

3. Conclusion

Given that Nama will be taking over loans amounting to almost half of Ireland's GDP, its business plan should, at a minimum, have included "scenario-based" P&L statements and balance sheet projections as well as cashflow forecasts for the ten years. These would have given a fuller picture about Nama and facilitated analyses which might have helped anticipate problems identical to those being experienced by the banks that Nama is seeking to rescue.

I hope that the foregoing assessment is error-free (at least from my side) and that my identification of possible additional subsidies linked to rolled up interest proves useful during your assessments of the Government's plans to refinance and restructure the Irish banks.

Perhaps a member of your staff would email me to confirm recept of this submission. Naturally, I'd also be interested in any comments or queries on the issues raised.

Thank you for your time and attention.

Yours sincerely

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Brian Flanagan